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The Impact of Government Policy on Economic Growth

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Abstract

Government policy has always had a significant influence on economic growth and new business formation. During the past two decades, policy uncertainty has grown in the United States as the polarization of the electorate has intensified. The stark political differences are increasingly on display by elected officials in Washington. The recent political brinksmanship surrounding the so-called "Fiscal Cliff" is one example of the costly policy uncertainty facing U.S. businesses that is now endemic in Washington. While much of the focus of the Fiscal Cliff debate was on the constituents who would lose benefits or see their taxes increase, there was less attention to the debilitating impact of poorly fashioned policies, and policy uncertainty, on the nation's businesses and the impact on the economy. Those issues were most significant for small businesses and entrepreneurship, which account for more than fifty percent of U.S. private sector economic activity. Through a review of the literature, this paper examined the consequences of government policy uncertainly and sought to identify gaps in the related literature, especially those arising from the application of new policy tools. The research found that contemporaneous monetary policy may be having a greater impact upon business activity than previously identified and is an area in need of further study. While the policy uncertainty and its impact on business expansion discussed in this paper are principally associated with the U.S., the implications can be readily applied across borders. The results of this analysis will be helpful in enhancing the understanding of these important policy issues, which are commonly excluded from policy debate and often given insufficient treatment in post secondary institutions of management practice.

Keywords

Policy uncertainty, Economic growth, Entrepreneurship, Quantitative easing

1. Introduction

Conditions of uncertainty have always been a part of the economic environment of free enterprise. Entrepreneurs and business strategists commonly seek opportunity in that arena. In the past two decades, however, policy uncertainty has risen to a level that makes forward economic planning and the search for opportunity more inscrutable for even the most adept in business challenges. In both United States and the European Union, the lack of new business formation, partly attributable to rising uncertainty, has contributed to stubbornly high levels of unemployment and underemployment.

The jobs that are being created in the U.S. are typically not of the quality of past economic recoveries, leaving many newly-employed workers in the unenviable position of remaining on various modes of government assistance, even after acquiring their new employment. As reported by Rampell (2012), "lower-wage occupations, with median hourly wages of $7.69 to $13.83, accounted for 21% of job losses during the retraction. Since employment started expanding, they have accounted for 58% of all job growth."

The policy uncertainty and related decline in small business startups is taking a toll not only on the traditional lower wage occupations, but on college graduates as well. According to Sum (2013) of the Center for Labor Market Studies at Northeastern University, 36% of college graduates were working in jobs that did not require a college degree (Figure 1). That rate was less than 28% in the year 2000. Such underemployment can impact future earnings, as college skills dwindle. It also increases the difficulty for them to pay their student loans, purchase a home, or become married, since their wages are typically 40% below their peers working in traditional college graduate careers (Luhby, 2013).

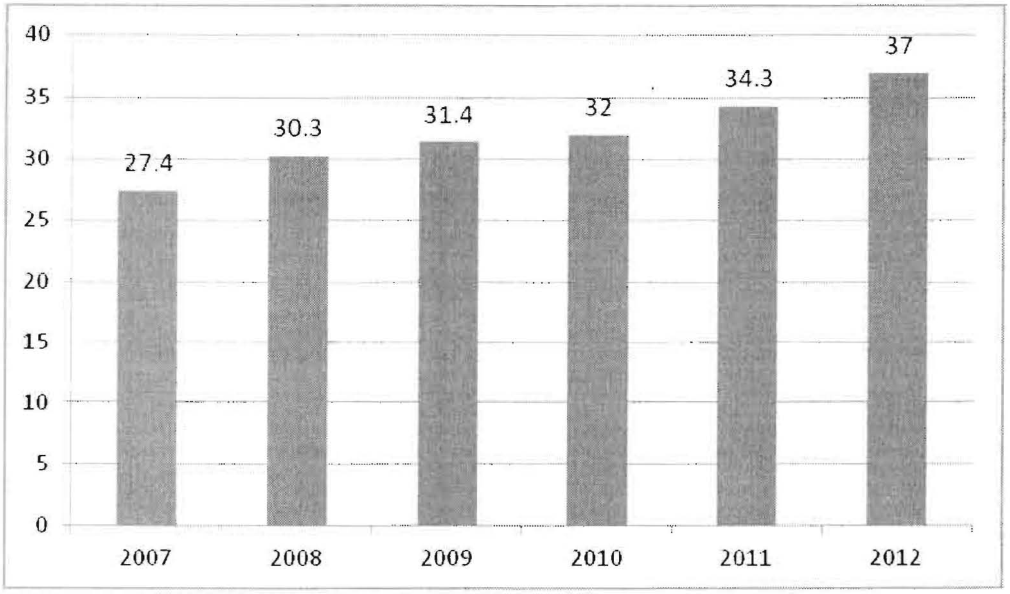

Figure 1. Recent College Graduate Underemployment Rate (%) – (Source: Northeastern University – Center for Labor Market Studies, 2013)

In addition to the lower skills and wages in many of the post 2008 recession jobs, uncertainty has contributed to a significant increase in the number of temporary employees. In "Is the U.S. Turning into a Nation of Temps," Fastenberg (2013) notes that the "hiring rate of temp workers is five times that of hiring overall in the past year... and the number of temp workers has been rising steadily since the recession-impacted year of 2009.

Supporting Fastenberg's research, Dhanya and Wohl (2013) reported that the largest retailer in the U.S. has embarked upon a strategy has in recent months been only hiring temporary workers at many of its U.S. stores, the first time the world's largest retailer has done so outside of the holiday shopping season. Internally, Wal-Mart calls these temporary employees flexible associates. According to Fastenberg (2013), the number of part-time workers at Wal-Mart has risen from just 1% of its 1.3 million employee workforce to 10% in just one year. Given the employer's size, that has had a chilling impact on the already tepid market for full-time employment, and the trend has been adopted by many other large employers as well.

These difficult economic conditions have contributed to a decline in middle-class aspirations in America. While the question of policy uncertainty has received broad study, it is likely that the new and artful strategies of important policy making institutions, such as the U.S. Federal Reserve, have produced gaps in the literature.

This paper will review the work of researchers in this area, seek to identify gaps, and attempt to find new methods for understanding the implications of rising policy uncertainty. The paper focuses on the negative implications of policy uncertainty due to the current climate of lethargic GDP and job growth, while recognizing that there are positive components of uncertainty that many businesses have and will continue to successfully exploit (Sawyerr *et al.*, 2003).

2. Prior research on policy uncertainty

The most recent and robust study on the implications of government policy uncertainty for the U.S. economy was conducted by Baker *et al.* (2013) in their seminal *Measuring Policy Uncertainty*. The authors found that businesses delay investment and hiring in times of uncertainty. The authors identified several factors that were influencing the uncertainty, including debt and spending problems associated with the so-called "Fiscal Cliff" that was looming in Washington, the continuing problems in Europe, and the lingering impact of the housing crisis.

The authors created an index of policy uncertainty through an intensive study that sampled 5,000 newspaper articles to assess whether they actually discuss policy uncertainty. They also compared the index against the frequency of the word "uncertainty" in the Federal Open Market Committee (FOMC) Beige Book. They also analyzed stock market movement that was initiated by policy news (Baker *et al.*, 2013).

The authors concluded that, in times of high uncertainty, businesses delay investment and hiring. They determined that the rise in uncertainty from 2006 to 2011 cut employment by as many as 2.3 million jobs and industrial production by up to 4%. They found that taxes, government spending, and fiscal policy accounted for 40% of policy-related economic uncertainty in the period from 1985 to 2011percent. Monetary policy accounted for 33% of that diminution (Baker *et al*, 2013).

Following the research of Baker *et al.* (2013), Gulen and Mihai (2013) investigated how corporate capital investment at the firm and industry level is affected by policy uncertainly. Their research found that policy related uncertainty is negatively related to firm and industry level investment, and the economic effect is substantial. They found that approximately two thirds of the 32% drop in corporate investments observed during the 2007-2009 crisis period can be attributed to policy related uncertainty.

Interestingly, they also found the relation between policy uncertainty and capital investment is not uniform in the cross-section of U.S. firms. It is significantly stronger for firms with a higher degree of investment irreversibility, for firms that are more financially constrained, and for firms operating in less competitive industries. Policy uncertainty is also associated with higher cash holdings and lower net debt issuance. They noted that "overall, these results lend empirical support to the notion that policy-related uncertainty can depress economic growth through a decrease in corporate investment. This decrease is related to precautionary delays induced by investment irreversibility and to increases in the cost of external borrowing" (Gulen and Mihai, 2013). Their research added an important component to the topic, by quantifying the drop in corporate investment related to policy uncertainty. Further, they found that these basic effects maintained their relationship cross border, specifically citing countries such as Canada, the United Kingdom, France, Germany, and Italy.

In his paper *Economic policy uncertainty in the U.S. and Europe: A cointegration test*, Sum (2012) also examines policy uncertainty in and its trans border applicability. Sum concludes that heightened policy uncertainty in a major nation can have a direct or indirect effect on the world economy. His study focused on the relationship between economic policy uncertainty between the United States and Europe. The results reveal a long-run equilibrium relationship (cointegration) in economic policy uncertainty between the United States and Europe. Sum indicated that the results "provide evidence of the interconnectedness of economic conditions between the United State and Europe in line with the international transmission and spill-over literature" (2012).

Johannsen (2012), in *When are the effects of fiscal policy uncertainty large?*, found that uncertainty about short-run and long-run fiscal policy can cause large falls in consumption, investment, and output, and have depressed economies across the globe. He also noted that the fiscal impact on the economy is small when the monetary authority is not constrained by the zero lower bound (ZLB). He presents empirical evidence indicating that shocks to policy uncertainty had larger effects on the U.S. economy during the Great Recession, a period in which the Federal Reserve's policy rate has been at its effective lower bound, than in the preceding years. Johannsen postulates that relatively high real interest rate continue to encourage households to forego consumption in order to save, which decreases demand and causes the economy to contract. Importantly, his work concluded prior to the launch of the Fed's massive and unlimited $85 billion per month program of quantitative easing known as "QE3."

Giertz and Feldman (2012), in *The Economic Costs of Tax Policy Uncertainty: Implications for Fundamental Tax Reform*, argue that uncertainty fosters rent-seeking, which represents a shift between productive and unproductive or destructive entrepreneurship. They found that "with little policy uncertainty, higher returns may be sought from investing in productive activities. However, when government is receptive to policy changes, the returns from rent-seeking (through lobbying, political action committees, etc.) may be more appealing. When policy uncertainty does not otherwise exist, politicians sometimes manufacture it."

They concluded that enduring reform of the tax code would produce efficiency and higher productivity, with the effects widely distributed. However, as they noted, that wide distribution of benefits creates an environment among policy makers that becomes ripe for "carve outs" by influence-seeking lobbyists willing to pay rent to effect their goals. Giertz and Feldman (2012) agreed that societies relying heavily on "institutions that reward rent-seeking tend to stagnate; societies that rely on institutions whose wealth is achieved through private competitive markets tend to prosper."

Dunkelberg (2013), chief economist for the National Federation of Independent Business (NFIB) noted the counterproductive implications of Fed policy, stating that "uncertainty probably increases with the size of the Fed's portfolio. He hypothesized that Fed policies made no contribution to the improvement of the economy, or even slowed it down, by creating uncertainty and fear among investors. Dunkelberg, in the NFIB's April 2013 "Small business economic trends" indicated that over 60% of small business owners, a record number, had no interest in further borrowing because the funds did not have a high probability of generating a return. With more than 50% of jobs in the U.S. created by small businesses and entrepreneurs, Dunkelberg's findings cast a sobering view of the stimulative impact of the Fed's quantitative easing programs.

3. The impact of quantitative easing

A review of the seminal work for Baker *et al.* (2013), *Measuring Policy Uncertainty*, demonstrated the exhaustive efforts of those authors in identifying indications of public policy uncertainty in the public domain. The authors distinguished between the level of policy uncertainty derived from fiscal issues and monetary issues. They concluded that, between 1985 and 2011, taxes, government spending, and fiscal policy accounting for about 40 percent of the policy uncertainty, with 33% precipitated by Fed policy. They determined that the uncertainty led to a postponement of business investment in hiring.

While this author found it unnecessary to further examine their rigorous work surrounding fiscal policy, it was apparent that the authors' work concluded prior to the imposition the largest tranche of the Fed's quantitative easing, known as "QE3." Further, it appeared that the authors' method of analysis might not fully capture the policy uncertainty implications of any of the Fed's quantitative easing programs, given that media articles reporting on the QE programs would focus on the enhancement in economic prospects to flow from the programs, rather than policy uncertainty. That is especially true with the Fed's latest, and, by far, the most robust program of QE3, which provides for a continuing flow of $85 billion per month as long as the Fed determines that the economy is sufficiently weak. Thus, media articles following QE3 would, once again, focus on the certainty, or predictability, of Fed policy, which would have likely lowered the authors' 33% calculation. That reduction in the robustness of the monetary component would have given the Fed a higher level of policy credence than warranted, a theory supported by the data reported by Dunkelberg (2013).

In the research by Dunkelberg of the NFIB, businesses surely look at a different policy scenario when contemplating the later, more voluminous states of quantitative easing, such as at QE3. First, the massive amounts of monetary intervention by the Fed were, in large part, precipitated by a stunning failure of fiscal policy, or lack thereof. The use of the Fed to intervene in the salvation of the economy, to the near exclusion of Congressional and Executive Branch action, is unique at current levels and indicative of the dysfunction in the political system. More importantly, small businesses realize that, despite the announced duration of the Fed's QE3, it is a poor substitute for enduring tax and investment policies and will someday come to an end. They appear to comprehend that the unwinding of perhaps more than $4 trillion from the Fed's balance sheet could cause significant GDP shrinkage and calamitous conditions in the economy. From the NFIB research, those businesses clearly question whether the incipient recovery in the economy will be able to survive the removal of Fed stimulus, and thus, as shown in the data, are unwilling to borrow and expand under these conditions of uncertainty.

Due to its time frame, the Baker *et al.* (2013) work does not appear to identify this component of uncertainty. From the NFIB "Small business trends" report of April, 2013, it is clear that this QE uncertainty is extant for small business and impacting their expansion and job creation. Further research, with in depth quantitative and qualitative surveys of businesses, both large and small, will be necessary to better determine the impact on the economy from this component of Fed policy.

4. Fiscal policy and entrepreneurship

Entrepreneurs and small businesses have a lesser incentive to develop and grow in an environment shrouded in policy uncertainty, such as the current, highly-contentious climate that remains deeply impacted by the 2008 financial crisis (Patterson, 2011 and Barnes, 2012). Governments around the world were faced with extraordinary challenges following the failure of Lehman Brothers and the near-collapse of the global financial system. In the United States, the federal government increased spending from 21.4% of gross domestic product (GDP) in 2007, to a high of 27.3% in 2009, including the historic budgetary legislation in the Troubled Asset Relief Program (TARP), an expenditure of $860 billion. With TARP and additional measures, U.S. government "stimulus spending over the past five years totalled more than $4 trillion" (Laffer, 2012), but has not achieved a significant growth in jobs and output. In fact, the recovery from the recession that ended in 2009 has been the weakest since World War II (Wiseman, 2012). The growth of nonfarm employment in the U.S. has been the most muted of any post-recessionary period since 1981, despite the record federal spending and stimulus programs.

This has been the first recession in the post-war period that combined U.S. federal, state, and local government employment has fallen. Most of that employment loss is at the state and local level, where budgets must be in balance and deficits are not allowed. As a result of the myriad headwinds in the current cycle, such as falling housing prices and weak tax revenues, states and local governments have been a significant drag on the U.S. economy.

The rise in bankruptcies of U.S. cities, despite the public sector budget cuts and layoffs, has reduced small business investment and an increased economic uncertainty. With 706,000 jobs lost by state and local governments from May 2009 through June of 2012 (Dewan and Rich, 2012), those important sectors of the economy are creating another large obstacle to economic recovery and a deterrent to new business creation. According to Nayab (2011), such unstable political conditions and uncertain government policies suppress entrepreneurship. The historic financial problems of the public sector in the U.S. economy exemplify the instability and its impact on the economy. According to Haltiwanger *et al.* (2012), the start-up rate of firms has declined from "as high as 12 percent to 13 percent, as a percentage of all firms, in the 1980s to 7 percent or 8 percent in recent years."

5. Uncertainty in trade policy

According to the U.S. House of Representatives Committee on Small Business, entrepreneurs and small businesses face a variety of barriers that significantly inhibit their ability to compete in the export market. Those barriers include higher tariffs, and anti-competitive technical standards. Adding to the global issues, some nations, including the U.S. create complex domestic rules regulating international trade. Entrepreneurs must navigate multiple federal agencies to obtain that license. With their limited resources, entrepreneurs and small businesses rely on free trade agreements to navigate the complexities of international trade (2012).

Despite the agreements in place, their complexity and uncertain, or disparate, enforcement have deterred entrepreneurial activity in international markets. Unfair trade practices, especially the theft of intellectual property (IP), deter small business engagement in that arena. According to the U.S. House of Representatives, China is the preeminent offender, including dumping, intellectual property theft, and market access. In total, domestic firms lost an estimated $48 billion from this theft. Notably, only one percent of the 27 million small businesses are engaged in export (2012).

The U.S. Government has been a failure in consistently ensuring that trade agreements with nations like China have been "fair" as well as "free." Large enterprises have the scale and clout – for the present – to better monitor and limit intellectual property theft. The U.S. could impose more significant penalties on certain Chinese manufacturers and products where IP theft is known. The lack of strong action by the U.S., as some allege, may be due to fear of losing the nation's key source for its debt-fuelled economy. To stimulate entrepreneurial development and to restore manufacturing jobs in the U.S., the nation must take a stronger stance against global IP theft.

In a positive signal for entrepreneurs and a possible shift toward a tougher posture on violators, on February 29 of this year the Obama administration signed an executive order to target the unfair trade practices of nations such as China. Commerce Secretary John Bryson, who will appoint the deputy director, said his department "is committed to making it as easy as possible for U.S. businesses to build things here and sell them everywhere." (Barklay and Favole, 2012).

6. Lobbying and its impact on entrepreneurship

Increased lobbying and the rapidly growing outside influence on lawmakers in Washington and other political circles of power have an outsized negative impact on entrepreneurship (Figure 2). Small businesses and entrepreneurs do not have the financial resources or infrastructure available to larger entities, leaving them relatively unable to mount a viable defense when they are confronted by regulatory issues. As derived from Baumol (1990), when the need for lobbying increases, more of an entrepreneurs time and resources must be utilized in non-innovative rent seeking activities, such as lobbying government officers instead of productive activities.

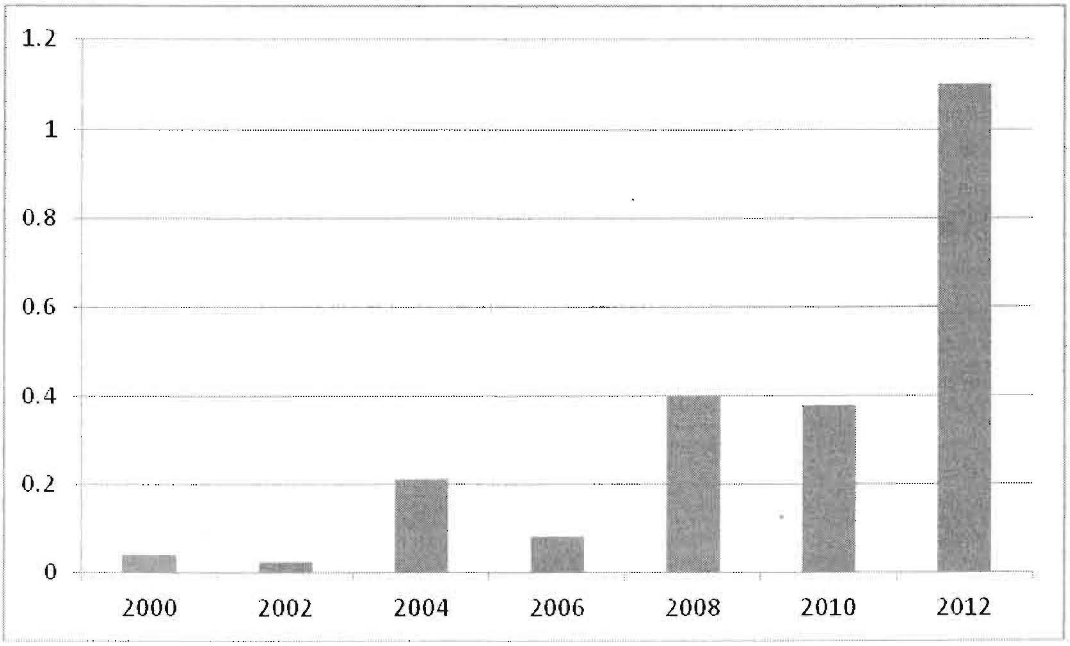

Figure 2. Outside Spending in U.S. Federal Election Cycles (Billions of Dollars) (Source: U.S. Federal Elections Commission)

The increase in outside monetary influence in recent years has been historic, with $1.1 billion spent in the 2012 cycle. Given that more than 50% of all new jobs created in the U.S. are from small businesses, the growing and outsized influence of larger firms could explain some of the sluggish job growth that America has experienced. Significantly, entrepreneurship is fundamental to a society's long term growth, due to its ability to transfer new knowledge into commercial applications (Audretsch *et al.*, 2006).

The implications of the increases in non-productive rent seeking are not unique for small business, though more profound due to their resource limitations. The cost to an economy of rising rent seeking, typified by Figure 2, adds a debilitating dimension to any free market economy that increases uncertainty and reduces opportunity for ascension of the middle class.

7. Conclusion

The role of governments can be helpful in fostering entrepreneurship and economic growth. Most efforts to stimulate business creation and expansion have been in the form of tax incentives. While preferential taxation, such targeted capital gains reductions and investment tax credits can be helpful, other, sometimes more subtle policy factors of predictability that are noted in this paper, can be more enticing. Chief among them is an environment in which a medium- to long-term assessment of government policy is possible. In the U.S., for example, the lack of policy visibility in a politically divided nation, and fear of new regulations, taxes, and rent seeking by lobbying groups, is having a chilling effect on new business creation.

Some Western nations are recognizing the value of providing a more positive viewpoint from government, and one that can diminish policy fears harboured by entrepreneurs. The U.K.'s Department of Business, Innovation, and Skills recently announced the elimination or modification of 3,000 rules that impacted small companies. The U.K.'s Business Secretary noted that "in these tough times, businesses need to focus all their energies on creating jobs and growth not being tied up in unnecessary red tape" (Vina, 2012).

Entrepreneurs and small businesses realize a nation that has incurred more debt in just four years than in its entire 200 year history, increased the rent seeking in its bastions of political power, and effectively printed nearly $4 trillion, as is the case for the U.S., is on an unsustainable trajectory. As a result, the government's job creating and GDP enhancing efforts have produced modest, and arguably unsustainable, results. Some of these same issues are an impediment to business formation elsewhere, such as the European Union. Until a more stable environment, built upon policies that engender private sector growth and investment is visible to the job creating cadre, we can expect sub-par economic growth and missed opportunity.

Further study is needed to quantify the impact of contemporaneous issues in policy uncertainty, such as quantitative easing. Research that would include a broad sampling of small business leaders would assist in closing the gaps in the literature and enhance the understanding of effective policy. The benefits of such an enhanced understanding would be beneficial on a global basis.

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