

RESEARCH BRIEF

Elections, Political Polarization, and Economic Uncertainty

Based on BFI working paper No. 2020-145, "[Elections, Political Polarization, and Economic Uncertainty](#)," by Scott R. Baker, Associate Professor, Northwestern University; Aniket Baksy, PhD Student, Stanford University; Nicholas Bloom, Professor, Stanford University; Steven J. Davis, William H. Abbott Distinguished Service Professor of International Business and Economics, Chicago Booth; and Jonathan Rodden, Professor, Stanford University

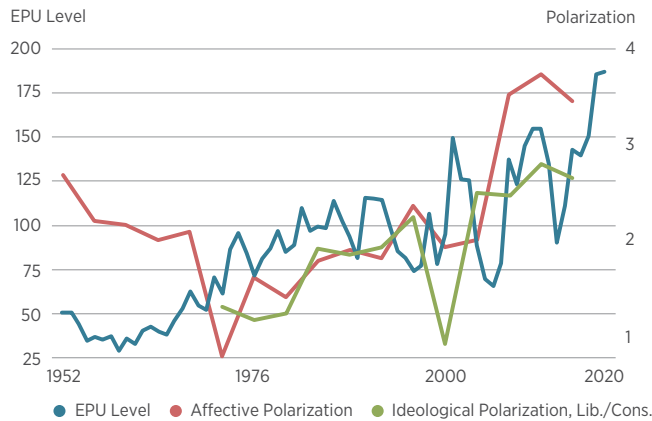
KEY TAKEAWAYS

- ✓ Uncertainty is ever present in economic decision-making, but it can spike during national elections.
- ✓ Since the 1990s, political polarization has increased in the United States.
- ✓ This polarization has increased economic policy uncertainty, especially in close elections.
- ✓ High levels of uncertainty can disrupt business and consumer spending plans.

Uncertainty is the bane of economic decision-making. Whether to invest, start a new business, change jobs, or a myriad of other questions are difficult choices even in relatively stable times (however one chooses to define "stable"). However, such events as hotly contested national elections turn up the dials of uncertainty and complicate decision-making beyond normal bounds of ambiguity. This is especially true when a large gap exists between the likely economic policies of competing candidates and political parties.

Figure 1

Polarization in US Presidential Elections and EPU



Note: Time series of the level of policy uncertainty and a measure of affective polarization in the US for elections 1952-2016. Policy uncertainty (the left axis) is measured using the level of the EPU normalized so that the mean level between 1985 and 2009 is 100, and then averaged across months within each year. For 2020, we only include data until February. Affective polarization is measured by the mean absolute difference in affect between parties averaged over all respondents and weighted by demographic weights (right axis). Ideological polarization is an analogous measure, calculated as the mean absolute difference in ideological positions on a Liberal – Conservative scale, between parties averaged over all respondents and weighted by demographic weights (right axis). Policy uncertainty data from policyuncertainty.com, and our polarization data is created using the ANES.

In their recent paper, “Elections, Political Polarization, and Economic Uncertainty,” Scott R. Baker, Aniket Baksy, Nicholas Bloom, Steven J. Davis, and Jonathan Rodden find that economic policy uncertainty (EPU) rises around national elections, especially those that are polarized and close. With political polarization on the rise in many democracies, this uncertainty effect will likely become more intense in many forthcoming national elections around the world.

Short-term swings in electoral uncertainty induce, in effect, an electoral business cycle. Firms, for example, could restrict investment and hiring decisions during periods of high EPU, and households may delay major purchases.

Uncertainty roils expectations

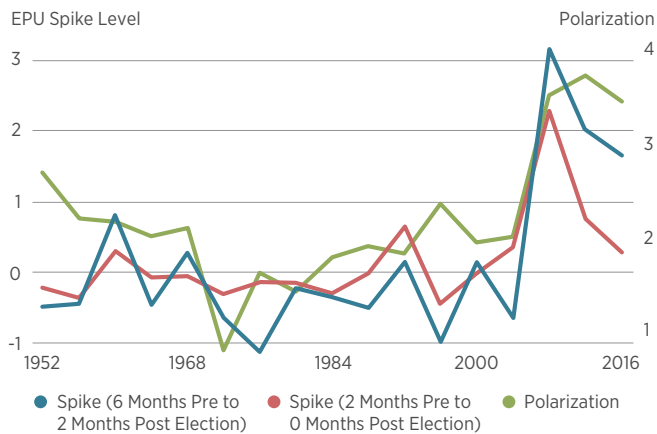
National elections offer a clear signal about the future of a country’s economic policy over the following years, and expectations align when a particular candidate seems poised to win. However, a tight race with an uncertain outcome can result in a shock to the policy and investment environment. The authors cite a number of instances within the last 10 years where such a shock has occurred, including Australia, India, Brazil, the UK, and, of course, the United States in 2016.

While political parties sometimes hold similar views around economic policy, that has not been the trend of late in many democracies, where voters have come to view political parties as increasingly polarized, and which has led to an increase in EPU, especially in the months leading to an election. These short-term swings in electoral uncertainty induce, in effect, an electoral business cycle. Firms, for example, could restrict investment and hiring decisions during periods of high EPU, and households may delay major purchases.

To investigate this phenomenon, the authors employed their novel methodology for tracking the frequency with which newspapers discuss topics related to economic policymaking. They used this technique to measure EPU both across and within more than 20 countries. On average across countries, EPU rises in the months leading up to a national election, peaking at a 13 percent rise in the election month itself.

Focusing on more detailed data from the United States, the authors find that this pattern is not common to all elections. Indeed, many elections involve little uncertainty about economic policy. The

Figure 2
Size of EPU Spike around US Presidential Elections



Note: Election spikes as defined in (5) over time, for i) spikes starting 6 months prior to an election to 2 months post an election in the US (left axis) and ii) spikes starting 2 months prior to an election to the month of the election in the US (left axis), against affective polarization (right axis). The election spike measures the cumulative excess uncertainty (in log points) in the run-up to an election and immediately after it, relative to the level of uncertainty prevailing in the election cycle. We measure this spike between the May of the year of the election and the January following the election to adequately capture the run-up in uncertainty that can result as party primary elections and debates occur, and the resolution of uncertainty when the newly-elected government takes office.

key factor is political polarization, suggesting that who is in charge matters less than expectations about the economic policies that may be enacted. Further, elections that are not hotly contested bring a smaller rise in EPU. In such cases, voters have more certainty about an election’s outcome and, thus, can anticipate future policies with more confidence.

However, recent US presidential elections—steeped in polarization and often close—have turned up the dials on EPU with concomitant effects on the US investment environment. In the months around elections that are both close and polarized, EPU rises by 28 percent relative to elections that are neither. The authors released their study in advance of the November 2020 US presidential election. Given the extent of U.S. political polarization, their results suggest that a close or contested election would bring a large rise in EPU.

Separate work by Bloom and Davis, among others, reveals that this uncertainty carries over into the months following an election.¹ An October 2020 survey revealed that uncertainty surrounding the 2020 election was the second biggest source of concern for businesses. Importantly, the survey shows that these uncertainties negatively affect firms’ plans for future investment.

Conclusion

Policy uncertainty has trended upwards in the United States, driven in part by increased political polarization. In terms of economic policy, voters and investors see the two parties as offering increasingly divergent platforms. Given the government’s previous role in addressing the COVID-19 pandemic through massive spending programs, there is likely some expectation that a future government response is imminent. But how large? And what would such a package include?

The authors show that voters’ expected answers to those and other questions are shaped by political polarization. As polarization has grown, presidential elections have become associated with larger spikes in economic policy uncertainty. This finding dovetails with the observation that stock market volatility tends to increase in the month before elections. This phenomenon is not limited to the United States, as the authors also find evidence of sizable election-induced spikes in policy uncertainty in other democracies around the world.

The authors’ US EPU index reached new highs in the Spring of 2020 during the uneven US

¹ frbatlanta.org/blogs/macroblog/2020/10/22/covid-election-uncertainty-weigh-heavily-on-firms-outlook

response to the COVID pandemic. A variety of important policies are likely to change if the incumbent president is unseated. Perhaps the greatest danger, however, lies in an election that is still being contested in the courts in December or January.

CLOSING TAKEAWAY

Focusing on more detailed data from the United States, the authors find that this trend is not common to all elections. Indeed, many elections reveal little change in uncertainty surrounding economic policy. The deciding factor is political polarization, suggesting that who is in charge matters less than expectations about the economic policies that may be enacted.

READ THE WORKING PAPER

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bfi.uchicago.edu/working-paper/2020145

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Research Brief: "Elections, Political Polarization, and Economic Uncertainty"

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