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State-Level Economic Policy Uncertainty

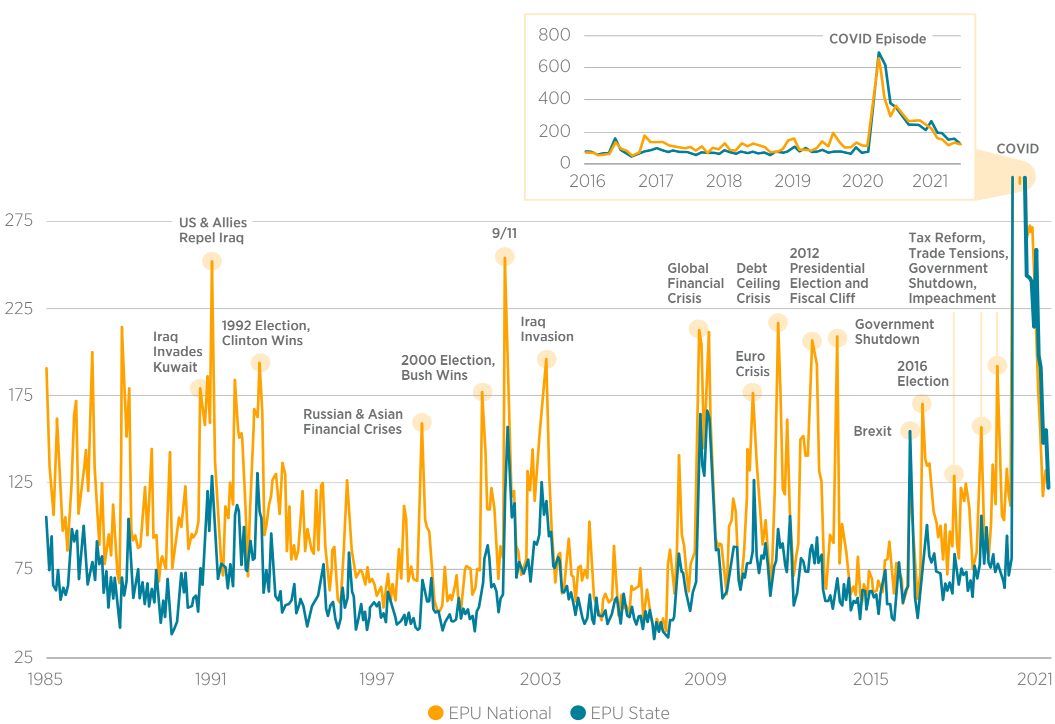
Based on BFI Working Paper 2022-21, "State-Level Economic Policy Uncertainty" by Scott R. Baker, Northwestern University; Steven J. Davis, Chicago Booth; and Jeffrey A. Levy, University of Chicago's Harris Public Policy

Economic policy uncertainty in US states rises around gubernatorial and presidential elections, as well as around state-specific and national events; also, the COVID-19 pandemic drove huge increases in policy uncertainty and unemployment, more so in states with stricter government-mandated lockdowns.

High economic policy uncertainty (EPU) can depress economic activity by causing firms to defer certain investments, by raising credit spreads and risk premiums (thereby dampening business investment and hiring), and by prompting consumers to postpone purchases of durable goods. While several studies provide evidence that uncertainty increases around elections and that election-related uncertainty has material effects on economic activity, this new paper provides the first evidence on the relative importance of state and national sources of state-level policy uncertainty, how these sources differ across states, and how they vary over time within states.

The authors employ the digital archives of nearly 3,500 local newspapers to construct three monthly indexes of economic policy uncertainty for each state: one that captures state and local sources of policy uncertainty

Figure 1 • Average Values of Economic Policy Uncertainty (EPU)
EPU-State and EPU-National by Month



Note: The figure plots equal-weighted cross-state average values of EPU-S and EPU-N by month. The authors cover all states from January 2006 onward, 38 states from 1996 onward, and 12 states throughout the period from January 1985 to June 2021.

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(EPU-S), another that captures national and international sources (EPU-N), and a composite index (EPU-C) that captures both state + local and national + international sources. Half the articles that feed into their composite indexes discuss state and local policy, confirming that sub-national matters are important sources of policy uncertainty. Key findings include:

- EPU-S rises around presidential and own-state gubernatorial elections and in response to own-state episodes such as the California electricity crisis of 2000-01 and the Kansas tax experiment of 2012.

- EPU-N rises around presidential elections and in response to such shocks as the 9-11 terrorist attacks, the July 2011 debt-ceiling crisis, federal government shutdowns, and other "national" events.

- Close elections (winning vote margin under 4 percent) elevate policy uncertainty much more than less competitive elections; a close presidential election contest raises EPU-N by 60 percent and a close gubernatorial contest raises EPU-S by 35 percent.

- EPU spiked in the wake of the COVID-19 pandemic, pushing EPU-N to 2.7 times its pre-COVID peak, and (average) EPU-S to more than four times its previous peak. Policy uncertainty rose more sharply in states with stricter government-mandated lockdowns.

- Upward shocks to own-state policy uncertainty foreshadow higher unemployment in the state.

This research also finds that the main locus of policy uncertainty shifted to state and local sources during the pandemic. The authors offer the following simple metric: Consider the ratio of EPU-S to EPU-N for a given state. The cross-state average value of this ratio rose from 0.65 in the pre-pandemic years to 1.1 in the period from March 2020 to June 2021. Since the timing, stringency, and duration of gathering restrictions, school closure orders, business closure orders, and shelter-in-place orders during the pandemic were largely set by state and local authorities, it makes sense that EPU-S saw an especially large increase after February 2020.

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