

Assessing the Impact of Policy Uncertainty on Entrepreneurial Activity

Parul Manocha, Virginia Tech, USA

In 2016, when UK voted to leave Europe—Brexit, it created uncertainty on trade, security and migration between UK and EU, which in turn created a ripple effect in other non-EU countries as well. Brexit was catalyst in spiking uncertainty related to policy decisions. Startups questioned whether they would get access to venture capital funding after Brexit. The episodic uncertainty created by this event spread in both spatial and temporal dimensions, making potential entrepreneurs wonder: does policy uncertainty provide elixir, or does it act as an obstacle to entrepreneurial activity?

Entrepreneurs operate under conditions of uncertainty, including policy uncertainty, which relates to policy changes causing business fluctuations in both domestic and international markets. Entrepreneurs' perceptions of these policies shape their activities. Policy changes can reflect in economic changes, including a spectrum of entrepreneurial behavior—actions, conditions, and outcomes.

Policy uncertainty can significantly impact the environment for existing and new businesses. For potential entrepreneurs this can elevate the role of judgement to ascertain future conditions. At low levels of policy uncertainty, much of the opportunities will be taken up by the incumbent firms, leaving little room for new businesses to be formed. As policy uncertainty increases, the environmental munificence for entrepreneurial opportunities increases—new businesses will be formed to take advantage of the opportunities associated with the changing entrepreneurial landscape. However, this ascent is possible only to a certain point after which levels of policy uncertainty will deter entrepreneurial activity.

The period of Great Depression was marked with high levels of uncertainty from government actions and its effect on private investments and entrepreneurial action thus discouraging business activity. High policy uncertainty makes it difficult for the potential entrepreneurs to form reliable expectations about the future and undertake calculated risks. The corollary of very high levels of policy uncertainty is that opportunity pathways for business venturing may be limited.

New businesses, in a sense, be considered a call option, the value of which increases exponentially with volatility; however, only to a point since there are presumably limits to that when policy uncertainty is extremely high. Thus, there exists a curvilinear—inverted U-shaped relationship between policy uncertainty

and entrepreneurial activity.

To get the full picture, we need to understand the quality of governance. Better quality governance provides a more efficient market system. Thus, when economic opportunities arise due to policy changes, established firms are better able to pursue these opportunities, thus limiting the opportunities for nascent entrepreneurs to spot – and exploit – profitable niches. Higher governance quality would mean stricter formal regulations, which would reduce the incentive for entrepreneurs. This can attenuate the relationship between policy uncertainty and entrepreneurial activity.

Whereas, when the governance quality is lower, it amplifies the effect of policy uncertainty on entrepreneurial activity. Increases in policy uncertainty make the opportunity costs of self-employment less and thereby leads to an amplified relationship between policy uncertainty and entrepreneurial activity. When the governance quality is lower, increasing level of policy uncertainty will lead to a steep increase in entrepreneurial activity up to a point, after which the additional increase in policy uncertainty will lead to declining levels of entrepreneurial activity making it difficult to sustain the entrepreneurial activity as the level of policy uncertainty increases.

Using a longitudinal country-level data, the preliminary analysis provide support for these relationships.

Key takeaways

Essentially, to understand the complex relationship between policy uncertainty entrepreneurial action, below are the three key takeaways:

1. Policy uncertainty creates opportunities for entrepreneurial activity
2. Moderate levels of policy uncertainty are less of a deterrent than it is an invitation; too little and too much of policy uncertainty curbs entrepreneurial activity
3. Governance quality can dampen the impact of policy uncertainty on entrepreneurial activity

Where do we go from here?

Understanding that entrepreneurship is an effective strategy to spurring employment, to curb the negative effects of heightened regulation, policymakers should be encouraged to remove the bottlenecks in setting up ventures and provide a conducive environment for the functioning of entrepreneurial ventures, such as

setting new institutional arrangements in case the existing ones seems to deter the growth of entrepreneurial activity. Therefore, regulators, are faced with striking an appropriate balance in terms of providing smooth ecosystem and implementing new policies.

CONTACT: Parul Manocha; parul@vt.edu; (T): +1 540 986 8676; Virginia Tech; 880 West Campus Drive, Pamplin Hall, Blacksburg, VA 24061, USA.