Entrepreneurship and political risk

Nabamita Dutta  
Department of Economics, College of Business Administration, University of Wisconsin, La Crosse, Wisconsin, USA
Russell S. Sobel  
The Citadel, Charleston, South Carolina, USA, and  
Sanjukta Roy  
World Bank Institute, Arlington, Virginia, USA

Abstract

Purpose – Previous literature has clearly demonstrated the need for sound government policies or “institutions” to promote and support entrepreneurship in a country. The purpose of this paper is to explore the role of one such institution – political stability – in boosting entrepreneurial endeavors. A politically stable nation will have lower risk and transaction/contracting costs, and higher levels of government transparency, predictability, and accountability. Thus, the paper should expect that with greater political stability there should be a greater degree of entrepreneurial activity.

Design/methodology/approach – Using dynamic panel estimators (System GMM estimators) and considering multiple proxies of political risk, our results confirm this hypothesis. Such estimators handle challenges associated with panel data efficiently.

Findings – The paper’s results show that greater political stability for a country does indeed lead to an increased rate of entrepreneurship and wealth creation.

Originality/value – Entrepreneurship is critical to the process of economic growth and development. To prosper, countries must unleash the creative talents of their citizens through the decentralized process of formal private sector entrepreneurship. New legal businesses create jobs, opportunities, wealth, and goods and services that make a nation grow. Sadly in many nations, this process is stifled and poverty is the result. While previous research has examined which types of specific policies matter for promoting entrepreneurship, the paper considers the different question of how the stability of political institutions impacts the rate of entrepreneurship.

Keywords Entrepreneurship, Development, Economic growth

Paper type Research paper

1. Introduction

The development literature has stressed the lack of political stability as a major impediment to the economic growth and development of a nation (Aisen and Veiga, 2006; Jong-a-Pin, 2009; Alesina and Perotti, 1996; Levine and Renelt, 1992; Barro, 1996). Many studies have found that higher levels of socio-political instability lower investment and lead to inflation (Alesina and Perotti, 1996; Aisen and Veiga, 2006). Financial institutions and specifically, financial development are also negatively affected by political instability (Roe and Siegel, 2011). In this paper, we test the effect of political stability on entrepreneurship rates in countries. Political instability leads to greater risk and uncertainty in contracting, applications of legal rules, the structure of property rights, and tax/expenditure policies. On the other hand, stable and sound institutions reduce transaction costs and, thus allow individuals to capture the gains from exchange in market transactions (Boettke and Coyne, 2003, 2006). Games of inter-culture conflict can be converted into ones of inter-cultural cooperation in the presence of better “rules of the game” or good institutions (Coyne, 2008; Easterly,
Under good institutions the entrepreneurial process of creative destruction (Schumpeter, 1911/1934) is unleashed in a way that leads to continuous wealth creation and growing prosperity through time. In this paper we hypothesize that there should therefore be a positive association between political stability and entrepreneurial activity (and thus higher levels of economic growth).

Related work by Baumol (1990) stresses that the productivity of a country’s entrepreneurial process depends on the quality of its institutions. Entrepreneurial efforts are driven by the corresponding rates of return or profit rates of such actions. When a country has good institutions the rate of return to market entrepreneurship rises, while when institutions are weak or poorly designed it increases the rate of return to political action, rent seeking, and lobbying – or more simply fights over wealth transfers through the political process. When political institutions are unstable, changing power structures and centers within government create new opportunities for wealth transfers, leading to more unproductive (and less productive) entrepreneurship. Without stable and predictable judicial systems, contract enforcement, and effective limits on government’s ability to transfer wealth through taxation and regulation, the process of political instability lowers the relative profitability of productive private sector entrepreneurship and increases the return to political and legal entrepreneurship. Therefore, political risk will impact the functioning of both public and private institutions and this, in turn, affects the rate of entrepreneurial endeavors.

Political instability can also affect entrepreneurship rates through the channel of financial institutions. According to Roe and Siegel (2011), the political risk of a country greatly affects its capacity to secure protection for potential investors. They argue that unstable governments fail to commit credibly to policies that can encourage saving and thereby hamper the efficient functioning of the financial markets that allocate a nation’s supply of capital to the entrepreneurial process. In contrast, more stable political climates create an environment in which contracting and financial markets work better, thereby encouraging more individuals to take up risky ventures. Thus, we hypothesize in this paper that a greater political stability leads to higher levels of productive, private sector entrepreneurial activity.

Our empirical results, indeed find that higher political stability (or equivalently lower political risk) leads to higher rates of entrepreneurship. We consider multiple proxies of political risk from the International Country Risk Guide (ICRG) database. In order to efficiently handle challenges associated with panel data, we consider dynamic panel estimators, System GMM estimators. Our results are robust for bureaucratic quality, socioeconomic conditions, law and order, internal conflict, corruption, investment profiles, and military involvement in the political process.

Section 2 describes the data used in the paper. Section 3 describes the empirical methodology and also presents our benchmark results. Section 4 provides robustness tests, and Section 5 concludes.

2. Data
   a. Dependent variable
   Our data comes from the new database on entrepreneurship developed by Klapper and Love (2010). The main measure of entrepreneurship we employ is “entry density” which they define as “the number of newly registered limited liability firms in the corresponding year as a percentage of the country’s working age population (ages 15-64) normalized by 1,000.” This provides our “flow” measure of entrepreneurial activity within each country’s formal private sector. The mean of our sample for entry
density is 3.23 and the standard deviation is 4.6. There is a high degree of variance across countries in this measure with countries like Niger for whom the entry density is almost zero and countries like Cyprus for whom the average entry density over the sample period is as high as 30. This will provide sufficient variation and a wide enough sample of countries on which to test our hypothesis about the impact of political stability on rates of entrepreneurial activity. The list of countries employed in our sample is provided in Appendix A.

b. Independent variables
Our main independent variables of interest are measures of political stability from the ICRG database. The different measures we consider from this database (in their terminology) are: government stability, socioeconomic condition, investment profile, internal conflict, external conflict, corruption, bureaucratic quality, democratic accountability, law and order, religion in politics, military in politics, and ethnic tension. All these measures to one degree or another assess or are associated with the extent of political stability of a country, with some measures clearly more closely related than others. A detailed description of these variables is provided in Appendix B. The ICRG measures are indices on different scales, however, for all measures higher numbers denote more political stability and should therefore be positively related to entrepreneurship rates if our hypothesis is correct.

The ICRG variables corruption, military in politics, religion in politics, law and order, ethnic tension, and democratic accountability take values that range from 1 to 6. While the variables internal conflict, investment profile, socioeconomic condition, government stability, and external conflict range from 1 to 12. Bureaucratic quality is the only variable that ranges from 1 to 4. Among the political stability proxies, socioeconomic condition has the highest standard deviation (2.39) across countries while bureaucratic quality has the lowest (1.03).

c. Control variables
For control variables we follow other studies on cross-country rates of entrepreneurial activity (Klapper and Love, 2010; Dutta et al., 2010). These include macroeconomic indicators such as GDP per capita (2005 purchasing power parity) and GDP growth. These help to control directly for the level of income and economic fluctuations that may impact the rate of entrepreneurship. The control variables are taken from the World Development Indicators (WDI) 2011 database. Endogeneity is a potential concern here as higher economic development will affect the entry rate of new firms, and simultaneously greater entry rates of firms will lead to higher economic development. We therefore employ system GMM specifications to correct for this endogeneity. We also include measures of the extent of barriers to entry facing entrepreneurs. In our benchmark specifications we include a variable measuring the number of procedures involved in starting a business within each country. This is expected to be negatively correlated with the entry rate of new firms.

3. Empirical methodology and benchmark results
a. Empirical methodology
We employ System GMM specifications in our estimations. These dynamic panel estimators are best suited for small $T$ (fewer time periods) and large $N$ ($N > T$, where $N$ is the number of countries) panels, a linear functional relationship, a single dependent variable that is dynamic, depending on its own past realizations, independent variables which are not strictly exogenous and are correlated with present as well as past
realizations of the error, fixed country effects and finally, heteroskedasticity[1] and autocorrelation within countries (see, Roodman, 2009). Our estimation model satisfies all of these conditions – $N > T$, the model is linear, fixed country characteristics like legal origins and colonial histories have the potential to affect the dependent variable, political stability proxies and controls like GDP per capita, growth will not be exogenous and we do expect that there will be heteroskedasticity and autocorrelation within countries. The model is transformed into first differences and sequential moment conditions are used. We use System GMM estimators because Difference GMM estimators can suffer from poor finite sample properties in terms of bias and precision when the series is persistent (Bun and Windmeijer, 2010; Blundell and Bond, 1998). System GMM estimators uses extra moment conditions that rely on stationarity conditions of the initial observations.

We start with bivariate specifications. Our reduced form equation takes the following form:

$$\text{Entry Density}_{it} = \alpha_0 + \alpha_1 \text{Entry Density}_{it-1} + \alpha_2 \text{Entry Density}_{it-2} + \alpha_3 \text{Pol Risk}_{it} + \alpha_4 \theta_i + \alpha_5 Z_t + e_{it}$$

(1)

where $\text{Entry Density}_{it}$ is the number of newly registered firms as a fraction of the working age population in country $i$ in time $t$. The two lags, $\text{Entry Density}_{it-1}$ and $\text{Entry Density}_{it-2}$ captures the persistence of the dependent variable over two periods and take into account any serial correlation. $\text{Pol Risk}_{it}$ generally represents our measures of political risk/stability. $\theta_i$ is the time-invariant country fixed effects, $Z_t$ is the vector for time dummies, and $e_{it}$ represents the random error term. Since the dynamic panel estimators, both System and Difference GMM estimators, consider the estimation in first difference form, the model gets rid of country fixed effects. We have 90 developed and developing countries in our sample over the period 2004 to 2009.

b. Correlation and scatter plots

Before running the empirical specifications, we consider simple correlation among the variables and also construct scatter plots to better understand our data. Table I provides the summary statistics of the variables and Table II presents the correlation matrix. As we can see from the table, all the measures of political stability considered are correlated strongly with entry density, with variables like corruption and socioeconomic condition having the highest magnitudes.

Figure 1 present the scatter plots with the different political risk measures. From all the plots, it is evident that the association between political risk and entrepreneurship is strong – with lower political risk, entry density rises, implying that more firms emerge as the political stability of a country gets better. From the different plots, it is clear that the lines are the steepest for corruption and socioeconomic condition. We now turn to our formal econometric estimation using this data.

c. Benchmark results

Table III presents our benchmark results. For bureaucratic quality, corruption, socioeconomic condition, internal conflict and law and order, the coefficients are positive and significant at the 1 percent level. The coefficient for military in politics is positive and significant at the 5 percent level. For investment profile, the coefficient is weakly significant ($p = 0.12$). Thus, as political stability of a country improves be it
in terms of bureaucratic quality, corruption, socioeconomic condition, internal conflict, law and order or military in politics, the country experiences greater entrepreneurship as far as the number of newly registered firms are concerned. We can calculate how a standard deviation change in political stability can affect entry density. For specifications in column (1), for a standard deviation rise in bureaucratic quality (SD = 1.03, see Table I), entry rises by 3.43 percentage points. Similarly, for corruption (see column (2), the corresponding rise is 1.97 percentage points. The changes are the smallest for investment profile and internal conflict.

In Table IV, we add controls. The controls added are GDP (in constant US $), GDP growth and number of procedures involved in starting a business. Apart from socioeconomic condition, the other proxies of political stability have a positive and significant impact on entry density. The coefficient value for internal conflict is only significant at the 11 percent level of significance, however, falling only slightly short of the normal 10 percent level. The impact of political stability on entry density is lower when compared to Table III, with the additional controls. A standard deviation rise in bureaucratic quality raises entry density by 1.91 percentage points. Given that our range for entry is 0-38.2 (see Table I), a 1.2 percentage points increase will still imply a
Notes: a, bureaucratic quality; b, corruption; c, socioeconomic condition; d, investment profile; e, internal conflict; f, military in politics; g, law and order.

Figure 1. Scatter plots showing the association between entry density and political risks.
Table III
System GMM specifications: impact on political risk on entrepreneurship

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Bureaucratic quality</th>
<th>Corruption</th>
<th>Socioeconomic condition</th>
<th>Investment profile</th>
<th>Internal conflict</th>
<th>Military in politics</th>
<th>Law and order</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lag entrepreneurship (1)</td>
<td>0.976*** (0.0358)</td>
<td>1.040*** (0.0279)</td>
<td>1.027*** (0.0338)</td>
<td>0.983*** (0.0363)</td>
<td>1.060*** (0.0299)</td>
<td>0.953*** (0.0462)</td>
<td>1.059*** (0.0296)</td>
</tr>
<tr>
<td>Lag entrepreneurship (2)</td>
<td>-0.462*** (0.0351)</td>
<td>-0.402*** (0.0344)</td>
<td>-0.321*** (0.0338)</td>
<td>-0.212*** (0.0374)</td>
<td>-0.287*** (0.0356)</td>
<td>-0.472*** (0.0302)</td>
<td>-0.421*** (0.0304)</td>
</tr>
<tr>
<td>Political risk</td>
<td>3.328*** (0.592)</td>
<td>1.599*** (0.394)</td>
<td>0.421*** (0.154)</td>
<td>0.363 (0.234)</td>
<td>0.482*** (0.147)</td>
<td>1.818*** (0.826)</td>
<td>1.315*** (0.419)</td>
</tr>
<tr>
<td>Year dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Constant</td>
<td>-6.951*** (1.367)</td>
<td>-3.727*** (0.951)</td>
<td>-2.104** (0.840)</td>
<td>-3.097 (2.168)</td>
<td>-4.223*** (1.368)</td>
<td>-6.260 (3.875)</td>
<td>-4.471*** (1.528)</td>
</tr>
<tr>
<td>Observations</td>
<td>322</td>
<td>322</td>
<td>322</td>
<td>322</td>
<td>322</td>
<td>322</td>
<td>322</td>
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<tr>
<td>Number of countries</td>
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<td>88</td>
<td>88</td>
<td>88</td>
<td>88</td>
<td>88</td>
<td>88</td>
</tr>
<tr>
<td>Sargan test</td>
<td>p = 0.14</td>
<td>p = 0.36</td>
<td>p = 0.09</td>
<td>p = 0.11</td>
<td>p = 0.12</td>
<td>p = 0.53</td>
<td>p = 0.27</td>
</tr>
<tr>
<td>Auto-correlation test</td>
<td>p = 0.25</td>
<td>p = 0.26</td>
<td>p = 0.44</td>
<td>p = 0.66</td>
<td>p = 0.42</td>
<td>p = 0.27</td>
<td>p = 0.26</td>
</tr>
<tr>
<td>Number of instruments</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
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<td>18</td>
</tr>
</tbody>
</table>

Notes: Standard errors in parentheses, ***p < 0.01; **p < 0.05; *p < 0.1
### Table IV.

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>(1) Bureaucratic quality</th>
<th>(2) Corruption</th>
<th>(3) Socioeconomic condition</th>
<th>(4) Investment profile</th>
<th>(5) Internal conflict</th>
<th>(6) Military in politics</th>
<th>(7) Law and order</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lag entrepreneurship (1)</td>
<td>0.599***</td>
<td>0.704***</td>
<td>0.803***</td>
<td>0.749***</td>
<td>0.836***</td>
<td>0.607***</td>
<td>0.688***</td>
</tr>
<tr>
<td>Lag entrepreneurship (2)</td>
<td>-0.0734</td>
<td>-0.0832</td>
<td>-0.106</td>
<td>-0.0629</td>
<td>-0.122**</td>
<td>-0.0476</td>
<td>-0.0718</td>
</tr>
<tr>
<td>Political risk</td>
<td>1.850***</td>
<td>0.755***</td>
<td>0.0611</td>
<td>0.226*</td>
<td>0.137****</td>
<td>1.266***</td>
<td>0.871**</td>
</tr>
<tr>
<td>GDP constant US $2,000 (in billions)</td>
<td>-0.003</td>
<td>-0.0002*</td>
<td>-0.002</td>
<td>-0.002*</td>
<td>-0.002**</td>
<td>-0.0001</td>
<td>-0.002***</td>
</tr>
<tr>
<td>GDP growth (annual)</td>
<td>0.0492***</td>
<td>0.0531***</td>
<td>0.0580***</td>
<td>0.0506***</td>
<td>0.0529***</td>
<td>0.0519***</td>
<td>0.0550***</td>
</tr>
<tr>
<td>Starting a business (procedures)</td>
<td>-0.0130</td>
<td>-0.0275</td>
<td>-0.0400</td>
<td>-0.0278</td>
<td>-0.0433</td>
<td>-0.0267</td>
<td>-0.00911</td>
</tr>
<tr>
<td>Year dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Constant</td>
<td>-2.628**</td>
<td>-0.567</td>
<td>0.877</td>
<td>-0.924</td>
<td>-0.0947</td>
<td>-4.003***</td>
<td>-1.806</td>
</tr>
<tr>
<td>Observations</td>
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<td>318</td>
<td>318</td>
<td>318</td>
<td>318</td>
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<td>318</td>
</tr>
<tr>
<td>Number of countries</td>
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<td>88</td>
<td>88</td>
<td>88</td>
<td>88</td>
<td>88</td>
<td>88</td>
</tr>
<tr>
<td>Sargan test</td>
<td>$p = 0.15$</td>
<td>$p = 0.12$</td>
<td>$p = 0.08$</td>
<td>$p = 0.09$</td>
<td>$p = 0.08$</td>
<td>$p = 0.77$</td>
<td>$p = 0.97$</td>
</tr>
<tr>
<td>Auto-correlation test</td>
<td>$p = 0.87$</td>
<td>$p = 0.77$</td>
<td>$p = 0.65$</td>
<td>$p = 0.86$</td>
<td>$p = 0.60$</td>
<td>$p = 0.28$</td>
<td>$p = 0.10$</td>
</tr>
<tr>
<td>Number of instruments</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>21</td>
</tr>
</tbody>
</table>

**Notes:** Standard errors in parentheses. ****$p < 0.01$; ***$p < 0.05$; **$p < 0.1$; *$p < 0.1$
3 percent rise, which is substantial. GDP growth has a positive and significant impact on entry density for all the specifications. Yet, GDP has a negative impact, though the coefficient is significant for some of the specifications only. The coefficient for procedures of starting a business, as expected, has a negative sign but it is not significant for any of the specifications.

4. Robustness analysis

In order to check the robustness of our results, in this section we include different control variables and run alternate specifications. First, we consider different indicators from the The World Bank (2011) database. Instead of the number of procedures, we now include the number of days it takes to start a new business. In terms of the specific definition it is the “the number of days that incorporation lawyers indicate is necessary to complete all required procedures with minimum follow-up with government agencies and no extra payments” (Klapper and Love, 2010). Again, the lengthier the process is, the less attractive the location will be in terms of entry rate of new firms. Our results remain robust to the inclusion of this alternate proxy for business. All coefficients of political stability measures (except socioeconomic condition) are positive and significant. We consider other alternate indicators of strength of business like cost involved in starting a business and minimum capital requirements in starting a business. The results remain robust to the inclusion of these alternate proxies. The coefficient on political stability is positive and significant for the specifications with bureaucratic quality, law and order, military in politics, corruption and close for internal conflict. The overidentifying restrictions are met for all the specifications. In terms of estimated impacts, they are similar to Table III. For example, a standard deviation rise in bureaucratic quality raises entry rate by 1.9 percentage points while a standard deviation rise in law and order raises entry rate by 1 percentage point.

While the focus of our analysis is the role of political institutions on entrepreneurial initiatives, literature has also stressed the role of economic institutions (Bjørnskov and Foss, 2008; Nystro¨m, 2008: Hall and Sobel, 2008). Accordingly, we control for economic freedom in our specifications. We present the results in Table V. We do not control for “starting a business” measure since the index of economic freedom incorporates that dimension. The coefficients of the different measures of political risk and their statistical significance are as expected – economic freedom has a positive impact on entry rate. We, however, lose statistical significance in the case of socioeconomic condition, internal conflict, and investment profile.

We consider, yet, another measure from the Doing Business database – the minimum capital requirement measured as a fraction of income per capita which they define as “the amount that the entrepreneur needs to deposit in a bank or with a notary before registration and up to 3 months following incorporation and is recorded as a percentage of the economy’s income per capita.” Thus, a high minimum capital requirement will act as a disincentive for entrepreneurs and will deter new business from entering the market. The coefficient of political stability is positive and significant for all measures except socioeconomic condition.

Finally, we also consider the cost of starting a business expressed as a percentage of an economy’s income per capita. This includes all “official fees and fees for legal or professional services if such services are required by law” (The World Bank, 2012). Similar to the minimum capital variable, higher cost will also discourage new firms from entering the market. Again, other than socioeconomic condition, the coefficient of political stability is positive and significant for all the other proxies.
We, further, test our results with a self-constructed index of political stability. By applying the method of principal components, we construct an index of political risk by considering the seven measures used in our benchmark specifications – bureaucratic quality, corruption, law and order, socioeconomic condition, internal conflict, military in politics, and investment profile. The results remain robust to the inclusion of these controls.

5. Conclusion
Entrepreneurship is critical to the process of economic growth and development. To prosper, countries must unleash the creative talents of their citizens through the decentralized process of formal private sector entrepreneurship. New legal businesses create jobs, opportunities, wealth, and goods and services that make a nation grow. Sadly in many nations, this process is stifled and poverty is the result. While previous research has examined which types of specific policies matter for promoting entrepreneurship, we consider the different question of how the stability of political institutions impacts the rate of entrepreneurship. There is good reason to believe that political risk and uncertainty can stifle the process of entrepreneurship as it interferes with transactions costs, contract enforcement, the security of property rights, and the protection of investors.

Using several different measures, differing controls, and dynamic panel estimators (System GMM estimators), we empirically examine the relationship between political stability and rates of entrepreneurial activity across countries. We find that greater political stability (or alternatively lower political risk/instability) enhances the entry

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>(1) Bureaucratic quality</th>
<th>(2) Corruption</th>
<th>(3) Military in politics</th>
<th>(4) Law and order</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lag entrepreneurship (1)</td>
<td>0.758***</td>
<td>0.891***</td>
<td>0.820***</td>
<td>0.913***</td>
</tr>
<tr>
<td>Lag entrepreneurship (2)</td>
<td>-0.393***</td>
<td>-0.325***</td>
<td>-0.363***</td>
<td>-0.348***</td>
</tr>
<tr>
<td>Political risk</td>
<td>3.693***</td>
<td>1.520***</td>
<td>1.556*</td>
<td>1.360**</td>
</tr>
<tr>
<td>GDP constant US $2,000 (in billions)</td>
<td>-0.004***</td>
<td>-0.0001</td>
<td>-0.002</td>
<td>-0.002</td>
</tr>
<tr>
<td>GDP growth (annual)</td>
<td>0.0300*</td>
<td>0.0331*</td>
<td>0.0326**</td>
<td>0.0417**</td>
</tr>
<tr>
<td>Economic freedom</td>
<td>1.131***</td>
<td>0.729</td>
<td>0.969*</td>
<td>0.679</td>
</tr>
<tr>
<td>Year dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Observations</td>
<td>310</td>
<td>310</td>
<td>310</td>
<td>310</td>
</tr>
<tr>
<td>Number of countries</td>
<td>85</td>
<td>85</td>
<td>85</td>
<td>85</td>
</tr>
<tr>
<td>Sargan test</td>
<td>0.58</td>
<td>0.20</td>
<td>0.54</td>
<td>0.35</td>
</tr>
<tr>
<td>Auto-correlation test</td>
<td>0.51</td>
<td>0.44</td>
<td>0.51</td>
<td>0.40</td>
</tr>
<tr>
<td>Number of instruments</td>
<td>19</td>
<td>19</td>
<td>19</td>
<td>21</td>
</tr>
</tbody>
</table>

Notes: Standard errors in parentheses. ***p < 0.01; **p < 0.05; *p < 0.1

Table V. System GMM specifications: impact on political risk on entrepreneurship – controlling for economic freedom
rate of firms and, thus, raises entrepreneurial activities for a nation. To promote growth and development, good policies are important, but stable policies and political climates are also a major contributing factor.

Notes
1. The idiosyncratic disturbances usually have country specific patterns of heteroskedasticity and serial correlation.
2. The $p$-value of internal conflict is 0.12.

References


Further reading


Appendix A

Appendix B: Description of political risk measures

- **Ethnic Tension** captures any unrest in a country attributable to racial, nationality, and language diversities. Higher scores denote better situation for all types of risk.

- **External Conflict** assesses the influence of foreign action on incumbent government. Higher value indicates lower risk.

- **Internal Conflict** is composed of threat of civil unrest, terrorism or political violence and occurrence of civil war.

- **Government Stability** assesses the government’s ability to stay in office and perform its declared duties.

- **Law and Order**, as the name suggests, consists of law and order separately. Higher values depicting “Low Risk.”

- **Military in Politics** measures the risk associated due to involvement of military in politics.

- **Religion in Politics** reflects dominance of the government by any particular religion and suppression of the others and has the potential to initiate civil strife.
• Socioeconomic Condition measures the socioeconomic pressures present in a society, like unemployment, poverty, and consumer confidence, that can lead to social dissatisfaction.

• Investment Profile is an assessment of the risks of investment like payment delays, expropriation, and profits repatriation, not covered by the other economic, political, and financial risk ratings published by ICRG.

• Corruption measures the extent of corruption in the political system of a country. Although the measures take into financial corruption in business, it considers all other kinds of corruption in the form of excessive patronage, nepotism, job reservations, and so on.

• Democratic Accountability is an assessment of government’s responsiveness to its masses. Based on ICRG definition “[…] on the basis that the less responsive it is, the more likely it is that the government will fall, peacefully in a democratic society, but possibly violently in a non-democratic one.”

• Bureaucratic Quality measures the institutional strength and quality of bureaucracy of a country.

Corresponding author
Nabamita Dutta can be contacted at: ndutta@uwlaus.edu