

# Do Financial Reforms Promote Entrepreneurship?\*

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## Abstract

This paper investigates whether financial reforms promote entrepreneurship. Using a panel of 41 developed and developing countries from around the world, we find that financial sector reforms are positively associated with early-stage entrepreneurial activity. In a variety of robustness checks, including a falsification test, we fail to find the evidence that this relationship is driven due to the omission of unobserved, country-specific factors. Investigating the relationship between reforms in different dimensions of the financial sector and entrepreneurship, we find reforms in directed credit, credit controls, banking supervision, and international capital flows dimensions to be significantly associated with early-stage entrepreneurial activity.

*JEL classification codes:* L26; M13; G20

*Keywords:* Entrepreneurship; Banks; Financial Sector Reforms; Liberalization; Financial Sector Regulation

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# 1 Introduction

This study investigates whether financial reforms promote entrepreneurship in a panel of 41 countries from around the world. Our hypothesis is that reforms in different dimensions of the financial sector will promote entrepreneurship by providing an improved access to funds required for starting a business. Hence, we focus on early-stage entrepreneurship with our primary independent variable being the percentage of the population aged 18–64 who are either a nascent entrepreneur or owner-manager of a new business. Our study advances the recent strand of literature documents a number of positive effects of financial sector reforms (liberalization) .<sup>1</sup> Consistent with our hypothesis, we document a positive and robust association between reforms in the financial sector and early-stage entrepreneurship. We also identify the dimensions of the financial sector, reforms in which are positively associated with early-stage entrepreneurship. We perform a number robustness checks, including a falsification test, that minimize the possibility that the relationship between financial reforms and entrepreneurship is spurious and is driven due to the omission of factors that might determine entrepreneurship in a country.

We utilize the financial liberalization index constructed by Abiad et al. (2010) that covers several dimensions of the financial system. Reforms in several of these dimensions are likely to promote entrepreneurship as discussed below. For instance, banking sector reforms that allow domestic and foreign banks to enter the market and open new branches will promote entrepreneurship in two ways. First, new bank branches in regions that had no banks, will allow prospective entrepreneurs to obtain funds required to start business. Second, a greater competition between these banks caused by such reforms will likely result in a lower cost of borrowing that will attract more entrepreneurs. Further, financial sector reforms can pro-

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<sup>1</sup> For instance, Tressel and Detragiache (2008) show that financial reforms and financial development are positively associated and Agnello et al. (2012) and Jha (2018; 2019) find financial reforms to be negatively associated with income inequality and corruption, respectively. And, financial liberalization has been shown to positively impact economic growth (Gamra, 2009) and output changes at firm-level (Boubakri et al., 2005).

mote entrepreneurship because it has been shown that they lead to financial development (Tressel and Detragiache, 2008) and financial development is positively associated with the entry of new firms and entrepreneurship (Guiso et al., 2004). Moreover, the privatization of banks, an important dimension of the financial sector, has been shown to increase lending (Berkowitz et al., 2014). Clearly, a greater availability of loanable funds will promote entrepreneurship. Next, since a well-developed securities market promotes savings and investment (Henry, 2000), financial sector reforms will encourage entrepreneurship because these savings can be used to support businesses. Finally, reforms easing excessive reserve requirements and providing greater autonomy to banks in regards to credit allocation decision is likely to promote entrepreneurship by making more funds available to be lent to prospective entrepreneurs.

## 2 Data and Empirical Specification

We employ the fixed effects estimator to estimate the following equation using a sample of 41 developed and developing countries<sup>2</sup>

$$\begin{aligned}
 Entrepreneurship_{it} = & \alpha_i + \beta Financial\ Reforms_{it} + \delta_1 \log(GDP\ PC_{it}) + \delta_2 Govt.\ Size_{it} \\
 & + \delta_3 Openness_{it} + \delta_4 Govt.\ Stability_{it} + \delta_5 Law\ and\ Order_{it} \\
 & + \delta_6 Judiciary\ Independence_{it} + \gamma_i + \phi_t + \varepsilon_{it}
 \end{aligned} \tag{1}$$

where  $i$  and  $t$  denote country and year respectively. The dependent variable,  $Entrepreneurship_{it}$ , is the percentage of population aged 18–64 who are either a nascent entrepreneur or owner-manager of a new business. Additionally, we use some other variable related to entrepreneurship in robustness checks, which are described later. The data for all the entrepreneurship variables come from the Global Entrepreneurship Monitor.<sup>3</sup> Following the literature (*e.g.*,

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<sup>2</sup>See footnote of Table 1.

<sup>3</sup><https://www.gemconsortium.org>.

Agnello et al., 2012 and Jha, 2018), country  $i$ 's financial reform in year  $t$  is the difference between its financial liberalization index in year  $t$  and year  $t - 1$ . Reforms in the different dimension of the financial sector are defined in the similar fashion. A greater score in each dimension indicates a greater liberalization and, hence, a greater difference between the indices of years  $t$  and  $t - 1$  implies a greater reform.  $\gamma_i$  and  $\phi_t$  are included in each specification to eliminate the possibility that results may be driven because of the omission of country- and/or year-specific fixed factors.

The financial liberalization index reflects the state of repression/liberalization of several dimensions of the financial sector in a country. A fully repressed financial sector scores a 0, while a score of 21 indicates a fully liberalized financial sector. The credit controls and reserve requirements reflect how restrictive the reserve requirements and banks' credit allocation decisions are. Countries with minimal reserve requirements (less than 10%) are considered liberalized and receive a score of 2, while countries with reserve requirements between 10–20% receive 1, and countries with higher than 20% reserve requirements are considered repressed with a score of 0. Many countries require banks to provide a minimum amount of lending to certain sectors (such as agriculture, small scale enterprises, and even to the government for financing budget deficits) at subsidized rates. Countries where such mandatory lending policies exist are considered repressed and receive a 0. In a country, where deposit and lending rates are determined by the market, and not controlled by the government, is considered liberalized in the interest rate control dimension. Scores in the banking supervision dimension are assigned on the basis of several factors including whether a country follows the Basel standard capital adequacy ratio and whether the banking supervisory agency is free from executives' influence. This dimension also accounts for the coverage of the banking supervisory agency and the on-site and off-site examinations conducted by the banking supervisory agency. The privatization sector is fully liberalized if “the percentage of public bank assets is less than 10 percent” and fully repressed if it is greater

than 50 percent. Finally, if there are no or minimal restrictions on capital inflow and outflow then the international capital flows dimension is considered to be liberalized. In addition, the index also takes into account the restrictions placed on the entry of domestic and foreign banks, regulation/deregulation of stock exchanges, pension funds, and portfolio investments as well as whether the equity market is open to foreign investors.

Data source for GDP per capita, openness, and government size is the World Development Indicators. We control for openness because there may be greater incentives to be an entrepreneur in more open countries. Several cultural and institutional factors have been identified to determine entrepreneurship across countries (Parker and Robson, 2004; Freytag and Thurik, 2007). Since we employ fixed effects estimator, the omission of cultural factors is not a concern because culture tends to be invariable in the short-run. Though institutions do not change drastically in the short-run, there may be considerable variations in institutional quality following a change in the political regime and government, hence, we control for a number of institutional variables. More specifically, entrepreneurship may be impacted by the government stability as well as the efficacy of ‘law and order’ and independence of the judicial system in a country. Hence, we control for the quality of ‘law and order’ and ‘government stability’ using the data from the International Country Risk Guide and for the ‘independence of the judiciary system’ using the data from CIRI Human Rights Project.<sup>4</sup>

Summary statistics are reported in Table 1. The sample consists of a good mix of financially repressed and liberalized countries as the minimum value of the index is 8.25 while the maximum value is 21 (the maximum possible score). For several countries, reform variable in one or more dimension of the financial sector assumes a negative value suggesting that a liberalization process has not been unidirectional.

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<sup>4</sup>Visit <http://www.humanrightsdata.com/p/data-documentation.html> for further details.

### 3 Results

Our main results are reported in Table 2. Financial reform is positively and significantly associated with the early-stage entrepreneurship in the first column. Moreover, directed credit, credit control, banking supervision, and international capital flows dimensions—all have positive and statistically significant coefficients indicating that reforms in these dimensions of the financial sector are positively associated with the early-stage entrepreneurship. On the other hand, the privatization of banking sector does not seem to matter for the early-stage entrepreneurship. Somewhat surprisingly, liberalization in interest rate control dimension is negatively correlated with the early-stage entrepreneurship. This may be because market determined lending rates may be too high for new entrepreneurs discouraging early-stage entrepreneurship in certain sectors.

It has been argued that financial liberalization may have asymmetric impact on countries depending on their development status. And, transition economies and Emerging Asian countries have received extra attention from economists in recent decades because of their high growth rates. Some studies, *e.g.*, Gamra (2009), have noted that financial liberalization has played an important role in the growth of the Emerging Asian economies. Hence, we investigate the robustness of our estimates by excluding the sub-samples of different countries. In addition to increasing the reliability of the estimates, this exercise also provides additional insights.<sup>5</sup> These results are reported in Table 3. The coefficient of financial reforms is highly significant in all the three columns suggesting that the positive relationship between the liberalization of the financial sector and early-stage entrepreneurship is not driven by the sub-sample of selected countries. Among the dimensions of the financial sector, reforms in the banking sector dimension is found to be most robustly correlated with entrepreneurship as its coefficients are significant in all the three columns at conventional levels. Additionally, while

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<sup>5</sup> We cannot investigate this relationship in sub-samples of these countries because the number of observations will be too small.

reforms in the directed credit sector are not significantly associated with entrepreneurship in non-transition economies (column 2), reforms in the international capital flows dimension are insignificantly associated with entrepreneurship for the sub-sample of developing economies (column 1). Note that, the countries included in the specifications reported in the first column are developing economies. The results reported in this column suggest that reforming the directed credit/reserve requirement dimension, reforming the banking supervision mechanism, and privatizing the banking sector are positively associated with entrepreneurship for developing economies.

Though our fixed-effects estimator eliminates the possibility that result may be biased because of the omission of country-specific unobserved time-invariant factors, the possibility of the omission of such time-variant factors cannot entirely be ruled out. We carry out a variety of robustness checks to minimize such possibilities.

## 4 Robustness Checks

First, we report the results of a falsification test that shows that financial reforms are not associated with entrepreneurial perceptions. The idea is that, if some unobserved, omitted country-specific factors cause a spurious relationship between financial reforms and early-stage entrepreneurship then reforms should also be significantly associated with perceptions associated with entrepreneurship in that country. However, we fail to find the evidence of such an association: Financial reform is shown to be not significantly associated with both the percentage of population aged 18–64 who agree with the statement that (1) successful entrepreneurs receive high status in their country in column 1 and, (2) most people consider starting a business as a desirable career choice in their country in column 2 of Table 4. Moreover, we find that financial reform remains a significant predictor of early-stage entrepreneurship in column 3 even after controlling for the proportions of the population

that agree with the statements that (1) successful entrepreneurs receive high status in their country and (2) most people consider starting a business as a desirable career choice in their country. Expectedly, the perception that entrepreneurship is a good career choice is positively associated with early entrepreneurship. On the other hand, high status factor does not seem to be related to early-stage entrepreneurship. Since these variables proxy for the individual characteristics and other factors that shape attitudes of individuals associated with entrepreneurship in a country (which may be time variant and unobserved), controlling for these variables further reduces the possibility of an omitted variable bias.

Could it be possible that our results are driven because of the omission of the “entrepreneurial intentions” of the residents of a country? If financial reforms are more likely to be adopted in countries where a greater percentage of the population have entrepreneurial intentions then the omission of the latter will cause our estimates to be biased. We show that this is not the case in column 4 of Table 4, where after controlling for the entrepreneurial intentions of the population aged 18–64, the relationship between financial reforms and early-stage entrepreneurship does not only remain statistically significant but becomes even stronger. Since individual characteristics are found to be important determinants of entrepreneurship, which cannot be controlled for in a cross-country setting, inclusion of this variable in the regression specification mitigates the concerns that this relationship is driven due to the omission of country-specific time-invariant individual characteristics associated with entrepreneurship. This argument is supported by a positive and significant association between this variable and early-stage entrepreneurship. Our final robustness exercise attempts to check the presence of reverse causality. Our reasoning is that if policymakers respond to entrepreneurial intentions of the residents of their country by liberalizing the financial sector, then if we regress the percentage of the population with entrepreneurial intentions on financial reforms, we should find a positive and statistically significant coefficient. However, we fail to find the evidence of such a connection as shown in the last column of

Table 4. In sum, the relationship between financial reforms and entrepreneurship are found to be very robust and unlikely to be driven due to the omission of unobserved factors.

## 5 Discussion and Conclusion

Entrepreneurship positively impacts economic growth and development (Carree and Thurik, 2010; Wennekers et al., 2005), making it important to understand what determines entrepreneurship. Several individual-level as well as country-level factors have been identified by previous studies to influence entrepreneurship (Blanchflower, 2000; Parker and Robson, 2004; see Freytag and Thurik, 2007 for a review). This paper contributes to this literature by documenting a significant relationship between financial reforms and entrepreneurship. The results of this study therefore indicate that policymakers should adopt reforms in the financial sector because they are likely to induce economic growth and development by promoting entrepreneurship. Note that reforms in directed credit and banking supervision dimensions are also found to be negatively associated with corruption (Jha, 2018) and reforms in directed credit dimension are shown to be negatively associated with income inequality (Agnello et al., 2015). All these three dimensions are shown to be positively associated with entrepreneurship in this study. Additionally, the results indicate that developing economies may benefit greatly from the privatization of banks as far as entrepreneurship is concerned. Since liberalization is a gradual process for several reasons including the push-back from economic and political interest groups (Abiad and Mody, 2005), the results of this study in conjunction with the findings of other studies on this topic suggest that while adopting reforms, policymakers may want to prioritize certain sectors over others.

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Table 1: Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
<i>Entrepreneurship variables</i>					
Early-stage entrepreneurial activity	147	8.862	6.144	1.480	40.270
Entrepreneurial intentions	120	12.650	11.164	0.750	48.250
High Status to Successful Entrepreneurs	89	67.532	10.234	34.470	87.050
Entrepreneurship as a Good Career Choice	89	61.648	13.970	28.040	91.270
<i>Financial reforms variables</i>					
Financial liberalization index	147	18.701	2.818	8.25	21.00
Financial reforms	147	0.058	0.385	-2.00	2.00
Directed credit	147	0.007	0.143	-1.00	1.00
Credit control	147	0.003	0.121	-1.00	0.75
Interest rate control	147	0.007	0.082	0.00	1.00
Banking supervision	147	0.048	0.244	0.00	2.00
Privatization	147	0.020	0.142	0.00	1.00
International capital flows	147	-0.020	0.184	-2.00	0.00
<i>Control variables</i>					
GDP per capita	147	23800.23	11444.09	801.44	47626.28
Government size	147	18.46	4.48	9.96	28.59
Openness	147	39.31	32.21	9.81	200.27
Government Stability	147	8.93	1.28	5.33	11.42
Law and Order	147	4.752	1.327	1.00	6.00
Judiciary Independence	147	1.741	0.511	0.00	2.00

GDP per capita is adjusted for the purchasing power parity and is measured in international dollars. Openness is measured as the share of imports of goods and service in total GDP. Government size is measured as the government final consumption expenditure as percentage of GDP. Government Stability takes values between 0 and 12 with higher number indicating greater stability. Law and Order can range from 0 to 6 (very strong legal system). Judiciary Independence takes values 0 (not independent), 1 (partially independent), and 2 (generally independent). The analysis in this study includes all the countries for which the required data are available: Argentina, Australia, Austria, Belgium, Brazil, Britain, Canada, Chile, China, Denmark, Ecuador, Finland, France, Germany, Greece, Hungary, India, Ireland, Israel, Italy, Jamaica, Japan, Jordan, Latvia, Mexico, Netherlands, New Zealand, Norway, Peru, Poland, Portugal, Russia, Singapore, South Africa, Spain, Sweden, Switzerland, Thailand, Uganda, United States, and Venezuela.

Table 2: Financial Reforms and Early Stage Entrepreneurship

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Financial Reform	1.389*** (0.462)						
Directed credit		2.329* (1.209)					
Credit controls			2.922* (1.502)				
Interest rate controls				-1.871** (0.783)			
Banking supervision					2.460** (1.022)		
Privatization						0.703 (0.793)	
International capital flows							1.953** (0.795)
Income	-2.623 (5.324)	-3.416 (4.468)	-3.189 (4.515)	-6.442 (4.806)	-5.967 (5.179)	-4.943 (4.953)	-3.901 (4.944)
Government size	-0.0840 (0.392)	-0.212 (0.404)	-0.173 (0.409)	-0.415 (0.430)	-0.304 (0.410)	-0.438 (0.429)	-0.175 (0.436)
Openness	0.108** (0.0531)	0.0754 (0.0559)	0.0766 (0.0555)	0.0787 (0.0619)	0.115* (0.0577)	0.0796 (0.0612)	0.100 (0.0636)
Government stability	-0.229 (0.260)	-0.234 (0.287)	-0.238 (0.286)	-0.267 (0.291)	-0.261 (0.257)	-0.259 (0.292)	-0.287 (0.287)
Law & Order	-0.336 (0.763)	-0.595 (0.913)	-0.551 (0.913)	-0.755 (0.958)	-0.414 (0.784)	-0.755 (0.951)	-0.578 (0.930)
Judiciary independence	-0.754 (1.232)	-0.329 (1.218)	-0.287 (1.216)	-0.434 (1.247)	-0.545 (0.978)	-0.721 (1.355)	-0.522 (1.167)
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	147	147	147	147	147	147	147
Country	41	41	41	41	41	41	41
Adjusted $R^2$	0.263	0.207	0.209	0.184	0.272	0.181	0.201

Fixed effects estimator. Standard errors clustered at country-level in parentheses. \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ . Constant not reported.

Table 3: Financial Reforms and Entrepreneurship: Robustness Excluding Sub-Samples

Excluding →	Developed	Transition	Emerging
	Economies	Economies	Asia
	(1)	(2)	(3)
Financial Reform	1.751** (2.27)	1.254*** (2.86)	1.551*** (2.90)
Directed credit	4.910* (1.82)	1.537 (1.31)	2.308* (1.82)
Credit Controls	5.152 (1.37)	2.056 (1.41)	2.980* (1.90)
Interest rate controls	-2.528 (-1.32)	-1.944** (-2.57)	Omitted#
Banking supervision	2.783** (2.29)	2.452** (2.46)	2.443** (2.49)
Privatization	5.961*** (2.93)	-0.339 (-0.59)	1.000 (1.11)
International capital flows	1.261 (0.73)	2.028** (2.42)	2.101** (2.58)
Observations	50	138	135
Countries	15	37	37

Fixed effects estimator. Standard errors clustered at country-level in parentheses. \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ . # Interest rate control variable dropped in this specification because of multicollinearity. Each cell reports the coefficient of the variable in the first column from a separate regression specification that excludes the countries indicated in the top row. All the specifications include baseline control variables: GDP per capita, Government Size, Openness, Government Stability, Law & Order, and Judiciary Independence. Number of observations and countries at the bottom of each column refers to all the specifications reported in that column. Constant not reported.

Table 4: Robustness: Financial Reforms and Entrepreneurship

	<b>Dependent Variable:</b>				
	Entrepre- neurs high status	Entrepre- neurship Good Choice	Early Stage Entrepreneurship	Early Stage Entrepreneurship	Financial Reforms
	(1)	(2)	(3)	(4)	(5)
Financial Reform	-2.646 (1.667)	-1.429 (2.679)	0.793* (0.407)	0.919** (0.350)	
Entrepreneurial intentions				0.154*** (0.0259)	0.00127 (0.00750)
Entrepreneurs high status			-0.102 (0.0615)	-0.0529 (0.0540)	
Entrepreneurship good choice			0.149** (0.0603)	0.0943* (0.0474)	
Income	-35.96 (27.25)	19.65 (26.91)	-14.80 (9.646)	-16.09** (6.222)	-1.216 (1.437)
Government Size	-2.215 (1.409)	-1.626 (1.774)	-0.568 (0.626)	-0.617 (0.557)	-0.187 (0.191)
Openness	-0.596** (0.253)	-0.506 (0.356)	0.120* (0.0707)	-0.000889 (0.0929)	-0.0257 (0.0237)
Government Stability	0.376 (1.553)	0.246 (1.720)	-0.910** (0.444)	-0.594 (0.393)	-0.0546 (0.0695)
Law & Order	0.160 (3.674)	-2.212 (4.337)	0.103 (0.902)	-0.227 (0.700)	-0.226 (0.166)
Judiciary Independence	11.05*** (3.218)	2.312 (3.565)	0.523 (1.471)	1.005 (0.985)	0.273** (0.126)
Year dummies	Yes	Yes	Yes	Yes	Yes
Observations	89	89	89	89	120
Country	39	39	39	39	41
Adjusted $R^2$	0.187	0.051	0.333	0.450	0.051

Fixed effects estimator. Standard errors clustered at country-level in parentheses. \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ . Constant not reported.