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# Does religion affect capital structure?☆



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### ARTICLE INFO

#### Article history:

Received 1 December 2011

Received in revised form 10 April 2012

Accepted 6 June 2013

Available online 21 September 2013

#### JEL classification:

G32

M14

#### Keywords:

Capital structure

Culture

Religion

Behavioral finance

Debt

Equity

### ABSTRACT

We hypothesize that if the cultural characteristics of a region are important, then firms located in Protestant- and Catholic-majority counties within the U.S. will have different attitude toward leverage. We find that a 1% increase in a county's Protestant religiosity leads to a 0.4% lower leverage and less frequent debt issuances. This religiosity also has significant effect on the firms' adjustment speeds toward the target capital structure. Using a sample of international firms, we find that these differences in leverage in the U.S. are similar to the behavior of firms in Catholic and Protestant countries outside of the U.S.

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## 1. Introduction

The differences in the financing decisions of the firms in Catholic and Protestant countries have been documented in La Porta et al. (1999) and a number of other studies. They find that countries with bank-based systems are likely to correspond to more robust debt markets, and that these countries tend to be more Catholic than Protestant. However, these Catholic countries also tend to have weaker shareholder protections, less developed capital markets, lower economic development, and a Civil legal system.

☆ We thank seminar audiences at Suffolk University, the University of St. Thomas, the FMA, and the EFA meetings for helpful comments. All errors are our own.

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In fact, in many cases, there is almost a one-to-one correspondence. As a result, the presence of these additional factors makes it impossible to properly study whether there is a link between religion and debt using cross-country data. To avoid the impact of these factors, we empirically test this relationship by focusing on the different religious environments within a single country, the U.S.

While the U.S. is a Protestant-majority country, it was settled by immigrants and has a robust representation of different religious communities clustered in various areas. Furthermore, this country is based on a Common law system and considered to be one of the most developed market-based economies. Regardless of the location of the firms within the U.S., they all have access to similar financial and legal institutions.<sup>1</sup> These firms also adhere to some common standards and rules written and enforced by the federal government. As a result, it would be easier for us to control for the confounding factors common in international studies and observe if there are any significant differences in the behavior of the firms on the basis of the religious characteristics of the regions where they are situated.

To identify the proxies for the religiosity of the regions of the firms, we follow the empirical corporate finance literature. A number of studies, including Hilary and Hui (2009), Kuhnén and Niessen (2009), and Kumar et al. (2011), use the religiosity of the firm's location to study the decisions of the firm. Similar to Kumar et al. (2011), we disaggregate this variable and use the denominational data to identify Catholic and Protestant religiosity. We find that when Protestant religiosity of counties increases, the level of leverage for firms located in these counties declines. To control for various characteristics of the firms, we use propensity-score based matching in our regression models. This means that we compare firms belonging to two different religious environments, but they are from the same industry,<sup>2</sup> with similar size, and operate in the same year. The results are robust to controls for various issues that differentiate the regions. It is interesting to note that unlike the Catholic countries of the world, the Catholic-majority counties within the U.S. are more economically developed. Yet the firms in these regions show similar preference for debt-financing. This implies that financial development may not be the sole driver behind this choice of debt over equity.

We also find that there are significant differences in the characteristics of these debt financings. We find that an increase in the Protestant religiosity of the county where the firm is located is associated with less frequent issuance of debt. Furthermore, firms located in Protestant counties adjust toward the target leverage at a faster speed if the firm's leverage is higher than its target leverage. In contrast, firms located in Catholic counties adjust their capital structures at a faster pace if the firm's leverage ratio is lower than the target.

This study has implications beyond the determinants of capital structures of firms. It is usually taken that countries can develop by introducing structural reforms to their institutions. However, this paper highlights some of the shortcoming of this approach as structural reforms may ignore the importance of culture. Specifically, we find that a firm can persistently maintain a level of leverage different from the optimum if it is influenced by a less debt-dependent culture. Our intention is not to claim that legal and institutional factor are inconsequential, but that incorporating the effects of cultural can help us develop a better understanding of some of the puzzles observed in the literature.

The rest of the study is structured as follows: Section 2 develops the hypothesis. Section 3 constructs the variables from the various data sources. Section 4 tests the hypotheses linking capital structure to religion. Section 5 discusses the implications of the findings. This study concludes in Section 6.

## 2. Related literature and hypotheses development

In this section, we hypothesize the theoretical links between debt and the two major Christian denominations. We provide a short summary of some of the important historical forces that have generated different preferences for financing methods among Catholics and Protestants and thus, present a connection between capital structure of firms and the religious characteristics of the region.

<sup>1</sup> While there are some differences in State laws, there are instances where both Catholic and Protestant counties exist within the same State. Our results hold even when we compare the firms with the Catholic and the Protestant counties within the same State.

<sup>2</sup> We define industry using Fama-French 48 industry classification scheme.

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