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Culture and externally financed firm growth

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ABSTRACT

In this paper, we provide the first firm-level evidence on the importance of culture, and its interdependence with legal (formal) institutions in affecting firms' use of external financing to fund growth. We conjecture that culture, after controlling for its macro-economic impact through political and legal institutions, has a direct micro-economic effect on firm-level growth. Using an international sample of 42,341 firms from 56 countries over the period 1989 to 2012, we find support for our hypothesis that cultural dimensions of individualism, masculinity, uncertainty avoidance and power distance affect firm's ability to overcome financial constraints, with individualism exhibiting a strong robust impact compared to the other dimensions. We further find that the link between individualism and growth is stronger in countries with low access to finance, suggesting that firms' ability to overcome financial constraints is more affected by individualism when access to finance is lower.

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1. Introduction

Because firm growth is considered to be the driver of industry-wide and overall economic growth, its dynamics has been at the core of economic policies around the world. To foster firm growth, it is now established that access to finance through well-functioning capital markets is a necessary pre-requisite. This has conditioned the design of many financial development policies across a wide set of countries aimed at fostering financial markets and banking sectors' growth to provide the vital sources of external financing needed by corporations to finance their investments (Rajan and Zingales, 1998; Levine, 2005). Formal institutions embedded in the legal environment and framework also condition financial constraints and hence firm growth as the “Law and Finance” view holds, and across-country differences in firm-growth are shown to depend indeed on the quality of these institutions (Demirgüç-Kunt and Maksimovic, 1998, 2002). However, even after taking into account the impact of access to finance and legal institutions, a full understanding of the dynamics of firm growth is yet to be achieved, since several questions remain unanswered. For instance, do informal institutions, namely culture, play a role in firms' externally financed growth? If so, how do formal and informal institutions interplay in affecting firm growth?

In this paper, we contribute to the debate on what determines firms' growth by providing the first firm-level evidence on the importance of culture, and its interdependence with legal institutions in determining firms' ability to exploit growth options through long-term financing. Specifically, we test whether culture, after controlling for its impact through political and legal institutions, has a direct effect on externally financed firm growth. To conduct our analysis, we adopt Demirgüç-Kunt and Maksimovic (1998, 2002) planning model framework that identifies firms that need external financing to fulfill their ability to

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exploit growth options. Our firm-level approach linking culture and firm growth complements country-level evidence on the importance of culture to long-term economic growth (Gorodnichenko and Roland, 2011), and to financial systems (Kwok and Tadesse, 2006).

North (1990) distinguishes formal institutions (which correspond to political, legal and regulating structures) from informal institutions, which he defines as follows: "They (the informal institutions) come from socially transmitted information and are part of the heritage that we call culture." It is these informal institutions (through values and preferences) that shape individuals' perceptions and incentives (Tabellini, 2010). Li and Zahra (2012) also clearly define formal institutions as a set of political economic and contractual rules that regulate individual behavior, while culture refers to the set of attitudes and beliefs prevalent among individuals in a society. These perceptions embedded in national culture are found in the literature to determine economic choices and individuals' behavior (e.g., Guiso et al., 2006; Chui et al., 2010). For instance, at the *macro level*, national culture has been linked with creditor rights and investor protection (Stulz and Williamson, 2003), financial development and financial structure (Levine, 2005; King and Levine, 1993; Kwok and Tadesse, 2006). Research has further established that national culture has an impact on various corporate policies and management practices at the *firm level*, including disclosure policies (Hope, 2003), corporate governance (Doidge et al., 2007), composition and structure of boards of directors (Li and Harrison, 2008), risk-taking and innovation (Li et al., 2013), capital structure decisions (Chui et al., 2002; Li et al., 2011), and dividend policy (Shao et al., 2010).

Our interest in revisiting the determinants of externally financed firm growth is grounded in the following observations: (1) to maintain their competitiveness, firms continually strive to identify new opportunities that generate revenue streams. In an increasingly more globalized environment, this task has become more challenging, thus making understanding the determinants of growth a timely issue. (2) This is also a crucial question because it "[c]an provide insights into the dynamics of the competitive process, strategic behavior, the evolution of market structure, and even the growth of the aggregate economy" (Carpenter and Petersen, 2002: 298). (3) Understanding the determinants of externally financed firm growth is important to policy-makers who seek to establish customized development strategies to encourage access to finance, risk-taking, entrepreneurship, and innovation. (4) Finally, examining externally financed growth at the corporate level can offer insights into how financial systems affect long-term investment and hence promote economic growth at the macro level (Aghion et al., 2010).

In our investigation, we posit that culture affects the extent to which firms are able to overcome their financial constraints and differentiate between micro-level and macro-level transmission mechanisms running from culture to externally financed firm growth. Specifically, we argue that culture affects corporate growth through its effect on individual decision-making at the firm-level (e.g., incentives, attitude, risk-taking…), in addition to its effect on the country's formal institutions, such as investor protection, rule of law, and financial structure.

The indirect channel of influence running from culture to externally financed firm growth is at the *macro level*. Indeed, culture can indirectly affect firm growth through its impact on formal institutions and financial development (both of which condition the firms' access to finance). Previous studies show that culture is linked to the level of institutional development, specifically with creditor rights, investor protection, and judicial efficiency (Stulz and Williamson, 2003; Radebaugh et al., 2006). For instance, Licht et al. (2007, p. 661) find that the rule of law, corruption, and democratic accountability are related to "a cultural dimension addressing the place of individuals in the group." Using religion as a proxy for culture, Stulz and Williamson (2003) also show that cross-country variation in creditor rights, and investor protection are strongly related to the country's culture. Likewise, culture seems to explain cross-country variations in financial systems as demonstrated by Kwok and Tadesse (2006) who find that countries with higher uncertainty-avoidance (one cultural dimension) are dominated by bank-based financial systems, rather than by stock-markets. Individualism, another cultural dimension, is also associated to market-based systems that provide financing to innovative and growing firms. Lee and Peterson (2000) show in this regard that countries that emphasize individualism are characterized by a strong entrepreneurial orientation, more entrepreneurship, and enhanced global competitiveness. Collectively, these arguments suggest that, since (i) firm growth and their ability to overcome financial constraints is conditioned by the quality of institutions in the country and by access to finance (Demirgüç-Kunt and Maksimovic, 1998, 2002), and given that (ii) culture affects both of these formal institutions (e.g., Licht et al., 2005, 2007; Kwok and Tadesse, 2006), then culture will affect firms' externally financed growth through these channels.

The second channel of influence of culture on firm externally financed growth materializes at the *micro level*, by shaping expectations and preferences, that affect managerial decisions through the choices on scarce resources' allocation. Several studies show how national culture influences capital providers and their representatives (such as corporate boards) (Griffen et al., 2014). For instance, Hope (2003) finds that national culture, specifically uncertainty avoidance, is (positively) related to firm-level disclosure policies, and forecasts' accuracy. Corporate governance and the composition of boards of directors are also found to be associated to culture values (Doidge et al., 2007; Li and Harrison, 2008). In this vein, Li and Harrison (2008) show that individualism, uncertainty avoidance, and power distance are positively related to the percentage of outsiders on the board of directors, and CEO duality. Li et al. (2013) also document an association between risk-taking and culture dimensions, and establish that firms in societies with lower uncertainty avoidance, and higher individualism scores tend to be characterized by more risk-taking.[1] In sum, we posit here that culture will affect firms' externally financed growth because the effective internal

[1] By risk-taking and following this literature (Boubakri et al., 2013a, 2013b), we mean the managerial risk choices in corporate investments or what John et al. (2008) refer to as the "managers' choices of investment risks," that have positive implications for firm growth, performance, and survival (Bromiley, 1991; Shapira, 1995). That is to say, our interest is on the "good quality" risk-taking, rather than neutral risk-taking. We thank the reviewer for suggesting this clarification.

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