J. of Multi. Fin. Manag. xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

Journal of Multinational Financial Management

journal homepage: www.elsevier.com/locate/econbase

How does the tax status of the country impact capital structure? Evidence from the GCC region

Akram Temimi*, Rami Zeitun, Karim Mimouni

Department of Finance and Economics, College of Business and Economics, Qatar University, P.O. Box 2713, Doha, Qatar

ARTICLE INFO

Article history:
Received 18 November 2015
Received in revised form 15 August 2016
Accepted 17 August 2016
Available online xxx

JEL classification:
G3
G32
H2
D8

Keywords:
Dynamic capital structure
Taxes
Agency costs
Debt conservatism puzzle

ABSTRACT

We investigate whether the tax status of a country has an impact on the corporate capital structure. This research question is important and timely given that the empirical literature has not reached a consensus on the effect of taxes on corporate leverage. The Gulf Cooperation Council region, which is characterized by a unique fiscal environment, provides a natural laboratory for the analysis. We find that taxes have a direct and indirect effects on leverage. The presence of taxes strengthens the effect of tangibility and GDP growth on leverage while it weakens the effect of profitability and liquidity. The relationships between firms' growth opportunities and leverage, size and leverage do not seem to be affected by taxes. We also show that the effect of taxes is different by industry. Accordingly, controlling for the tax status of the country is important in some industries and irrelevant in others.

© 2016 Published by Elsevier B.V.

1. Introduction

A central decision that firms face is how to finance their capital. Is there an optimal mix between debt and equity that firms converge to? What are the main factors that affect this decision? Despite the rich literature on capital structure starting with the seminal work of Modigliani and Miller (1958), there is no unifying theory that offers satisfactory answers to these questions and that provides a definitive list of the determinants of capital structure. The existing theories focus on different aspects of the benefits and costs of debt and equity; and hence lead to different predictions on the main determinants of the capital structures of firms and on the direction of the relationship between the capital structure and its determinants (Öztekin, 2015; Graham et al., 2014; Graham and Leary, 2011; Frank and Goyal, 2008; Shyam-Sunder and Myers, 1999).

While the trade-off theory focuses on the role of taxes, bankruptcy costs and agency costs, the pecking order theory highlights the role of asymmetric information. In environments where taxes and agency costs are not important but where asymmetric information is severe, the pecking order theory may offer better predictions. At the other end, if taxes and agency costs are important while asymmetric information is not, the trade-off theory may offer better results. However, in most environments, all of these dimensions may be significant and interact in complex ways. While the costs of financial distress and agency costs between shareholders and debtholders lead firms to choose less debt, tax considerations, asymmetric information and the agency costs between managers and shareholders lead firms to have more debt. Hence, it is difficult

* Corresponding author.
E-mail addresses: atemimi@qu.edu.edu (A. Temimi), rami.zeitun@qu.edu.qa (R. Zeitun), kmimouni@qu.edu.qa (K. Mimouni).

http://dx.doi.org/10.1016/j.mulfin.2016.08.002
1042-444X/© 2016 Published by Elsevier B.V.

to isolate the effect of the different factors and to identify the critical factors that affect the capital structure of firms. In particular, the effect of taxes, one of the main leverage factors, has been difficult to establish in the large existing literature (Frank and Goyal, 2008; Graham, 2008, 2000; Hennessy and Whited, 2005; Shyam-Sunder and Myers, 1999). Myers stated in his 1984 presidential address: "I know of no study clearly demonstrating that a firm's tax status has predictable, material effects on its debt policy."

Specifically, the presence of omitted variables in the cross-country studies, the difficulty to deduce marginal tax rates from the data, and the lack of significant variability in tax incentives has made the measurement of tax effects on leverage particularly challenging (Öztekin, 2015; Panier et al., 2013; Barakat and Rao, 2012; Frank and Goyal, 2009; Graham, 2000).

An emerging literature shows that taxes have a significant effect on leverage (Faccio and Xu, 2015; Dwenger and Steiner, 2014; Panier et al., 2013; Feld et al., 2013; Fan et al., 2012; An, 2012; Heider and Ljungqvist, 2012). This paper contributes to this literature by exploring the capital structure of firms in the Gulf Cooperation Council countries (GCC), a region characterized by a unique fiscal environment. Except for Oman that imposes taxes on corporate profits, taxes are practically non-existent in the other GCC countries. Within this framework, we first investigate how the presence of taxes in Oman affects the capital structure of firms compared to the rest of the GCC countries.

To further study the impact of the tax status of the country, we then extend the analysis by including Malaysia and Thailand and divide the new overall sample in two groups. The first group which imposes corporate taxes includes Thailand, Malaysia and Oman. The second group composed of five countries, namely Bahrain, Kuwait, Qatar, Saudi Arabia, and UAE, is characterized by very low taxes (Belkhir et al., 2016; Sbeiti, 2010).[1]

Given that the use of leverage and the characteristics of firms are different across industries, we investigate if the country's tax status has a similar impact in different sectors of the economy. It is well documented that the firm specific factors like size, tangibility, profitability, and liquidity impact leverage ratios. Depending on the level of corporate tax rates, hence the tax status of the country, the impact of these factors on leverage may vary substantially. If we add to this that the magnitude of the firm specific factors vary largely across industries, the nature of the interaction between the tax status and the capital structure determinants becomes more complex. This paper attempts to unveil and understand these relationships by answering the following questions. Does the tax status of a country matter in determining the leverage ratios? Is the effect of taxes different by industry depending on the tax status of a country? Which capital structure determinants are impacted by the presence of corporate taxes?

Identifying the effect of taxes on leverage is very timely and has important policy implications especially in the wake of the recent financial crisis. If tax effects are significant, then the favorable tax treatment of debt may have contributed to the recent financial crisis by inducing firms to take on excess leverage in which case the recent calls (Admati, 2014; Mirrlees et al., 2012; Admati et al., 2012) for fiscal reforms to align the tax treatment of debt and equity would be an appropriate response. If taxes have second order effects, then fiscal reforms to remove the structural bias towards leverage would not be impactful.[2]

As the benefits and costs of debt depend on the characteristics of the firms, the macro, and institutional environment, the large empirical literature (Ebrahim et al., 2014; Fan et al., 2012; Antoniou et al., 2008; Deesomsak et al., 2004; Booth et al., 2001; Rajan and Zingales, 1995; among many others) has investigated a myriad of factors including firm-specific, macroeconomic, and stock market factors, that may affect the capital structure of firms. The existing research has shown that while some of the factors are consistently important, others are insignificant. In this paper, we investigate whether the various factors that have proven to be important in different regions of the world play the same role in tax-paying versus tax-free countries.

As the relationship between leverage and its determinants evolves over time, we use a target adjustment model to analyze how firms respond to changing market conditions. More specifically, we investigate if firms have a target leverage and the speed with which they adjust to their optimal leverage. To estimate our dynamic panel model, we use a System Generalized Method of Moments estimator.

This paper conveys several novel results. First, we find that the firm-specific factors that were consistently significant in the empirical literature are also important in the GCC countries. More specifically, we find that leverage is negatively related to tangibility, profits, and liquidity but positively correlated with size and firms' growth.

Second, when we control for Oman's tax status via a tax (country) dummy, our results show that one cannot use the capital structure coefficients from the pooled regression to predict the level of leverage in Oman, the only country that imposes corporate taxes in the GCC region. Doing so would underestimate the leverage ratios (in all models) by 8–11%. This result suggests that the effect of taxes on the corporate capital structure is significant. Thus, failing to control for the country tax status may result in a biased estimation.

Third, we investigate if the findings of the paper hold in a more general environment and explore whether the results found for the GCC countries help us understand the capital structure determinants in other tax-paying countries. We therefore expand the analysis to other non-GCC countries and include Malaysia and Thailand in our sample. Using this larger sample,

[1] Except for Oman where the corporate tax rate is 12 percent, the other GCC countries either impose virtually no taxes or low taxes on foreign investors. See Belkhir et al. (2016) for more details.

[2] Panier et al. (2013) investigate the effect of a Notional Interest Deduction introduced in Belgium in 2006 on leverage. They show that this equity subsidy has resulted in a significant increase in equity.

Download English Version:

https://daneshyari.com/en/article/5101605

Download Persian Version:

https://daneshyari.com/article/5101605

Daneshyari.com