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Culture, agency costs, and governance: International evidence on capital structure

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ABSTRACT

We examine social characteristics (individualism and risk aversion) and their interaction with firm governance and capital structure across the G20 countries from 1995 to 2009 using roughly 13,000 firms. We show that higher levels of individualism are associated with increased firm use of debt and lower cost of capital, whereas higher risk aversion has the opposite effects. Better firm-level governance substantially reduces these cultural effects, as does larger firm size, and less research-intensity at the firm. The results show that capital structure in emerging markets is considerably less affected by national culture relative to developed countries. To address endogeneity concerns, we show our results hold after using a propensity score matching procedure.

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1. Introduction

How do national culture and firm governance interact to influence capital structure in firms as well as across markets with different levels of economic development? Past research (e.g., Chuluun et al. (2014), Chang et al. (2012), and Kim and Nofsinger (2008)) has suggested that behavioral and cultural factors can influence equity valuation and managerial decisions, but to date, we still have a limited understanding of the role that governance and national economic development play in conjunction with behavioral forces.[2] Greater understanding in this area is important given the on-going study of how firms set their capital structure and the evidence that firms in emerging markets and developed markets exhibit important differences in their

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[2] For example, Benson et al. (2011) show that good governance may reduce the ill effect of agency costs and can thus lead to shareholder value maximization. In our paper, we examine governance and agency costs, as well as the impact of cultural and social traits on a firm's capital structure.

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capital structure choices (see DeAngelo et al. (2010), Fama and French (2005), and Baker and Wurgler (2002)).[3]

Chui et al. (2010) hypothesize that increased levels of national individualism impact equity market trading decisions. They find that higher levels of individualism are correlated with increased confidence by individuals in their own trading ability and that this increased confidence leads to increased stock price momentum. Chui et al. (2002) use static national-level time-invariant data on culture (mastery and conservatism) and find that national culture impacts managers' decisions on the use of leverage. Our work builds upon these findings by showing how national time-varying culture interacts with firm governance, the level of economic development, and capital structure.[4]

Capital structure choice is important in the US, but it is even more important internationally, where many equity markets are less developed (the Bank of International Settlements estimates that the worldwide debt outstanding is $100 trillion as of mid-2013). Gozzi et al. (2012) show that even for large international firms, which have the capacity to access both domestic and international debt markets, domestic and foreign bond markets are complements rather than substitutes. Thus, the international differences in culture we identify are important because they have economic significance for firms that issue debt. Our results demonstrate that firm governance and national culture impact capital structure choices and that there is a markedly different impact in emerging versus developed nations.

Specifically, our research (to the authors' knowledge) is the first to show 1) that firm- and national-level governance offsets time-varying cultural effects on capital structure; 2) that governance and culture interact to jointly impact the likelihood of using debt, debt-to-equity ratios, and the debt cost of capital in both emerging and developed nations; and 3) that culture appears to be a more significant driver of capital structure choices in developed markets than in emerging markets. We focus on two major cultural characteristics, individualism and risk aversion, that define a society's behavior related to the measures proposed by noted sociologist Gert Hofstede (2001). We construct time-varying proxy indices for these cultural norms using data from the World Values Survey (WVS).[5]

In this paper, we find that culture has a significant impact on capital structure, particularly in developed nations. We also find that better firm governance largely offsets this relation. We first examine the relation of culture and governance on the likelihood of using debt. We conclude that the probability a firm uses debt increases when individualism is higher. On average, a 1% increase in the Individualism Index (our measure of individualism) increases the probability of using debt by an average of 1.6% Alternatively, increases in the Risk Aversion Index negatively impact the probability of using debt (a 1% increase leads to an average 1.9% decrease in the probability of using debt). Firms in the top quartile (well governed) of firm-level governance are only 0.6% more likely to use debt given a 1% increase in individualism, and 0.7% less likely to use debt given a 1% increase in risk aversion. This is consistent with those firms with significantly better governance offsetting more than 50% of the influence of culture on management decisions. Further, we find that firms in emerging countries are an average of 13% less likely to use debt than comparable firms in developed countries, a result that we attribute to the differences in capital market development between emerging and developed nations.

Second, we examine the impact of culture on the debt-to-equity ratio of the firm. We find that increases in the Individualism Index are associated with increases in the leverage of the firm, while increases in the Risk Aversion Index have a significant negative association with leverage. This result only holds in developed markets, which may be a result of firms in emerging markets facing other constraints, such as limited access to capital. This is consistent with the work of Demirgüç-Kunt and Levine (1996), who show that firms in nations with more-developed stock markets make greater use

[3] Differences in emerging and developed market capital structure are noted by Desai et al. (2004), who show that multinational firms in less-developed countries use less debt and pay more for that debt.

[4] These topics are increasingly important, as noted by the September 2012 UK Stewardship Code submitted by the Financial Reporting Council. It states that investors should “include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration.” The report can be found here: https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx. It is important to note that the code focuses on mechanisms that increase long-term risk-adjusted earnings to shareholders.

[5] Our results are quantitatively similar when using the Hofstede measures (including authoritarian control), but without the time-series component, as his measures are static measures in 2001 and 2010.

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