

Chapter 4

Rule of Law, International Trade, and Corporate Financing Decisions in Europe: Evidence From the COVID–19 Pandemic

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ABSTRACT

This chapter investigates whether the institutional environment that the firms operate has an impact on their leverage choice. Namely, rule of law is used as an institutional variable. Considering that better implementation of rule of law impacts positively firms' export performance, total exports in each country are also used as the other main explanatory variable. The findings show that both institutional variables and exports negatively and significantly affect the leverage level. This implies that firms in favorable institutional environment tend to borrow less, which results with lower leverage. Moreover, this study finds that the COVID-19 pandemic period as an unprecedented shock to economies pushed the leverage levels higher. Regarding the implications of the findings, firms' capacity to access external finance especially during a significant crisis period depends on the institutional environment. Namely, the effective implementation of rule of law should be first priority for the policy makers.

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INTRODUCTION

Corporate finance has focused on the effects of imperfections on capital structure considering the “idealistic” assumptions of Modigliani and Miller (1958). One of the deviations from the ideal Modigliani-Miller world is the existence of agency conflicts between the shareholders and managers (Jensen, 1986). Firms may have different strategies to overcome agency problems. Besides, the institutional environment that the firms operate may affect firms’ agency costs. Thus, the strength of legal environment and institutional quality, as a tool to minimize agency problems, impacts the leverage choice of the firms. The institutional literature confirms the positive effect of high-quality institutions on increasing firm performance and accordingly facilitating economic growth (North, 1993; Acemoglu et al., 2003). However, what is interesting and overlooked in the literature is the joint effect of country governance quality and international trade on leverage choice of the firms. This is because high quality institutional setting in a country may create more favorable environment impacting positively firms’ performance (LiPuma et al., 2013). As a complementary argument, the firms who benefit interaction with outside world may also have advantages in overcoming conflicts within the firms. Therefore, it is interesting and timely to analyze the impact of both institutional environment and trade performance on firms’ corporate financing decisions.

This chapter aims to empirically analyze how country governance impact on leverage of European firms considering international trade as well. A comprehensive firm-level data is utilized from 25 European countries retrieved from Datastream. This chapter considers *rule of law* as the proxy for institutional quality collected from WGI database. This variable reflect the institutional environment that firms operate in, which has an impact on corporate financing decisions (Tekin, 2022a, 2022b; Tekin and Polat, 2020c, 2021a; Tekin et al. 2021a). Namely, firms tend to use leverage as a tool to mitigate agency conflict and to discipline the managers if institutional environment is not good enough to deal with agency problems (Tekin and Polat, 2020a; 2021c). Though there are studies focusing on the relationship between international trade and the capital structure separately, there are no studies examining the effect of country governance and trade on the choice of financial leverage in Europe. For trade variable total value of exports of a country is used as a proxy, since there is an important relationship between institutional quality and export performance (Francois and Manchin, 2006; 2013).

This study focuses on European evidence in order to understand the changing dynamic due to the Covid-19 pandemic (Mugaloglu et al., 2021a, 2021b; Polat, 2020a,b; Polat, 2021; Polat et al. 2021) which significantly affects all European countries. Considering the effect of the pandemic on world trade and supply chain it will be insightful to analyze the pandemic in terms of its global impacts. Crisis

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