Sociology & Cultural Research Review (SCRR)
Available Online: https://scrrjournal.com
Print ISSN: 3007-3103 Online ISSN: 3007-3111
Platform & Workflow by: Open Journal Systems
https://doi.org/10.5281/zenodo.22648122

From Culture to Capital: A Conceptual Framework of Cultural, Religious, and Social Influences on SME Financing Decisions in Pakistan

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Abstract
The traditional theories on the corporate finance, such as Pecking Order Theory, Trade-Off theory and Agency Theory, have assumed that the choice of capital structure is basically a rational one with the three aims of maximizing profit, minimizing cost of capital and reducing information asymmetry. However, in emerging and developing economies that are characterized by significant institutional gaps, institutional friction effects on markets and strong socio-cultural norms, financing behavior of small and medium enterprise (SMEs) can significantly vary from such classic predictions. An integrative conceptual framework is presented in this paper which expresses the jointly effect of cultural values, religious tenets and social capital on the choice of capital structure for SMEs in Pakistan. Incorporating the findings of the existing literature in the region, specifically Zeb et al. (2024), who studied the socio-cultural factors influencing debt, equity and informal financing decisions in Peshawar, we model interpersonal and institutional trust as a major mediating mechanism between socio-cultural factors and the choice of debt, equity and informal financing. Based on the above relationship between cultural factors (individualism/collectivism, uncertainty avoidance), religious aspects (prohibition of Riba, ethical risk avoidance), and social network factors (Biradari, ethnic affiliations) with financing outcomes, we propose 7 propositions that can be tested. This framework offers conceptual bridging between formal debt/ equity markets and informal institutional providers of finance in developing economies.

Keywords: *Capital Structure, SMEs, Informal Institutions, Social Capital, Religion, Cultural Norms, Pakistan, Trust, Islamic Finance.*

1. Introduction

Small and Medium Enterprises (SMEs) are the backbone of the Pakistani economy as they represent more than 90% of total enterprises in the country, around 80% of the non-agricultural labour force and about 40% of the annual Gross Domestic Product (GDP) of the country (State Bank of Pakistan, 2021). SMEs, in Pakistan, while playing a macroeconomic vital role, face chronic credit rationing and capital constrains continuously. Supply-side frictions, such as high transaction costs, the absence of collateralizable physical assets, a high level of information asymmetry, and the lack of credit-scoring infrastructure, have been identified in classic corporate finance literature as the reasons behind such financing gaps (Stiglitz & Weiss, 1981; Beck & Demirguc-Kunt, 2006). But, in the context of emerging markets, the supply-side arguments are far from complete, as suggested by a growing body of institutional and behavioral finance literature (Allen et al., 2005; Aggarwal & Goodell, 2010). Capital structure decisions are not formulated in a socio-cultural vacuum. Entrepreneurs in South Asian countries have to deal with the deeply rooted informal institutional architectures, while the traditional theories such as the Trade-Off Theory (Kraus & Litzenberger, 1973) and Pecking Order Theory (Myers & Majluf, 1984) assume that managers of firms assess options along a continuum of tax shield benefits, bankruptcy costs, and information costs. In Pakistan, entrepreneurial activities are heavily influenced by informal institutions like religious restrictions on interest (Riba), tribal and ethnic norms (such as Pashtunwali in Khyber Pakhtunkhwa), and tight-knit kinship relations (Biradari) (Khattak & Shah, 2021; Zeb et al., 2024). Empirical evidence indicates that small businesses often avoid formal bank financing despite having access to credit and it is also not a cost-effective option, preferring to access informal capital instruments or to be under-capitalised (Khan, 2021; Dragota et al., 2018). Zeb et al. (2024) conducted an empirical study by interviewing owner-managers of SMEs in Peshawar, Pakistan. They found that ethnic groups and religious duties play a dual role as catalyst and constraint in the process of capital structure formulation. Ethnic trust and religion are more powerful determinants of capital choices than costs of money, and form what might be considered 'irrational' decisions. In order to overcome these theoretical bounds, this paper presents a conceptual model which embraces cultural dimensions, religious beliefs and social capital into a unified model of SME financing choices in Pakistan. Interpersonal trust and institutional trust are two types of mediators between informal institutional forces and the preference towards the choice of formal conventional banking, formal Islamic financial products (Murabaha, Mudarabah, Musharakah), and informal credit networks (Rotating Savings and Credit Associations / Committees, family loans, and trade credit).

2. Theoretical Foundations and Literature Review

2.1 Classical Theories and Emerging Market Limits

The basic model underlying the modern capital structure, the irrelevance proposition of Modigliani and Miller (1958), assumes frictionless capital markets. Theories that followed incorporated taxes, bankruptcy costs and agency conflicts (Jensen & Meckling, 1976; Kraus & Litzenberger, 1973). Later on, Myers and Majluf (1984) came up with the Pecking Order Theory which suggests that when information is asymmetric, firms would prefer to use internal equity over external debt, and external debt over external equity.

Theoretical Paradigm Shift:
Classical Finance Assumptions:
[Perfect Rationality] ---> [Cost-of-Capital Minimization] ---> [Profit Maximization]

Emerging Market Reality (Pakistan):
[Informal Institutions] --> [Socio-Religious Constraints] --> [Non-Financial Value Outcomes]

These assumptions create structural friction in developing markets such as Pakistan. Institutional voids (Khanna & Palepu, 2000), stem from weak judiciary, gaps in contract enforcement, and lack of efficiency in the bureaucracy. Although Pecking Order Theory adequately depicts the use of retained earnings in developing economies, it does not provide an explanation as to why SME owners opt to avoid external equity or formal debt after their own capital is exhausted (Beck & Demirguc-Kunt, 2006). This missing explanatory dimension is the informal institutions which regulate economic interactions in non-Western environments (North, 1990).

2.2 Cultural Dimensions and Financing Dynamics

Culture is the collective programming of the mind (Hofstede, 2011), and can be viewed as an informal governance structure that affects risk preferences, time preferences, and debt receptivity. The principles of Hofstede are found to have a systematic influence on corporate financial decisions, such as Individualism vs Collectivism, Uncertainty Avoidance & Power Distance (Aggarwal & Goodell 2010). Economic survival and solid capital are combined with the owner's immediate group (kinship or ethnic tribe) in high-collectivist societies. While taking loans from formal external sources could be considered a neutral action on the family balance sheet, it can also be perceived as a threat to collective family dignity (Izzat) (Zeb et al., 2024). In addition to that, economic downturns tend to solidify the high Uncertainty Avoidance of the Singaporeans to the formal commercial banks' fixed repayment schedules during economic slowdowns (Ooi & Chu, 2020).

2.3 Religious Tenets and Islamic Finance Constraints

Religious beliefs exist as informal institutions that influence economic agency, in a normative way (Guiso et al., 2003). The principle of Riba (interest) and Gharar (excessive contractual uncertainty) intended in Islamic jurisprudence (Shariah) changes the nature of financial contracting (Dragota et al., 2018). Islam is the state religion in Pakistan and plays an important role in its daily life, so that the moral and psychological costs of conventional interest-bearing leverage are a problem for enterprise managers in Pakistan (Khan, 2021). Islamic banking has grown rapidly in Pakistan with the introduction of profit-and-loss sharing banking (Musharakah, Mudarabah) and asset-backed sales banking (Murabaha), but the adoption of these products by small firms is limited. Zeb et al. (2024) point out that managers of SMEs are often skeptical of conventional banks on religious grounds, and skeptical of the formal Islamic bank for re-packaging of interest in Arabic terms.

2.4 Social Capital and Informal Credit Infrastructure

According to Putnam (1993), Nahapiet and Ghoshal (1998) and Lin (2001), social capital can be defined as the networks, norms, and social trust that provide the foundation for coordination and cooperation for mutual benefit. Granovetter's (1985) theory of social embeddedness states that economic transactions are not purely market driven but they take place in social networks. Social capital in Pakistan is organized in clans (Biradari), ethnic trade associations, and regional trade networks (Khattak & Shah, 2021). These social institutions are also alternative financial systems that allow the use of informal financial instruments like:

- **Rotating Savings and Credit Associations (ROSCAs / Committees):** Pooled savings and credit association groups, where people save fixed amounts of money each month, and they take turns to get the big pile of money without paying any interest.
- **Qard al-Hasan:** Benevolent loans with no interest, given in the family or peer group.

- **Trade / Supplier Credit:** Deferred payments that are informal based on community reputation and not legally binding.

2.5 Regional Empirical Focus: Zeb et al. (2024)

The empirical foundation of Zeb, Jabin, Rabbi, Ali, and Ali's (2024) conceptual synthesis serves as its foundation. Zeb et al. (2024) conducted a primary survey of small and medium-sized enterprises (SMEs) in Peshawar, the economic capital & Hub of Khyber Pakhtunkhwa, to investigate the impact of ethnic identities (primarily Pashtunism) and religious beliefs on capital structure selection. They identified two primary points to comprehend:

- **1. Ethnic Solidarity (Pashtunwali) as an Informal Risk Mitigator:** Ethnic solidarity builds localized trust networks that make informal equity sharing, trade credit, and peer borrowing easier while lowering the costs of monitoring and transactions. However, entrepreneurs are reluctant to interact with formal financial institutions because this internal reliance breeds institutional isolation.
- **2. Religious Impediments and Opportunities:** Formal debt demand is significantly lowered by rigid religious views that oppose Riba. At the same time, entrepreneurs are returning to informal, non-institutional arrangements as a result of formal Islamic banking's perceived misalignment with true Islamic profit-sharing principles and high collateral requirements failing to fill this demand gap.

3. The Conceptual Framework

On this theoretical basis we elaborate the integrative conceptual model. The framework builds on three socio-cultural factors (Cultural Norms, Religious Tenets and Social Capital) that can be referred to as the antecedents which serve as a bridge to the SME Financing Decisions, with Interpersonal Trust and Institutional Trust being the two factors that mediate between the three socio-cultural factors and the SME Financing Decisions.

> **Structural Conceptual Architecture:**
> *INDEPENDENT ANTECEDENTS:*
> • *Cultural Norms (Collectivism, Uncertainty Avoidance, Family Honor)*
> • *Religious Tenets (Riba Avoidance, Moral Aversion, Shariah Authenticity)*
> • *Social Capital (Biradari Ties, Ethnic Solidarity, Structural Networks)*
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> |
> ▼
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> *MEDIATING MECHANISMS:*
> • *Interpersonal Trust (Kinship & Peer Reliability)*
> • *Institutional Trust (Legal & Banking Systems)*
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> *DEPENDENT OUTCOME:*
> • *SME Financing Decisions (Formal Conventional Debt, Formal Islamic Products, Informal Network Capital)*

4. Development of Research Propositions

4.1 Cultural Norms and Capital Structure Choices

In Pakistan's business landscape, high collectivism and uncertainty avoidance influence firm-level financial risk-taking. The protection of ancestral family wealth and communal cohesion are central to the values of the collectivism movement. In the event of default, a company that takes on formal commercial bank leverage puts the company—and, by extension, the family's reputation—at risk of public legal action or asset foreclosure. This, independent of tax shield benefits, creates a psychological and social barrier against formal leverage.

Proposition 1: *The preference for formal conventional debt is negatively correlated with higher levels of collectivism and uncertainty avoidance among Pakistani SME owners, while the preference for internal retained earnings and informal family financing is positively correlated.*

4.2 Religious Tenets and Shariah Compliance

The religious beliefs are explicit behavioural constraints on choice of contract. Avoidance of Riba is one of the key factors which influences the financial demand dynamics in Muslim majority developing countries. But the provision of Islamic banking does not necessarily overcome this limitation. If SME owners feel that the products of Islamic banking are conventional interest-based loans, then they reject the Islamic banking products too because they feel that it is not religiously compliant.

Proposition 2a: *The demand for conventional interest-bearing debt is negatively impacted by SME owners' religious observance.*

Proposition 2b: *The relationship between religiosity and the adoption of formal Islamic credit is moderated by SME owners' perceptions of the authenticity of formal Islamic financial instruments; when perceived authenticity is low, religiosity drives reliance on informal interest-free mechanisms (Qard al-Hasan).*

4.3 Social Capital, Ethnicity, and Transaction Costs

Ethnic and kinship ties (Biradari) are informal credit networks in Peshawar as noted by Zeb et al. (2024). Social networks reduce information asymmetry among members, via social sanctioning, reputational risk, and shared moral expectations. These are non-formal ways in which transaction costs are lowered in the group. As a result, entrepreneurs operating in a high value of social connections have to deal with fewer formalities such as credit applications, administrative procedures, and collateral requirements.

Proposition 3: *An increased structural and relational social capital of ethnic or kinship networks is associated with increasing needs for informal financing instruments as opposed to formal banking facilities (ROSCAs, trade credit, peer loans).*

4.4 The Dual-Mediating Role of Trust

One important aspect of this is that it differentiates interpersonal trust and institutional trust:

- **Interpersonal Trust:** Trust in the honesty and dependability of people you know in your social, family, or ethnic circle.
- **Institutional Trust:** Trust in formal systemic structures like commercial banks, contract enforcement by the courts, and state regulatory bodies.

Institutional trust suffers as a result of institutional voids in Pakistan's economy. Confidence in the banking system is lowered by bureaucratic hurdles, collateral requirements, and complicated loan procedures. On the other hand, interpersonal trust remains high in ethnic and local trade circles. Financial transactions are channeled into informal systems as a result of interpersonal trust compensating for weak formal institutions.

Proposition 4a: *The positive relationship between informal credit mechanisms and social/ethnic capital is mediated by interpersonal trust.*

Proposition 4b: *The adoption of formal financial products (both conventional and Islamic) is mediated by institutional trust, according to cultural and religious perceptions.*

Proposition 4c: *When institutional trust is low, high interpersonal trust encourages informal network capital to replace formal bank debt.*

5. Comparative Framework and Summary of Variables

Variable Construct	Dimensions / Indicators	Theoretical Basis	Primary Effect on SME Capital Choice	Key Regional References
Cultural Norms	Collectivism, Uncertainty Avoidance, Family Honor (Izzat)	Hofstede (2011); North (1990)	Reduces formal debt uptake; increases reliance on internal & family equity	Aggarwal & Goodell (2010); Ooi & Chu (2020)
Religious Tenets	Riba Prohibition, Gharar Avoidance, Shariah Authenticity	Guiso et al. (2003); Khan (2021)	Eliminates conventional bank debt demand; drives conditional Islamic or informal credit	Dragota et al. (2018); Zeb et al. (2024)
Social Capital	Biradari Networks, Ethnic Solidarity (Pashtunwali), ROSCAs	Granovetter (1985); Lin (2001)	Lowers informal transaction costs; substitutes formal bank credit	Khattak & Shah (2021); Zeb et al. (2024)
Interpersonal Trust	Relational Reliability, Peer Reputation, Social Sanctions	Putnam (1993); Nahapiet & Ghoshal (1998)	Mediator: Channels capital into informal networks (Committees, trade credit)	Allen et al. (2005); Zeb et al. (2024)
Institutional Trust	Legal Enforcement, Banking Transparency, System Fairness	Khanna & Palepu (2000); Beck & Demirguc-Kunt (2006)	Mediator: Enables transition from informal networks to formal financial markets	Stiglitz & Weiss (1981); Khattak & Shah (2021)

6. Conceptual Contribution and Theoretical Implications

here are three primary conceptual contributions that this framework makes to the literature on entrepreneurship and corporate finance in developing markets:

- **1. Extending Capital Structure Theory Beyond Western Perspectives:** Classical theories of corporate finance hold that financial decisions are primarily influenced by calculations of cost-minimization and profit-maximization. This framework demonstrates that capital structure decisions in emerging markets like Pakistan are equally influenced by social risk, religious compliance, and ethnic reputation by integrating cultural, religious, and ethnic dimensions. It expands on the Pecking Order Theory by describing the reasons why business owners deliberately avoid formal debt even when their internal resources are depleted.
- **2. Separating Interpersonal and Institutional Dimensions of Trust:** Previous research frequently treats trust as a single concept. This framework provides an explanation for the continued reliance on informal credit in developing economies by separating trust into interpersonal and institutional dimensions. When institutional trust is low, ethnic or kinship networks with high interpersonal trust can actively replace formal financial engagement, stabilizing informal credit markets over time.
- **3. Reconciling Formal and Informal Financial Preferences:** This model conceptualizes informal capital as an enduring institutional mechanism rather than a temporary friction that disappears with economic development. It provides a structured foundation for

evaluating how informal social networks (Biradari, ROSCAs) interact with formal financial markets and Islamic banking institutions.

7. Policy Implications and Managerial Relevance

- **1. Redesigning Islamic Banking Instruments for Small and Medium-Sized Enterprises (SMEs):** In Pakistan, formal Islamic financial institutions must look beyond asset-backed sales models (Murabaha), which are very similar to conventional loans. Real instruments for profit and loss sharing—Mudarabah and Musharakah—may be more in line with SME owner-managers' religious and risk preferences.
- **2. Leveraging Social Networks for Credit Distribution:** Utilizing Existing Social Capital Structures to Bridge Formal and Informal Finance Policymakers and microfinance institutions can use social capital structures to distribute credit. Group-lending models that make use of ethnic and business associations as informal guarantors can be designed by financial intermediaries to maintain low default rates while lowering collateral requirements.
- **3. Building Institutional Trust:** Reducing administrative complexity, simplifying loan documentation, and enhancing judicial efficiency around contract enforcement are critical to building institutional trust. Without reforms that raise institutional trust, supply-side financial initiatives will continue to face demand-side resistance from SME owners.

8. Conclusion and Directions for Future Research

This paper presents a conceptual framework explaining how cultural norms, religious tenets, and social capital shape SME financing decisions in Pakistan, with interpersonal and institutional trust serving as key mediating mechanisms. The framework shows that informal institutional and socio-cultural structures deeply underpin enterprise financing decisions in developing markets, making it impossible to fully comprehend them using only financial cost metrics. Using structural equation modeling (SEM) or mixed-methods approaches, the seven proposed relationships can be tested in subsequent empirical studies. How informal institutions influence capital structure choices in developing economies can be further validated and refined by contrasting urban trade centers in Punjab with tribal and border commerce zones in Khyber Pakhtunkhwa and Balochistan in comparative empirical studies across Pakistan's distinct socio-economic regions.

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