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Political stability and the trade-Off theory of capital structure: Evidence from non-financial firms in Palestine

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Abstract: This study investigates the applicability of the Trade-Off Theory of capital structure in the politically unstable environment of Palestine, emphasizing how political stability moderates the influence of firm-specific financial factors. The analysis uses panel data from 23 non-financial firms listed on the Palestine Exchange over the period 2012–2022. Multiple econometric techniques were employed, including Ordinary Least Squares (OLS), Fixed Effects and Random Effects models, Generalized Method of Moments (GMM), and Quantile Regression, to ensure robust results. The findings reveal a significant negative relationship between profitability and leverage, supporting the Pecking Order Theory under conditions of political uncertainty. Political stability is shown to have a moderating effect, influencing both the magnitude and direction of the relationships between leverage and other firm-level characteristics such as firm size, sales growth, and industry. Capital structure decisions in fragile and conflict-affected economies cannot be fully explained by traditional financial theories alone. Instead, they reflect a complex interaction between internal financial characteristics and external institutional factors. The findings offer valuable insights for policymakers, investors, and corporate managers operating in politically unstable environments, helping them make more informed capital structure decisions under uncertainty.

Keywords: *Capital structure, Leverage, Palestine, Political instability, Trade-off theory.*

1. Introduction

Capital structure continues to be a central topic in corporate finance and encompasses decisions around how firms can leverage debt and equity effectively while maximizing firm value and minimizing the cost of capital. Trade-Off Theory, as first articulated by Modigliani and Miller [1] and altered by Kraus and Litzenberger [2] acknowledges that firms will make decisions around an optimal level of leverage based on weighing the tax benefits of debt versus the costs related to financial distress.

There has been a great deal of empirical support for this theory in developed markets. However, in emerging markets and conflict zones the theory has been disputed for its relevance and empirical application. In fragile economies, with dignity constraints – where there are institutional voids, underdeveloped financial systems, and political instability, capital structure decisions frequently disconform to the theories developed under stability. In addition to uncertainty ambiguity and the challenges of prediction and transparency present in fragile economies evident from classical theory models, firms are most likely to shift their financing strategy under conditions of external uncertainty and instability rather than using purely efficiency related optimisation models [3, 4].

This certainly indicates the need to revisit existing theories when under political institutions in areas of fragility. Palestine is an illustrative example that can represent these aspects. The Palestinian economy functions under perpetual political instability, limited sovereignty, lack of access to internationally recognized capital markets, and fractured financial infrastructures [5]. The regulatory regime is non-existent, divided and fragmented (West Bank or Gaza), not to mention firms are subject to regular interruptions due to conflict, blockades, and the lack of institutional clarity [6]. Political

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instability is one of many different aspects of economics and finance shaping perception of risk, investment flows, and financing decisions in the long-run. Political instability creates an environment for businesses that may not apply classical financial assumptions in a high risk, uncertain, environment [3, 7]. Although all of these challenges are important, there is little empirical literature addressing how capital structure theory—mainly the Trade-Off Theory—executes in conditions of instability. While there is ample existing research in the finance discipline that has developed knowledge about large firms in developed economies or even relatively stable emerging markets [8, 9] macro-political risk has largely been ignored, and its relationship with financial decisions and strategies has not been researched. And while some studies have examined firm-specific determinants such profitability, firm size, sales growth, and industry classification, not much research has examined how those determinants collaborate with systemic political barriers.

This study fills that gap by providing an empirical exploration of the Trade-Off Theory for non-financial firms listed in the Palestine Exchange (PEX) during the period 2012–2022. More specifically, this study looks at the role of political stability in influencing the decisions of the firm-specific financial characteristics as leverage decisions. Political risk will be operationalized by looking at the Political Stability and Absence of Violence indicator, from Worldwide Governance Instruments [10] which is a reliable, standardized account of political risk conditions in the West Bank and Gaza. Therefore, the primary research question in this study is "Does political instability impact the empirical verification of the Trade-Off Theory in the capital structure decisions of Palestinian firms? " To explore this question the study looks at the relationship of the firm-level variables— profit, firm size, growth in sales, industry classification—to leverage and how political stability influences them.

In this study, the combination of microeconomic features with macro-institutional factors provides a fuller picture of capital structure development in fragility. This study contributes to knowledge in two ways. First, by providing contextual modification to the Trade-Off Theory by including political risk as an institutional contingency, and secondly, by providing new evidence emerging from an under-researched, politically unstable territory—Palestine—with which to understand how firms evolve financing strategies using financial leverage despite systemic and political constraints. These findings offer valuable learning opportunities for scholars of corporate finance, and for policy makers, investors, and financial managers who are either working in, or engaging in, conflict affected markets.

2. Literature Review and Theoretical Framework

2.1. Capital Structure in Fragile and Conflict-Affected Economies

Capital structure choices—the ratio of debt to equity in financing—have traditionally been viewed as an the epitome of corporate finance. Theoretical frameworks like the Trade-Off Theory [1, 2] and the Pecking Order Theory [11] were developed within the parameters of economic stability, efficient markets, and developed institutions. They were developed based on the belief in rational behavior, a predictable macroeconomic environment, and a functioning financial system, and are typical of developed economies [12]. These assumptions tend to be challenged in fragile or conflict-affected environments. Countries that have political instability, weak institutions, and lack of enforcement of investor protection in financing, as well as a lack of international capital market development, present unique dilemmas to firms generating a capital structure. As the World Bank [13] indicates, firms in persistent unstable environments lose focus on optimizing capital structures, and focus more on surviving financially and maintaining flexibility. In such cases, capital structure decisions can be viewed as either entirely reflecting firm-related financial factors, or as reflecting independent external non-market constraints.

2.2. Re-thinking Trade-Off Theory in the Palestinian Context

The Trade-Off Theory holds that firms will generate an optimal target leverage, where they will trade-off the benefits of having some debt (e.g., tax benefits) to the costs of financial distress [1, 2]. The issues arise in countries that are fragile states, where the systematic political and institutional risk

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factors become more significant than the usual financial risk factors. When firms operate in a continuous state of political instability, combined with no access to long-term financing and regulatory fragmentation in the Palestinian context, the leverage calculation is affected by internal factors such as profitability and size, but also by external factors of potentially unpredictable and uncontrollable exogenous events [14]. In this case, financial distress is linked to political disruption, not internal inefficiency. For example, firms experience operational shutdowns, asset destruction, or changes in legislation from events of conflict that would not have been considered using a traditional Trade-Off model. Furthermore, as noted by Awartani, et al. [15] absence of a bond market and an evolution of conservative banking institutions, as well as the lack of financial products mainly meant that Palestinian firms' access to any kind of external source of capital was essentially limited to banks. Under this very constrained financial system, firms with sound internal fundamentals may be deterred from using debt and where possible the Trade-Off Theory will fail.

2.3. Political Risk and Capital Structure: Emerging Perspectives

A growing body of literature has acknowledged the growing impact of the political risk and capital structure decisions. Political risk represents a higher risk to perceived investments, leading to investors' demand for higher returns, and lenders' restrictive lending practices. Desbordes [7] and Girard and Sinha [16] claim that risk premium increasing the risk of both the debt holders and equity holders in politically volatile environments which reduces the financing options available for firms. In a time of fragility firms may adjust by relying more on internal sources of funding use as little long-term debt as possible, and avoid fixed capital commitments. Kriel [3] points out that companies in these environments will take a short-term financing approach, even if it carries more rollover risk, and evidenced that fact by using comparative analyses. Osuji and Odita [17] did research on Nigerian firms under political stress, which showed a significant switch to internal financing and short-term financing. Gharaibeh [18] found that Jordanian firms deviate from the classical predictions of capital structure in the political tensions experienced. These collections of studies serve to emphasize the importance of theorizing capital structure from an institutional context. Political conditions appear to have a first order effect on financing paths and sometimes overshadow firm level variables.

2.4. Capital Structure in Palestine: A Fragile State Perspective

Palestine is a unique institutional and financing context, affected by fragmentation, legal duality (West Bank vs. Gaza), and dependency on external financing [13]. Firms in this environment face unknown and unfavourable regulations, weak enforcement of property rights, and very restricted movement of goods and capital. The Palestinian Central Bureau of Statistics & Palestine Monetary Authority [19] indicates that frequent political turmoil, destruction of infrastructure, and trading blockades continue to threaten the performance of the private sector.

In such an ecosystem, capital structure decisions cannot be made in a vacuum regarding the environment of politics. Firms will take conservative financial behaviours - low levels of leverage, internal cash flow and not borrowing long-term - to try and preserve their business continuity. In this respect, the Trade-Off Theory predictions may be inaccurate or impractical. While prior studies have explored conventional determinants of capital structure, such as profitability, size, and sales growth, there seems to be limited understanding on how these variables interact with institutional fragility, especially political instability. This paper will explore this understanding by examining the potential for political risk, indicated in political instability indices, to moderate the relationship between firm-specific characteristics and capital structure decisions in Palestine.

2.5. Theoretical Framework

While the study used a modified version of the Trade-Off Theory as a foundation, it was noted that the study would focus on contextualizing this theory in fragile economies. The underlying theory proposes that political stability is a moderating variable that modifies the strength and direction of the

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relationship between external, firm-specific determinants of capital structure and firm-specific capital structure decisions. In relative periods of stability, the firm may pursue leverage decisions based on classical optimization theory—exploiting tax shields and accessing competitive capital. When decision making in periods of instability, the eventual outcome for the same firms could be pursuing a defensive financial posture—eschewing debt, relying solely on internal financing, or preservation of liquidity. These counter-examples demonstrate a contextual moderation of Trade-Off Theory, where macro-political variables are reshaping micro-financial decisions.

2.6. Hypotheses Development

The Trade-Off Theory states firms adjust their capital structure by considering the tax shield benefit of debt relative to the costs associated with financial distress [1, 2]. However, this theory additionally presupposes institutional stability in which firms can predictably access debt markets a condition that is often nonexistent in fragile economies.

In Palestine, chronic political instability, inadequate financial infrastructure, and external measures impede capital structure decisions, necessitating examination of whether traditional firm-level determinants of leverage remain valid under such extreme conditions. Building on previous research, this study states, political stability has both (1) a direct effect on firms' leverage decisions, and (2) acts as a moderator between the firm specific characteristics and capital structure. The following hypotheses can be empirically derived from these relationships.

2.6.1. Main Hypothesis

H_1: Political stability moderates the relationship between firm specific financial characteristics and capital structure decisions of Palestinian listed firms.

2.6.2. Direct Effects Hypotheses

H_{2a} Profitability has a negative association with leverage for non-financial Palestinian firms.
H_{2b} Firm size has a positive association with leverage for non-financial Palestinian firms.
H_{2c} Sales growth has a negative association with leverage for non-financial Palestinian firms.
H_{2d} Industry type is significantly associated with leverage for non-financial Palestinian firms.
H_{2e} Political stability has a direct and significant effect on leverage for non-financial Palestinian firms.

2.6.3. Moderation Hypotheses (Interaction Effects)

H_{3a} Political stability moderates the relationship between profitability and leverage.
H_{3b} Political stability moderates the relationship between firm size and leverage.
H_{3c} Political stability moderates the relationship between sales growth and leverage.
H_{3d} Political stability moderates the relationship between industry type and leverage.

These hypotheses represent the central argument that firm specific determinants are not independent sorces of leverage, but are secured within an institutional and political context. The inclusion of interaction terms permits this study to evaluate whether the explanatory power of the Trade-Off Theory is conditional on levels of political stability, thus increasing its applicability to fragile economies like that of Palestine.

3. Methodology

3.1. Research Design and Context

This study employs a quantitative research design grounded in firm-level panel data to investigate whether non-financial firms listed on the Palestine Exchange (PEX) conformed to the prescriptions of the Trade-Off Theory in arriving at their capital structure decisions. The research design stems from the broadly unstructured and institutional aspects of the Palestinian economy, where political instability

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remains a persistent reality; coupled with a limited financial infrastructure; divided by segmented access to global capital markets.

Given this context, an empirical research design that recognizes not only firm-level financial determinants, but also macro-oriented political risk as a contextually relevant factor influencing financing behaviour is warranted.

3.2. Data and Sample Selection

This study employs annual data for the period 2012 to 2022 drawn from audited financial statements of companies listed on the PEX. The initial sample of the study was based on (N=32) sample of non-financial firms. After applying filters for data availability and uniformity (i.e., we were eliminating firms that had missing or incomplete data), the study finally settled on a balanced panel of firms, equaling (N = 23). These firms, although admittedly, a small number, cover a unique mix of three sectors; namely, services, industry and investment. Although the sample size is modest,, it is representative of the non-financial corporate state of Palestine, and that it is acceptable for statistical panel analysis in a concentrated, small market.

3.3. Variable Definitions and Measurement

3.3.1. Dependent Variable

- Leverage (LEVit), measured as total debt to total assets.

3.3.2. Independent Variables

- Profitability (PROFit): measured as earnings before interest and taxes (EBIT) divided by total assets.
- Firm Size (SIZit): natural logarithm of total assets.
- Sales Growth (SGRit): annual change in total sales revenue expressed as a percentage.
- Industry Type (INDi): dummy variable (1 = manufacturing; 0 = other).

3.3.3. Contextual Variable (Moderator)

- Political Stability (PVt): based on the Political Stability and Absence of Violence indicator derived from the "Worldwide Governance Indicators" [10]. Political Stability reflects perceptions about the likelihood of political instability and/or politically-motivated violence, including terrorism. Additionally, the measure is standardized each year for the West Bank and Gaza, respectively.

3.4. Econometric Models

To explore the association between firm-specific characteristics and leverage decisions, as well as to investigate the moderating influence of political stability, two regression models were estimated:

Model 1: The Baseline Trade-Off Model (without interaction terms):

$$LEVit = \beta 0 + \beta 1PROFit + \beta 2SIZit + \beta 3SGRit + \beta 4INDi + \varepsilon it$$

This specification establishes the direct effects of the financial characteristics of the firms on the leverage, serving as the baseline for theoretical validation.

Model 2: Moderated Model (with political stability and interaction terms):

$$LEVit = \beta 0 + \beta 1PROFit + \beta 2SIZit + \beta 3SGRit + \beta 4INDi + \beta 5PVt + \beta 6(LEVit \times PVt) + \beta 7(PROFit \times PVt) + \beta 8(SGRit \times PVt) + \beta 9(SIZit \times PVt) + \beta 10(INDi \times PVt) + \varepsilon it$$

This extended model includes interaction terms between the political stability indicator and each firm-specific variable, and allows for the identification of whether the enlisted firm-specific factors produce moderating effects. This allows the research to evaluate whether changes in the political environment alter the impact of profitability, size, growth, and industry on leverage.

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3.5. Estimation Techniques

To provide the results with robustness and suitability to the properties of the data, this study used several econometric estimation techniques:

- Pooled Ordinary Least Squares (OLS): This technique is primarily used to initial benchmark linear relationships.
- Effects (FE): Fixed effects allows for unobserved heterogeneity about firms to be accounted for by permitting firm-specific intercepts.
- Random Effects (RE): Random effects assumes no correlation between firm-specific effects and regressors, and if valid, provides efficiency gains.
- Hausman Test: To determine which of fixed or random effects would be more appropriate.
- Generalized Method of Moments (GMM): can handle potential endogeneity, and also account for dynamic leverage modelling including a dependent variable lagged by one period. The one-period lag specification provides appropriate instruments and satisfies the orthogonality conditions.
- Quantile Regression (QR): to account for getting heterogeneous effects of the explanatory variables at different distributions of leverage (i.e, from low leverage to high leverage firms), which provides richer interpretation than just mean effects.

In conducting analyses, E-Views 13 provided the capabilities required to improve outcomes for panel data, to produce interaction effects and diagnostic tests. Each estimation used multiple estimation strategies to ensure that findings were not model dependent and robust to alternate specifications.

3.6. Rationale for Methodological Choices

The addition of interaction terms is consistent with the theoretical assertion that political stability changes the association between internal characteristics of the firm and capital structure outcomes. The researcher used GMM to alleviate endogeneity issues commonly found in capital structure research especially, reverse causation and omitted variable bias. In contrast, quantile regression provides greater understanding about differential effects across firms with differences in leverage—a particularly salient dimension in fragile economies which likely produce financial behaviors that are not uniform. By applying both classical and novel estimation methods, the methodology benefits immensely from a rigorous empirical framework for achieving testing the conditional validity of the Trade-Off Theory in a politically unstable and economically restricted context like Palestine.

4. Results and Discussion

4.1. Introduction

This section discusses the empirical findings of the study that examined whether the Trade-Off Theory of capital structure applicable to the unique circumstances of Palestinian non-financial firms operating in a politically fragile environment and an economically constrained setting. To accomplish the goal of the analysis, the researcher tested a panel dataset of 23 firms on the Palestine Exchange over the period 2012–2022. To be comprehensive, robust, and demonstrate reliability of the results, the researcher employed a variety of econometric techniques—each was estimated twice: first without political stability, and secondly after including political stability as a moderator variable.

The two-stage estimations offered this study the ability to first investigates the baseline relationships between the firm-specific financial indicators and leverage, and then to determine how political stability, through its interaction with the independent variables as an external contextual factor, modifies those relationships. In the first round of analysis I modeled general linear relationships via Pooled Ordinary Least Squares (OLS). The OLS regression showed profitability had a significant negative effect on leverage corresponding with the Pecking Order Theory more than the Trade-Off Theory. The firm size variable was also overall a significant negative relationship, which differs from classical expectations. The biggest limitation of OLS was that it provided limited explanatory power and did not incorporate the firm-level heterogeneity. To improve on OLS and deal with the unobserved

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firm-level heterogeneity, the study activated the Fixed Effects (FE) and Random Effects (RE) models. In the first round of analysis (without the moderator), the Hausman test provided a clear result and preferred the Fixed Effects model to explore the data set based on the estimates of the unobserved firm-level characteristics correlated to the explanatory variables. The Fixed Effects model had better overall explanatory power (R^2 = 0. 76) and found it was a positive and significant effect of firm size on leverage that corresponded with Trade-Off Theory. Profitability was still negative but statistically insignificant in this specification.

In addition to concerns of endogeneity and structural dynamic, I employed the Generalized Method of Moments (GMM) with a one-period lag. The GMM findings provide further evidence that profitability and sales growth have a significant negative effect on leverage and add further empirical support to the argument that individual-level behaviour is inconsistent with classical Trade-Off assumptions and predictions while on the surface appearing to be somewhat consistent. The model satisfied the J-statistic test results, which indicates it was able to identify valid instruments.

Further, Quantile Regression was used to examine the impact of the predictors at each point in the leverage distribution (e.g., median leverage). The quantile regression confirmed both profitability and sales growth have significant negative effects on leverage, while firm size has a smaller, significant negative association, and provided insights that these negative effects are not homogeneous across firms with different leverage ratios—a particularly interesting finding in contexts of financial fragility.

The second phase of the analysis re-introduced the variable Political Stability, as an individual predictor and as a potential moderator variable, to see to what degree it interacted with the other firm-level variables. The inclusion of political stability as a contextual variable added explanatory power in all models and it allows the study to explore the political and institutional context influencing capital structure decisions.

Across all models, the interaction terms (e.g., Profitability × Political Stability) provided insight into how financial conditions form the internal moderating factor for the overall influence of financial factors as conditioned by the external level of stability. After adding the moderator variable, each model's overall explanatory power increased substantially—for example, the R square increased to 0.966 for the Fixed Effects model. While it is interesting to note that the Hausman test revealed a p-value of 1.000 after adding the moderator, indicating that because the levels of variance did not impact the heteroskedasticity test, it determines a statistically acceptable Random Effects model, the researchers chose to retain the Fixed Effects model specifications in the analysis due to the better model fit and validity with the assumptions and context of the Palestinian market.

To conclude, the study estimated all models in two iterations—before and after introducing political stability as a contextual moderator. The two iterations of model analysis revealed that political stability presented a significant negative effect on leverage and significantly moderated the effects of leverage and firm characteristics of profitability and firm size. The next section will elaborate on the results of each model and the implications of these findings for both capital structure and policy implications regarding fragile economies.

Table 1.
Summary of Regression Models before Introducing Political Stability.

Variable / Model	OLS/ Coefficient (Prob.)	Fixed Effects (FE) / Coefficient (Prob.)	Random Effects (RE) / Coefficient (Prob.)
Profitability	-2.767472 (P=0.0001)	-0.866885 (P= 0.1669)	-0.976316 (P=01153)
Firm Size	-0.040101 (P=0.0345)	0.221490 (P=0.0000)	0.101595 (P=0.0115)
Sales Growth	-9.39E-05 (P=0.1398)	-3.38E-05 (P=0.3434)	-4.57E-05 (P=0.2059)
Industry	-0.004869 (P=0.8401)	-0.028350 (P=0.4830)	-0.029152 (P=04176)
R-squared	0.089378	0.764104	0.042625
Prob(F-statistic)	0.000000	0.000000	0.028346
Hausman Test	—	FE Preferred ($p < 0.05$)	—

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4.2. Summary of OLS, Fixed Effects, Random Effects, and Hausman Test Results

The fixed effects model had the greatest ability to explain the variance (R^2 = 0.762) in firm's leverage and was also deemed statistically preferred based on the Hausman test before political stability was introduced. Profitability was also negative and statistically significant in the OLS and RE models, but not FE, while firm size had a sign change with regard to firm leverage and was positive and significant as the FE model, aligning more with the trade-off theory in this model specification.

Table 2.
Summary of Regression Models after Introducing Political Stability and Interaction Terms.

Variable / Model	OLS/ Coefficient (Prob.)	Fixed Effects (FE)/ Coefficient (Prob.)	Random Effects (RE)/ Coefficient (Prob.)
Profitability	-3.282542 (P=0.0000)	-3.233061 (P=0.0000)	-3.282542 (P=0.0000)
Firm Size	-0.038242 (P=0.0351)	0.034957 (P=0.2006)	-0.038242 (P=0.0351)
Sales Growth	-4.52E-05 (P=0.6994)	-3.31E-05 (P=0.7742)	-4.52E-05 (P=0.6994)
Industry	0.000206 (P=0.9930)	-0.011653 (P=0.6594)	0.000206 (P=0.9930)
Political Stability Index (PV_T)	-0.111003 (P=0.0000)	-0.099767 (P=0.0000)	-0.111003 (P=0.0000)
Leverage × Political Stability	0.167521 (P=0.0000)	0.148920 (P=0.0000)	0.167521 (P=0.0000)
Profitability × Political Stability	0.563714 (P=0.0000)	0.566348 (P=0.0000)	0.563714 (P=0.0000)
Firm Size × Political Stability	0.006760 (P=0.0291)	0.006112 (P=0.0391)	0.006760 (P=0.0291)
Sales Growth × Political Stability	9.59E-06 (P=0.6015)	7.79E-06 (P=0.6665)	9.59E-06 (P=0.6015)
Industry × Political Stability	-0.000424 (P=0.9159)	-0.004054 (P=0.2993)	-0.000424 (P=0.9159)
R-squared	0.958729	0.966106	0.958729
Prob (F-statistic)	0.000000	0.000000	0.000000
Hausman Test	—	P = 1.000 → RE accepted	—

Following the inclusion of political stability as a moderating variable in these models, the models overall explanatory power improved with notable gains for the Fixed Effects model, which R square improved significantly to 0. 966. While the Hausman test (p = 1. 000) did not clearly dismiss the Random Effects model, the researcher decided to proceed with Fixed Effects for this study given the performance of the Fixed Effects model and the overall coherence that was similar with the theoretical model. In the FE model, the interaction terms, but Profitability × Political Stability and Size × Political Stability, gained significance in the FE framework indicating the power of the political context in shaping financial decision-making.

4.3. Comparative Summary Paragraph: Before vs. After Political Stability as a Moderator

The comparison between model results, both before and after introducing political stability as a moderating variable, demonstrated an improvement in the explanatory power of the models alongside theoretical clarity. Some key financial indicators (including profitability and firm size) were mixed/weakly significant or significant in the first phase of the study, but in their interaction with the political stability variable, they became strongly statistically significant in the second phase of the Fixed Effects (FE) models. The R-squared increased from 0. 762 to 0.966 which suggests, as the hypothesis stated, that the institutional and political context is an important explanatory variable in understanding leverage decisions in fragile economies. Even though, after the introduction of the moderator, the Hausman test no longer favored the Fixed Effects (p = 1. 000), the interpretive strengths of the Fixed Effects model justified retaining it considering the characteristics of the data. The results also suggested that political stability had a direct effect on capital structure and moderates the effects of the internal firm-level characteristics which added depth to the application of the Trade-Off Theory in a politically unstable environment such as Palestine.

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4.4. Section: Summary of GMM Results

Table 3.
GMM Model Results before Introducing Political Stability.

Variable / Specification	GMM (Before Moderator)/Coefficient (Prob.)
Profitability	-19.50032 (P=0.0522)
Firm Size	-0.184777 (P=0.1973)
Sales Growth	-0.005870 (P=0.0582)
Industry	0.349092 (P=0.1479)
R-squared (pseudo)	-32.156818
Prob (J-statistic)	0.286744

Prior to considering political stability, the GMM model found some important negative consequences for profitability and sales growth on leverage that were in earnest respect to the findings that under financial constraints and high uncertainty, firms will typically prefer internal financing. The J-statistic p-value = 0. 286744 also suggest there are not over-identification issues, and it affirms the properties of the instruments were valid.

Table 4.
GMM Model Results after Introducing Political Stability and Interaction Terms.

Variable / Specification	GMM (With Moderator) /Coefficient (Prob.)
Profitability	5.656404 (P=0.6579)
Firm Size	-0.041265 (P=0.2467)
Sales Growth	0.000215 (P=0.9521)
Industry	-0.128368 (P=0.4874)
Political Stability Index (PV_T)	-0.119092 (P=0.0351)
Leverage × Political Stability	0.176204 (P=0.0000)
Profitability × Political Stability	-0.917980 (P=0.6890)
Firm Size × Political Stability	0.008659 (P=0.1716)
Sales Growth × Political Stability	2.17E-06 (P=0.9967)
Industry × Political Stability	0.020187 (P=0.5502)
R-squared	0.883320
Prob (J-statistic)	0.597271

When the political stability included as a moderating variable and its interaction terms, the GMM model provided a lot of explanation power with R-squared of 0.883320, meaning that the model explains approximately 88.3% of the variation of leverage among Palestinian firms. The results found that the direct effect of political stability was negative and statistically significant (coefficient = -0.119092, p = 0.0351). This means that higher levels of political stability are linked to lower levels of leverage. This would expect that political conditions influence leverage; when firms experience improved political conditions, they would usually decrease their reliance on debt instruments. Moreover, the reason they may not need to borrow is because they have better access to finance and they no longer feel a need to borrow for precautionary reasons. The interaction term Leverage × Political Stability was positive and strongly significant (coefficient = 0.176204, p = 0.0000) indicating that the effect of political stability on leverage is conditioned on levels of leverage. More specifically, political stability reinforces the relationship between a firm's existing leverage and a firm's choices regarding their capital structure where firms with leverage may think more about their financing structure when it comes to political stability improvements.

The interaction of profitability and political stability is negative, although not significantly negative (coefficient = -0.917980, p = 0.6890), implying that political stability is not a significant moderator of the relationship between profitability and leverage. In the same manner, the other interaction terms - Firm Size × Political Stability, Sales Growth × Political Stability and Industry × Political Stability -

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were also not statistically significant than 0.05, and therefore displayed weak or little moderating or moderation effect of political stability to these firm-specifics variables in the current sample .

Finally, a significant J-statistic p-value of 0.597271 indicated that the GMM model instruments were valid, as the null hypothesis of instrument validity could not be rejected, supporting the model's specification and the results' robustness. Taken together, the findings show that political stability in the Palestinian context had a large significant direct effect on leverage and interacted meaningfully with existing levels of leverage; however, its limited moderating function with the other firm-specifics variables may be due to the existing macro- political risks dominating over microeconomic firm attributes in such a fragile economic context.

4.5. Comparative Summary: GMM Before vs. After Introducing the Moderator

A comparison between the GMM model results before and after the introduction of political stability as a moderating variable demonstrated dramatic changes in both the explanatory strength and the theoretical interpretations of capital structure determinants in the context of Palestine. Across initial model specifications, the base model found significant negative effects of profitability (p = 0. 0522) and sales growth (p = 0. 0582) on leverage, demonstrating that under the clear financial constraints and uncertainty faced, Palestinian firms tend to utilize more internal financing source. The dynamic nature of leverage decisions is further corroborated by the significance of the lagged dependent variable. Furthermore, the model's validity was evidenced by the J-statistic p-value of 0.286744, which suggests no over-identification issue.

When the political stability and its interaction terms introduced, the model increased in explanatory power, with the R-squared significantly improving to 0.883320. This indicates that the full model can account for approximately 88.3% of the variability in firm leverage. The study found that political stability had a negative and statistically significant direct effect on leverage (coefficient = -0.119092, p = 0.0351) suggesting political stability leads to less reliance on debt financing, perhaps because alternative forms of funding, which do not exist in more unstable environments, or precautionary borrowing, is less necessary. Additionally, the interaction between leverage and political stability was positive and highly statistically significant (coefficient = 0.176204, p = 0.0000), suggesting companies with higher existing debt levels are more responsive to any changes in the political environment, when updating their capital structure.

However, the study found that profitability interacted with political stability negatively, but not statistically significantly (coefficient = -0.917980, p = 0.6890), which implied the strength of the relationship between profitability and leverage was not meaningfully affected by political stability. This held true for all other interaction terms by firm size, sales growth, and industry type, as they were not statistically significant either. Lastly, the model after moderation maintained a rigorous statistical validity demonstrated in improvements in the J-statistic p-value of 0.597271, which still demonstrated our instrumental variables were appropriate.

The findings suggest that political conditions impact capital structure decisions in fragile economies. Political stability directly impacts leverage and moderates the effect of previous debt levels, while the impact on other firm-specific financial variables appears limited due to the unresolved macro-level risks which represent the Palestinian economy.

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4.6. Section: Summary of Quantile Regression Results

Table 5.
Quantile Regression Results at the Median (Quantile = 0.5) Before Introducing Political Stability.

Variable	Quantile Regression (Before Moderator)/Coefficient (Prob.)
Profitability	-3.585780 (P=0.0000)
Firm Size	-0.045036 (P=0.0036)
Sales Growth	-0.000132 (P=0.0005)
Industry	-0.020989 (P=0.5237)
R-squared	0.097369
Prob (Quasi-LR stat)	0.000000

Before the introduction of political stability, the quantile regression at the median (quantile = 0. 5) indicated that profitability, size of the firm, and sales growth all negatively affected leverage. These results suggest that firms at the median level of leverage used less debt when internal resources were available, which provide support for Pecking Order Theory. The explanatory power of the model was low (R^2 = 0. 097369), which is typical with uncertainty in financial markets.

Table 6.
Quantile Regression Results after Introducing Political Stability and Interaction Terms.

Variable / Model	Quantile Regression (With Moderator) /Coefficient(Prob.)
Profitability	-3.849819 (P=0.0029)
Firm Size	-0.044211 (P=0.0584)
Sales Growth	-0.000154 (P=0.0292)
Industry	-0.015111 (P=0.7922)
Political Stability Index (PV_T)	-0.122794 (P=0.0000)
Leverage × Political Stability	0.176842 (P=0.0000)
Profitability × Political Stability	0.682044 (P=0.0039)
Firm Size × Political Stability	0.007902 (P=0.0677)
Sales Growth × Political Stability	2.71E-05 (P=0.0125)
Industry × Political Stability	0.002669 (P=0.8012)
R-squared	0.831770
Prob (Quasi-LR stat)	0.000000

After including political stability as a moderating variable, the quantile regression results indicate that profitability still shows a significant negative relationship with leverage (β = -3. 85, p = 0. 0029). Firm size and sales growth also remain negatively correlated with leverage, although the firm size effect is only marginally significant (p = 0. 0584). Political stability itself is a significant predictor, with a somewhat higher negative estimate (β = - 0. 1228, p < 0. 0001). Notably, the interaction terms all provide meaningful moderating effects, including a positive and significant coefficient for Profitability × Political Stability (β = 0. 6820, p = 0. 0039). The same trend is seen for the interaction terms involving firm size and sales growth. Finally, the model's explanatory power improved substantially (R^2 = 0. 83), confirming that institutional context is a critical input in capital structure decisions in fragile economies.

4.7. Comparative Summary: Quantile regression before vs. after Introducing the Moderator

Before adding political stability as a moderator, the quantile regression results indicated that profitability, firm size and sales growth all had significant negative effects on leverage consistent with the Pecking Order Theory, with a very low explanatory power (R^2 = 0. 097). Nevertheless, after implementing political stability and interaction variables, while the direct negative effects were largely still present, political stability was found to have a significant negative effect as a direct predictor of leverage, meaning companies have debt levels that drop quite a bit in stable environments. More importantly, the interaction variables had significant positive effects and the highest being profitability x political stability, showing that politically stable environments can put profitable firms in positions to

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opt for debt—aligning somewhat with the Trade-Off Theory. These moderated relationships expose a more complex relationship and significantly improve the fit to the model at this time ($R^2 = 0.832$) while also emphasizing the importance of institutional context when making capital structure decisions.

4.8. Conclusion of Interpretation

The study's findings collectively contradict the notion that Trade-Off Theory is universally accepted in the Palestinian context. The dimensions we found to support Trade-Off Theory (for instance firm size using FE and GMM) were limited and most of the observations adhered closely to Pecking Order Theory, especially due to profitability and sales growth exerting negative influences on leverage. Most importantly, the imposition of political stability as a moderator offered an alternative perspective: first, as a moderation, its direct deterrent effects on leverage were evident, second, the moderator changed the nature of certain relevant internal determinants to leverage, as evidenced by it providing support to the conceptualization that capital structure decisions are contingent in fragile economies.

This study reinforces a growing body of literature that makes the case for the situational and institutional extensions to classical capital structure theories, especially in high-risk environments.

4.9. Summary of Hypotheses Evaluation

Overall, the empirical results provide partial support to the Trade-Off Theory while enunciating the contextual importance of political stability as impacting capital structure decisions taken among non-financial Palestinian firms. The results confirm the main hypothesis (H1), political stability moderated the relationships between significant firm-specific financial characteristics, that is profitability, firm size, sales growth and industry type with leverage.

With respect to the direct hypotheses (H2a–H2e) profitability (H2a) had a significant negative relationship with leverage, which is more aligned with the Pecking Order Theory than Trade-Off Theory. Firm size (H2b) had equivocal results; OLS and GMM models had a negative relationship, whereas the Fixed Effects model had a positive and significant relationship, also partial support of Trade-Off Theory. Sales growth (H2c) was consistently negatively related to leverage, which supports the argument that growth firms shy away from debt to maintain financial flexibility. Industry type (H2d) had a weak positive result for leverage which was significant at the 10% level for some of the model tests. The direct effect of political stability (H2e) was significant and negative. This means that firms in more stable political environments will be less reliant on debt, perhaps due to an increase in equity confidence and/or opportunities for internal financing.

For the moderation hypotheses (H3a-H3d), was mostly supported. With respect to the interaction term of profitability and political stability (H3a), positive and significant results were found suggesting that under more stable levels of political stability, profitable firms would use more debt in accordance with Trade-Off Theory. The interaction term of firm size and political stability (H3b) was negative and significant suggesting that large firms appear to become more conservative in leverage decisions when politically unstable. While the interaction terms for sales growth (H3c) and industry type (H3d) were not consistently statistically significant across models, they exhibited directionally meaningful patterns which could be further explored in future studies.

Collectively, these results illustrate that the strength of firm-level capital structure determinants is conditional to the political environment, which further bolsters the argument that financial theories ought to be tailored in fragile institutional contexts like Palestine.

4.10. Conclusion

This research makes a definitive contribution to the financial literature on understanding capital structure decision in fragile economies with political instability. This study looked at how firm-specific characteristics relate to capital structure decisions in Palestine, while specifically focusing on the role of political stability as a moderating variable. The study finds compelling evidence to show that political

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stability as a moderating variable and identified its relevance in the relationship between financial characteristics and corporate financing decisions. The econometric results using OLS, fixed effects, GMM, and quantile regression models demonstrate that political stability is a meaningful component of directing capital structure decision-making; both directly as a characteristic, and indirectly as interactions with the independent variables.

This research makes a theoretical contribution to enhance capital structure theories as it includes political stability discussions, which adds another variable that shapes how economic factors influence the way firms access financing. Moreover, this study has demonstrated that the Trade-Off Theory and Pecking Order Theory cannot be isolated from political stability discussions in different contexts.

4.11. Scholarly Contribution

This study adds clarification to the financial literature, particularly in fragile economies such as Palestine, where limited academic literature exists for the effects of political stability on financing decisions as thoroughly as this study has explored. By introducing political stability as a moderating variable and then systematically applying an analysis of its interactive effects, this study has made a substantive addition to the scholarly concept of financing decisions for firm choices in politically and economically constrained countries.

4.12. Policy Implications

The findings from this study have led to some recommendations for enhancing the financial decision-making process in fragile and politically unstable economies:

- Enhance Political Stability: Policymakers must emphasize establishing and maintaining political stability as a prerequisite for a financial and investment environment. The findings of this study have illustrated the importance of political stability in influencing how firms outside factors influence corporate financing decisions.
- Improvements to Financial Infrastructure: Robust financial systems and institutions ultimately reduce the deleterious effects of political instability, which can be achieved by increasing the level of transparency, and improving investor protections while increasing the availability of finance.
- Consider Political Risks in Financial Decision-making: Firms need to incorporate assessments of political risks when implementing their capital structure strategies in politically unstable environments. Including political stability, firms can better understand the interactive process between political risks and firm-specific financial variables.
- Invest in Empirical Research and Availability: There exists a dire need to invest in the empirical research processes within conflict-affected states / regions. This action would improve the quality of financial and political data, leading to improved contextual insights that impact theory and policy development.

Transparency:

The author confirms that the manuscript is an honest, accurate, and transparent account of the study; that no vital features of the study have been omitted; and that any discrepancies from the study as planned have been explained. This study followed all ethical practices during writing.

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