Summary on Implications of Capital Structure Hypotheses
(“The Capital Structure Puzzle: The Evidence Revisited; JACF 2005)

A. M&M without Corporate Taxation (AER 1958)
- -- Capital structure does NOT matter!

B. M&M with Corporate Taxation (AER 1963)
- -- Approaching 100% debt financing!

C. Static Tradeoff Hypothesis (Scott, BJE 1973; Titman & Wessels, JF 1988)
- -- Balancing tax benefits with agency and (expected) bankruptcy costs
  - -- May have an optimal/target capital structure that maximizes firm value!
- -- Tax benefits derived from tax deductibility of interest expenses, but depend on the availability of other tax shields such as depreciation, ITC, amortization, etc. (DeAngelo and Masulis, JFE 1980), and profitability.
- -- Bankruptcy risk ➔ more debt for profitable and stable firms with rich CFs!
  Bankruptcy costs ➔ more debt for mature firms with mostly tangible assets!
- -- Agency costs such as risk shifting (Jensen & Meckling, JFE 1976) and underinvestment (Myers, JFE 1977) ➔more debt for firms with less growth opportunities!

D. Agency Cost of Equity Financing Hypothesis
- -- Free Cash Flow (FCF) argument (Jensen, AER 1986)
  - ➔ FCF is defined as CFs available after meeting all financial obligations and funding all NPV>0 projects!
    - ⇨ debt financing (to repurchase equity) helps reduce free cash flows
  - ➔ debt financing is more valuable for mature firms with rich CFs!

E. Information Asymmetry (Smith JFE 1986)
- -- Signaling Explanation (Ross, BJE 1977) – Debt financing signals better firm quality, i.e., can sustain associated greater financial obligation
  - ➔ more debt for profitable and stable firms with rich CFs!
- -- Pecking Order Hypothesis (Myers & Majluf, JFE 1984)
  - ➔ profitable and liquid (financial flexible) firms prefer internal financing to external financing, and least risky securities are preferred to most risky securities when seeking external capital!
  - ➔ more debt for growth firms with low OCFs!
  - ➔ NO optimal capital structure!

F. Miller (JF 1977) – Personal and Corporate Income Taxation
- -- Tax benefits of debt financing at the corporate level are offset by differential tax disadvantage of interest income versus equity return at the personal level
  - ➔ Optimal capital structure at the aggregate level, but NOT at the firm level!