CF-Theory1: Inner Logic and Connections

Causal Chain (From Institutions to Stylized Facts)

- **Separation of ownership and control** → creates **agency frictions** (managers may not maximize shareholder value).
- **Agency frictions** → generate **governance mechanisms**:
  - **Incentives** (align objectives),
  - **Monitoring** (detect and deter),
  - **Discipline** (constrain discretion),
  - **Replacement** (remove underperforming managers).
- **Governance mechanisms** → directly shape **financing choices**, because **financing is itself a governance tool**:
  - **Debt**: discipline + monitoring via covenants and rollover threat.
  - **Equity**: weaker discipline but greater flexibility; stronger dilution/control effects.
  - **Takeovers/LBOs**: extreme form of replacement, often combined with high-leverage discipline.
- **MM benchmark (Modigliani–Miller)** → if there were **no frictions**, items above would not affect firm value (capital structure irrelevance).
- **Stylized facts** (financing patterns differ across firms, countries, and time) → empirical evidence that **frictions exist**, so governance and financing choices matter for value.
- **Frictions** explain both governance choices and stylized facts (shared drivers):
  - **Taxes** → push toward debt.
  - **Distress costs** → cap debt.
  - **Agency** → push toward debt/controls (but excessive debt can induce underinvestment and risk shifting).
  - **Information asymmetry** → pecking order: internal funds → debt → equity.

System Summary (One Line)

Institutions (law/markets/ownership) → Frictions → Governance & financing choices → Obse