Debt and Taxes: Evidence from a Bank based system

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ABSTRACT

This paper analyzes the impact of corporate taxes on the capital structure in a country where bank financing is the main external financing source. It is found that the existence of a debt tax shield and provisions for tax loss carry-forwards has an important impact on the capital structure of the firm. These results differ from the general result in the literature that taxes do not matter for the capital structure decision. The main difference is that these results are obtained from a bank based financing system where asymmetric information and agency problems are solved differently than under a market-based system where most of the general results from the literature are obtained. Consistent with this, the pecking order theory of capital structure is rejected. Finally, it is found that small firms may be credit rationed by the banks.

Keywords: Capital Structure, Debt, Marginal Tax Rate, Taxation, Trade-off Theory
JEL classification codes: G3, G32

Tuesday, January 14, 2003