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Financing Regimes

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A B S T R A C T

In this study we revisit tests of capital structure to determine the predominant theory that correctly anticipates and relates firm financing decisions. We first identify financing decisions that are correctly classified employing commonly used tests of capital structure theory and then focus on explaining departures from these models. The results reveal a sharp divide in the financing patterns of firms across all industries (Fama-French 48) pre and post 1987. The empirical evidence suggests that the pecking-order theory is the predominant financing regime from 1970 to 1987 and after 1987 the trade-off model is the principal method of capital financing. The results are chiefly attributed to changes in tax regulation. An examination of adjustments to capital structure also offers support for the trade-off theory noting evidence of regular adjustments.

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