Taxes, Financing Decisions, and Firm Value

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Using a cross-sectional regression methodology, the authors measure how the taxation of dividends and debt affects firm value. The authors find that firm value is positively related to dividends and negatively related to debt, which refutes many of the existing tax hypotheses concerning firm financing decisions. The authors infer that dividends and debt convey information about profitability that dominates any tax effects of financing decisions.

The authors use cross-sectional regressions of firm value on earnings, investment, and financing variables to measure tax effects in the pricing of dividends and debt. The market value of a firm is the sum of two components: (1) the market value of an all equity, no-dividend firm with the same pretax expected net cash flow as the firm and (2) the value of the tax effects of the firm's expected dividend and interest payments. The authors argue that if control variables can capture information about pretax expected net cash flows in financing decisions, then estimated regression coefficients on dividend and debt variables can isolate tax effects.

Using a wide range of variables to proxy for pretax expected net cash flows, the authors fail to find reliable evidence of tax effects. The estimated marginal relationship between firm value and dividends is positive, and the estimated marginal relationship between leverage and value is typically negative. Many of the existing tax hypotheses suggest a positive relationship between debt usage and firm value.

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Although the authors' results fail to measure the tax effects of financing decisions, they do provide information about value created by investment and financing decisions. Furthermore, evidence presented by the authors contradicts the results of published event studies and provides more-robust information concerning the relationship between dividends and value. Event study evidence suggests that the univariate response of stock prices to investment announcements is weak, but in their cross-sectional regressions, the authors find a strongly positive relationship. Event studies show that changes in dividends produce stock price changes of the same sign; the authors' results are more robust in that they indicate that dividends have information about value that is missed by earnings, investment, research and development, and debt. Any negative tax consequences for the pricing of derivatives are obscured by the positive information implications.

Finally, although event studies find that the response of stock prices to changes in debt is small and statistically unreliable, the authors find a negative relationship between debt and value even after controlling for earnings, dividends, investment, and research and development.

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