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Taxation, Portfolio Choice, and Debt-Equity Ratios: A General Equilibrium Model

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Abstract

This paper explores the portfolio behavior of investors differing with respect to both tax rates and risk aversion, emphasizing the role of constraints on individual and firm behavior in ensuring the existence of and characterizing portfolio equilibrium. Under certain conditions on the securities available in the market, which also are necessary for shareholders to be unanimous in supporting firm value maximization, investors will be segmented by tax rate into two groups, one specialized in equity and the other in debt. Though the relative wealths of the two groups determine the aggregate debt-equity ratio, each firm will be indifferent to its financial policy.

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