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Article

How Big Are the Tax Benefits of Debt?

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Abstract

I integrate under firm-specific benefit functions to estimate that the capitalized tax benefit of debt equals 9.7 percent of firm value (or as low as 4.3 percent, net of personal taxes). The typical firm could double tax benefits by issuing debt until the marginal tax benefit begins to decline. I infer how aggressively a firm uses debt by observing the shape of its tax benefit function. Paradoxically, large, liquid, profitable firms with low expected distress costs use debt conservatively. Product market factors, growth options, low asset collateral, and planning for future expenditures lead to conservative debt usage. Conservative debt policy is persistent.

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Citing Literature

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