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Debt Financing and Tax Status: Tests of the Substitution Effect and the Tax Exhaustion Hypothesis Using Firms' Responses to the Economic Recovery Tax Act of 1981

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ABSTRACT

This study tests the joint prediction of the substitution effect and the tax exhaustion hypothesis that an increase in non-debt tax shields leads to a decrease in leverage. Controls are introduced for the debt securability effect, the pecking order theory of financing, and the probability of losing tax shields. Using the relationship between changes in investment tax shields and changes in debt tax shields of firms in response to the Economic Recovery Tax Act of 1981, strong empirical support is found for predictions based on the substitution effect and the tax exhaustion hypothesis.

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