Capital Structure, Payout Policy, and Financial Flexibility

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Abstract

We combine elements of the pecking order and trade-off theories of capital structure to develop a more powerful and empirically descriptive theory in which firms have low long-run leverage targets, debt issuances are temporary deviations from target to meet unanticipated capital needs, firms rebalance to target with a lag despite zero adjustment costs, and mature firms pay substantial dividends to foster access to external equity while limiting internal funds to control agency costs and reduce corporate taxes. The theory generates new testable hypotheses and resolves the main capital structure puzzles including (i) why equity is not "last resort" financing, (ii) why profitable firms pay dividends and maintain low leverage despite the corporate tax benefits of debt, (iii) why firms fail to "lever up" after stock price increases, and (iv) why leverage rebalancing occurs with a lag despite trivial adjustment costs.

Keywords: capital structure, payout policy, dividends, financial flexibility, pecking order, trade-off theory

JEL Classification: G32, G35, G31

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