THE COMMITMENT ROLE OF EQUITY FINANCING

Matthias Fahn
Johannes Kepler University Linz

Valeria Merlo
University of Tuebingen

Georg Wamser
University of Tuebingen

Abstract
Existing theories of a firm's optimal capital structure seem to fail in explaining why many healthy and profitable firms rely heavily on equity financing, even though benefits associated with debt (like tax shields) appear to be high and the bankruptcy risk low. This holds in particular for firms that show a strong commitment towards their workforce and are popular among employees. We demonstrate that such financing behavior may be driven by implicit arrangements made between a firm and its managers/employees. Equity financing generally strengthens a firm's credibility to honor implicit promises. Debt, however, has an adverse effect on the enforceability of these arrangements because too much debt increases the firm's reneging temptation, as some of the negative consequences of breaking implicit promises can be shifted to creditors. Our analysis provides an explanation for why some firms only use little debt financing. Predictions made by our theory are in line with a number of empirical results, which seem to stay in contrast to existing theories on capital structure. (JEL: C73, D24, D86, G32)

The editor in charge of this paper was Juuso Valimaki.

Acknowledgments: We thank Ricardo Alonso, Daniel Barron, Felipe Balmaceda, Mike Fishman, Florian Englmaier, Nicola Gennaioli, Ricard Gil, Hendrik Hakenes, Daniel Herbold, Jin Li, Niko Matouschek, Mike Powell, Jean-Charles Rochet, Klaus Schmidt, Monika Schnitzer, Caspar Siegert, Marta Troya Martinez and Robert Ulbricht, as well as seminar participants at the JKU Linz, the LMU Munich, the 1st Bavarian Micro Workshop (Regensburg), the 16th Colloquium on Personnel Economics (Tuebingen), the 11th IIOC (Boston), the 2013 EEA meeting (Gothenburg), and the 2013 EARIE meeting (Evora) for helpful comments. Matthias Fahn gratefully acknowledges financial support from the German Science Foundation (DFG) through collaborative research center CRC TRR 190. Fahn and Merlo are Research Affiliates at CESifo

E-mail: matthias.fahn@jku.at (Fahn); valeria.merlo@uni-tuebingen.de (Merlo); georg.wamser@uni-tuebingen.de (Wamser)