A Multinational Perspective on Determinants of Capital Structure

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This paper analyzes whether there exist significant differences in determinants of capital structure between multinational corporations (MNCs) and domestic corporations (DCs). Taxes, agency costs of debt, and bankruptcy costs are selected as determinants of capital structure and tested in the international environment. Using a new proxy for marginal tax rate, this study finds that taxes are not major factors explaining the difference in the capital structure between MNCs and DCs. Since taxes are known to be essential determinants of capital structure, this finding is important to understand the capital structure of MNCs. Test results confirm higher agency costs of debt and a lower leverage level of MNCs consistent with previous results. This study also finds that bankruptcy costs of MNCs are not different from those of DCs in contradiction to prior findings.

Key words: Multinational corporations, Determinants of capital structure, Marginal tax rate

I. Introduction

The choice of debt and equity is an important decision for the corporations because an optimal choice of financing decision increases the value of the firm. In the finance literature, the optimal choice of debt and equity is known to be determined by the trade-off between the tax-related advantage of debts and the leverage-related costs.1) For multinational corporations (MNCs), the decision of optimal choice of financing decision is more complicated

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1) The leverage-related costs are mainly agency costs of debt and bankruptcy costs.
because MNCs are operating in a complex international environment.

In this paper, determinants of capital structure of multinational corporations are discussed. More specifically, this paper addresses the following issues:

1. How can we define MNCs vs. domestic corporations (DCs)?
2. Is the marginal tax rate of MNCs higher than that of DCs?
3. Are the leverage–related costs different between MNCs and DCs?

First, how to define MNCs is not clear cut. Various ways to define MNCs are suggested in the prior studies. However, to be useful in an empirical study, the data representing the definition of MNCs should be measurable and easily available. Thus, we employ the foreign income ratio as a measurable definition for MNCs in this paper.

Second, several factors are tested as determinants of capital structure of MNCs in many previous studies. However, empirical studies regarding taxes are scarce. One of the reasons is the difficulty of measuring tax variables. The other reason is, as MacKie–Mason (1990) suggests, lack of power of most tax shield variables in explaining the marginal tax rate. Graham (1996a, 1996b) suggests the simulation method to estimate marginal tax rate. This simulated marginal tax rate known to be the best proxy for the tax variable is used in this study.

Finally, whether MNCs have lower bankruptcy costs than DCs is not agreed among researchers. In general, MNCs are believed to have lower bankruptcy costs than DCs because of diversification. In addition, agency costs of debt of MNCs are expected to be different from those of DCs. Using a new definition of MNCs, this paper tries to shed more light on this issue.

The organization of this paper is as follows. Chapter II reviews the previous literature. Chapter III develops the hypotheses. Chapter IV explains the data, and Chapter V presents the empirical results. Chapter VI concludes the paper.

### II. Review of Literature

This chapter reviews criteria for defining MNCs and determinants of capital structure of MNCs.