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**OPTIMAL CORPORATE CAPITAL STRUCTURE
THEORY: ITS IMPLICATIONS FOR
CAPITAL MARKET DEVELOPMENT
IN TRINIDAD AND TOBAGO**

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A firm's capital structure represents the mix of securities that it has sold over time to finance its operations. Capital structure theory therefore seeks to explain how a firm's financing mix is determined. This literature has significant implications for capital market development because it impacts on supply of capital market securities such as corporate bonds and shares. This aspect of capital market theory has, however, not received much attention in the literature.

Regionally, research in corporate finance (Farrell, Najjar and Marcelle 1986, Palmer 1967, Bourne 1972 and Clarke, Stoddard and Shield 1993) has not been voluminous. The studies that were done focussed primarily on the pattern of financing in the Caribbean especially, the dominance of commercial banks in the financing of corporate activities. They did not, however, deal with the issue of how the determinants of corporate capital structure impacted on capital market development. This avenue of research is important because it has powerful and direct implications for policy makers engaged in capital market development.

This explorative paper therefore reviews the literature on optimal corporate capital structure theory and corporate financing patterns in Trinidad and Tobago in an attempt to glean some policy implications from capital market development.

The issue of appropriate or optimal capital structure has been extensively dealt with in the literature.¹ This purely financial topic is very important as it deals with microeconomic issues which often determine the amount, as well as, the type of capital accumulated by the financial system. The way in which these micro-issues affect capital market development has, however, been largely overlooked in developing countries.

¹ Harris and Raviv (1991) and Miller (1988) have done comprehensive reviews of the literature.

An inadequate understanding of these micro-issues on the part of policy makers in these countries has often led to the implementation of inappropriate and flawed policies and systems for capital market development.

A variety of capital structure theory has appeared in the finance literature.² The seminal piece of work in this area by Modigliani and Miller (1958) pointed the way in which such a theory should take, by showing the conditions³ under which financial structure was irrelevant.

They established that the market valuation of the firm was independent of its financial structure, that is, its debt/equity ratio. In a broader sense therefore, the Modigliani-Miller theorem suggested that there was a dichotomy between finance and the real economy (Singh and Hamid 1972).

This ran contrary to the traditional approach to valuation and leverage which assumed that there is an optimal capital structure and that the firm can increase the value of the firm through the judicious use of leverage. This approach posits that as cheaper debt funds are increased the value of the firm increases, eventually, however, the leverage of the firm reaches a point where the marginal benefit derived from cheaper debt funds is offset by the marginal cost of increased risks of bankruptcy due to leverage. At this point the firm is at its optimal leverage position or optimal capital structure.

²Capital structure theory which does not have direct implications for capital market development is not considered.

³Modigliani and Miller (1958) assumed that there was no taxes (or tax policy did not treat debt and equity differently), there were no transaction costs, individual borrowing could substitute for firm borrowing, investors are rational and that firms can be categorized into risk classes.

The radical nature of the Modigliani-Miller propositions generated a great deal of interest in the issue of optimal corporate capital structure. It is ironic that some of the most productive responses to the Modigliani-Miller theorem have come from those who did not accept the conclusion that financial policy is irrelevant. Some of the most important contributions to this theoretical debate is reviewed below.

Many authors following Modigliani and Miller also assumed frictionless markets⁴ (Modigliani and Miller 1963, Miller 1977 and De Angelo and Masulis 1980). In 1963, Modigliani and Miller published a paper which introduced corporate taxation into their analysis. This paper focussed on the different treatment of dividends to shareholders and interest paid to debt holders. According to the study, if interest expenses on debt was deductible against corporate income while dividends were not, firms had a significant advantage if they financed their operations with debt rather than equity. Miller (1977) incorporated the differential personal taxation of bond and stock income into the basic Modigliani-Miller Model. The basic result of this paper was that firms' capital structure is a matter of indifference to their owners but there is an optimal leverages position for the market as a whole. This optimal aggregate capital structure reflects the distribution of savings across the range of personal tax brackets.

De Angelo and Masulis (1980) furthered worked in the area of optimal capital structure by factoring into the basic Modigliani-Miller framework, a limit on firms' ability to use tax credits to offset taxable income. In this model, the firm found the use of debt beneficial so long as it could take advantage of the deductibility of interest expenses.

⁴There are no costs involved in the buying and selling of securities such as information costs, brokerage fees and other costs related to trading in the market.

The ability of the firm to utilize its interest expense as a tax break depends on the fraction of interest expenses that the tax authority allows the firm to deduct from taxable income, the level of the firm's taxable income and the amount of tax deductible expenses it accrues from its operations.⁵ The important insight of this paper was that it showed that a limit on a firm's abilities to take advantage of its tax credit will produce an optimal capital structure for each firm as well as for the whole economy.

The assumption of frictionless markets that the above-mentioned studies used is, however, far from reality. The theoretical literature reviewed so far, although generating useful insights into what drives capital structure choices, do not consider many of the practical considerations that firms encounter in making financing choices. In what follows, the assumption of frictionless markets is discarded and a range of factors which affect the daily financing decisions of firms are considered.

Myers (1984) argued that a firm's financing decision conformed to a "pecking order" theory of capital structure. According to Myers, firms prefer internal to external financing and if external financing is needed firms generally prefer debt, with equity being a last resort. Essentially, the firm's observed capital structure is a reflection of historical financing decisions based on its profitability, divided policy and investment opportunities. However, while Myers pecking order theory may accurately reflect actual corporate financing practices (especially in developed countries) it does not explain why corporations act in this way. To this end, a rich body of work has developed, especially in the areas of principal/agency (managerial capitalism), asymmetric information models and corporate control.

⁵Depreciation on fixed assets and investment tax credits.

A study by Jensen and Meckling (1976) introduced the concept of agency costs into capital structure theory. In this model, principals (shareholders) must engage agents (managers) to run the business because of the separation of ownership and management in modern corporations. Managers do, however, have different objectives⁶ to shareholders which creates a problem in terms of managers acting in shareholders' interests. The costs involved in monitoring managers, which are called agency costs, can be significant.

Jensen and Meckling argued further that if the managers' absolute investment in the firm is held constant, increases in the debt finance would increase their share of equity and mitigate the conflict between managers and shareholders. This constitutes the main benefit of debt financing. This paper also implies that the conflict between managers and shareholders can be alleviated by compelling managers to hold more shares in the firm, managerial incentive schemes and by more complicated financial contracts such as convertible debt. Jensen and Meckling concluded that an optimal capital structure can be obtained by trading of the benefit of debt against its agency costs.⁷

⁶For example, managers may prioritize job security over share maximization (shareholders objective). This may involve choosing less risky (lower returns) investment projects so there is little chance of failure (with its attendant negative consequences for job security).

⁷ One of the most important agency cost of debt is that it can generate incentives for risky, value decreasing investing by shareholders. This occurs because most of the high returns generated by risky investments accrue to shareholders, however, more of the cost of failure falls on debtholders because they are not protected by limited liability.

The explicit modelling of private information in economic analysis has made possible a number of approaches to explaining capital structure. These asymmetric information theories are based on the premise that firm managers (insiders) are assumed to have more information about the firm's prospects than shareholders and bondholders (outsiders). In these models, capital structure choices either signal to outsiders the information that insiders possess (Ross 1977, Leland and Pyle 1977), or mitigate inefficiencies in the firms investment decisions that are caused by information asymmetries (Myers and Majluf 1984).

Myers and Majluf (1984) shows that information asymmetries can cause equities to be mispriced by the market. If firms are required to finance new projects by issuing equity, underpricing may be so severe that new investors capture more than the net present value of new projects resulting in a net loss to existing shareholders. In such cases, new projects will tend to be financed by debt which is not so devalued by underpricing.

In the signalling literature on capital structure (Ross 1977, Leland and Pyle 1977), issuing more or less debt signal that the shares of the firm is either underpriced or overpriced. Firms will therefore not want to issue equity because this will be perceived by investors as a confession that the firm is over-valued by the market. Investors acting on this perception often cause the share price to fall on the announcement of a new issue (Krasker 1986, Lucas and McDonald 1990). All these factors creates a preference on the part of managers for debt financing.

Corporate control considerations also impacts on capital structure choices. Harris and Reviv (1988) and Shultz (1988) use models which exploit the differential voting rights of debt and equity. The capital structure is seen to affect the value of the firm, the probability of takeover and the price effect of takeover attempts. It is shown that the more leveraged is a firm the less likely are takeover attempts and proxy fights to be successful. More debt therefore, helps to protect managers from the discipline of the markets which increases their preference for debt.

These new developments in terms of capital structure lent support to the pecking order theory which argues that firms prefer internal to external finance and debt to equity. Why then, do firms occasionally issue equity? An explanation for this can be found from the various "debt capacity" theories.⁸ Simply put, if debt financing increases the risk of financial distress and significant costs⁹ are associated with financial distress and failure, then the limited use of debt financing is understandable. In this case, the optimal financial structure occurs when the firm's value is maximized or where the marginal benefits of debt is equal to the marginal cost of debt.

The literature contains a relatively small number of empirical studies which have tried to investigate whether these theories adequately explain observed differences in capital structure between firms (Titman and Wessels 1988, Williamson 1988). The empirical results on the whole seems to validate many of these theoretical propositions (Harris and Raviv 1991).

⁸See Kim (1976), Scott (1976), and Kraus and Litzenger (1973).

⁹Bankruptcy costs include capital losses caused by distress selling of assets in imperfect markets, deadweight administrative expenses that arise in bankruptcy proceedings and lost tax credits from the discontinuance of the firms operations.

Although most of the theoretical and empirical work relates to developed countries, important implications for developing countries on how capital structure relates to capital market development can still be derived from the literature. Fundamental factors which seem to influence the debt/equity mix in firms include bankruptcy costs, personal income taxes, differential taxation of income from different sources, differences in information among corporate insiders and outsiders and, issues related to corporate control. These factors have serious implications for capital market development because they can have a significant impact on the supply of corporate securities which are important capital market instruments.

I would now like to focus on some of the more important of the above mentioned factors for capital markets in developing countries. Firstly, the tax advantage of debt (the tax deductibility of interest payment on debt) is probably the most powerful incentive for firms to issue debt rather than equity. In many developing countries, this advantage is reinforced by the fact that interest rates on loans is often kept artificially low for some favored sectors. Additionally, the excessively high cost associated with the issuance¹⁰ of corporate bonds and equities bias financing patterns in favor of loan finance rather than bond or equity finance. This depresses the supply of these corporate securities.

¹⁰High issuance cost in developing markets is often caused by inadequate institutional mechanisms for trading, fixed commission fees, a lack of competition among brokers and the practice of pricing equities at par or below par.

Secondly, the impact of financing decisions on the riskiness of the firm can damage the marketability of its bonds and equities on the capital market. As a firm increases its leverage their ability to meet fixed interest payments out of current earnings diminishes. This increases the probability of bankruptcy as well as their cost of capital (risk premium). The firm therefore, finds that the demand for its capital market securities drop and investors are only willing to take up these securities at a considerable premium. This of course, can ultimately lead to an illiquid and unstable market dominated by a few players.

Thirdly, financing patterns determines who control the firm. In emerging markets where the tradition of family ownership is strong, control can dominate the financial decisions of a firm. The owners defer public issue of equity which dilute control but which also prevent a firm from exploiting all its growth opportunities. This not only stunts the development of the capital market by limiting the supply of corporate equities but hampers the growth process as well.

Lastly, and somewhat coincidentally with the control issue, is the matter of disclosure. The issue of shares or bonds by companies usually involves the disclosure of information that closely held firms may wish to keep private. This preference for privacy can be linked to economic strategy but is often due to emotional individual preferences. Closely held firms are therefore unwilling to issue shares which limits the supply of corporate securities.

Evidence from developed countries indicate that financing patterns generally follow the pecking order theory of capital structure. For example, during the period 1970-1985 internal finance as a percentage of total finance ranged from an average of 91.9% for the U.K to 57.9% for Japan. During the same period, the proportion of equity financing used ranged from a high of 4.6% for Japan to a low of -2.5% for the U.K. Bond finance ranged from a high of 11.6% for the U.S to a low of -1.0% for Germany and loan financing ranged from a high of 50.4% for Japan to a low of 7.6% for the U.K.¹¹

Firms in developing countries, however, have tended to rely more on external funds and equity sometimes accounted for a significant portion of external financing, although debt is more often preferred. This seems contrary to the pecking order theory of capital structure. (Singh (1995), Singh and Hamid (1992)). This is not surprising when one considers the institutional and tax measures that governments in these countries have instituted in the last decade.

Factors, such as the low cost of loan finance (especially before financial liberalization programmes), the practice of pricing shares at or below par, forcing corporations to issue stock when their debt/equity ratios rise above a certain limit (Korea) and the huge tax advantage given to firms issuing equity by lowering their corporation tax and the tax deductibility of income from these securities. Added to this, is the significant improvements being made to the regulatory and institutional capital market systems in these countries which increase the demand for securities on the part of local and foreign investors.

¹¹ See table A-1 on page 44 in Singh(1995).

These governments have taken a pro-active role in capital market development which is markedly different to the demand led growth of capital markets experienced by most developed countries. The predominance of external finance especially in the last decade can be directly attributed to government policies. The issue of whether the benefits generated by these policies vindicate the costs¹² associated with them is important but will not be dealt with in this paper.

I now turn to the specifics of the Trinidad and Tobago situation with respect to corporate capital structure. In Trinidad and Tobago two surveys have been done on the local financing patterns of corporations. (Farrell, Najjar and Marcelle (1986) and Clarke, Stoddard and Shield (1993)). The study by Farrell, Najjar and Marcelle (1986) found that on average internal funds (from operating income, before depreciation and other non-cash expenses are debited) accounted for 51% of the total source of funds. Larger firms generally exhibited a higher percentage of use of internal funds (61-90%) while small firms depended more on external finance. Government firms also exhibited high use of internal funds (55%) with local firms having an internal fund ratio of 27%.

External funds accounted for a weighted average of 49% of total source of funds. The most important external source of funds was decreases in cash and bank balances accounting for 49.8% of total external funds. Bank loans accounted for 10.2%, loans from non-bank sources accounted for 5.7% and increases in trade credit for 17.8% of total external funds. The issue of shares accounted for only 2.9% of external funds while none of the firms in the survey used corporate bonds as a source of external financing.

¹²The opportunity cost associated with these policies include the tax revenues forgone, the dangers inherent in developing the market ahead of real demand and the possible distortion that occurs in the savings and investment process.

The level of gearing or leverage as expected from this financing pattern was also relatively high. For example, the debt/equity ratio as revealed by the survey was 1.32:1. Expressed as a percentage, debt was 57% while equity was 42% of total assets.

The report by Clarke, Stoddard and Shield (1995) investigated some of the same issues as the earlier study. This study indicated that the weighted average of the ratio internal fund/total sources of funds was approximately 50.3%. Generally, larger firms display a greater reliance on internal funds with the median value of the internal funds/total funds ratio being 37.9% for large firms compared to 23.9% and 32.9% for medium and large firms respectively.

External finance accounted for 49.7% of total funds used by firms. The preferred means of external financing has not changed much since the last survey. Once again bank funds accounted for a large part of external financing accounting for approximately 26.8% of total funds or 54% of external funds. Trade credits accounted for 15.5% of external funds. The response level in this survey was not adequate to make an accurate assessment of the level of bond and share financing but it appears that this type of financing was relatively insignificant.

Indeed, after the initial flurry of new issues on the stock market as it began operation in 1982, new issues of shares have not been significant. Where shares have been issued, it have been mostly rights issues. The level of gearing reported by this survey was similarly high as that reported in the 1983 survey. The median debt/equity ratio was 1.27:1. Debt as a percentage of total assets was 59.6% while the corresponding figure for equity was 40.4%. These figures again reflected the preference for debt financing on the part of firms.

These results are markedly different from results obtained by Singh (1995) in his Survey of corporate financing patterns in developing countries. In Singh's paper, internal funds did not generally account for a large part of total financing and equities and long term debt instruments accounted for a significant portion of external finance. The utilization of capital market instruments in Trinidad and Tobago is much smaller than the usage in the countries surveyed by Singh.

These differences can, however, be explained by institutional and taxation systems in Trinidad and Tobago relative to the countries surveyed by Singh. As already noted, in many of these countries the pro-active stance of the government in the area of capital market development implemented policies which gave tremendous advantages to firms financing their operations through capital market instruments such as corporate bonds and shares. The combination of taxation and institutional measures either forced or enticed corporations to issue shares and bonds. These policies not only increased the supply of capital market instruments but also stimulated demand for these securities by raising their real after-tax rate of return and by improving their marketability.

Although corporate financing in Trinidad and Tobago does not exhibit the patterns exhibited by developed countries, it appears to conform more closely to the pecking order theory of capital structure than the countries surveyed by Singh (1995). In particular, the apparent strong preference for debt over equity. The capital structure exhibited by firms in Trinidad and Tobago can, however, be easily explained by the institutional, taxation and regulatory environment in which they have had to operate. It should be noted also that the present financial structure of firms often reflects the cumulative impact of various policies over time.

The key taxation, institutional and regulatory features which shape corporate financing patterns are discussed below. Perhaps the most powerful incentive to use debt rather than equity is the practice of allowing interest expenses to be a deductible expense against corporate income. This tax benefit is determined by the corporate tax rate (which has been as much as 45% but dropped to 38% in 1994), the amount of taxable income and other tax breaks. This makes debt a much cheaper after-tax source of finance compared to other alternatives. It is therefore, not surprising that high gearing (leverage) is a dominant feature of corporate financial structure in Trinidad and Tobago.

Dividend payments on the other hand do not attract a tax break. In fact, it is taxed at the personal level as well. Previous to 1995, equity was taxed at a rate determined by the personal income tax system.¹³ This meant that equity distributions attracted a tax of up to 40 per cent (the highest marginal rate of personal income tax) at times during the last decade. This not only decreased the demand for equities but meant that firms contemplating using equity to finance their investment plans would only attract savers if they had the potential (demonstrated ability) to deliver high dividends. This in effect rationed many firms out of the option of using equity finance leaving debt finance as the only real financing option. Additionally, a withholding tax of 15% on dividend income was introduced in 1994 which reinforces the disadvantages of equity finance.

¹³ A dividend income allowance is available to investors receiving dividend income. However, this allowance is insignificant for small investors benefiting mostly institutional investors.

Moreover, the practice (at the advent of the Stock Market) of forcing listed companies to issue their share at par or below par, to attract investors,¹⁴ also meant that the costliness of equity finance was more pronounced. This practice has since ceased as the market developed, however, its impact on the financing pattern of corporations in Trinidad and Tobago is still evident. The elimination of this component of merit regulations is part of the overall process of liberalization, where the market is allowed to play a more important rule in pricing and the allocation of resources.

All these factors mitigated against the use of equity finance, limiting the supply of corporate equities and hampering the development of the local capital market. The government has made some efforts to redress this imbalance. The dividend income allowances which reduces the real effective tax on dividend income has helped and the withholding tax on dividends being repatriated was reduced from 25% to 15%.

These policies were meant to equilibrate the tax treatment of equities and debt and so help to redress the tax advantage of debt. All these policy changes reduces constraints on the return to equities which means corporations can pay smaller dividends and still compete effectively for investors. The cost of equity financing will, therefore, fall and corporations will be more inclined to use more equity financing with its attendant positive effect on capital market developments. Having said this however, the tax deductibles of interest expenses still would appear to favor debt financing.

¹⁴This practice is a normal part of merit regulations used at the initial stage of stock market development by many developing countries. The aim is to artificially lower the price of the stock below its value so the investor would benefit from capital gains. This was normally done to entice investors into the market so as to improve its liquidity and pricing efficiencies.

I have so far only differentiated between debt and equity financing. However, corporate bonds is a debt instrument, as well as, an important capital market instrument. One would have expected this financing instrument to have been used more intensely. The empirical data shows, however, that this instrument is an insignificant source of external finance. The reason for this seems to be the transactions costs relevant to this capital markets instrument.

The magnitude of these cost is largely determined by the institutional features of the capital market. In particular, the small number of brokers operating does not promote competitiveness so fees charged by brokers and underwriters may tend to be higher than they would be in a more competitive situation. Costs such as brokerage fees and commissions, legal fees, auditors fees, the cost of printing prospectus and listing fees charged by the exchange¹⁵ can lead to a bond issue (abstracting from interest payments) being an expensive financing option.

¹⁵Listing costs for bonds include a flat sum of \$5,000. regardless of the size of the offer, a charge of 0.14% for listings of value under \$5.5 million and 0.10% for listing over \$50 million. These costs are due to be increased in 1986 to 0.22% and 0.17% respectively.

This form of finance could be especially expensive to medium and small firms since underwriters are likely to charge higher commissions to float bond issues for these firms because of their perceived greater risks. The experience with bond flotation so far seems to bear this out with only large private sector firms and government affiliated firms floating bond issues. When the ease and speed with which loans are accessed relative to bond issues¹⁶ it is not surprising that firms in Trinidad and Tobago has an overwhelming preference for loan relative to bond finance.

Institutional and regulatory factors also tend to favor loan finance relative to equities and corporate bonds. The small numbers of brokers in the market increases the likelihood that insider dealings and price manipulation can occur. Firms may, therefore, have a legitimate concern about the value of their shares being manipulated to their disadvantage, possibly damaging the marketability of future share issues. The lack of disclosure and transparency in brokerage and trading operations often reinforces a firm's suspicion about price fixing which increases their preference for loan finance.

The presence of large institutional investors who often end up controlling large blocks of shares in companies can also be a problem. Corporate control is a legitimate concern of local corporations. The movement of large blocks of a listed firm's shares among these institutional investors means that the ownership of the firm can change in these transactions.

¹⁶Bond issues can involve quite a lot of administrative work especially in terms of providing information to the underwriter of the issue.

The potential for this change of ownership is a disincentive for firm's current owners and managers to issue shares. This concern is manifested in the fact that much of subsequent issues of shares are bonus issues to existing shareholders so as not to change the distribution of ownership and therefore control of the firm. The recent standoff between an important insurance company and a commercial bank is a good example of this sort of situation.¹⁷

This incident highlights some weaknesses in the current regulatory systems. There must be clear and unambiguous rules regarding proxy fights and mergers and takeovers. In particular, the potential of an agent to enlist the services of a third party to purchase shares on their behalf must be eliminated. Ownership must be unambiguous for the smooth management of the firm. A management team and board of directors must have a clear idea of the direction in which the firm is going and such irregularities and uncertainties regarding ownership of a firm does not promote this. Hopefully, the new Securities Legislation will address these problems. Until then, however, most managers and firms will tend to prefer debt finance due to the problems of corporate control introduced by equity finance.

A review of the theoretical literature on corporate capital structure and, corporate financing patterns in Trinidad and Tobago generates some useful implications for capital market development. These implications are explored below.

¹⁷ The alleged purchase of Republic Bank shares by CLICO through a third party.

Firstly, firms in Trinidad and Tobago utilize a sizeable amount of external finance. There is, therefore, great scope for external finance through capital market instruments such as corporate shares and bonds. So far, however, corporations have shown a marked preference for loan finance with its attendant negative consequences for capital market development.

The theoretical literature on optimal corporate capital structure offers some explanation for the observed local preferences. The literature reviewed indicated that factors such as personal income taxation, the differential taxation of income from different sources, differences in information between insiders (managers) and outsiders (shareholders and bondholders), corporate control considerations and bankruptcy costs have strong influences on a firm's financing decisions and therefore corporate capital structure. The taxation system is a particularly important determinant of corporate financing patterns.

In Trinidad and Tobago, these factors have combined to generate a strong corporate preference for loan finance and a high degree of gearing. This has negative consequences for instability (the possibility of bankruptcy), especially during difficult economic periods. It would therefore seem that the relevant authorities in Trinidad and Tobago will have to take a careful and critical look at the present taxation, institutional and regulatory systems relating to corporate financing decisions if they are serious about promoting capital market development.

The theoretical literature and the experience so far implies that in Trinidad and Tobago, certain changes will have to be made to facilitate capital market development. Indeed, some of the required changes have already been made to facilitate capital market development. The changes that have been made include the discontinuance of the practice of forcing corporations to issue shares at par, changes to the taxation system to promote equitable treatment of income from different sources, unifying the top marginal rate of personal and corporate taxation and, the proposed introduction of more comprehensive securities legislation.

The authorities however, have to go further in their efforts to remove the barriers which biases corporate financing patterns in favor of loan finance and away corporate stocks and bonds. The most significant of the remaining barriers is the deductibility of interest expense on debt against corporate income. There are two possible solutions, this element of the system can be removed or it can be extended to dividend distributions. The first option is likely to be too traumatic to corporations who have become used to this and who probably were expecting to be receiving the benefits on their remaining loan payments. The latter systems therefore appear to be more suitable.

Other changes which are required is a combination of stipulated accounting standards and information disclosure rules to bring some transparency into the market. This will tend to increase firms' confidence in the market and reduce their unwillingness to raise finance through bond and stock financing. Control considerations also drives much of firms' unwillingness to use the capital market. The authorities will therefore have to ensure that clear and unambiguous rules with respect to proxy fights and mergers and takeovers are included in the new security legislation.

Lastly, and by no means the least important, is the question of competition among capital market service institutions (brokers and underwriters) and its impact on the cost of issuing capital market securities. The present number of five (5) brokerage firms appears not to be sufficient given the growth of the market. This number appears even more inadequate when one considers that there are 12 and 15 such institutions in Jamaica and Barbados respectively. Additionally, although there appears to be a sufficient number of underwriters (mostly the trust companies owned by commercial banks), there is a suspicion that they engage in mostly non-price competition which would mean that transactions costs remain relatively high. The authorities therefore have to find some way of fostering real competition among these capital market service institutions.

These changes discussed above can redress present imbalances and contribute to the increased financing of corporate investments through the capital market. The positive impact that this has on the supply of corporate banks and share would energize the capital market. Any capital market development programme in Trinidad and Tobago can therefore benefit from the inferences generated by corporate capital structure theory. In the past, little emphasis was placed on these micro-financial issues. This neglect led to policies (especially taxation policies) which distorted corporate financing patterns in favor of loan finance and militated against the development of the capital market. A recognition of the importance of these micro-financial issues by policy makers has created a better policy environment for the capital market. Hopefully, more work in this area will eventually lead to a reasonably well-developed capital market which can effectively serve its important functions in the developing economy of Trinidad and Tobago.

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