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Financing Investment Spikes in the Years Surrounding World War I

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Abstract

In the period surrounding World War I, US firms sharply increased investment in fixed assets and working capital to accommodate large increases in demand associated with the war. Concurrently, the US adopted an excess profits tax, which created a tax bias in favor of equity financing. Despite this tax bias, firms in need of external funds largely issued debt, not equity, to finance investment spikes when the excess profits tax was in effect. Further, we find these firms systematically reduced debt after the war, whereas other firms did not. The results support models that link the dynamics of firms' financing decisions with the dynamics of their investment opportunities and are inconsistent with models that emphasize taxes as a primary determinant of financing decisions.

Keywords: Capital structure; Financing flexibility; Investment spikes; Corporate taxes
JEL Classification: G32; G38

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