

Financing Investment Spikes in the Years Surrounding World War I

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PII: S0304-405X(18)30179-X
DOI: [10.1016/j.jfineco.2018.07.003](https://doi.org/10.1016/j.jfineco.2018.07.003)
Reference: FINEC 2924

To appear in: *Journal of Financial Economics*

Received date: 13 August 2014
Revised date: 23 May 2017
Accepted date: 28 May 2017

Please cite this article as: Leonce Bargeron , David Denis , Kenneth Lehn , Financing Investment Spikes in the Years Surrounding World War I, *Journal of Financial Economics* (2018), doi: [10.1016/j.jfineco.2018.07.003](https://doi.org/10.1016/j.jfineco.2018.07.003)

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June, 2017

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

[◇] We thank an anonymous referee, Steven Bank, Alex Butler, Harry DeAngelo, Philipp Immenkotter, Vidhan Goyal, Ambrus Kecskes, Michael Roberts, Jason Sturgess, Mark Walker, Toni Whited (editor) and seminar participants at the 2014 SFS Finance Cavalcade, BI Norwegian Business School, Boston College, Duquesne University, HEC-Paris, Hong Kong University of Science and Technology, Indiana University, Manchester Business School, Michigan State University, University of Alabama, University of Alberta, University of Arizona, University of Bristol, University of Colorado, University of Illinois, University of Kentucky, University of Pittsburgh, University of Tennessee, University of Utah, Warwick Business School, and York University for helpful comments. We also thank Peter Baschnegal, Arup Ganguly, and Tian Qiu for excellent research assistance.

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