

## **INTERNATIONAL PRAGMATIC REVIEW AND ASSESSMENT OF CAPITAL STRUCTURE DETERMINANTS**

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### **ABSTRACT**

*This paper considered various combinations of financing instrument that makes up the capital of a firm. Various relevant concepts were properly defined and narrated; this includes capital structure's scope and importance, profitability, solvency and flexibility. Major theories of capital structure were reviewed, such as MM theory, Agency theory, Trade off theory, Signaling theory, Pecking order theory and Free cash flow theory. The determinants of capital structure of some countries across the globe were assessed such countries include, Pakistan, Libya, Turkey, Ghana, Sri Lanka, India, South Africa, Nepal, Egypt, United States, China and United Kingdom. The paper discovered some specific country factors such as cultural setting, development of capital markets, monetary policies, political risk and fiscal policies as major determinants of capital structure. The paper recommends that major country specific factors should be considered carefully in determining the capital structure of a firm.*

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*Key Words: Capital Structure, Determinants, Profitability, Debts, Equity*

### **INTRODUCTION**

Ensuring an optimal capital structure and securing the financing sources with the least cost of capital is as important, if not more, for corporate entities. The ability of an organization to perform well in the market depends on the efficiency of its capital structure.

The importance of finance to any type of business cannot be overemphasized. Besides serving as working capital, it is also needed for all forms of business investment activities. Finance decisions affect the various facets of a business directly or indirectly, and to a reasonable extent determines the wealth of its owners and its investors. There are various sources of funds for a business, part of which belongs to the owners while the rest is borrowed. While some of the funds are permanently held in business, such as share capital and reserves (owned funds), some others are held for a long period such as long-term borrowings or debentures, and still some other funds are in the nature of short-term

borrowings. The entire composition of these funds however constitutes the overall financial structure of a firm which is often times referred to as its capital structure.

Capital structure defines policies that determine the composition of long term funds. It pays particular attention to the debt equity ratio and the dividend decisions of a firm. According to Chen (2007), Capital structure refers to the way a corporation finance itself through some combination of equity, debt or hybrid securities. Many scholars and researchers have identified a large number of potential determinants of capital structure. Although according to Harris & Raviv (1991), empirical works so far have not been able to sort out which of these are important in various contexts.”

The factors involved in choosing a capital structure are complex and must be done with utmost care. Decision regarding what type of capital structure a company should have is of critical importance because of its potential impact on profitability and solvency. **Ensuring an optimal capital structure and securing the financing sources with the least cost of capital is as important, if not more, for corporate entities as it is for individuals.** The ability of an organization to perform well in the market depends on the efficiency of its capital structure.

Baharuddin et.al. (2011) notes that capital structure decisions have the underlying aim towards maximizing the value of a firm. The determination of an optimum capital structure in practice is a formidable task, and must go beyond theories, even though most discussion on the issue is highly theoretical. Bauer (2004) notes correctly the existence of several conditional theories of capital structure with little known about their empirical evidence. Rajan & Zingales (1995) also noted that ...very little is known about the empirical relevance of the different theories.” These observation might very reasonably explain the significant variations among industries and among' different companies within the same industry regarding capital structure.

Although there has been plenty of research focusing on the primary determinants of capital structure, there is still disagreement regarding which factors significantly affect a firm's capital structure. While there is no general agreement as to what determines the capital structure decisions of firms or whether firms have an optimal capital structure, it is clear that, in addition to firm-specific determinants, the characteristics of the economic and institutional environment in which firms operate affect their capital structure. Booth et al, (2001) state that, *“In general, debt ratios in developing countries seem to be affected in the same way and by the same types of variables that are significant in developed countries. However, there are systematic differences in the way these ratios are affected by country factors, such as GDP growth rates, inflation rates, and development of capital markets.”*

This study attempts to identify on a universal basis some of these economic and institutional factors that very likely allows for differences in capital structure even in identical firms and industries, different economies and nations. The remaining part of the paper has been organized in the following order, immediately after this introduction is the examination of various concept adopted, followed by review of various theories of capital structure, international review and assessment of capital structure, determinants of capital structure beyond firm specific factors while the last portion consists of concluding remarks.

## **BASIC CONCEPTS IN CAPITAL STRUCTURE DISCUSSION**

### **Capital Structure: Scope and Importance**

According to Darwood et al (2011), capital structure refers to the way a corporation finances its investments through some combination of equity and debt. Akhtar et al (n. d.) defines it as a particular combination of debt, equity and other sources of finance that a firm uses to fund its long-term asset. In the words of Song (2005), the term capital structure refers to the mix of different types of securities (long-term debt, common stock, preferred stock) issued by a company to finance its assets. A company is said to be unlevered as long as it has no debt, while a firm with debt in its capital structure is said to be leveraged. Emery et al, (2004) simply defines it as the leverage ratio. It is the composition of various sources of long-term funds in the total capitalization of the company. According to Mishra (2011), Capital structure policy is normally concerned about:

- i. The proportion of debt and equity to finance the company's operations
- ii. How does the long term to short-term debt mix look like?
- iii. In case equity finance is to be raised, should it be through a rights issue or primary issue?
- iv. To what extent should internal funds be used to finance the company's various activities?

How a firm is financed is of vital importance to both the managers of firms and providers of funds. Therefore, every firm must strive to determine for itself a capital structure that maximizes the value of its shares. This will occur when the marginal real cost of each source of funds is the same. If a wrong mix of finance is employed, the performance and survival of the business enterprise may be at stake.

A sound and appropriate capital structure should have the following features:

**Profitability:** The capital structure of the company should be most advantageous, within the constraints. Maximum use of leverage at a minimum cost should be made.

**Solvency:** The use of excessive debt threatens the solvency of the company. Debt should be used judiciously. As far as solvency is concerned, capital structuring must be approached with due caution. The debt capacity of the company which depends on its ability to generate future cash flows should not be exceeded. It should have enough cash to pay periodic fixed charges to creditors and the principal sum on maturity.

**Flexibility:** The capital structure should be flexible to meet the changing conditions. It should be possible for a company to adapt its capital structure with minimum cost and delay if warranted by a changed situation. It should also be possible for the company to provide funds whenever needed to finance its profitable activities.

## **RELEVANT THEORIES OF CAPITAL STRUCTURE**

In an attempt to explain the basic determinants of capital structure of firms, research has advanced several theoretical models, and empirical studies have been carried out to determine whether these theoretical models have explanatory power when applied to the real business world. As noted by Harris and Raviv (1991), several studies shed light on the

specific characteristics of firms and industries that determine leverage ratios. However, Myers (2001) opines that there is no universal theory of the debt-equity choice and no reason to expect one. Finance literature identifies the most prominent of these theories as the trade-off theory (Ross, 1977), the signaling theory, the agency theory (Jensen – Meckling, 1976), (Myers, 1977), the free cash-flow theory (Jensen, 1986), and the pecking-order theory (Myers – Majluf, 1984), (Myers, 1984). All developed after the pioneering work of Modigliani and Miller in 1958 on the issue. These theories are considered below.

### **MM Theory**

Proposed by Franco Modigliani and Merton Miller in 1958, is the earliest profound theory of capital structure. The first proposition, also referred to as the debt irrelevance theorem, states that the value of a firm is unaffected by its capital structure. It maintains that under perfect market conditions, the market value of a company is unaffected by how that company is financed. The second proposition states that the required rate of return on equity increases as the firm's debt equity ratio increases. This exactly offsets the less expensive funds represented by debt. It should be noted that these capital structuring theories operate under various assumptions, such as no taxes, rational investors, perfect competition etc. However, the actual marketplace is quite different. Besides impacting the financials of the firm, capital structure of a firm also has intangible effects, particularly regarding investors' perceptions of the firm.

### **Agency Theory**

The agency costs refer to the costs generated as the result of conflicts of interest between shareholders, managers and debt holders (Jensen & Meckling, 1976). In the Agent-Principal relationship, the manager who is usually the agent might choose not to maximize the wealth of the principals – the shareholders and the debt holders. Where this is the case, conflict is imminent. The theory states that an optimal capital structure will be determined by minimizing the costs arising from conflicts between these parties.

The conflict between managers and shareholders may arise because managers hold less than 100 percent of the residual claim (Harris and Raviv, 1990). Where ownership is separated from control, inefficiency might define a firm's business environment. Managers may invest less effort in managing the firm's resources thus reducing the value of the firm, and may even transfer the firm's resources for their own personal benefits. This inefficiency is reduced when a large fraction of the firm's equity is owned by the managers.

Since the claim of the debt holders is fixed, they are usually very concerned about the extent to which firms invest in excessively risky projects. However, shareholders may desire to boost their earnings and would likely ignore this concern if they stand to gain more from the risky business. This conflict can be resolved if debt holders strives to confine the opportunistic behavior of managers by writing the debt contracts accordingly.

### **Trade-off Theory**

Under this theory, there are two factors that determine a firm's leverage decision: taxes and costs of financial distress or bankruptcy costs (the costs incurred when the perceived probability that the firm will default on financing is greater than zero (Abor, 2008)).

According to Scoot (1977), a firm's optimal debt ratio is determined by a trade-off between the bankruptcy cost and tax advantage of borrowing. This means that the higher the possibility of a firm becoming bankrupt, the lower will be its desire to increase its leverage. Thus a firm's optimal debt equity ratio is achieved at the point when the marginal present value of the tax on additional debt is equal to the increase in the present value of financial distress costs (Hassan, 2011). This further suggests that firms that have the ability of making high profits will incur little or no costs of distress and as a result, they can increase their tax benefits by raising leverage.

Green, Murinde and Suppakitjarak (2002) observe that tax policy has an important effect on the capital structure decisions of firms. Corporate taxes allow firms to deduct interest on debt in computing taxable profits. This in effect makes debt financing less expensive than the use of equity financing and as a result, encourages more debt use by the firm, as this increases the earnings of the owners (Modigliani and Miller, 1963; Miller, 1977).

This might suggest that the tax advantages derived from debt would lead firms to be completely financed through debt. This is not necessarily true since firms rarely use 100% debt financing. When a firm raises excessive debt to finance its operations, it may default on this debt and can be exposed to bankruptcy costs. For these reasons, trade off theory claims that tax shield benefits of debt financing need to be adjusted for financial distress costs that rise with increasing debt levels, creating an optimal capital structure that balances both forces (Brounen and Eichholtz, 2001).

### **Signaling Theory**

Developed by Ross (1977) considers the signaling role of debt issuance. In his model, managerial quality is private information. A low ability manager will not be able to repay a high level of debt, and will therefore face bankruptcy. A high ability manager will be able to repay a high level of debt. In effect, the high ability manager is using a high debt level to demonstrate his confidence in firm prospects to the market. (Ilyas, n.d.) signaling theory implies that a company chooses debt ratio as a signal about its type. Therefore in the case of a good company the debt must be large enough to act as an incentive compatible signal, (Bauer)

### **Pecking Order Theory**

This theory developed by Myers and Majluf (1984), emerged based on asymmetric information problems between better informed managers and less informed investors. In the pecking order model managers do not attempt to maintain a particular capital structure. In other words, therefore there is no well-defined optimal leverage. It predicts that firms will prefer internal financing (retained earnings) to issuing security, and, if forced to resort to external financing because internal cash flow is not sufficient to finance capital expenditure, firms will use debt before equity. This model explains many observed patterns in corporate finance including the tendency of firms not to issue stock and their choice to hold surprisingly large cash reserves and other forms of "financial slack." (Chen (2003) Hovakimian et al. (2004) because there are two kinds of equity, internal and external, one at the top of the pecking order and one at the bottom.

### **Free Cash Flow Theory**

Proposed by Jensen in 1986, this theory finds application in firms with extra-high free cash flow. It claims that unless the excess cash flow in a firm is given back to investors (creditors or equityholders), managers have a great incentive to cause their firms to grow beyond their optimal size by spending heavily on activities even though their average returns might be below the cost of capital (i.e. have negative NPVs). Thus, the high debt ratio disciplines managers to pay out cash instead of investing it below the cost of capital or wasting it on organizational inefficiencies. Jensen and Meckling (1976) supporting them also argue that increasing leverage would impose financial discipline on management and prevent unnecessary investments, as creditors demand annual payments and claim any free cash flow available to the firm, thus keeping the firm slim and cost efficient.

### **INTERNATIONAL REVIEW AND ASSESSMENT OF CAPITAL STRUCTURE DETERMINANTS**

Research has shown that factors that determine capital structure differ from firm to firm and even from country to country.

#### **In Pakistan**

Sheikh and Wang (2011) found that profitability, size, non-debt tax shields, tangibility, and liquidity were the significant determinants of capital structure in Pakistan. Their study used 160 firms listed on the Karachi Stock Exchange, Pakistan over a period of five years. They also noted that the firms used in their analysis represent the driving industrial force in Pakistan, and as such, the sample very well captures aggregate leverage in the country. Afza and Hussain (2011) also in Pakistan used Spearman's correlation and Regression techniques to analyze data from 37 firms. They identified tax provision, asset structure or tangibility, liquidity, non debt tax shield, size and profitability to be major determinants of capital structure. This is consistent with the study by Sheikh and Wang (2011).

#### **Libya**

Buferna et al 2005 using a multiple regression analysis and a total of 55 companies from both the public and private sector found profitability, tangibility growth, and size to be major determinants of capital structure for Libyan firms. Their study also included financial distressed firms since they considered that the cost of bankruptcy might have a significant impact on financing decisions. Their results showed that the static trade off theory and agency cost theory were pertinent in explaining the financing behaviour of firms in Libya.

#### **Turkey**

Terker et al (2009) carried out an empirical research that covers 42 selected firms traded at the Istanbul Stock Exchange for a period of seven years. They found that return on assets (profitability), and firms' tangibility has more statistical significance on the leverage decision of firms in Turkey. Considering their result, the Pecking Order Theory finds more relevance in explaining the capital structure decisions of Turkish firms.

### **Ghana**

In his study, Abor (2008) used a panel regression model on three sample groups – large quoted firms, large unquoted firms and small and medium scale enterprises. He identified the age of the firm, size of the firm, asset structure or tangibility, profitability, risk and managerial ownership as being very important in influencing the capital structure decisions of Ghanaian firms. The theories consistent with these findings are the Pecking Order theory, Agency cost Theory and also the Static trade off theory.

### **Sri Lanka**

Prahalathan (2010), Using a multiple regression analysis, examined the leverage behavior of 19 manufacturing companies in Colombo stock exchange market in Sri Lanka for the period of 2003-2007. The findings of his study, showed that tangibility, profitability, firm size and non-debt tax shields were the major determinants of capital structure in these firms. The result of the study is consistent with the static trade - off theory.

### **South Africa**

The findings of MGUDLWA (2009) after studying the determinants of capital structure in manufacturing firms in South Africa confirmed the correlation between gearing and size, asset structure (tangibility) and growth. The study also established that size significantly impacts on the capital structure choice of the firms. Small and medium enterprises particularly had difficulties accessing long term funds in South Africa. Using the survey method, the study identified Pecking Order theory, Agency theory and Trade off theory as theories that explain the funding behaviours of South African firms.

### **Nepal**

Baral (2004) used the multiple regression model on 40 listed companies in Nepal to assess the influence of certain defined explanatory variables on capital structure. This study concluded that size, growth rate and earning rate (profitability) were statistically significant determinants of capital structure of the listed companies. The result of this study is consistent with the Pecking Order theory and the Static Trade off theory

### **Egypt**

Dawood, Moustafa & El-Hennawi (2011) using a regression analysis on 37 non financial firms over a period of eight years. The results indicate that the overall significant determinants are mainly: firm size, profitability, liquidity, and business risk. They also noted

that the key factors influencing the firms' decision between equity and debt tend to differ across the different industries in Egypt. Since firms in Egypt tend to follow a certain hierarchy of finance, their behaviour is better described using the Modified Pecking Order theory of capital structure.

#### Swedin

Song 2005, investigated capital structure determinants of Swedish firms based on a panel data set from 1992 to 2000 comprising about 6000 companies. In his study he discovered that Swedish firms are on average very highly leveraged, and that short-term debt comprised a considerable part of Swedish firms' total debt. His paper studied determinants of total debt ratios using total debt ratio, long-term debt ratio, and short-term debt ratio. Although data limitation made it impossible to decompose short-term debt and long-term debt into its elements, the study found that the three forms of debt ratio are significantly related to tangibility, profitability, size, and income variability, while non-debt tax shield is only related to the short and long-term forms of debt, uniqueness and growth were not found to be relevant to any of the three debt measures.

#### United States

Coleman findings show that capital structure in small to mid-sized firms is determined by measures of firm size, firm age, organizational status, profitability, and asset structure. Industry sector on its own does not dictate the capital structure of small firms. Her results were consistent with the Life Cycle Theory of Berger and Udell's (1998) which states that firms use different sources of capital at different stages of their development and Myers' Pecking Order Theory (1984) which contends that firms prefer to use internal equity first as a source of financing before turning to external sources of debt or equity.

#### Less Developed Countries

Also Bas, Muradoglu, and Phylaktis (2009) after using data from World Bank Enterprise survey for twenty five African countries and 11,125 firms to examine the differences in the determinants of capital structure in developing countries confirmed the importance of three major determinants – tangibility, profitability and size. Their study focused more on small and medium firms since the contributions of these firms to GDP was higher. They also found that the Pecking order theory was most relevant in explaining the financing behaviour of the firms.

#### China

To explore the determinants of capital structure of Chinese-listed companies using firm-level panel data, Chen (2003) opined that that certain firm-specific factors that are relevant for explaining capital structure in developed economies are also relevant in China. However, the study also pointed out that one remarkable difference between the capital choices of Chinese firms and firms in developed economies is that Chinese firms prefer short-term finance and



have substantially lower amounts of long-term debt. According to Chen, the capital choice decisions of Chinese firms seem to follow a “new Pecking order”—retained profit, then equity, and lastly debt. He identified significant institutional differences such as the legal system governing companies’ operation and banking and securities markets, ownership concentration and the corporate governance structure of the listed firms, the agency problems inheriting from public ownership, and the financial constraints in the banking sector are all factors influencing the roles of firm-specific factors on firms’ leverage decision. The trade-off model was also noted to have very limited explanatory power in China because the Chinese environment still keeps some features of a centrally planned economy.

Huang and Song (n.d.) in their paper employed more than 1000 Chinese listed companies up to the year 2000, to document the characteristics of these firms in terms of capital structure. They found that as in other countries, leverage in Chinese firms increases with firm size, non-debt tax shields and fixed assets, and decreases with profitability and correlates with industries. Their study also suggested that the static tradeoff model rather than pecking order hypothesis seems better in explaining the features of capital structure for Chinese listed companies.

### **GCC Countries**

Gulf Cooperation Council (GCC) countries are located in the Arabian Peninsula. They are non-tax paying entities which make them an interesting case to investigate whether the determinants of the capital structure of firms operating in these markets are similar to those operating in the developed and industrial countries. Sbeiti (2010) investigated into the determinants of capital structure of firms in these countries using firms listed in three GCC stock markets between 1998-2005. The empirical findings showed that liquidity, tangibility and profitability are negatively and significantly related to the leverage ratios; while firm size is positively and significantly related to leverage ratio of firms operating in the countries investigated. Finally, growth opportunities are positively related to book leverage and negatively related to market leverage in all three countries.

### **Czech Republic**

Bauer (2004) in his study found out that Czech listed firms exhibit lower leverage than firms in G7 countries (France, West Germany, Italy, Japan, United Kingdom, United States, and Canada). His study also revealed that the major determinants of capital structure in Czech listed firms were size, profitability, non-debt tax shields, which were similar to the conclusions of most other empirical studies. The pecking order theory found more relevance as a model for determining the capital structure of these firms.

### **India**

Most study on capital structure are usually focused on activities in the private sector. Bearing this in mind, Mishra (2011) conducted a study to find out the determinants of capital

structure in PSUs (Public Sector Undertakings) in India. The study involved 48 profits making manufacturing firm from 2006 to 2010. Multiple regression analysis was employed in the empirical analysis and the study postulated that capital structure in these firms was determined basically by asset structure (tangibility), profitability and tax. The study was carried out keeping in view the agency theory and the pecking order theory.

### **United Kingdom**

With the objective to provide an insight into what determines a firm's level of debt, Chen (2007) conducted a study applying ANOVA and multiple regression analysis of secondary data on 80 UK public companies operating in 10 industries. Though the study demonstrated a disparity between empirical results and theoretical predictions, growth rate, firm size, tax shields and asset compositions were found to be significantly correlated to particular type of debt in different time period.

### **DETERMINANTS OF CAPITAL STRUCTURE: BEYOND FIRM SPECIFIC FACTORS**

According to Harris and Raviv (1991). Several studies shed light on the specific characteristics of firms and industries that determine leverage ratios. Although much of the works on capital structure have been based on data from developed countries, much work has also been done on developing and emerging economies. Sbeiti (2010) identified the following empirical works on capital structure - Rajan and Zingales (1995) test the determinants of capital structure in the G7 countries, and Antoniou et al (2007) in France, Germany, Japan, the UK and the USA. Booth et al (2001) examine the capital structure decisions of firms operating in ten emerging markets (Brazil, Mexico, India, South Korea, Jordan, Malaysia, Pakistan, Thailand, Turkey and Zimbabwe), while Deesomsak et al (2004) investigate the determinants of capital structure in four Asia Pacific countries, namely Thailand, Singapore, Malaysia and Australia. This literature shows that the capital structure decision is heavily influenced by firm specific factors such as age, asset structure, profitability, growth, firm risk, and managerial ownership. However, these factors dim in face of some identified market wide factors, such as the economic and institutional environment, corporate governance practices, tax systems, exposure to capital markets and the level of investor protection in the country in which the firm operates. In other words, without stability and/or growth in the later, the firm specific factor will become insignificant as they affect capital structure.

Booth et al, (2001) further asserts that, *"In general, debt ratios in developing countries seem to be affected in the same way and by the same types of variables that are significant in developed countries. However, there are systematic differences in the way these ratios are affected by country factors, such as GDP growth rates, inflation rates, and development of capital markets."* The proportion of debt and equity (leverage) in the capital structure differs across companies. The capital structure also varies according to the industry and the market situation that the company is operating in. For example, the average capital structure of European firms is significantly different than that of the American firms. This paper

identifies these specific country factors as the major determinants of capital structure rather than the firm specific factors. The factors so identified are:

- i. Cultural Setting: This defines the saving habit of the people. Savings refers to that part of income which is not consumed. Savings act as an inducement for investment. It can provide an excellent source for future business ventures as capital. The neo-classical growth models emphasize strongly the importance of savings particularly as a source of capital accumulation for investment purposes. The implication of these models is that higher saving rates should leads to higher capital investment.
- ii. Developed of Capital Markets: Capital markets are markets where people, companies, and governments with more funds than they need (because they save some of their income) transfer those funds to people, companies, or governments who have a shortage of funds (because they spend more than their income). Capital markets promote economic efficiency by channeling money from those who do not have an immediate productive use for it to those who do. Capital markets have been identified as an institution that contributes to the socio economic growth and development of emerging economies. It channels resources to areas of great need thus promoting reforms to modernize the financial intermediation capacity to link the deficit and the surplus sector. Furthermore, it serves as a veritable tool in the mobilization and allocation of savings among competitive users which is critical to the growth and efficiency of the economy. It helps to channel capital or long term resources to firms with relatively high and increasing productivity thus embracing economic expansion.
- iii. Monetary Policy: Monetary policy is the regulation of a country's money supply by the central bank of a country or region. Monetary policy is the attempt of central banks to control the supply, availability and cost of money so that the economy is stable, primarily through stability in prices. The primary tools used by a central bank are changes to the prime interest rate, changes to the amount of money in circulation and changes in the reserve requirements for banks. These actions have a direct effect on the interest rates charged on loans, credit cards and any other financial vehicle that is tied to the prime rate. A monetary policy decision that cuts interest rate, for example, lowers the cost of borrowing, resulting in higher investment activity and the purchase of consumer durables.
- iv. Political Risk: The political environment can affect a business either positively, or negatively, depending on the prevailing situation in a country. It mainly forms the external factors - which are part of the macro-environment, control of which is beyond the ability of humans and the business firm. Political Risk It is most commonly conceived in terms of (usually host) government interference with business operation (Carbon, 1979). Very simply, it refers to the possibility that political decisions or events in a country will affect the business climate in such a way that investors will lose money or not make as much money as they expected when the investment was made. Where the government is interested in working for the good of the people, business will thrive - owing to the good policies the government implements. Many developed countries have easy access to capital for smooth operations backed by government support unlike in the developing countries where corruption holds sway. For investors, political risk can simply be defined as the risk of losing money due to changes that occur in a country's government or regulatory environment. Acts of war, terrorism, and military coups are all extreme examples of political risk. Expropriation of assets by the government – or merely the threat – can also have a devastating effect on share prices.

- v. **Tax System:** Capital structure of the firm can also be explained in terms of the tax benefits associated with the use of debt. Green, Murinde and Suppakitjarak (2002) observe that tax policy has an important effect on the capital structure decisions of firms. Corporate taxes allow firms to deduct interest on debt in computing taxable profits. This suggests that tax advantages derived from debt would lead firms to be completely financed through debt. This benefit is created, as the interest payments associated with debt are tax deductible, while payments associated with equity, such as dividends, are not tax deductible. Therefore, this tax effect encourages debt use by the firm, as more debt increases the after tax proceeds to the owners (Modigliani and Miller, 1963; Miller, 1977).

## **CONCLUSION**

The paper has reviewed major popular theories of capital structure to include Agency theory, MM theory, Trade-off theory, Signaling theory, Pecking Order theory and Free Cash Flow theory. An extensive study of major determinants of capital structure in the study were found to include, tangibility, size, tax structure, solvency, managerial ownership, dividend policy, non-debt tax shields and income variability. In addition, this paper identifies some specific country factors as the major determinants of capital structure rather than firm specific factors. These factors include cultural setting, development of capital market, monetary policy, political risk and fiscal policies.

Finally it is recommended that country specific factors should be considered carefully in determining capital structure of a firm, in addition the firms' specific factors are more often than not determined by country's specific factors. Optimal capital structure aids performance and improve stakeholders confidence with positive influence on share prices.

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