Unifying the Basic Cost of Capital Theories (vis-à-vis Leverage)

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Introduction

Influence of leverage on cost of a firm's capital has been the subject of considerable theoretical and empirical study. Yet to-date, "the reported empirical evidences in the subject is so inconclusive that it offers little in terms of either resolving conflicting theoretical propositions or aiding the decision makers". The result has been that, to the ostensibly simple question like – "what happens to the market value of a firm, when its capital structure is changed?", there is no satisfactory answer. Not that there is no answer to the question; in facto there are more than one (either supporting or opposing the Modigliani – Miller proposition), and that is what seems to be the basic problem underlying the current status of the Cost of Capital – Leverage Theory. And, as the two "opposing" views continue to be substantiated by an ever-growing record of empirical studies, the problem seems to defy a solution more than ever before.

Given such an unresolved status of the theory, one may draw either of the following conclusions:

a. that more empirical evidence is required to uphold either one of the theoretical view-points as correct, in which case one makes an implicitly assumption that one and only one of the two "opposing" views can be correct,

b. that the M-M view is correct with respect to some industries and the opposing view is correct with respect to the others; in which case one grants that both the view-points may contain some elements of reality in them and that together they present a comprehensive picture of the entire phenomena, and are not intrinsically opposed to one another, as commonly held.

The efforts to resolve the dilemma so far, seem to have been based upon the first conclusion, as is borne out by the fact that the debate surrounding the issue, more often than not, assumes an "either-or" tenor, with the result hat the two views continue to be viewed as opposed to each other, to this day. And apparently, proceeding on these tracks, the problem is unlikely to reach a settlement, if the experience of the past 25 years is any guide.

It might thus appear more reasonable to arrive at the second conclusion as described above. However, the difficulty with this conclusion is that it offers no explanation as to why, even within the same economy, some industries should uphold the M-M view and the others not. If one could provide such an explanation, perhaps, the debate might be brought to a reasonable conclusion. And this thesis is an attempt towards that direction.