



Vaasan yliopisto
UNIVERSITY OF VAASA

Maksim Akkonen

Globalization and the Cost of Capital

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Author:	Maksim Akkonen	
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Supervisor:	Veda Fatmy	
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ABSTRACT:

The purpose of this thesis is to examine the impact of financial globalization on corporate cost of capital. While foundational capital theories, such as Modigliani and Miller (1958, 1963), suggest that in perfect frictionless market conditions, factors such as underlying assets and earning potential have the most impact on the cost of capital, real market conditions dictate different sets of rules. Through a literature review this thesis explores the hypothesis that companies' ability to access global finance market can reduce significantly the cost of capital. In global market risk diversification is enhanced, information asymmetry reduced and equity risk premiums lowered resulting in lower cost of capital. In this thesis, peer-reviewed literature will be examined to highlight the mechanisms, such as cross-border listings and improved institutional frameworks that allow businesses to achieve lower cost of capital.

KEYWORDS: cost of capital, capital structure, globalization effects, capital markets

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TIIVISTELMÄ:

Tämän tutkielman tarkoituksena on tutkia rahoituksen globalisaation vaikutusta yrityksen pääomakustannukseen. Vaikka perustavanlaatuiset pääomateoriat, kuten Modigliani ja Miller (1958, 1963) ehdottavat, että täydellisissä ja kitkattomissa markkinaolosuhteissa yrityksen varat ja ansaintapotentiaali ovat tekijöitä, joilla on suurin vaikutus pääomakustannukseen, todelliset markkinaolosuhteet noudattavat eri sääntöjä. Kirjallisuuskatsauksen avulla tässä tutkielmassa tarkastellaan hypoteesia, jonka mukaan pääsy maailmanlaajuisille rahoitusmarkkinoille voi mahdollistaa huomattavan alennuksen pääomakustannukseen. Globaaleilla markkinoilla riskinhajautus tehostuu, informaatioasymmetria pienenee ja osakeriskipreemiot laskevat, mikä johtaa alennettuun pääomakustannukseen. Tässä tutkielmassa vertaisarvioidun kirjallisuuden avulla pyritään selvittämään mekanismit, kuten ristiinlistautuminen ja parannettu institutionaalinen rakenne, jotka mahdollistavat yritysten alennetut pääomakustannukset.

AVAINSANAT: pääomakustannus, pääomarakenne, globalisaation vaikutukset, pääomamarkkinat

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1 Introduction

Cost of capital is one of the basic concepts of financing. The subject is also closely related to the field of accounting. Studying the cost of capital one cannot ignore another major topic, capital structure. Modigliani and Miller can be considered as the forefathers of the modern theory on the cost of capital. Their research papers in 1958 and 1963 laid foundation for future studies and work as a starting point for this thesis as well.

Realization that global companies must have lower cost of capital than domestic counterparts lights interest to investigate the underlying reasons for this assertion. The cost of capital consists of many factors. It is important to examine these factors to have core understanding of what affects the cost of capital and will enable us to answer why global and domestic companies have differences in their cost of capital.

Key components of the cost of capital that are examined in this thesis are based on the factors that are ignored in Modigliani and Miller (1958) theorem. Ignored but nonetheless important determinants are asymmetric information, taxes, agency costs and bankruptcy costs. Each one of the determinants is studied carefully to build basic framework for the theory of cost of capital.

Most of the determinants are found in the theories that Myers (1984) studies in his paper. Pecking order and trade-off theories both explain in their way corporate's financing decisions, thus capital structure. In pecking order theory, asymmetric information causes hierarchy amongst costs, which affects corporate's financing decisions. Trade-off theory on the other hand tries to find optimal balance between bankruptcy costs and benefits of tax deduction related to debt financing. According to the theory, being closer to the optimal balance increases the value of the company.

Addition to the more classical view of the cost of capital, studies like Stulz (1999) are included in the thesis to explain the effects of globalization on the firm's cost of capital. The study shows that globalization has many positive effects on the cost of equity. It also

presents the reasons for the positive effects. Capital market is researched to find differences in the cost of capital between domestic and multinational corporations.

1.1 Purpose of the study

This study's objective is to achieve broader understanding of the basic principles of the cost of capital and find answers for the hypothesis. This is possible to achieve through the examination of the determinants affecting the cost of capital. Also, studies concerning capital structure are examined with the intention of strengthening the theoretical basis.

H1: Financial globalization and global finance markets have insignificant effects on the cost of capital.

The main goal is to find underlying factors affecting the differences in cost of capital between domestic and global companies. To achieve this goal, literature on effects of globalization on the cost of capital and studies concerning capital markets are included, in purpose to better understand the effect of globalization.

H2: Financial globalization and access to global finance markets reduce significantly the cost of capital by enhancing global risk diversification and lowering equity risk premiums.

1.2 Structure of the thesis

Examining the topic begins with narrowed look at companies' capital structure to better understand underlying determinants of the cost of capital. Capital structure is discussed in basic details and from theoretical point of view. In theoretical section of capital structure is involved two theories of how the firm's capital is structured, pecking order and trade-off theories.

Following capital structure comes the cost of capital. It is the basis of thesis and involves own subchapters for costs of debt and equity. In this chapter WACC –model is presented in purpose to have basic knowledge of how the cost of capital can be measured. Variety sources of financing are presented to understand what kind of capital financing are used from which the costs of capital are deriving.

The fourth chapter includes capital markets. It observes different capital markets, segmented and integrated. The chapter discusses benefits from liberalization of capital markets and what are the key factors to enable lower cost of capital. The role of the institutional framework is observed in this process and what can disrupt the modernization of financial dynamics.

The fifth chapter expands on the effects of globalization on the cost of capital. Examination of international financing and cross-border listings will demonstrate how the companies operating on global markets are able to achieve lower cost of capital. Foreign debt markets and global risk diversification will further help understand the effects of globalization.

1.3 Previous studies

Cost of capital has been studied extensively over the past century. There have been breakthrough theories on the cost of capital in the late 1950s when Modigliani and Miller published their research in 1958 and 1963. Ever since, future research on the cost of capital and capital structure had an excellent ground from which to continue.

Many papers came after Modigliani and Miller (1958) which tried to supplement their theory. For it worked only in theoretical circumstances and as a basis for future studies. It discarded many determinants that are important to involve in calculations, to have

practical data in the real world. These supplementing theories discussed asymmetric information, taxes, agency cost and bankruptcy cost.

Easley and O'Hara (2004) provided research about the role and the impact of information on the cost of capital. In their paper they show that having different information composition between public and private information affects company's cost of capital. Finding out that the more private information is available for the investors, the higher is the demand for the return of the stocks they are holding.

Taxes have also played central role in studies on the cost of capital. Modigliani and Miller (1958) theorem was supplemented with their own research in 1963, where they made few corrections to their previous study regarding the role of taxes. King (1974) points out that taxes are important in discussion regarding cost of capital and capital structure. For taxes have great effect on firm's financial policies and investment decisions, on which the cost of capital is greatly dependent upon.

Myers (1984) continues to investigate the effects of taxation using trade-off theory. Also, bankruptcy costs are included in the trade-off theory, where the benefits of tax deduction and bankruptcy costs are weighed against. Purpose of this is to find the perfect equilibrium between the two, with the aim of maximizing the value of the company through optimal capital structure.

Jensen and Meckling (1976) discuss agency cost in their paper. They come to conclusion that manager's willingness to lead the firm is correlated with the amount of the company's equity he or she is currently holding. Later Jensen (1986) points out that the agency cost is reduced by the amount of cash is available in consequence of using debt financing. For managers have less funds to consume on "perquisites" such as corporate jets.

2 Capital structure

Every company has a need for financing. For there is a certain level in firm's assets and liquidity, which must be upheld to maintain continuity of the everyday business (Lauriala, 2008, pp. 29-30). Titman and Wessels (1988) argue that company's capital structure is often under the scrutiny of financial analysts. Capital structure indicates the solidity of the company, which affects strongly the decisions that the investors and the companies make regarding the cost of debt and equity.

Equity ratio is one of the ways to indicate firm's solidity. If the equity ratio of a company descends under 20%, it is usually considered to have a weak solidity (Kinnunen et al., 2007, p. 63). In these times importance of solidity has been ever so high, due to the past financial crisis. The financial crisis has challenged companies to maintain relatively high equity ratio for the purpose of surviving challenging times.

Another good indicator of solidity and the capital structure is the gearing ratio. It shows the amount of existing debt relative to the firm's equity. The gearing ratio is considered to be alarming when it surpasses the 100% mark (Kinnunen et al., 2007, p. 63). Formulas describing the equity ratio and the gearing ratio are presented below.

$$\text{Equity ratio} = (\text{Total equity} / \text{Total assets}) * 100 \quad (1)$$

$$\text{Gearing ratio} = (\text{Total debt} / \text{Total equity}) * 100 \quad (2)$$

Both equity and debt can be used as a source of finance. Knupfer and Puttonen (2012) lay the foundation for the theory. A firm's equity can be divided into two, internal and external equity. Internal equity is acquired through company's income revenue and external equity by issuing stocks. Many favor internal financing over debt financing. Internal financing is often seen as the cheapest source of finance, which is simply not true. Equity is practically always costlier than debt, due to fact that it includes a higher risk premium than the debt financing (p. 31).

There is no simple solution for choosing the nature of financing. If one were superior to another, there would be only one kind of financing (Knupfer & Puttonen, 2012, p. 31). The main characteristics of the financing types can be seen in the table below.

Table 1. Comparing equity and debt

	Equity	Debt
Bankruptcy situation	Paid last	Paid before equity
Obligation to pay income	None	Obligation set in the contract
Yield and risk	High yield and risk	Low yield and risk
Voting right	Yes	No
Return of the capital	Usually is not returned	Is set in the loan contract

Note. Adapted from Knupfer and Puttonen (2012, p. 31)

Knupfer and Puttonen (2012) state that equity-based financing provides an investor with a voting right, but in bankruptcy situation the equity investor is last in line when it comes to dividing the remaining capital. Debt investor has a contractual right for income; the amount of income is set in the contract. Equity investors do not enjoy the certainty of return on the investment. Nonetheless the risk is rewarded with a chance for a high return (p. 31).

2.1 Equity

Knupfer and Puttonen (2012) explain that firm's equity is consisted of share capital and retained earnings. It is acquired by issuing stocks and retaining earnings from previous years. Equity based financing holds much greater risks than debt financing, but as it is said in the investment theory, higher risks demand higher returns. Income from the

equity financing can be theoretically unlimited. Equity bears greater costs than debt, as it requires higher return including the risk premium (p. 33).

Equity's internal financing, that is investing the income revenue in future business, is one of the most popular ways of financing, Knupfer and Puttonen (2012) further expand on the theory. It lacks organizational fees that stock issuances entail, and it is easier for the management. Management does not have to be as particular about where the funds will be invested as in issuing the stocks. In the event of an equity offering, an attractive plan should be presented in order for it to be a success. Issuing stocks also means less control for the original shareholders, which can be a problem if a considered number of shares fall into the hands of an unwelcome investor. Internal financing can also be the only choice of financing, for example in small family businesses, where the owners are not willing to invest more of their own money (pp. 33-36).

Equity's external financing, that is the issuance of stocks, has its strengths as well. Knupfer and Puttonen (2012) argue that internal financing is not stable every year. When a company has a weak financial year, it may have insufficient funds to finance its future investments. This is especially a problem with companies that are dedicated to paying a stable stream of dividends. After all, paying dividends uses the funds that the firm would otherwise use to finance its investments (p. 36).

Equity works in a sense as a bumper for uncertain financial times as Knupfer and Puttonen (2012) further argue. Companies that have strong solidity survive hardships in business easier than the companies that have low equity ratio. If a company has too high debt relative to its capital, its default risk grows and so do the costs of financing. Consequently, this triggers a demand for a higher return on equity investments (p. 37).

2.2 Debt

Debt is a cheaper alternative to equity financing. According to Knupfer & Puttonen (2012) it is also cheaper regarding organizational fees, which the issuance of stocks includes. It does have its obligations regarding annual interest payments and returning of the capital at some point. The cost of debt is lower than the cost of equity on a principal level. For the demand on return is usually much higher on the equity's part, than on the debt's part. From the perspective of management, equity has more elasticity than debt. Firm does not have to pay dividends if it has a bad fiscal year, but it must meet its obligations regarding debt (p. 37).

Debt has many positive prospects concerning taxes. Knupfer & Puttonen (2012) states that debt fees are to be paid before taxes, so that they lower overall taxable income. Where on other hand, dividends are paid after taxes so that after paying corporate tax, one must also pay personal tax on the dividends (p. 37).

2.3 Theory of capital structure

Modigliani and Miller (1958) argue that company's value is not based on its capital structure. Theorem is examined in theoretical situation, where there are no taxes, no agency costs, no bankruptcy costs, no asymmetrical information and the markets are efficient. It is clear that such circumstances are not met in any market. That is why it's important to address other studies that include some of the circumstances mentioned above.

According to Modigliani and Miller (1958) theorem of capital structure, valuation of the company is not affected by its capital structure. But in realistic circumstances companies cannot be overleveraged, that would increase the risk of default which in turn would lead to the increasing cost of debt (Baxter, 1967, p. 395). Which brings us to the problem, what is the optimal ratio of debt and equity?

There is no simple solution for optimal capital structure. Myers (1984) argues that there are theories that provide explanations for how companies make decisions concerning their capital structure. One of these theories is the trade-off theory. It examines the benefits of tax deduction and the bankruptcy cost. Second is the pecking order theory, in which company's financial decisions are progressing hierarchically, from internal financing towards debt financing and finally to issuing equity.

Tong and Green (2005) test the hypotheses of pecking order and trade-off theory in their study using the largest listed Chinese companies. The aim of their study is to determine the applicability of the theories in explaining corporate's financing decisions of the Chinese companies. The main differences between the theories are to be found in their correlation between profitability and leverage, which the study revealed to be significant.

Trade-off theory states that the less profitable company is, the less debt is being used, as Tong and Green (2005) further expand on the topic. The greater use of debt increases the risk of default. Which leads to the increasing cost of debt and lowers the profits that the shareholders are making. So, the company is preferably using internal equity financing. This shows the positive correlation between profitability and leverage, when it comes to trade-off theory (pp. 2181-2182).

Tong and Green (2005) find that in pecking order theory exists asymmetrical information, which affects management's financial decisions. If the firm's cash flow is insufficient, future investments are financed through debt. This leads to the negative correlation between profitability and leverage using pecking order theory. The study comes to conclusion that the pecking order theory explains more accurately the financial behavior of the Chinese companies (pp. 2181-2182).

It is still not quite clear if one of the theories is more applicable than the other. Results of the tests are highly dependent on the methods and the data that are used. Shyam-Sunder and Myers (1999) argue that besides the strengths that the pecking order theory

has, the trade-off theory can yield better results if it is modified more specifically. The fact that the excessively specific models have many flaws should not be ignored, of which many are due to the risks that exist in using numerous variables (p. 242).

Besides the traditional theories of capital structure exists a theory of market timing, which is explained by Frank and Goyal (2009). It is a theory of choosing the cheapest source of finance, between the equity and the debt, of the current time. In situations where neither of the markets looks attractive, sometimes decision to finance is postponed. Alternatively, if both of the markets look promising, funds may be raised regardless of the need for finance (p. 6).

2.3.1 Trade-off theory

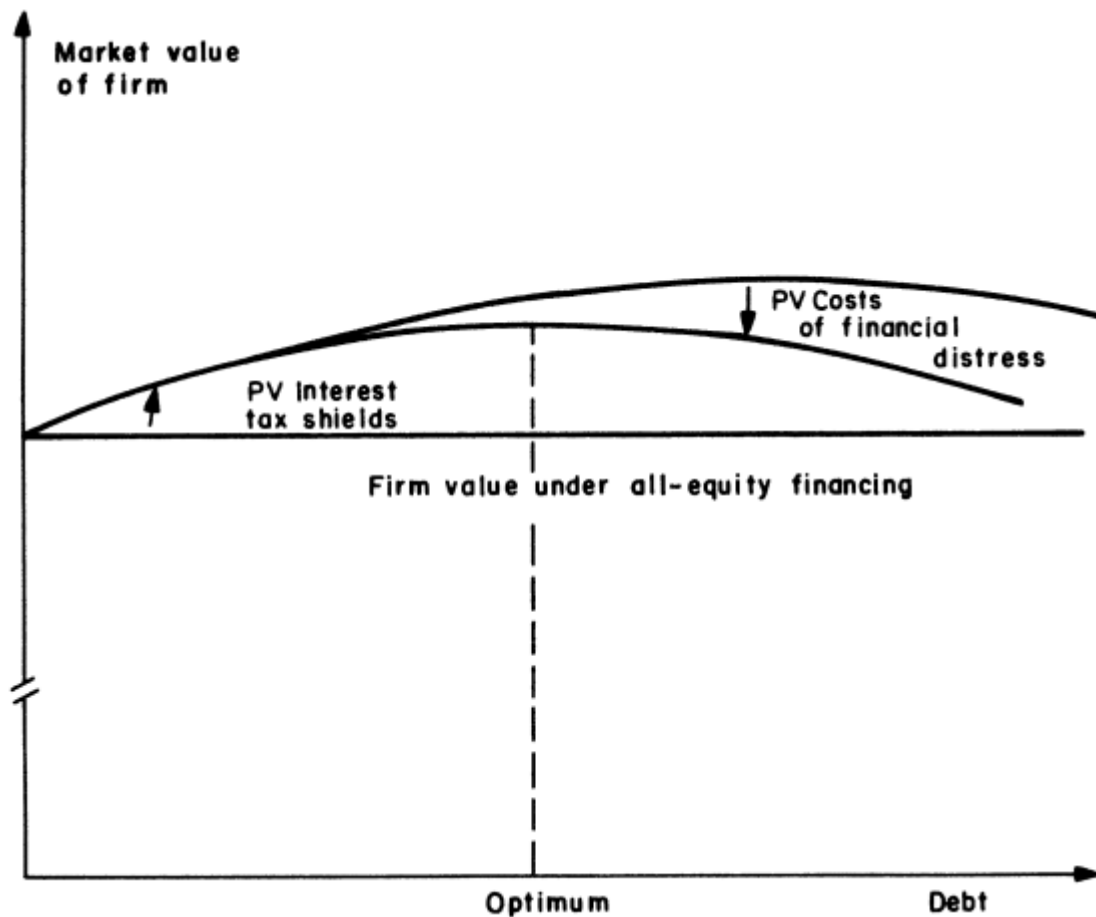
Task of the trade-off theory is to find the optimal balance of the benefits gain from the tax deductions on the debt's interest payments and the harm of the bankruptcy costs. Foundation of the theory are laid by Modigliani and Miller (1958), through their study of the optimal capital structure. Provided that company can choose freely the structure of its capital, the best structure would be 100 % debt. This generates the most benefit but does not include the bankruptcy costs.

Brealey and Myers (1996) expand on the theory, decisions concerning capital structure are strongly dependent on the type of company. If the company has a strong base of equity, it has more elasticity and durability to sustain an unfavorable financial situation, so a high level of debt is advised. In other hand companies with weak base of equity, for example when the equity is based on non-tangible assets such as personnel, has not the same prerequisites to sustain financial hardship, so a lower debt-to-equity ratio is advised (p. 496).

Illustrated in the figure below is the financial decision-making progress. Benefits and costs are being compared in order to find the optimal point of leverage. The point where

the benefits of tax deductions and the harm of financial distress are producing the highest point of firm's market value.

Figure 1. The Static-Tradeoff Theory of Capital Structure



Note. Adapted from Myers (1984, p. 577).

2.3.2 Pecking order theory

In the pecking order theory, asymmetric information causes a hierarchy of costs on which the financial decisions are based which is explained by Tong and Green (2005). First choice for the source of finance is the retentions; firms preferably use the funds already available to the company. This is followed by debt financing, which can be a traditional bank loan. Some type of hybrid financing such as bonds are considered before resolving

on the use of external equity financing, which is the last resort for firms. Usually, external equity financing constitutes as an issuance of stocks. Decisions are highly dependable on the net cash flow of the company, which determines current available funds for an investment. In contrast to trade-off theory, pecking order theory does not consider existence of the optimal capital structure (p. 2180).

According to Myers (1984), unlike trade-off theory the objective of pecking order theory is not to find an optimal capital structure, the capital structure simply evolves according to the current needs and the situation. Asymmetric information impacts the choice between internal and external financing. The choice also signals the outlook of management on investment. If the management believes strongly that the investment will succeed, they will choose debt financing. For it is not sensible to choose the issue of equity, if the management feels that the price of the stock is undervalued (p. 581).

It is important to understand that it is difficult to determine capital structure of a company using pecking order model. In other hand Myers (1984) argue that the model explains why profitable companies have less debt than others. Reason for this is simply, that profitable companies have less need for external financing, since they have more available funds to use in the first place. Also, less profitable companies issue more debt and are highly leveraged at financially difficult times. This might be the reason why there exists a negative correlation between profitability and the amount of debt.

In spite of the hierarchal order of finance, external finance is being used much more often than the theory gives reason to believe. Frank and Goyal (2003) demonstrate that external finance is often used more than any other source of finance and equity finance is an important part of that. On average, there are more net equity issues than net debt issues. Most interesting fact is that net equity issues correlate stronger with the financial deficit than net debt issues (p. 218).

3 Cost of capital

The cost of capital can be seen as a combination of two drivers. First there is companies' minimum requirement for the return on capital. Total return on the investment must outweigh the total costs on it, this is known as a cut-off point (Modigliani & Miller, 1958, p. 288). The second driver is the investors opportunity cost. Brealey and Myers (1996) define this as an expected return foregone by investing in a project, instead of a similar security. The investor is seen as a rational actor and if there are better opportunities on the market, they will be prioritized.

3.1 Cost of equity

Equity can be financed through internal and external equity financing. Internal equity financing means the use of retained earnings. It is difficult to measure the costs of internal equity financing, because the source of the funds is the business itself. So, the investor is the company itself. Theoretically costs of equity should be high, due to the risk premium they possess. But in reality, internal sources of finance are usually mistakenly considered to be one of the cheapest forms of financing, mostly because of the relatively easy access and usability of the funds (Knupfer & Puttonen, 2012, p. 31). Nonetheless internal equity financing remains a cheaper alternative to external financing. External equity financing includes additional fees such as organization fees concerning issuing the stocks, that additionally raise the costs of equity (Knupfer & Puttonen, 2012, p. 33).

Cost of equity is the rate of return that shareholders demand. Capital asset pricing model is an excellent tool to measure costs of equity. Model is shown below.

$$E(R_i) = R_f + \beta_i(E(R_m) - R_f), \quad (3)$$

where

$E(R_i)$ = expected return of the capital asset

R_f = risk-free rate

$E(R_m)$ = expected return of the market

β_i = beta of the asset

CAPM –model is usually the demanded return on asset, in this case the cost of equity. Brealey and Myers (1996) explain that the model has three key factors: the risk-free rate, the market risk premium and the beta. Risk free rate indicates the current interest rate of risk-free bonds, such as government bonds. Market risk premium is the difference between the expected market return and the risk-free rate ($E(R_m) - R_f$). Beta describes the sensitivity of the asset to the overall market. If the beta is greater than one, it is expected to have higher return and in other hand higher cost of equity (pp. 177-178).

3.2 Cost of debt

The cost of debt (r_D) before taxes can be seen as an interest rate that a company must pay to its creditors in order to arrange debt financing. Investors see this as a required rate of return. Brealey and Myers (1996, p. 224) point out that this cost must be calculated using dynamic methods reflecting today's market situation and the opportunity cost must be taken into account. Usually, the cost of debt can be lower than the cost of equity, due to the order of paying back in a bankruptcy situation.

Modigliani and Miller (1963) explain that taxes must be included in the equation when the total cost of debt is calculated. This is introduced in the next subchapter with the WACC model. Tax benefits are only applied to debt financing, so the equity financiers do not enjoy this advantage. Because of the tax benefits, the actual cost of debt is significantly lower than the initial interest rate. As attractive as the debt finance might sound, companies cannot simply finance with 100% debt. Baxter (1967, p. 395) explains that the default risk increases with the increase of the debt leverage, which usually causes creditors to demand a higher return.

3.3 The weighted average cost of capital

Cost of capital consists of cost of debt and cost of equity. By combining these two costs, a firm's total cost of capital can be calculated. The method used in this thesis is the weighted average cost of capital (WACC) model, which is presented below.

$$WACC = r_A = \frac{D}{V} \cdot r_D \cdot (1 - T_c) + \frac{E}{V} \cdot r_E, \quad (4)$$

where

r_A = weighted average cost of capital

r_D = cost of debt

r_E = cost of equity

D = total debt

E = total equity

V = total market value (D+E)

T_c = corporate tax rate

Knupfer and Puttonen (2012) emphasize that in order to get the most accurate results, one should use market values of equity and debt. The market value of a debt is rarely available, in which case book value can be used, for its market value does not differ as much from book value as does the equity's market value. It is important to use market values, because they include future expectations as well, so that the calculations are as realistic as possible. As previously mentioned, the component $(1 - T_c)$ incorporates tax deductibility of debt's interest payments into the model (pp. 182-183).

4 Capital markets

This chapter will explore capital markets in different settings and the effect they have on cost of capital. In order to understand the mechanisms of financial globalization, the chapter begins by examining market segmentation and integration and how integration lowers systematic risk and risk premiums. This is followed by observing limitations of domestic markets and what barriers and challenges it casts in hindering the market liberalization. In the end chapter evaluates institutional framework and what role it plays on the cost of capital.

4.1 Market segmentation and market integration

There is a clear difference in risk expectations when examining segmented and integrated markets. Karolyi and Stulz (2003) argue that a firm's systematic risk drops upon integration with the capital markets. While segmented markets carry covariance of the local markets, global markets' covariance is usually lower. This is supported by empirical findings from Bekaert and Harvey (2000) that measured an observable decline in equity yields in global market setting. It must be noticed that Karolyi and Stulz (2003) also warn that information asymmetry, transaction costs, and home bias can prevent complete asset pricing integration. In the end companies' ability to overcome these institutional obstacles will define the level of success in lowering cost of capital.

When transitioning from segmented to integrated capital markets structural changes are required to CAPM. While the standard CAPM consists of local parameters: risk-free rate, domestic liquidity constraints and risk premiums, upon entering integrated markets these parameters transition to the global framework (Stulz, 2022, pp. 8-23). Entering global markets enables investors to share risks across borders allowing global diversification which lowers market risk premiums $[E(R_G) - R_f]$.

$$E(R_i) = R_f + \beta_G * [E(R_G) - R_f] \quad (5)$$

$E(R_i)$	= expected return on asset
$E(R_G)$	= expected return in global market
R_f	= local country risk free rate
β_G	= global beta of a company

Evidence of positive effects on the cost of capital in the example of emerging markets is found by Bekaert and Harvey (2000). It supports Stulz's (2022) findings that allowing international flow of capital reduces the risk premiums of local markets. Bekaert and Harvey (2000) provide empirical evidence for this using multiple examples in their paper. Accepting the influx of international capital allows transition of local risk premiums to global ones, which leads to repricing the local equity.

Capital structure decisions are influenced as the cost of equity is reduced following market integration. There are observable changes in both trade-off and pecking order frameworks. Schmukler and Vesperoni (2006) provide empirical evidence and multiple examples of how firms adjust their trade-off, new cheaper equity can be favored over debt. Information asymmetry is also typically reduced in these settings as more rigorous needs for information disclosures are demanded. Stulz (1999) argues that this affects pecking order balance as external equity becomes more viable funding option.

4.2 Challenges in domestic capital markets

Structural frictions, such as limited capital pools and market liquidity, hinder the efficiency of companies that operate within a segmented capital market. Coeurdacier and Rey (2013) demonstrate in their comprehensive review that domestic investors have a clear home bias in their investment allocations, holding a disproportional amount of domestic assets and at the same time foreign institutional capital faces entry barriers. This leads to a situation where companies suffer from lower trading volumes and higher illiquidity risk. Goyal et al. (2023) confirms that suboptimal market liquidity has a direct increasing effect on the cost of capital.

Even with all the benefits that integrated markets and global diversification bring, investors still tend to make home bias influenced decisions. French and Poterba (1991) find that investors disproportionately favor domestic equities in their capital allocation. This is supported by more recent research from Cooper et al. (2013) who highlight that while regulatory barriers have been reduced, persistent home bias endures due to factors such as familiarity heuristics, institutional governance constraints and severe information asymmetry. This leads to a reduced capital pool and market liquidity, and once again is the cause of heightened cost of capital.

Home bias has an effect on capital structure of the steadily dividend paying companies on domestic markets. The connection between a firm's commitment to stable dividend payouts and local market frictions forces companies to choose suboptimal capital structures. Companies have a major reluctance to lower dividend payouts due to market penalties and negative signaling effects (Brav et al., 2005, p. 499). This is supported by Lambrecht and Myers (2012), who demonstrate that sticking to the dividend payout policy forces companies to often choose debt over costly external equity, caused by segmented markets or cutting dividend payouts when financing in challenging internal cash flow situations.

Inflated cost of equity often can be found in limited capital markets because home bias in investors' decision-making leads to smaller pool of capital. Capital flows are not completely free, higher risk premiums are demanded, which drives up the cost of equity (French & Poterba, 1991, pp. 224-225). This rising cost of equity combined with locked dividend payoff policies fueled by information asymmetry start to have significant inflationary effect on the firm's weighted average cost of capital that results in clear competitive disadvantage for companies operating in segmented market framework.

4.3 Institutional frameworks and governance

Further investigations are needed to understand the underlying mechanics of reducing cost of capital when transitioning from segmented to integrated capital markets. Transition alone does not guarantee lower capital costs. The institutional framework is what defines the efficiency with which the new capital starts to move to the integrated market. Cooper et al. (2013) suggest that no single factor seem to explain the equity home bias. They speculate that the combination of factors such as behavioral aspects, barriers to foreign investment and governance issue could be the lead cause. This is further supported by Easley and O'Hara (2004) findings that regulatory environment with more demanding disclosure practices reduces information asymmetry and can lead to lower costs of capital.

The role of institutions in protecting investors cannot be underestimated. When distance and difference in legal practices grows between foreign investors and corporate insiders so does the risk on heightened agency cost. Hail and Leuz (2006) provide extensive empirical evidence of this. When companies operate in weak legal institutional settings the cost of equity is heightened. Lacking strong legal framework foreign investors demand higher risk premiums due to the possible managerial abuse. These risks can be mitigated by regulations and strict enforcement mechanisms that prevent extraction of benefits by corporate insiders.

Stulz (1999) argues that opening the markets to foreign investors should bring the benefits of reduced capital costs, but the quality of domestic corporate governance cannot be ignored, for it can limit the actual effect. If the local legal framework is not sufficient in its protection of the shareholders, risk premiums will remain heightened and foreign investors will continue to treat the market as partially segmented. This is later supported by Karolyi and Stulz (2003) who demonstrate that the presence of barriers such as high information asymmetry and a weak institutional oversight leads to assets being priced locally rather than globally. Stulz (2022) concludes that globalizing markets must be

followed by reformation of domestic institutions in order to further improve attractiveness to foreign capital.

Examining all the studies so far, it starts to be clear now that global markets should have reduced cost of capital compared to domestic markets. It cannot be ignored that market liberalization alone is not enough. Domestic frictions such as information asymmetry, governance conflicts, and home bias can prevent full realization of the benefits. To overcome domestic frictions and access globally priced equity, companies must engage in international financing and cross-listing mechanisms, which will be the focus of the next chapter.

5 Globalization effects

What are the key mechanisms for companies to take full advantage of the globalization effect? Changing perspective to a company level, a more practical examination will uncover the factors that help firms to achieve a lower cost of capital. By exploring cross-border listings, risk diversification, and international debt market, this part of the thesis will try to answer the second hypothesis.

5.1 Cross-border listings and information asymmetry

Companies have several tools at their disposal to improve the financing of their equity. One of these tools is expanding into new markets. Karolyi and Stulz (2003) argue that listing a company's shares on a major international exchange helps the firm to escape limitations of a segmented market. This allows the company to access a much wider pool of capital and find globally diversified investors. This is further supported with definitive empirical study by Hail and Leuz (2009), which analyzed foreign firms entering U.S. exchange. Their study found a major reduction in the cost of capital, proving the benefits of cross-border listings. From this evidence, it can be concluded that increasing the investor demand globally will have a lowering effect on the cost of equity.

It is understood that globalizing an investor base has a positive effect on finding a new cheaper source of capital, but what are the main drivers behind this? Hail and Leuz (2006) conclude that mandatory securities regulations and strong legal institutions play a significant role. Entering new markets forces companies to abide by stricter regulations. Firms can use this as a tool, as the reduction in information asymmetry lowers the risks of hidden information or an abuse by corporate insiders. This helps investors to feel more secure and results in decreasing the costs of equity.

The benefits of information asymmetry reduction are further supported by Easley and O'Hara (2004). When previously private corporate information is publicized through

mandatory disclosures, investors tend to demand a lower return. This increase in transparency can also affect the decisions regarding capital structure. According to Myers (1984), external equity is the most expensive financing option in the pecking order theory, caused by information asymmetry. Transparency changes affect the balance of this, making external equity a more viable option for funding.

5.2 Risk diversification and equity risk premiums

A global framework allows international investors to share risks geographically, thus their demand for return can be lower than that of a domestic investor. Local economic shocks affect a domestic investor more severely than an investor whose portfolio is globally diversified. Stulz (2022) argues that beta in the global CAPM is usually reduced upon entering global markets when the profit and value link between local markets is removed, which reduces the cost of equity. This is demonstrated with the example of Nestlé, whose beta dropped from 0.9 to 0.6 when Swiss ownership requirements were eliminated.

This also has a direct effect on the financing costs of a company. Projects previously deemed non-viable can be pursued as the cut-off point defined by Modigliani and Miller (1958) moves lower. This provides a competitive edge over a domestically operating company. A new source of global capital can enable faster growth of the company and increase its overall value.

5.3 International debt markets

It would be logical to think that accessing international debt provides similar benefits as the global equity market. A contradicting point of view is provided by the extensive empirical study of Gozzi et al. (2010). They demonstrate that while access to the

international debt market offers some benefits, it does not largely result in great reduction in cost.

The global debt market opens up possibilities by providing a larger pool of available capital, which is essential especially for larger companies, that cannot find sufficient debt funding in domestic markets. Gozzi et al. (2010) conclude that only a small portion of companies tend to utilize international debt markets, with the top 10% having 69.7% of total debt issuances. Even after accessing the new markets, companies often continue the use of domestic sources. They also note that the profitability of these companies does not change after accessing the global debt market, conclusion of the study is that companies tend to grow larger, but do not become more lucrative.

Interestingly, an earlier paper by Miller and Puthenpurackal (2005) ends up with a different conclusion. They examine 230 fungible bond issuances by 93 different companies in the global market. Their results suggest that having access to a larger pool of capital and higher liquidity enables a noticeable reduction in the cost of debt. Also, a positive share price movement is common following the announcement of a global bond issuance. This demonstrates that there is an ongoing debate on these effects. The results may vary depending on the conditions of the research. Variables such as the time period, geographic location, and the company itself may be the cause of differing results.

Regardless of the actual effects from the utilization of the global debt market, the tax benefits remain. Access to a near-limitless pool of capital enables companies to maximize their debt leverage as much as needed, without the fear of limited local market liquidity. This greatly benefits a company through tax reductions. The combination of high-volume, tax-shielded debt and a noticeably cheaper cost of equity has a significant reductive effect on the firm's total WACC.

Hypothesis 2 finds definitive support in this chapter. There is clear evidence of the positive effects of global access to equity capital, and while the total cost benefits of the global debt might be unclear, there are still several certain benefits to gain.

6 Conclusions

The purpose of this study was to establish the basic principles of the cost of capital and test the hypotheses to understand what are the underlying mechanics that affect the costs of the equity and debt. The foundation of the thesis is laid through examination of capital structure and two central frameworks: the pecking order and the trade-off theories. The theoretical basis is complemented by the CAPM and WACC models as the study continues to examine the pricing of equity and debt. Chapters 4 and 5 start the debate around market integration and globalization, whose purpose is to find answers for the hypotheses.

The first hypothesis (H1) might have been correct in theoretical past models, but empirical evidence of the modern financial conditions does not fit with this premise. Domestic markets have clear structural weaknesses, such as a limited pool of capital, weak liquidity and a persistent home bias. All of these factors accumulate and affect the decision-making of investors and corporate managers alike, who are forced to make suboptimal financing choices. Local risk premiums grow, proving that limiting financial options leads to a heightened cost of capital.

Globalization has a definitive effect on capital markets widely and on a smaller scale, on the companies themselves. With cross-border listings, companies access a larger pool of capital and it forces companies to maintain elevated levels of transparency, reducing information asymmetry. Global market integration allows for global risk diversification, lowering equity risk premiums. International debt markets bring a seemingly endless volume of capital, which can be utilized to gain the maximum tax benefit. Hypothesis 2 (H2) can be confirmed without a doubt, with the vast amount of empirical evidence these studies have established.

While the evidence cannot be ignored, it must nonetheless be reminded that these benefits are not automatic. They are strongly dependent on the institutional frameworks

and the governance that local markets provide. Integrating the markets is only the first important step. Adopting a global approach is no longer a choice, it is a necessity.

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Appendices

Appendix 1. Declaration of AI Usage

I hereby declare the use of the AI large language model Gemini (September 2026 version) in the preparation of this Bachelor's thesis. The AI has been used for language revision, spell checking, and grammatical corrections. Additionally, it was used to brainstorm ideas concerning the topic and structure of the thesis, and to help find relevant source material. Every source provided by the AI has been verified, primarily using Tritonia's Finna service. I take full responsibility for the content and accuracy of this thesis.