Tests of the Pecking Order and the Tradeoff Theory of Capital Structure

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Abstract

This study adopts the basic Shyam-Sunder and Myers (1999) approach in testing the theories by examining firms' capital structure decisions facing financing needs and/or deviation from target debt ratios. The study focuses on several other issues. The study allows for different target debt ratio estimation considering moving target debt rather than fixed target debt for the whole period. The target debt ratio is estimated as the three years moving average debt ratio or it is estimated using the determinants of optimal debt ratio that are more common in finance literature.

The study finds evidence that firms adjust their debt levels according to target debt ratios. The pecking order theory also explains a considerable portion of the variation in debt levels. Both theories are not distinguishable in explaining firms' capital structure decisions. The two theories appear to be supplementary rather than contradictory. Firms are more likely to increase debt level when they face external financing needs as well as below-target debt level and use surplus cash flows to lower debt toward target levels. Overall, firms' financing decisions are in accordance with both the pecking order and the tradeoff theories. The analysis of the firm behavior with regard to issuing equity asserts that firms follow a pecking order when they adjust toward a target debt level. Therefore, firms follow a moving target debt level and adapt a pecking order when they try to adjust to that target.