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The international evidence on the pecking order hypothesis

Bruce Seifert[a,*], Halit Gonenc[b]

[a] Department of Business Administration, Old Dominion University, Norfolk, VA, USA
[b] Centre for International Banking, Insurance and Finance (CIBIF), Department of Finance, University of Groningen, Groningen, The Netherlands

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Abstract

This study attempts to ascertain how well pecking order behavior applies to firms in the US, the UK, Germany and Japan. Investors in the US and UK have an asymmetric information problem caused, in part, by the relatively widespread ownership of stock in these two countries where managers and insiders know more than outside investors. German and Japanese investors, on the other hand, face an information asymmetric problem arising from relatively less and sometimes distorted information flows and generally less investor rights. Our empirical findings find little overall support for pecking order behavior for American, British, and German firms. On the other hand, the evidence is generally favorable for Japanese firms especially during the 1980s and early 1990s. Our results for Japan are also consistent with the notion that relative transactions costs for debt and equity may be an important influence on financing decisions of firms in Japan.
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1. Introduction

A fundamental issue in corporate finance involves understanding how firms choose their capital structure. There is no consensus theory that explains a firm's capital structure[1] but the tradeoff theory and the pecking order hypothesis appear to have the most support. The tradeoff theory

* Corresponding author. Tel.: +1 757 683 3552; fax: +1 757 683 5639.
E-mail addresses: bseifert@odu.edu (B. Seifert), h.gonenc@rug.nl (H. Gonenc).

[1] See Harris and Raviv (1991) and Barclay and Smith (2005) for a summary of capital structure theories.

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arrives at an optimal capital structure by balancing the benefits of debt (tax and reduction of free cash flow problems) with the costs of debt (bankruptcy and agency costs between stockholders and bondholders).

The pecking order hypothesis (e.g., Myers, 1984; Myers and Majluf, 1984) describes a hierarchy of financial choices firms make. According to the pecking order hypothesis,[2] internally generated financing is preferred first, followed by debt (safe and then risky), and lastly outside equity. Myers (1984) modifies the strict pecking order hypothesis and argues that firms with a lot of future investment opportunities may decide to issue equity before it is absolutely necessary. These firms may issue equity in order to build up financial slack so that they will be able to undertake future investment opportunities.

One of the driving forces behind the pecking order hypothesis is that managers have more information about the value of the company than do outside investors. This asymmetric information problem makes managers wary of issuing equity because investors will interpret this action as bad news (investors will assume that managers are issuing stock when the price of stock is overvalued). Pecking order behavior can be caused from a number of factors (agency costs, taxes, transaction costs, etc.) in addition to information asymmetries.

The purpose of our study is to examine the validity of the pecking order hypothesis in different national environments. Specifically we test pecking order behavior in four of the most important economies in the world – US, UK, Japan, and Germany. Examining this hypothesis in the four countries allows us to test this hypothesis under different causes of information asymmetry. On one hand, the information asymmetry problem in the US and the UK may be the result of the relative widespread ownership of stocks (La Porta et al., 1999). Many small investors may simply not get the information that managers possess. On the other hand, outside investors in Germany and Japan seem to have an information asymmetry problem because they receive less information (Bushman et al., 2004; Antoniou et al., 2007) and the information obtained is more likely to be distorted or managed (Leuz et al., 2003). In addition, outside investors in Germany and Japan also suffer relative to their counterparts in the US and the UK in terms of their legal rights (La Porta et al., 1998, 2006). Investors with less legal rights face more uncertainty concerning their expected share of the firm's profit.

Overall our results are not supportive of the pecking order hypothesis. In all four countries the financing deficit is financed mainly with equity, a result that is clearly inconsistent with the pecking order hypothesis. Issuing equity is clearly not a last resort. Our regression results do not provide support for the pecking order hypothesis in the US, UK, and Germany. The findings for pecking order behavior are generally supportive in Japan, especially during the early years of our study. We conjecture that less firm reliance on main banks, greater investor rights, and fewer restrictions on equity issues have contributed to a diminished role for pecking order behavior in Japan in recent years. Alternatively, our results are consistent with a relative reduction in the cost of equity during the latter years of our study. If the driving force behind pecking order behavior in Japan is relative transaction costs (external debt being cheaper than external equity) then our results could be explained by the relative reduction in transaction costs for equity.

The rest of this paper is as follows. We start in Section 2 by reviewing previous studies of the pecking order hypothesis. Section 3 contains a brief description of the financial and legal environment in the four countries with an eye toward detecting some of the differences in information

[2] In this paper we use the terms pecking order behavior and the pecking order hypothesis to describe the sequence of financial choices firms make. On the other hand, pecking order theory attempts to explain the reason for this hierarchy.

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