Testing Static Tradeoff Against Pecking Order Models

Of Capital Structure: A Critical Comment

Robert S. Chirinko

and

Anuja R. Singha

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(Abstract)

In a recent paper, Shyam-Sunder and Myers (1999) introduce a new test of the Pecking Order Model. This comment shows that their elegantly simple test generates misleading inferences when evaluating plausible patterns of external financing. Our results, coupled with the power problem with the Static Tradeoff Model documented by Shyam-Sunder and Myers, indicate that their empirical evidence can evaluate neither the Pecking Order nor Static Tradeoff Models. Alternative tests are needed that can identify the determinants of capital structure and can discriminate among competing hypotheses.

Corresponding Author:
Professor Robert S. Chirinko
Department of Economics
Emory University
Atlanta, Georgia USA
30322-2240
PH: (404) 727-6645
FX: (404) 727-4639
EM: rchirin@emory.edu

Dr. Anuja R. Singha
INVESCO Global Asset Management (N.A.)
Suite 100
1360 Peachtree St. NE
Atlanta, GA USA 30309
PH: (404) 439-3313
FX: (404) 439-3330
EM: asingha@atl.invesco.com
1. Introduction

Capital structure remains enigmatic. Following on the famous irrelevance result of Modigliani and Miller (1958), most theories have sought to explain capital structure by introducing frictions omitted in the Modigliani and Miller framework (Taggart, 1989). In the Static Tradeoff Model (Myers, 1977), two frictions -- the agency costs of financial distress and the tax-deductibility of debt finance -- generate an optimal capital structure. An alternative model (Myers and Majluf, 1984) emphasizes frictions due to asymmetric information between managers and outside investors. In this Pecking Order Model, a financial hierarchy descends from internal funds, to debt, to external equity.

In a recent paper, Shyam-Sunder and Myers (1999) assess these non-nested capital structure models by examining debt financing patterns through time. They show that, under the Pecking Order Model, a regression of debt financing on the firm's deficit-of-funds -- real investment and dividend commitments less internal funds -- should yield a slope coefficient close to unity. For 157 U.S. firms from 1971-1989, Shyam-Sunder and Myers find that this hypothesis is sustained. Furthermore, they evaluate the ability of their test to discriminate against a prominent alternative model of capital structure, the Static Tradeoff model. For this and several other reasons, Shyam-Sunder
and Myers believe that the data favor the Pecking Order Model.

This comment demonstrates that this elegantly simple test of
the Pecking Order Model suffers from an important shortcoming.
Section 2 presents a graphical treatment of their testing
strategy. Section 3 considers three plausible patterns of
external financing, and raises serious questions about the
validity of inferences based on this new testing strategy. Our
results, combined with the power problem with the Static Tradeoff
Model documented by Shyam-Sunder and Myers, indicate that their
empirical evidence can evaluate neither the Pecking Order nor
Static Tradeoff Models. Alternative tests are needed to resolve
capital structure puzzles.
2. Testing The Pecking Order Model Of Capital Structure

The central friction in the Pecking Order Model of capital structure is the asymmetric information between managers and less-informed outside investors. Myers and Majluf (1984) show how this asymmetry leads firms to prefer internal funds to external funds. When the former are exhausted and there exists a deficit in funds, firms will prefer safer debt to riskier equity. Thus, there exists a financial hierarchy descending from internal funds, to debt, to external equity. Funds are raised though equity issues only after the capacity to issue debt has been exhausted.

The test advanced by Shyam-Sunder and Myers is based on the implication that, under the Pecking Order Model, a substantial amount of intertemporal variation in debt issues (\(\Delta D\)) should be explained by a single variable, the deficit-in-funds (DEF). The DEF variable is defined as capital expenditures, dividend payments, the net increase in working capital, and the current portion of long-term debt (at the start of the period) less operating cash flows, after interest and taxes (Shyam-Sunder and Myers, 1999, p. 224). The testing strategy relies on the following elegantly simple model,

\[
\Delta D_{it} = a_{PO} + b_{PO} \text{DEF}_{it} + e_{it},
\]

where \(i\) represents firms, \(t\) represents time, \(e\) is an error term, and \(a_{PO}\) and \(b_{PO}\) are parameters. Note that, in the Pecking Order Model, time-series variation is key to estimating the parameters.
Equation (1) is not an identity because net equity issues are absent. Indeed, the appearance of equity issues at the bottom of the financial hierarchy is the central element in the empirical testing strategy. The strong form test of the Pecking Order Model is that firms meet their deficit-in-funds by relying only on debt finance, and the associated null hypothesis is $a_{PO} = 0$ and $b_{PO} = 1$ (p. 224).

The strong form test is very restrictive, and hence will not be very useful in evaluating the Pecking Order Model. This test is likely to indicate rejection if the firm goes to the equity market for new capital. The capacity to issue debt will be curtailed at sufficiently high leverage ratios by the costs of financial distress and, at this point, firms must resort to equity issues. To accommodate this behavior, the test of the Pecking Order Model can be recast in a semi-strong form, which states that firms meet their deficit-in-funds by relying initially and primarily on debt finance. Trips to the equity market are both a rarity and a last resort. The semi-strong form test of the Pecking Order Model does not yield a precise null hypothesis, but implies that $b_{PO}$ will be less than but close to unity (Section 2.2).

Equation (1) was estimated for 157 U.S. firms from 1971-1989. The Pecking Order Model is identified by time-series

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1 The slope parameter, rather than the constant term, is key to evaluating the Pecking Order Model. While a non-zero constant suggests rejection, this result is a thin reed upon which to evaluate the test. If there are omitted variables that influence debt issue and have a non-zero mean, then the constant can be non-zero even if the semi-strong form of the Pecking Order Model is valid.
variation, and the parameter estimates are very similar if estimated with the pooled model (containing both cross-section and time-series variation) or random-effects and fixed-effects models (containing only time-series variation). The constant, $a_{PO}$, is close to zero in both statistical and economic terms. The slope parameter, $b_{PO}$, ranges from 0.75 to 0.85 depending on the estimation technique and dependent variable, and is precisely estimated with a standard error of 0.01. The range of parameter estimates is consistent with the semi-strong form test of the Pecking Order Model. Despite the parsimonious specification, the Pecking Order Model had substantial explanatory power, with $R^2$'s ranging from 0.67 to 0.86. The parameter estimates and the impressive ability of the Pecking Order Model to explain debt issues, as well as the relatively favorable power properties discussed below, led Shyam-Sunder and Myers to prefer the Pecking Order Model.

These empirical results can be interpreted in terms of a simple graph. Figure 1 plots $\Delta D$ and DEF on the vertical and horizontal axes, respectively, and, without loss in generality, these variables range from zero to unity. Assume that there are 100 time periods and, consistent with aggregate data, 89% of external financing needs are met by new debt with the remaining deficit covered by new equity. This mix of debt and equity

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2 The results for the Pecking Order Model are from Shyam-Sunder and Myers (1999): Table 2.A, Columns 2, 4, 6 and Table 2.B, Columns 2, 5, 8.

3 The data are from a special compendium of the SIA Fact Book (Securities Industry Association, 1990). The data refer to U.S.
implies that, for 67% of the observations, the deficit-in-funds is met only by debt issues.\footnote{4} During the remaining periods, the deficit is covered by a mix of debt (the distance from the horizontal axis to the horizontal solid line) and equity (the distance from the horizontal solid line to a 45 degree line emanating from the origin). The least squares estimate of $b_{po}$ from this model is 0.74.\footnote{5} Thus, the data graphed in Figure 1 reproduce Shyam-Sunder and Myers' empirical results, which are consistent with the semi-strong form of the Pecking Order Model recognizing equity finance at the bottom of the financing hierarchy.

Before evaluating the ability of (1) to discriminate among competing hypotheses, we mention another important aspect of the Shyam-Sunder and Myers paper, its emphasis on assessing empirically the power of regression tests. The authors introduce corporate underwriting activity from 1980-1989 for both public and private placements. Issues of high yield bonds are subtracted from total debt, and issues of preferred stock and initial public offerings are subtracted from equity. The reported ratio is average debt issues (adjusted) divided by the sum of this number and average equity issues (adjusted), where the averages are computed for 1980-1989.

\footnote{4} The critical value of 0.67 equates the area under the solid curve (representing new debt finance) to 89%, and defines the "kink" in the solid line. Algebraically, $X$ (the critical value) is the solution to the following quadratic equation: $[X^2/2.0 + X*(1-X)]*2.0 = 0.11$, where the left-side is multiplied by 2.0 to normalize the deficit-in-funds (the area under the 45 degree line ranging from 0.0 to 1.0) to unity. One of the two solutions to this quadratic equation is greater than one, hence inadmissible.

\footnote{5} The least squares estimate is based on $D$ and $DEF$ being distributed uniformly from 0.0 to 1.0 (in increments of 0.01) according to the true model represented by the solid line in Figure 1. The results are independent of the size of the increments.
a method to evaluate alternative models: debt financing histories are simulated using a specific model of capital structure and data inputs for actual firms and then an alternative model is evaluated econometrically using this simulated series. They demonstrate that the Static Tradeoff Model has low power against the Pecking Order alternative when data are generated by the Pecking Order Model. However, the reverse is not true, as the Pecking Order Model correctly rejects when data are generated by the Static Tradeoff Model. This technique is further applied to cross-section tests (Section 4.4). The Static Tradeoff Model is represented by a regression of debt on R&D, plant, earnings, and tax loss carry forwards (all relative to assets). When the debt ratio is generated by the Pecking Order Model, cross-section regressions using the above variables fail to reject, indicating that the Static Tradeoff Model lacks power in this frequently used regression.
3. Inference Problems

Consideration of three plausible alternative patterns of external financing raises serious questions about the validity of inferences based on (1). Assume that the firm follows the financial hierarchy consistent with the Pecking Order Model, relying initially on debt finance and then equity finance. However, unlike the analysis in Section 2 and Figure 1, assume that equity issues constitute a more substantial percentage of overall external finance. Such a situation might arise because debt finance becomes relatively costly as a result of changes in business conditions, information asymmetries, or tax rules. As shown in Figure 2, a doubling of the proportion of equity finance from 11% to 22% markedly lowers $b_{PO}$ from 0.74 to 0.54. Thus, even though the Pecking Order Model is valid, the testing strategy proposed by Shyam-Sunder and Myers suggests rejection. Tests of the Pecking Order Model based on (1) are tests of the joint hypothesis of ordering (the financial hierarchy) and proportions (equity issues constitute a low percentage of external financing).

Even if one maintains a favorable assumption about the proportion of equity finance, tests based on (1) are unable to detect situations where the ordering hypothesis is violated. The

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6 Shyam-Sunder and Myers (1999, Section 2.2) note that their testing strategy may not be applicable at high leverage ratios when debt capacity is exhausted. However, the criticism raised in this section is that when the proportion of equity finance is large for whatever reason, (1) will not be useful for testing the Pecking Order Model.

7 When equity issues constitute 33% or 44% of external finance, $b_{PO}$ falls to 0.40 or 0.27, respectively.
key empirical prediction of the Pecking Order Model is that equity issues, if they occur at all, are at the bottom of the financial hierarchy. Unfortunately, the ability of (1) to identify this financing pattern against relevant alternatives is limited. Consider a situation where equity issues are in the middle of the financial hierarchy -- firms rely initially on internal funds, but then issue equity before issuing debt. Such a situation might occur if there are hidden costs to debt or hidden benefits to equity that have not yet been identified by researchers. This convoluted financial hierarchy is depicted in Figure 3, where we again assume that 11% of DEF is met by equity issues. This financing pattern is strongly at odds with the Pecking Order Model, and should be rejected by the test based on (1). However, the least squares estimate of $b_{PO}$ is 0.99, a result suggesting incorrectly that the Pecking Order Model is valid.

Lastly, consider a third case in which debt and equity are always issued in equal proportions, as might arise if there exists an optimal debt/equity ratio. In this case, each dollar of DEF is financed by $0.89 of debt, and this financing pattern is represented by a straight-line emanating from the origin with a slope of 0.89. Estimating equation (1) on this series of debt issues would result in $b_{PO} = 0.89$ and the $R^2 = 1.0$, thus leading to the incorrect inference that this financing pattern is consistent with the Pecking Order Model.

In sum, these three situations highlight serious difficulties with using (1) to evaluate the Pecking Order Model.
Our results, coupled with the power problem with the Static Tradeoff Model documented by Shyam-Sunder and Myers, indicate that their empirical evidence can evaluate neither the Pecking Order nor Static Tradeoff Models. Alternative tests are needed that can identify the determinants of capital structure and can discriminate among competing hypotheses.
References


Figure 1. The solid line represents the true model in which 89% of the deficit-in-funds (DEF) is met by new debt ($\Delta D$) with the remaining deficit covered by new equity. This mix of debt and equity implies that, for 67% of the observations, DEF is met only by debt issues. During the remaining periods, DEF is covered by a mix of debt (the distance from the horizontal axis to the horizontal solid line) and equity (the distance from the horizontal solid line to a 45 degree line emanating from the origin). See fns. 3 and 4 for further details about the construction of the figures. The dashed line represents the fitted value from the least squares regression of $\Delta D$ on DEF with an estimated slope coefficient, $b_{PO}=0.74$. The least squares estimate is based on $\Delta D$ and DEF being distributed uniformly from 0.0 to 1.0 (in units of 0.01) according to the true model.
$b_{po} = 0.74$
Figure 2. The solid line represents the true model in which 78% of the deficit-in-funds (DEF) is met by new debt ($\Delta D$) with the remaining deficit covered by new equity. This mix of debt and equity implies that, for 53% of the observations, DEF is met only by debt issues. During the remaining periods, DEF is covered by a mix of debt (the distance from the horizontal axis to the horizontal solid line) and equity (the distance from the horizontal solid line to a 45 degree line emanating from the origin). See fns. 3 and 4 for further details about the construction of the figures. The dashed line represents the fitted value from the least squares regression of $\Delta D$ on DEF with an estimated slope coefficient, $b_3^0=0.54$. The least squares estimate is based on $\Delta D$ and DEF being distributed uniformly from 0.0 to 1.0 (in units of 0.01) according to the true model.
Figure 3. The solid line represents the true model in which 89% of the deficit-in-funds (DEF) is met by new debt ($\Delta D$) with the remaining deficit covered by new equity. This mix of debt and equity implies that, for 6% of the observations, DEF is met only by equity issues. During the remaining periods, DEF is covered by a mix of equity (the distance from the sloping solid line to a 45 degree line emanating from the origin) and debt (the distance from the horizontal axis to the horizontal solid line). See fns. 3 and 4 for further details about the construction of the figures. The dashed line represents the fitted value from the least squares regression of $\Delta D$ on DEF with an estimated slope coefficient, $b_{p0}=0.99$. The least squares estimate is based on $\Delta D$ and DEF being distributed uniformly from 0.0 to 1.0 (in units of 0.01) according to the true model.
$b_{po} = 0.99$