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Testing trade-off and pecking order theories financing SMEs

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Abstract

This paper explores two of the most important theories behind financial policy in Small- and Medium-Sized Enterprises (SMEs), namely, the pecking order and the trade-off theories. Panel data methodology is used to test empirical hypotheses on a sample of 3,569 Spanish SMEs over a 10-year period dating from 1995 to 2004. Results suggest that both theoretical models help to explain SME capital structure. However, despite finding clear evidence that SMEs follow a funding source hierarchy (pecking order model), our results reveal that greater trust is placed in SMEs that aim to reach target or optimum leverage (trade-off model). This remains true even when SMEs take a long time to reach this level, due to the high transaction costs they have to face. Non-debt tax shields (NDTS), growth opportunities and internal resources all seem to play an important role in determining SME capital structure. Both size and age are also found to be

significant factors. Moreover, the empirical evidence obtained confirms that SMEs clearly behave differently to large firms where financing is concerned.



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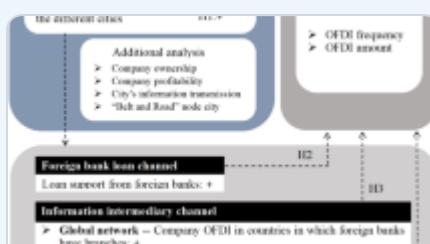
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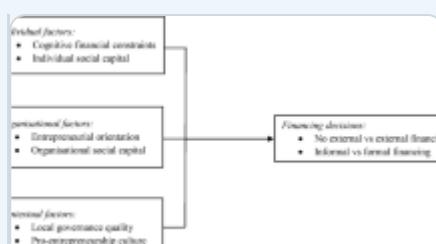
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Notes

- On May 6th, 2003 the Commission adopted the new Recommendation

2003/361/EC which increased the financial ceilings and replaced Recommendation 96/280/EC as from January 1st, 2005.

2. It should be noted that we have not corrected the figures of employment, sales or assets by subsidiaries and mother companies as the SABI database does not provide the necessary information.

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Appendix

Table A.1 Empirical hypotheses

Table A.2 Dependent and explanatory variables description

Table A.3 Capital structure models

Table A.4 Sample representation by sector

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