Optimal Capital Structure Vs. Pecking Order Theory: A Further Test

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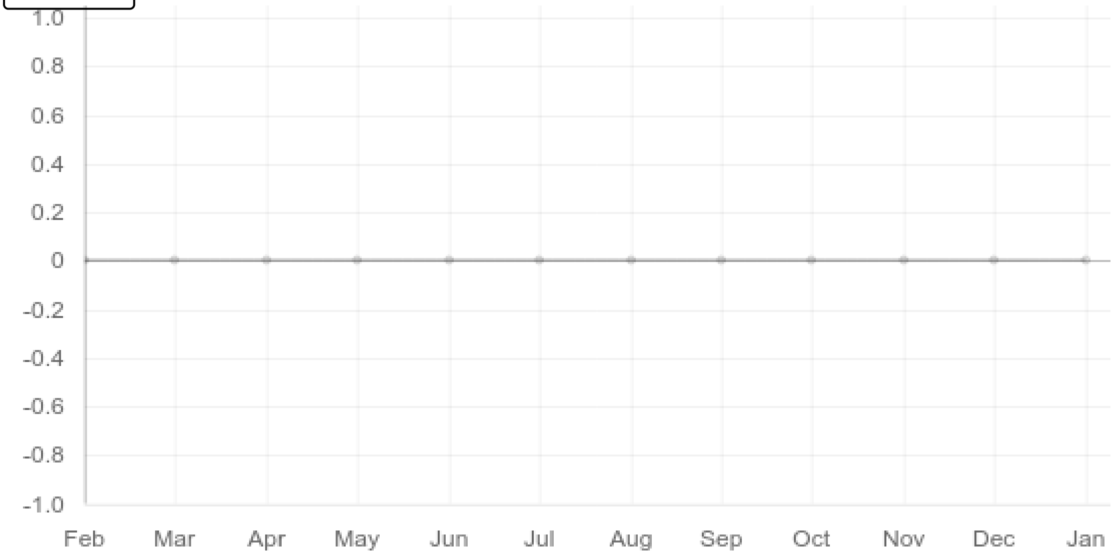
Keywords

Abstract

In this paper we have used the Compustat data-set covering 1983-2003 to test empirically whether a firms' capital structure follows "optimal capital structure" or" pecking order theory"(POT) as advanced by Professor Stewart Myers. Using the industry mean as a predictor of a firm's capital structure, we have found that in general, a firm's debt level is moving toward the industry's mean is not significantly different from that it is moving further away from the industry mean, while a firm's debt level is moving toward the industry mean is very high when it is above the industry mean.

The empirical result suggests that the optimal capital structure is not a single point, rather a range of values from zero to the industry mean within which a typical U.S. firm will be indifferent to the firm's debt level. In other words, a firm will only adjust to the optimal capital structure when the firm's debt level is out of this range. Out result also generally agrees with the pecking order theory, that is, firms prefer using internal financing as opposed to using external financing. Furthermore, when external funds are required, a firm prefers debt financing to equity financing.



Published
Aug 1, 2004

DOI https://doi.org/10.19030/jber.v2i8.2912 (https://doi.org/10.19030/jber.v2i8.2912)

How to Cite

Ghosh, A., & Cai, F. (2004). Optimal Capital Structure Vs. Pecking Order Theory: A Further Test. *Journal of Business & Economics Research (JBER)*, *2*(8). https://doi.org/10.19030/jber.v2i8.2912

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ISSN 1542-4448 (print), ISSN 2157-8893 (online)
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