FROM THE COMPROMISE THEORY TO THE PECKING ORDER THEORY – COMPROMISE AND INTERPRETATIONS

1. Introduction

With the developed market economies, the pecking order theory has been put forward[1]. This theory comes as a natural response to the new approach concerning the enterprise organization concept within a market economy.

The pecking order theories establish a hierarchy of financing ways: for example favoring auto financing, subordination of indebtedness and finally the choice of capital raise.

Contrary to compromise – based models, these theories are not centered on the problem of the most financial structure.

We could ask ourselves on the one hand if a firm – establishing a hierarchy with financing ways for making an investment takes most propitious financing decisions, that means it chooses the best combination of financing ways and on the other hand we may wonder if carrying out the pecking order principle won't lead to a different approach on the most propitious financial structure, but having the same objective in target (the best indebtedness rate).

Two groups of trends have been released from the very heart of the pecking order theories, making themselves clear by considering or not the compulsions appearing during the hierarchy's lay out, between financing ways and the consideration of the difference regarding the manager's behavioral hypotheses and the fact that that the predictions are sometimes conflicting:

1. the theories where the manager acts on behalf of a partner of the organization, in private;

[1] S.C. Myers, "The capital structure Puzzle", Journal of Finance, no. 39, 1984, pp. 575–592.

An. Inst. cerc. ec. „G. Zane", t. 8–9, Iaşi, 1999–2000, p. 41–46

2. ways of minimizing the contract's costs;

Reading these models, starting with the gambling theory, shows that they can only be built with the purpose of reaching the top. The hypothesis according to which establishing a hierarchy among financing ways would be the result of a procedural based remark, is an erroneous hypothesis.

Nevertheless, although compromise theories and pecking order theories would compete in reaching for the top, there still exists a real rupture in financial rationalism:

- for the former, we're dealing with the question of primarily reaching a most propitious indebtedness degree in order to reach a "global best in the financing structure";
- for the latter the hierarchy among financing ways is tied to certain circumstances, even if for several theories this could lead to determining the whole financing structure.

The most propitious financial structure becomes then a line – up of optimal decisions.

These last theories have therefore on innovating character. Moreover, in a multi – periodical horizon, the authors of certain pecking order theories do not disregard the role of the compromise theories, for example the consideration of bankruptcy costs. The question rises then to determine when it is necessary for these to be taken into account.

For a too fast integration would imply the extreme application of the pecking order principle.

2. Differences and similitudes between compromise and pecking order theories

Consequently, compromise and pecking order theories would approach differently the firm's financing policy.

Moreover, we consider the discussion between compromise and pecking order theories to be based on different grounds:

- For starters, theoretical articles predicting a hierarchy among financing ways are of recent origin and seem subordinate to the compromise principle. Previously, the examination of financial decision would not suppose the likelihood of a classification of different financing ways. All these considered, the pecking order principle lacks a theoretical justification.

- Secondly the two categories of models generally lead to opposite solutions. Even more, until now, no crucial test has been conducted to allow the assessment of the financing theories' relevancy[2].

These few remarks raise even more questions:

- Do the pecking orders theories really bring a new explanation for the firms' financing structure?
- The differences we acknowledge between the two categories of models, are they minor or do they indicate a rupture in the financial judgement?
- Are the explanations brought by the pecking order theories relevant?

In order to answer these questions we must detail first of all the possible interpretations for the classification principle between financing ways and show how this synthesis allows the removal of one of these situations:

1. the pecking order principle is a form of "compromise" to the extent where a particular situation a financing way wouldn't present but profits and costs. For example assuming that, in a given context, indebtedness wouldn't present but costs, the use of the compensation principle between the profits and the costs of the financing ways (in other words the use of the compromise principle) would lead to the favor of loan and the establishing of a classification between these two external financing ways.
2. The application of the pecking order principle is another decision means on financing ways compared to the compromise and it allows to the same extent the reach of a peak for particular situations.

   With these two cases the pecking order theories allow the aim of an optimal.
3. the pecking order principle is a decision on financing ways different from the compromise. These theories being based on different judgments. These judgements derive from the particular situations firms may sometimes find themselves in.

Summing up, the application of the pecking order principle leads to the same conclusion as Modigliani and Miller's from 1958; therefore there is no most propitious indebtedness degree.

For a clarifying of this situation, the main differences acknowledged with the two theoretical bodies are presented in the annex[3].

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[2] E. Bultel, "Les théories du financement hiérarchique", Thèse de doctorat, Dijon, 1994, p. 16 seqq.

[3] Gh. Sandu, Formarea capitalurilor firmelor private, Ed. Economică, Bucureşti, 2000, p. 286.

Assuming that the application of the compromise and pecking order principles leads to the taking of optimal decisions we could ask ourselves whether:

- after all, are the acknowledged differences relatively minor?
- the separate presentation of the two models categories may be superficial?

From this point of view two interpretations of the pecking order principle must be taken into account.

First of all we're not talking here of a "form of compromise" but to the extent where for a particular situation a financing way wouldn't present but profits or costs. For certain contexts the applications of a compromise principle would bring about eventually the establishing of a financing ways classification.

Secondly the compromise and the pecking order principles are distinct and they allow, in a litigious manner, the attainment of the optimal in the financing structure, even if they allow the attainment of common interests. For these two possible ends, the pecking order theories explain how could a most propitious financial structure be reached.

Also, the pecking order principle could be interpreted a piori as having an "existence of its own", which could be especially explained by the fact that it was found on a different judgement. Carrying out this classification with financing ways, the leader would seek the attainment of a satisfying, but not optimal financial decision. The separate description of these models would then have a more profound symbolism.

The pecking order theories do not explicitly refer to the most optimal nation. In order to justify this interpretation one must consider the concrete difficulty in the application of the compromise principle and it is necessary to know whether the pecking order principle, whose operational character is more obvious, could be a better alternative.

The compromise principle does not present any ambiguity: the most propitious decision is the one that minimizes the costs (an optimal combination of the two financing ways).

The pecking order theories came out in the context of a major question having as subject determining the financial structure "how can an optimal degree of loans contracting be reached?"

In this direction, the compromise theories give an answer relying on the compensation principle, of marginal manner, of profits and costs of financing ways.

Through the classification of financing ways it suggests, the pecking order theories seem, according to a first impression, to introduce a fundamental difference in the financial judgement. Is it really possible for us to combine a hierarchy of financing ways considering an optimal degree of loans' contracting? Moreover, realizing a classification with financing ways could be no other means but compromise, in order to achieve the most propitious financial structure. Briefly, the pecking order theories are they (more or less) relevant as opposed to already existing papers?

The question suggested by these new theories, as well as their seeming originality, imply their positioning considered the already existing theories where the choice of financing ways is based on a more traditional logic.

3. Conclusions

We note that the predictions on the compromise and the pecking order theories, even if sometimes opposite, are sometimes put down in a similar way, that is making use of the same variables: growth, corporal investment, profitability. Nevertheless, they come out from a different judgement on the one side the primary search of an optimal indebtedness degree and on the other side the repeated application of a classification principle with financing ways.

Also to be noted is that the compromise order pecking order theories are not the only financial theories with the structure of financing ways as main plot. For example a trend recently promoted by Brander and Lewis, fulfilled by Rotemberg and Scharfstein (1990), Bo;lton and Scharfstein (1990), Poitevin (1988) where there are underlined the relations possible to occur between investments policies, making reference to industrial economy concepts like competition positioning and the desire to penetrate a new market, but the financial structure has not been mentioned[4]. Likewise, certain signaling theories, like the Leland and Pyle models (1977) or Ross (1977), and in a wider manner, the theories evoking the ways to obtain a signaling balance without a compromise or a hyerarchy of financing ways to be foreseen.

[4] M. Harris şi A. Raviv, "Capital structure and the information role of debt", The Journal of Finance, no. 2, 1990.

Annex: the fundamental differences between pecking order theories and compromise models.

Compromise theories	Pecking order Theories
1. The operational character of these theories: • The theoretical schemes described come from the new classical economic tradition – profit and costs are marginally counterbalanced hoping to reach a most propitious financial structure. • The quantifying of financing profits and costs is difficult: the operational character of these theories is not obvious.	1. The operational character of these theories: • The leader applies a simple decision rule which is respecting a hierarchy in financing ways in well determined contexts. • Theories are easily appliable.
2. The object of these theories • The compromise models globallz explain the financial structure. • The compromise theories are based on searching for the optimal indebtedness degree.	2. The object of these theories • Theories founded on this judgement offer suggestions in precise situations. • The problem of an optimal indebtedness degree is not considered.
3. Used methodology Theories are based on a frequently used principle in economic judgments: maximizing a target under the pressure of certain restrictions.	4. Used methodology • Two categories to be mentioned: – the leaders maximize the interest towards certain partners of the firm; – models based on minimizing the cost of certain contracts.
4. Investment decision and financing ones are inseparable. In the context of one of the compromise theories the desire to reach the propitious indebtedness rate leads the firms to choose a financial way according to aimed investments.	3. Investment and financing decisions are inseparable. The characteristics of the investment allow the firm to take more interest in certain financing ways.
5. The Compromise Theories which underline the way of attaining an optimal indebtedness degree: – do not directly discuss the concept of medium costs of capital as criteria in accepting or rejecting an investment. – reveals the necessity of a classification of financing ways.	5. Pecking Order Theories which reduce the determining of the financial structure to a major criteria, directly imply the notion of medium cost of capital to the extent where there is not optimal indebtedness degree to be achieved.