EXTERNAL (BANK) FUNDING FOR SMES: ‘FINANCE GAP’ VERSUS ‘PECKING ORDER THEORY’

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Principal Topic

Previous research suggests that a lack of external funding opportunities (referred to as a ‘finance gap’) might inhibit the growth of many small and medium enterprises (SMEs). Further, it has been suggested that banks might routinely discriminate against females causing the ‘finance gap’ to be more acute for female-controlled SMEs. Based on this concept of a ‘finance gap’ we would expect younger SMEs to have relatively less debt than older SMEs (other things being equal). By way of contrast, ‘pecking order theory’ suggests that SME owners will only consider external financing options where insufficient internal funds are available to take advantage of value adding opportunities. Based on ‘pecking order theory’, we would expect (other things being equal) younger firms to have relatively more debt than older SMEs (that have had time to generate internal funds). From the discussion above it can be seen that these two concepts (‘finance gap’ and ‘pecking order theory’) potentially lead to opposing conclusions with respect to the relative levels of external debt we might expect in younger versus older firms. It has also been suggested that, because females are more risk averse and have a higher need to be in control, ‘pecking order theory’ might apply more strongly to female- as opposed to male-controlled SMEs. However, the existing empirical research on the above issues is extremely limited. The aim of this study, therefore, was to gain a better understanding of the relationship between SME growth and external debt (bank) funding and, in particular, to determine if there are any significant differences between female- and male-controlled SMEs.

Methodology

The data for this study were taken from the 1994-95, 1995-96, 1996-97, and 1997-98 Business Growth and Performance Surveys (also known as the Business Longitudinal Survey) undertaken by the Australian Bureau of Statistics (ABS). The database had 2,367 SMEs (131 female-controlled and 2,236 male-controlled) that existed for the entire four-year period and could be analysed based on the sex of the major decision-maker.

Firms were classified as either high (above the median) or low (below the median) in terms of their debt to asset ratio and their growth in total income. Binary logistic regression was then used to, firstly, examine the relationship between a firm’s classification as a high or low debt to asset ratio firm and various independent (control) variables (such as: the sex of the owner; the age, industry, and profitability of the firm; and the owner’s human capital in the form of education and experience). Secondly, for both female- and male-controlled firms, binary logistic regression was used to examine the relationship between a firm’s classification as either a high/low growth firm and its classification as a high/low debt to asset ratio firm and the various independent (control) variables referred to above.
Results and Implications

The results support the notion of a ‘finance gap’, with younger SMEs generally having a lower debt to asset ratio, compared to older SMEs. However, the results do not support the assertion that banks routinely discriminate against female SME owners. Rather, the results indicate that ‘pecking order theory’ might relate even more strongly to female-controlled (compared to male-controlled) firms, as the debt to asset ratio was significantly lower (p=1%) for older female-controlled SMEs compared to older male-controlled SMEs. It is argued that for older SMEs (with an established track record), it is less likely that observed differences in debt levels will be the result of a ‘finance gap’ and more likely that such differences will be the result of owner preferences based on ‘pecking order theory’ and related to the owner’s risk aversion and desire to be in control. The results also indicate that there is no significant association between a firm’s level of external debt (bank) funding and its growth rate, after including various independent (control) variables.

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