Firm Fixed Investment and Financing Constraints in India during 1996-2001

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Abstract

This study examines whether certain types of manufacturing firms face financing constraints in undertaking profitable investments in fixed capital. It is found that large firms that do not retain most of their profits do not face financing constraints while all small firms and large firms which retain most of their profits face financing constraints. This has important implications for the revival of the manufacturing sector when the overall economy is in a low growth phase.

Introduction

Under perfect capital markets where managers and outside lenders or investors have the same information about the prospects of a firm's projects and on the assumption of no taxes, there would be no difference in the funding costs of outside and internal finance[1]. But in the presence of asymmetric information between managers on the one hand and outside investors or lenders on the other, internal funding will be the only source of funding or the outside funding premium will be so high as to make large number of projects unviable.[2] Asymmetric information is likely to be more acute for the set of smaller firms compared to larger firms. We would also expect that firm that are constrained by outside finance would be paying out no or low dividends as they rely on internal funds to finance their profitable projects.[3]

The Indian economy was liberalised in 1991-92 when it was argued that the era of 'financial repression' that existed prior to the reforms was overcome.

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[1] Modigliani (1958)
[2] Meyers (1984), Greenwald (1984)
[3] Fazzari (1988)