

*Investment and Capital Market
Imperfections: Some Evidence from a
Developing Economy, India*

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Abstract

The paper presents a switching regression model of investment decision, where the probability of a firm facing financial constraint is endogenously determined. The approach, therefore, obviates the use of a priori criteria to exogenously identify the financially constrained firms, and thereby addresses the potential misclassification problem faced in the existing literature. A sample of 576 Indian manufacturing firms, collected across 15 broad industries is used for this study. The study establishes that financially constrained firms exhibit a much higher investment-cash flow sensitivity than those identified to be unconstrained. It also identifies possible determinants of financial constraints, and finds empirical support for its hypothesis that young, liquidity constrained and low dividend payout firms are more likely to face financial constraints, when compared to their respective counterparts. The paper also provides some insight into the impact of the ongoing liberalization program on the financial constraints faced by the Indian firms.

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