Chapter 6
SUMMARY AND CONCLUSIONS

The study has analysed the financing patterns of the private corporate manufacturing sector in India for the period 1956/7 to 1998/9 and their implications for investment. The findings of the study assume significance as market forces now increasingly govern the financing and investment decisions in the context of ongoing economic and financial sector reforms. The study may, therefore, be concluded by giving a summary of the major findings.

The study has empirically verified the relationship between financing patterns and investment within a framework developed by a critical examination of Modigliani - Miller theorem and its relevance to Indian conditions. The framework has emphasised that the presence of institutional factors (for example, tax and financial intermediaries) and market condition (for example, imperfect information) can affect the firms' financing decisions and, in turn, investment.

The institutional framework within which corporate investment has to take place has been discussed to provide a background for the study. To elaborate, the examination of the role accorded to the corporate sector in terms of investment outlay under various Plan periods has underlined the increasing role of corporate investment in the economy, particularly since the early 1990s. Further analysis of the State's role has shown that both the fiscal framework, and the developments and functioning of financial system are closely aligned to Plans' thrust. This analysis brings into focus the changes in industrial policy, and the transition from a period of control and regulation until the 1980s to a period of decontrol and deregulation in the 1990s. Considering all these factors, the
period of study is divided into four phases, namely, 1956/7 to 1969/70; 1970/1 to 1979/80; 1980/1 to 1990/1; and, 1991/2 onwards.

Trend analysis of financing patterns shows that the importance of external funds relative to internal funds had increased during the period 1956/7 to 1998/9. A detailed analysis of external sources of funds reveals the following: Borrowings, mainly from commercial banks, and trade credit are the major sources of external funds during 1956/7 to 1979/80. In the 1980s, borrowings through other financial institutions and issue of debentures assume significance, whereas borrowings from commercial banks and trade credit decline. While the same trend continues in the 1990s, fresh issue of paid up capital, largely dominated by premium on shares, becomes more important. The significant rise in the role of paid up capital as an external source is observed to be a new feature of corporate financing in the 1990s. Though the analysis shows that tax incentives are conducive for generation of internal funds, they are outweighed by factors conducive for reliance on different external sources of funds. These changes clearly tally with the promotional and restrictive roles adopted by the State from time to time. The State played an important role in increasing the role of commercial banks and various other financial institutions in the economy while exercising control over capital issues till the 1980s and phasing out the controls in the 1990s.

To understand in more concrete terms the factors underlying financing patterns (narrowed down to the debt equity ratio), capital structure theories are relied upon. From a review of the theories, two major determinants of capital structure (market based) are identified, namely, interest tax shields and information asymmetry.
Examination of capital structure of the corporate sector reveals that debt financing in relation to equity financing increased over the years till the 1990s and showed a downward trend in the 1990s. Further analysis reveals that the decline in debt equity ratio in the 1990s was not brought about by decline in debt per se, but due to a rise in share premium through fresh issue of equity. The extent of tax savings due to interest deductibility (interest tax shield) has moved along with debt equity ratio. As the period prior to 1990s was characterised by higher statutory corporate tax rate, it is argued that resorting to debt was seen as a means to protect income. It has further been observed that interest tax shield reduced cost of debt relative to equity throughout the period. Its impact is noticed on debt equity ratio till the 1980s as reflected in the upward trend in the ratio. On the contrary, a decline in debt equity ratio is observed in the 1990s. That is, the relative cost of debt explains the behaviour of debt equity ratio till the 1980s but does not explain the decline in the ratio in the 1990s. Analysis using logit regression indicated that the move towards greater equity in the 1990s, despite higher relative cost of equity, is due to operation of information asymmetry in the capital market. What implications do these results have for investment?

Growth rate analysis shows that the dummy variable for the period after 1991/2 is not statistically significant implying no change in corporate investment in the 1990s. A simple correlation shows a positive association between debt equity ratio and investment suggesting higher the debt equity ratio greater the investment. This is a restrictive methodology because it is a bivariate analysis, which ignored other factors that determine investment. To overcome this, a multivariate specification has been used based on the model developed by Fazzari, Hubbard and Petersen. In order to bring out the differential behaviour of debt financed firms and equity financed firms, this model is
estimated for each of these groups by using panel data technique for the period 1988/9 to 1998/9. The major findings are; (a) level of investment in both categories of firms showed negative trends - the decline is higher for equity financed firms; (b) demand (proxied by value of output) is the only factor which affects investment behaviour of both categories of firms; and, (c) factors such as capital market imperfections (proxied by internal liquidity) and market valuation of investment opportunities (measured by Tobin's q) affect investment behaviour of only equity financed firms.

What do these results suggest for the financing practices of the corporate sector? The financial sector reforms are aimed at improving rate of capital formation and thereby economic growth. Of various reform measures, great emphasis was placed on broadening of the equity market by removing control over capital issues and pricing. In response to this, changes in corporate financing pattern are also observed with a movement towards greater equity financing. However, contrary to expectations, this has not had the desired impact on corporate investment. On the other hand, this change in financing practices seems to have been more of a drag on investment. What is it that has gone wrong?

All reforms concerned with broadening of equity market have been addressed to improve its fundamental valuation efficiency. It would be useful to recall that the underlying factor for equity financing is found to be information asymmetry, more specifically the operation of moral hazard and adverse selection, and that relative cost consideration is not the determining factor. This suggests that information failure in financial market made it inefficient so that relative cost principle, which is the driving mechanism in a market based system is not in operation. What does this imply particularly in the context
of the need to augment total resources available to corporate sector through capital market? We conclude that the inefficiency in capital market as noted above is part of the early stages of transition from a controlled to a market-based system. This underscores the need for greater role of the State in the capital market in terms of evolving suitable accounting standards, regulation on insider trading, strengthening fraud laws, and improving provisions for investors' protection.

The study has brought out some interesting findings on the relationship between financing patterns and investment at the aggregate level and concluded the positive role of the State in the financial market. However, it has not been possible for the study to incorporate an analysis of the behavioural pattern across different size classes and industry. The study suggests certain areas for further research with a particular focus on size classes and industry variations in order to get deeper understanding of the dynamic relationship between financing patterns and investment.