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# CORPORATE INVESTMENT EFFICIENCY: THE ROLE OF FINANCIAL DEVELOPMENT IN FIRMS WITH FINANCING CONSTRAINTS AND AGENCY ISSUES

## Abstract:

Corporate investment in firms deviates from optimal level due to financing and agency issues. Agency Theory stipulates the conflict of interest between shareholders and managers. The theory suggests that goals of shareholders and managers can be aligned if corporate decisions are taken as such which are beneficial for all stakeholders (Jensen, 1986). However, failure to formulate such decisions have associated costs which are termed as agency costs. Consequently, managers of affected firms trap into inefficient investment decisions. Additionally, Fazzari et al. (1988) indicate that firms plunge into inefficient investment decisions when they are financially constrained.

Limited research exists to address the ramifications of financial development on inefficient investment decisions. This study tries to fill this gap. Analyzing an extensive panel dataset of OECD member countries from 1990 to 2015, our empirical results show that 1) financial development has a positive impact on corporate investment; and 2) for a one percent increase in financial development, it can help to increase investment efficiency by 0.423 percent. When economic growth is taken into consideration, financial development is most effective on improving investment efficiency in countries with high GDP growth rates. Overall, these findings suggest that financial development has positive implications on corporate investment efficiency. Based on these results, this study recommends policy makers to advance policies and regulations that are conducive to the financial development of a country. Our findings are robust to various alternative specifications.

## Keywords:

Corporate investment; Financial development; Fixed Effects panel data analysis; OECD.