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on Firm Value and Investment

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Institutions and Financial Frictions: Estimating with Structural Restrictions on Firm Value and Investment

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Abstract

Using an enhanced version of the standard investment model, we estimate how institutions affect financial frictions at the firm (micro) level and, through the required rate of return, at the country (macro) level. Based on some 78,000 firm-year observations from 40 countries over the period 1990-2007, we show that good shareholder rights lower financial frictions, especially for firms with large external finance relative to their capital stock (e.g., small, growing or distressed firms). However, creditor rights generally do not affect financial frictions. It thus appears that in explaining cross-country differences in firm investment, frictions related to shareholder rights (e.g., shirking or “tunneling”) are more relevant than debt-related frictions (e.g., limited liability or collateral constraints).

JEL Classification Numbers: G30, O16, O43

Keywords: Financial friction, investment, Tobin’s Q, institutions, investor protection

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