

ABSTRACT

The purpose of this paper is to estimate a model that incorporates the effects of financial decisions on production, profitability, and productivity growth. Asymmetric information generates agency costs of debt and signaling benefits of dividends which then influence production decisions. The model is applied to the U.S. manufacturing sector.

Agency costs and signaling benefits are measured by their effects on profitability. A one percent increase in debt reduces variable profit by 0.04 percent, while a one percent increase in dividends raises variable profit by 0.12 percent. Agency costs also limit the adjustment of U.S. manufacturing to long-run equilibrium. On average, for \$1.00 of funds raised through bond issues, debt adjustment cost is about \$0.05. The dynamic efficiency of the manufacturing sector is affected by financial considerations. Signaling benefits contribute 4.2 percent to total factor productivity growth, while agency costs reduce efficiency by 3.3 percent. Thus the financial effects on dynamic efficiency approximately offset each other.

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