Dividend Policy in Developed and Developing Countries: A literature Review

Husaini[1*], Said Musnadi[2], Faisal[3]

[1]Department Economics and Business Faculty, Malikussaleh University, Lhokseumawe, Aceh, Indonesia

[2]Department of Economics and Business Faculty, Syiah Kuala University, Darussalam, Aceh, Indonesia
[3]Department of Economics and Business Faculty, Syiah Kuala University, Darussalam, Aceh, Indonesia
[*]*Corresponding Author*: husaini@fe-unimal.org

Abstract

This article aims to know the application of dividend policy in developing and developed countries. After reviewed 29 articles that located in ASIA and Europe and published by Elsevier and J-Stor publisher found the system of Common law is more dominant used in developed countries where the protection of the investors in stock market tends to be higher. Meanwhile, the system of Civil law tends to be applied by developing countries where the protection of the investors in the share market is relative low. Based the research results in some developed countries found that the application of the outcomes model related to dividend policy, although there exist different outcomes related to tax on dividends and profitability of the firms. While in developing countries, dividend policy is relatively lower that depends on the management of firms, and indicated the application of substitution model related to dividend policy.
Keywords*: Developed and Developing Countries, Outcome and Substitution Model.*

Introduction

Nowadays, the dividend is still become a topic of discussion related to firms because research results are still contradictive or debatable. Those conditions caused by the various attitudes of investors and managers on dividend policy. The policy of firms related to dividend payment interacts to the potential conflicts between the owners of firms and non-owner shareholders. The conflict is called “The first agency problem” (Villalonga and Amit, (2006).

Besides, the conflict also occurs between the large owners and the small owners that called as “Second agency problem”. The large ownership concentration could reduce the First agency problem yet will improve the Second agency problem, (Becht et al, (2003). The first agency problem seriously occurs in the Common Law countries. This problem analyzed and found the existence of a conflict of interest between the owners and managers and between the owners and creditors. (Becht et al, (2003), while the second agency problem occurs dominantly in Civil Law countries where the ownership concentration is higher (Shleifer and Vishny (1997). Second agency problem focused on taking over the majority shareholders to the minority shareholders, Fauver and Fuerst, (2006).

There are some previous research conducted about the conflicts among shareholders in the dividend policy of firms that have the ownership concentration (Rozeff (1982), Renneboog and Szilagyi (2006), Renneboog and Trojanowski (2007). But the results still cause a "serious ambiguity" because dividends are paid to make contrary predictions toward two agency problems. The high dividend payment will cause retained gains, capital gains and the welfare of unchanged shareholders which proves that dividend policy is still Puzzle, Laporta, et al (2000).

In the other hand, when a dividend divided, the investors will incur high tax. Meanwhile, the firms could reduce the tax by holding and reinvesting as the compensation toward gains. Although dividend could be coherent because of the changing of investment policy yet the other problems appear if the firms fail in investing because of liquidation. In this case, the shareholders desire the manager to used the fund from debt so that the risk of investor will be diminished, Modigliani and Franco (1982). Those views explain that dividend payout is higher in the countries that apply a good investor protection (common law) that also occurs in order to be a country with developed capital market. This view would mean that the company is poor in the Capital Market of Developed Countries and should reveal the extreme sensitivity of dividend payout for growth and investment opportunities because they can rely on the external fundraising

Meantime, in developing countries that apply the system of Civil law, if the firms rely on a higher debt, the firms should pay a higher interest. Most of the Civil low countries, especially France that has poor law protection of shareholders and creditors and cause a smaller debt and a smaller equity market, Laporta, et al (2000). Based on those phenomena, this research aims to know the evidence of tendency on the dividend payout in developing and developed countries. Both types of these countries do not only have a different economic growth but also apply different legal system toward the investor protection.

Literature Review

Agency Problem and Legal Regime

Conflict of interest between the people of firms such as managers and shareholders controllers, and the external investor such as minority shareholders used as the central analysis of modern firms, Berle and Means (1932), Jensen and Meckling (1976). The internal controller of firms' assets could use the assets in various purposes to prejudice the external investors. Simply, the external people can divert the assets of firms to themselves through indirect stealing, reducing external investors by selling stock to the internal people, excessive salary, selling asset for self interest or the other firms interest that are controlled by them with a favorable price or through transfer pricing with the other entities under their controls (Shleifer dan Vishny (1997). Besides that, the external people can use the firm assets to pursue the investment strategy that produces personal gains, such as growth or diversification without making gains to the external investors, Baumol (1959), Jensen (1986).

One of the main solutions of the agency problem is law. Law of firms and others provide the particular strength to the investors (include shareholders) to protect their investments toward taking over by the internal people. In fact, the existence of Law protection might explain why being the minority shareholders is the more feasible strategy of investment giving money to the strangers as a debt. La Porta et al. (1998), the level of Law protection of the external investor is extremely different in ever country. Law protection consists of Law protection consists of the content of legislation and the quality of enforcement. Some countries, especially the rich common law countries such as USA and the UK that provide the effective protection of minority shareholders so that the direct taking over of firm assets by a person is rarely occurs.

La Porta et al. (1998) particularly shows that the Common law countries have the best law protection to minority shareholders, while civil law countries such as France that has the weakest protection. The quality of investor protection can be recognized as a proxy to achieve the lower agency cost. This condition is a critical issue in corporate finance. For example, the company ownership is more concentrated in countries with the lower protection of stakeholder (La Porta et al. (1998), La Porta, Lopez-de-Silanes, and Shleifer (1999). Appraisal and the extent capital markets are greater in the countries with the better protection of the investors (La Porta et al. (1997), Demirguc Kunt and Maksimovic (1998). Finally, there is some evidence and perform that a good protection of investors contributesto the efficiency of human resource allocation and general economic growth (Levine and Zervos (1998), Rajan and Zingales (1998).

Dividend as the Outcome Model

Dividend is the result of law protection to the shareholders based on the *outcome model*, the dividend is the result of an effective law protection toward shareholders. Under the effective system, minority shareholders use their legal powers to force companies to give cash. This condition will hinder the managers as people who use too high free cash flow and profit of the firm for their own benefit, Laporta et al (2000).

In addition, a good protection for investors makes the transfer of assets is legally riskier and more costly for the manager so that it can increase the appeal of the dividend that makes the rights of minority shareholders more protected. If there is any good protection for minority investors, the dividend relationships with investment opportunities is inverse which means that the higher funds invested then the less dividend given, and the less money invested, the higher dividend granted to investors. However, if law protection to minority investors is weak, the investment will be a bit and the dividend payout to investors is also not too high, La Porta et al (2000).

Dividend as the Substitution Model

In this approach, dividend used as a substitute to Law protection of shareholders. This view depends on the needs of firms in the capital market in obtaining external funds. To get the external funds, the firms should establish reputation and the mediation of taking over the right of shareholders. One of the way of establishing reputation is paying out dividend. In order to make this mechanism work, the firms do not need "cash in" to establish reputation by stopping dividend and taking over the entire shareholders. The firms will never require cash flow, if there is the uncertainty about the future cash flow, the capital market always provide the space, Bulow and Rogoff (1989).

In the countries of Law protection of minority shareholders, reputation is the most valuable and reliable. In result, the need of dividend in creating reputation is frequently happen in those countries. The countries of high Law protection of shareholders come about in return. The needs of reputation mechanism is weak and the lack need to pay out dividend. These views indicate that Dividend payout Ratio should be higher in the countries with poor law protection of shareholders that the countries with high law protection of shareholders. Moreover, the better prospect firms also have strong incentives to establish reputation because of having larger potential necessary to the external funds. As the result, The better growth prospect firms select a higher dividend payout ratio than the firms with poor growth prospects. However, the good prospect growth of firms also has a better use of funds then the poor growth prospects firms, La Porta et al (2000).

Tax Issues
The economists assess the effect of tax at dividend assessment, Poterba and Summers (1985). The traditional view states that heavy taxes on dividends, both corporate and personal are the strong deterrent for pay out dividends and retain profits. There are two important purposes in this view. One of them, as stated by Miller and Scholes (1978) tat investors, have the access to a variety of dividend strategies in avoiding taxes that allow them to effectively escape from the dividend tax. The purpose is not so closely related to what is actually done by investors (Feenberg (1981). Another purpose, called the new view of dividends and taxes as stated by Raja (1977) and Auerbach (1979) that the money should be paid out as dividends sooner later. Therefore, earlier paying out the dividend does not impose a greater tax on shareholders than the delay. According to this theory, the tax does not preclude the payment of dividends. Harris et al. (1997) support this new view.

Research Method
This article applies literature review based on 29 articles published in an international journal powered by Elsevier and J-Stor publisher. The sample in study is Developing and Develop countries especially in Europe and Asia. This article focuses on the application of dividend policy at the countries that related common law and civil law systems. Based on the results of several researches are reviewed and written on this paper.

Result and Discussion
Dividend in Developed Countries
In developed countries, there are different research result related to a good law protection to minority and develop firms reputation related to the tax of firms and investors. It is alike with a research by Amihud and Murgia (1997), Germany with the system of non-tax toward dividend do not face the loss because of law tax toward most of the large class of investors. However, it has found that the share price reaction to the news of dividends in Germany is similar to that found in the US. This suggests another reason beyond the tax. In addition, a research by Brockman and Unlu (2009), at 53 countries during 1990-2006 indicated that paying out dividend was significantly lower in low creditor right countries. The creditor has a right to play an important role in determining the dividend policy to the whole sample of observation. The weaker rights of creditors in a country the more likely the company will restrict the payment of dividends as a substitute for a binding mechanism.

Then Misra and Ratti (2013) find out that the dividend tax reduction eliminates multiple taxes on domestic income. The effective tax reduction on domestic investment will make foreign securities investments to be reduced. Domestic investors that the dividend is paid under a system of "dividend imputation" receives the credit to the tax paid at the firm level and reduces the effective tax. The equity investments between countries increase if the tax credit rises to taxes paid abroad.

Dividend in Developing Countries
Dividend payouts in developing countries are relatively low in line with the financial ability of firms either on the level of company profitability or the ability to get fund from the external part. It is alike with a research conducted by Indra and Tandelilin (2014) that claim payout dividend in Indonesia move down by the time. The recommendation from this research should be asked to pay the dividend. Based on the research results, the firms should be obligated to pay the dividend when the firms reach the stages. Serious actions should be carried out to the firms that do not pay dividends.

In a research carried out by Sawicki (2003) indicates that there is some evidence claims that the dividend acts as a substitute for the other firm's management which is the mechanisms before the crisis.

However, there is a strong positive relationship between the government and the emersion of post-crisis dividend. The relationship is an addition to the effect of the legal regime (legal regime) which states that the protection of shareholders at the firm level is important to force the firm to devote cash in "Outcome model" dividend.

In addition, research conducted by Pandey (2013) finds that the probability of a dividend increase, decrease and loss are high with the increase in income, decline and loss. This causes volatility in dividend payments. KLSE firms seem reluctant to eliminate dividends except when they suffer losses. The study found no evidence supporting the usual conditions, but the less stable policy is pursued by dividends of KLSE firm. Then, a research by by Setiawan and Phua (2008) summarized that the firms in Indonesia tend to pay compensation toward the weak of corporate governance by paying the dividend which is a negative effect of corporate governance toward paying out the dividend. Research confirms that there are applications of "substitution model" rather than the "outcome model" in Indonesia.

Conclusion

The system of Common law is more dominant used in developed countries where the protection of the investors in stock market tends to be higher. It indicates that dividend as a outcome model. Even though, in some countries got the different result such as Netherland and Germany. In Netherlands, dividend policy is relatively low dividend policy in line with the development of firms' profitability, but the shareholders, institutional investor and manager strongly enforce and pay higher. While, In Germany claimed that the dividend policy is less affected even if the government does not impose the tax on dividend. The weaker rights of creditors in a country, the more likely the company will restrict the payment of dividends as a substitute for a binding mechanism, Laporta et al (2000).

In Civil law countries where the lack protection of government to the minority investors found that the applications of dividend policy are still different. Generally, it could be claimed that the dividend policy in developing countries is still relatively poor and weaker because of lack of government protection. The applications of dividend policy strongly related to the management of firms. The better management of the firms, the higher dividend payout to the investors. In the other part, pay out dividend also useful as the compensation of the weak corporate governance that indicates the application of Substitution Model.

References

Baumol, William, 1959, Business Behavior, Value and Growth (Macmillan, New York).

Berle, Adolf, and Gardiner Means, 1932, The Modern Corporation and Private Property (Macmillan, New York).

Becht, M, P. Bolton and A. Roëll (2003), Corporate governance and control, in G. Constantinides, M.

Bulow, Jeremy, and Kenneth Rogoff, 1989, Sovereign debt: Is to forgive to forget?, American Economic Review 79, 43-50.

Brockman, P., & Unlu, E. (2011). Earned/contributed capital, dividend policy, and disclosure quality: An international study. Journal of Banking and Finance, 35(7), 1610–1625. http://dx.doi.org/10.1016/j.jbankfin.2010.11.014

Demirguc-Kunt, Asli, and Vojislav Maksimovic, 1998, Law, finance, and firm growth, Journal of Finance 53, 2107-2138

Doddy Setiawan Lian Kee Phua, (2013),"Corporate governance and dividend policy in Indonesia", Business Strategy Series, Vol. 14 Iss 5/6 pp. 135 - 143 Permanent link to this document: http://dx.doi.org/10.1108/BSS-01-2013-0003

Feenberg, Daniel, 1981, Does the investment interest limitation explain the existence of dividends?, Journal of Financial Economics 9, 265-269.

Fauver, L. and M.E. Fuerst (2006), Does good corporate governance include employee representation? Evidence from German corporate boards, Journal of Financial Economics 82 (3), 673-710.

Harris, Trevor, Glenn Hubbard, and Deen Kemsley, 1997, Are dividend taxes and tax imputation credits capitalized in share values?, Manuscript, Columbia University

I. M. Pandey (2003), "Corporate Dividend Policy And Behaviour: The Malaysian Evidence", Asian Academy of Management Journal, Vol. 8, No. 1, 17–32, January.

Jensen, Michael, 1986, Agency cost of free cash flow, corporate finance, and takeovers, American Economic Review Papers and Proceedings 76, 323-329.

Jensen, Michael, and William Meckling, 1976, Theory of the firm: Managerial behavior, agency costs, and capital structure, Journal of Financial Economics 3, 305-360.

Julia Sawicki (2003), "Corporate Governance and Dividend Policy in Southeast Asia Pre- and Post-Crisis", Nanyang Technological University Nanyang Business School Singapore 639798 (65)6790.4669 ajsawicki@ntu.edu.sg.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, 1998, Law and Finance, Journal of Political Economy 106, 1113-1155.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W.Vishny "Agency Problems and Dividend Policies around the World", The Journal of Finance, Vol. 55, No. 1 (Feb., 2000), pp. 1-33.

Leo Indra Wardhana, Eduardus Tandelilin, I Wayan Nuka Lantara, John Eddy Junarsin (2014), "Dividend Policy in Indonesia: A Life-Cycle Explanation" Université de Limoges, LAPE, 5 rue Félix Eboué, 87031 Limoges, France Universitas Gadjah Mada, Faculty of Economics and Business, Bulak Sumur, Yogyakarta.

Mishra, Anil V & Ratti, Ronald A, 2013. " Taxation of Domestic Dividend Income and Foreign Investment Holdings," MPRA Paper 50601, University Library of Munich, Germany.

Modigliani, Franco, "Debt, Dividend Policy, Taxes, Inflation and Market Valuation," Journal of Finance, May 1982,37,255-73.and Miller, Merton H, "The Cost of Capital, Corporation Finance and the Theory of Investment," American Economic Review, June 1958,48,261-97.

Miller, Merton H. and Modigliani, Franco, " Dividend Policy, Growth, and the Valuation of Shares," Journal of Business, October 1961, 34, 411-13.

Modigliani, Franco, "Debt, Dividend Policy, Taxes, Inflation and Market Valuation," Journal of Finance, May 1982, 37, 255-73.

Poterba, James, and Lawrence Summers, 1985, The economic effects of dividend taxation, in Edward Altman and Marti Subramanyam, eds.: Recent Advances in Corporate Finance (Homewood, IL.: Richard D. Irwin Publishers).

Renneboog, L. D. R., & Szilagyi, P. G. (2006). How Relevant is Dividend Policy under Low Shareholder Protection?. (CentER Discussion Paper; Vol. 2006-73). Tilburg: Finance

Rajan, Raghuram, and Luigi Zingales, 1995, What do we know about capital structure? Some evidence from the international data, Journal of Finance 50, 1421-1460.
Rozeff, M.S. (1982), Growth, beta, and agency costs as determinants of dividend payout ratios, Journal of Financial Research 5, 249-259.

Stiglitz, Joseph, "On the Irrelevance of Corporate Financial Policy," American Economic Review, September 1974, 64, 851- 66.

Shleifer, Andrei, and Robert W. Vishny, 1997, A survey of corporate governance, Journal of Finance 52, 737-783.

Villalonga, B. and R. Amit (2006), How do family ownership, control and management affect firm value? Journal of Financial Economics 80, 385-417.

Yakov Amihud, Maurizio Murgia (1997), Dividend, Taxes and Signaling: Eviden from Germany, The Journal of Finance, Vol. 52, N0. 1. (Mar. 1997), pp.397-408.