26

DISCUSSION PAPER

Dividend Policy and Behavior in Emerging Markets

To Pay or Not to Pay

Jack D. Glen
Yannis Karmokolias
Robert R. Miller
Sanjay Shah

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Jack D. Glen and Yannis Karmokolias are senior economists in the Economics Department of the IFC. Robert Miller is a consultant and Sanjay Shah is an economist, also in the Economics Department of the IFC.

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Foreword

It has been recognized by managers and economists alike that dividend policy plays an important role in the overall corporate strategy. With this in mind, economists have spent a good part of the last four decades trying to understand the issues that drive dividend policy decisions. One could debate the degree to which those research endeavors have been successful, but one is forced to accept without protest the fact that the focus of that research has been almost entirely on the private sector in a few developed countries. Given IFC's interest in encouraging emerging market development, this paper carries the debate into the set of emerging markets. By doing so we hope to educate investors and economists about dividend policy in emerging markets and, through that process, promote further interest in those markets.

Guy P. Pfeffermann
Director, Economics Department
& Economic Adviser of the Corporation

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Abstract

From the investor's point of view, returns on their investment are split into two parts: capital gains and dividends. In part, corporate management determines the nature of that split when it decides on a corporate dividend policy. In developed countries, the decision between paying dividends and retaining earnings has been taken very seriously by both investors and managements, and has been the subject of considerable research by economists. As a result, a fairly detailed, if incomplete, picture of dividend policy is available for the major developed countries.

This paper carries the dividend debate into the emerging markets. It shows that dividend policy in those markets is often very different from the norms that have been accepted in developed countries. One major difference is that emerging market firms place more emphasis on dividend payout ratios than they do on the level of dividends paid. As a result, dividend payments tend to be more volatile in emerging markets than in developed countries, a factor that investors need to be aware of when investing in these markets.

Another point that emerges is that, as these markets develop and open to international capital, dividend policy increases in importance, even if it is not altered in character. Managers are more concerned about their dividend policy now than they were in the past. And this concern is augmented by the role of the government in many of these countries, which acts as a protector of both minority shareholders and creditors by imposing constraints on dividend policy.

I. Introduction

Firms raise equity capital in order to invest in assets that will produce future cash flows, flows to which the shareholders have a claim. Whether those cash flows are paid to shareholders as dividends or retained as a source of capital for further investment is a decision of potentially great importance to both shareholders and the firm, and one that has been subjected to much scrutiny by equity analysts and economists. Thus far, at least, controversy still surrounds the issue of how important dividend policy is to both investors and their firms and whether it has significant implications for the market value of the firm.

In industrialized countries the theoretical importance of dividend policy has resulted in considerable effort being put into identifying the effects dividends have on firms in those countries. No such effort has been made in less developed countries. This paper is an initial effort to carry the debate into the realm of emerging markets. In order to do that, we compiled aggregate and company information on dividend policy in a number of emerging market countries. In addition, we visited and interviewed managers and investors in some countries in order to learn first hand how dividend policy is determined.

We found that there are notable differences in dividend behavior in developed and developing countries. For example, the fraction of earnings paid as dividends to investors in developing countries was, on average, roughly two thirds the level paid in developed countries in 1994. This substantial difference reflects both the importance of internally-generated financing in developing countries, as well as a willingness on the part of investors in developing countries to forego current dividend cash flow in anticipation of higher future growth in earnings.

Investor attitudes in developing countries were not always so generous. In 1984 the dividend yield on developing country equity averaged 4.5 percent, above the dividend yield on developed country markets, which averaged 3.8 percent at that time. Since then, however, attitudes seem to have shifted; developing country dividend yields averaged just 1.9 percent in 1994, below the developed country average of 2.3 percent. This shift clearly represents a belief among investors that the growth prospects of equity are good. But, in addition, it also must represent a conscious belief on the part of managements that reinvestment of earnings is in the best interests of shareholders.

This paper examines dividend behavior in emerging markets both from the investor's perspective, and from the firm's point of view. It examines the evolution of dividend payments in recent years and looks at a variety of environmental factors that may have an impact on those payments.

The paper is organized as follows. First, the theory of dividend policy is presented. Then, the investor's perspective on dividend payments in developing countries is examined. That is followed by an analysis of the firm's perspective on dividends, with attention paid to environmental factors that influence dividend behavior. A summary concludes the paper.

II. Theory

Conceptually, the value of a share is given by the cash flow that it generates for its holder. Defining P_t as the stock price at time t and r as the discount rate required by shareholders on their equity investment, the value of a share is given by the relationship:

$$P_t = \frac{D_{t+1}}{1+r} + \frac{P_{t+1}}{1+r}$$

This simple relationship outlines the fundamental properties of equities. First, they are forward looking; in theory, a share's value today depends solely on the cash flows it will produce in the future. Second, the value of a share can be divided into two components: dividends and capital gains, both of which are uncertain. And finally, every stock has some expected or required rate of return, r, that reflects company and management attributes and the cash flows that they produce.

If future prices are determined in a like manner to today's price, then, by substituting in a similar relationship for the future expected stock price, the relationship can be rewritten as the infinite sum of all future dividend payments.

$$P_t = \frac{D_{t+1}}{1+r} + \frac{D_{t+2}}{(1+r)^2} + \frac{D_{t+3}}{(1+r)^3} + \ldots$$

Expressing the pricing relationship in this manner underlines the importance of dividends for investors because, ultimately, it is the cash flows from dividends that determine the value of the stock that they hold. This form of the pricing relationship also provides insight into the conditions under which shareholders will be inclined to agree with management decisions to retain earnings rather than pay them out as dividends. Earnings that are retained will produce future cash flows that will be available for dividend payments. As long as the return on those retained earnings exceeds the investor's required return, r, then the value to shareholders of reinvesting earnings exceeds the value received from higher current dividends. Under those conditions shareholders should agree with management to retain earnings.

The required rate of return for investors, r, represents a market rate and, as such, conceals much that can be important in dividend considerations. For example, it reveals little about individual attitudes among investors about risk; some investors might prefer the certainty of a dividend payment now over a possibly attractive, but uncertain, set of future cash flows. These shareholders may be in a distinct minority but, as any executive knows, they can be quite vociferous in their insistence that dividend payouts be maximized. Moreover, even a market-indicated rate of return can change over time, as investors alter their collective attitudes about company or market prospects.

While simple, the discounted cash flow stock pricing relationship provides an intuitive framework for understanding the link between stock price, growth and dividends. It does not, however, address all of the relevant questions. For instance, firms have available to them a variety of financing sources, including debt, issues of new equity and retained earnings. If management attempts to substitute one of these other sources for retained earnings and, consequently, increases the dividend payment, will there be a corresponding increase in the stock price? This question has been the subject of much debate, with three hypotheses having emerged.

• Dividends Have No Effect on Stock Price: This irrelevance hypothesis is based on the view that dividend policy need not affect either investment plans or capital structure and, hence, has no effect on future cash flows. Under this view, efficient capital markets are critical, and taxes are ignored. The intuitive argument in favor of the hypothesis is that if management could increase the market value of the firm's stock by changing dividend policy, why has it not done so already? The answer is that dividend policy does not matter. However, by introducing taxes into the debate one arrives at the second hypothesis:

• Dividends Decrease Stock Price: When the investor's tax rate on dividends exceeds that on capital gains, then investors should prefer reinvestment of earnings in order to maximize their after-tax return. Of course, under this line of reasoning, when the capital gains tax rate exceeds the dividend rate, then the reverse will be true. Despite the intuitive appeal of this tax-based argument, the possibility exists that investors are concerned about more than just taxes and are especially concerned about the information content of dividends, which leads to the third hypothesis:

• Dividends Increase Stock Price (Signalling Theory): Earnings are largely invisible to investors, except to the extent that they are paid out as dividends. A management decision to increase dividends provides a credible signal of strong future earnings, which leads to a higher stock price today. Conversely, lowering dividends signals a deterioration in future prospects and reduces the stock price.

Which hypothesis best explains observed behavior and the importance of each of the two factors—taxes and signalling—to stock prices remains an empirical question which is addressed below. Before proceeding to that, however, alternative explanations for dividend behavior need to be examined.

The management view on dividend policy is shaped largely by that of investors. Theoretically, management makes decisions on the basis of what is best for shareholders. This includes employing the lowest-cost capital, as well as taking whatever actions will enhance share value and, through that, lower the firm's cost of equity capital. Based on the three hypotheses presented, dividend policy has a potentially important role to play in determining stock price and management must bear in mind the possible effects of its dividend decisions when those decisions are made.

Research supports the idea that management takes dividend policy seriously. In what is arguably the classic study of corporate dividend behavior, a series of interviews were conducted with the management of a sample of U.S. firms.[1] The study concluded that dividend policy could be characterized by three stylized facts:

- Managers smooth dividend payments over time. They believe it is better to pay two moderate level dividends than to pay a high one today followed by a low one next period.

- Managers focus more on changes in dividends than on the level of dividends. Announcing changes in the level of dividend payment provides important information to investors and must be carefully considered.

- Firms have long-run target dividends expressed as a percentage of earnings.

The basis for these findings is the third hypothesis presented above. The logic behind smoothing dividend payments over time rests on the beliefs that earnings have both permanent and transitory components and that investors use dividend payments as signals of future earnings prospects. Even firms expected to produce strong future earnings can have bad years, and management, which is most fully aware of the firm's potential, can signal its private information on that potential to shareholders by maintaining dividend payments steady through hard times. The cost of this approach is that management becomes reluctant to either increase or decrease dividend payments until they believe that those changes will be supported by future earnings. This logic, of course, rests on the assumption that shareholders are unable to glean the information they need to forecast future earnings from other data the firm makes public.

Defining a dividend payout ratio as the fraction of earnings that dividends represent, the idea that firms should maintain a long-run target payout ratio has generated considerable debate. A mature firm with few investment opportunities could easily afford to pay a higher level of dividends than a young and growing firm. But even for a growing firm, shareholder preferences dictate that some level of dividends be made available. Add to that the complex manner in which environmental factors such as regulatory constraints, accounting standards and tax treatments enter into the picture and the decision of choosing a target payout ratio becomes very complicated.

With a theoretical view and a set of stylized facts on dividend policy as background, the remainder of the paper examines dividend policy in developing countries. Using evidence from a set of seven countries, dividend policy is examined from two different perspectives: those of investors and firms.[2] In each case an attempt is made to look at aggregate dividend behavior, as well as the supporting or conflicting evidence that has been compiled from research with individual firms.

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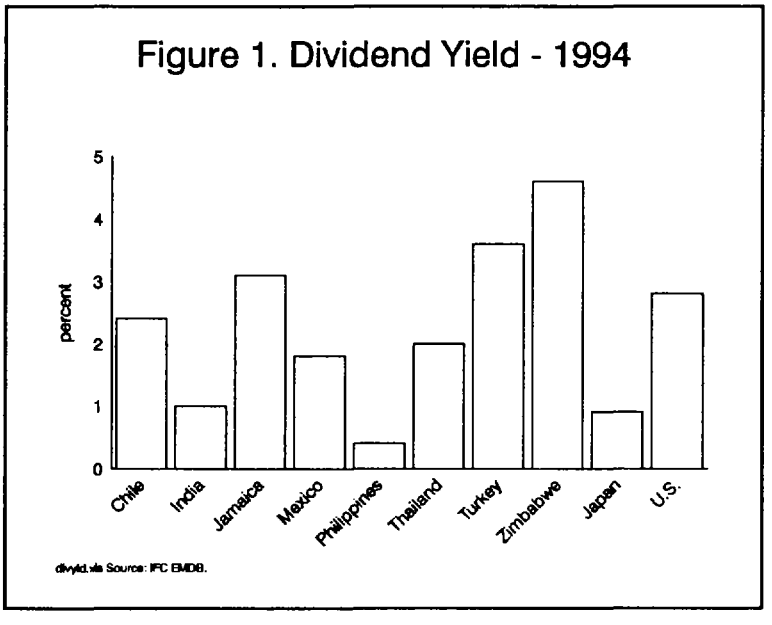
[1] Lintner (1956).

[2] The countries are: Chile, India, Jamaica, Mexico, the Philippines, Thailand and Turkey.

III. The Shareholders' View

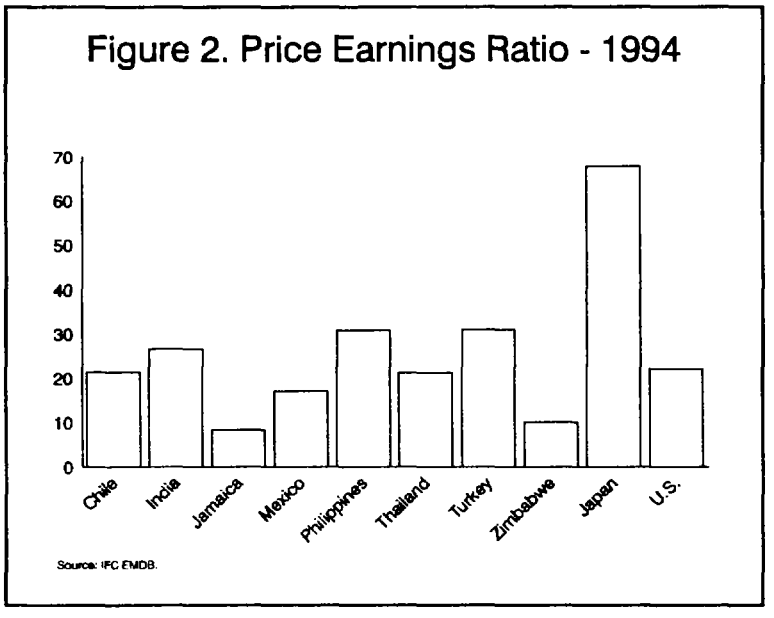
As noted, from the investors' perspective stocks produce a combination of dividend cash flows and capital gains. Shareholder preferences for one or the other should have a powerful influence on decisions regarding dividend payout, which leads one to examine the extent to which dividend payments and the yields that they represent vary significantly across countries, firms and time. Figure 1 presents evidence on the variation in average dividend yield—the dividend paid divided by stock price—for a sample of developing and developed countries.

The figure shows that dividend yields vary substantially across countries. Possible reasons behind such variations include growth potential and taxes. Consider first growth potential. As noted, earnings not paid as dividends can be reinvested and the potential for higher future earnings and capital gains may induce investors to accept a low dividend payout today. Low yields, then, may simply represent the market's collective belief that earnings prospects are promising.



Using the discounted cash flow model presented above, it can be shown that market expectations of firm growth are reflected in the ratio of stock price to earnings (P/E); a high P/E reflects high expectations for growth. To the extent growth prospects are good, the market should be willing to forego dividends in favor of capital gains. P/E ratios are presented in Figure 2, which shows that firms with high dividend yields had relatively low P/E ratios. Zimbabwe, for example, had the highest dividend yield, but also the lowest P/E ratio;

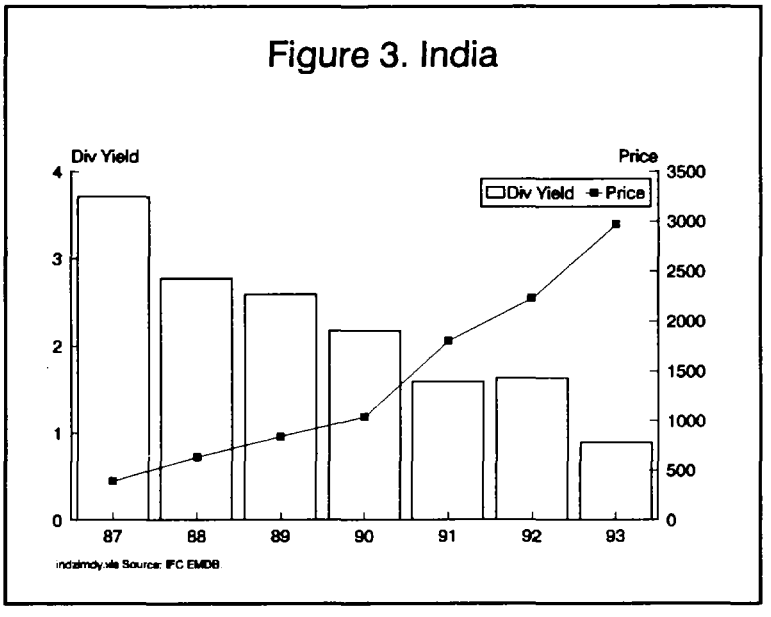
conversely, the Philippines had a low yield and high P/E. One must be careful in interpreting these ratios, however, because the denominator, earnings, is an accounting number and the nature of the accounting rules can over- or understate the resulting ratio. This is particularly notable in the case of Japan, where accounting rules tend to reduce the level of earnings, thereby overstating the P/E ratio.



Investor attitudes toward stocks and their potential for growth can vary significantly over time, as shown in Figure 3, which presents the dividend yield and stock price series for India for recent years. The figure shows a marked upward trend in stock prices in the Indian market for each of the last seven years, together with a remarkable decline in dividend yields from nearly 4 percent in 1987 to about 1 percent in 1993. This period was characterized by substantial change and market liberalization and investors seem to have been willing to forego dividend payments in return for possible future capital gains. In general, the Indian experience with dividend yields is representative of developing countries globally. On average, developing countries saw dividend yields decline over the last decade; the dividend yield on the IFC global composite of developing countries dropped steadily from 4.5 percent in 1984 to only 1.9 percent in 1994, suggesting that some broad explanatory factors applied to many countries.

Taxes and the Investor

In addition to the split between current cash flow and future growth, other factors can determine investor attitudes toward dividends. One significant factor, mentioned in the theoretical discussion, is the difference between the personal income tax rate on dividends and that on capital gains. If tax rates induce investors to favor capital gains over dividends, then investors should pressure management to reinvest rather than pay out earnings. Those investors with a need for immediate cash can always liquidate a part of their investment portfolio and recognize capital gains, rather than pay a higher tax rate on dividend payments.



Evidence from the U.S., the most thoroughly studied market, is informative, if somewhat inconclusive. Until 1986, U.S. tax rates on capital gains exceeded those on dividends. Empirically, however, tax rates have had, if anything, only a marginal effect on stock returns. A few studies have found that high dividend yield stocks pay lower pre-tax rates of return, a requirement under the tax-based theory, but other studies reject that finding.

Table 1 provides emerging market evidence on the tax effect. The table sorts a group of countries by the relationship between their capital gains and dividend tax rates. For example, in the first group of countries presented, the personal tax rate on capital gains exceeds the personal tax rate on dividend income. If the hypothesis that the tax system is an important element in determining dividend behavior is correct, then one should see a correlation between dividend payout and the relative tax rates.

A careful look at the table reveals no apparent relationship between the tax rates and either dividend payout or dividend yield. In both the upper and lower sections of the table there is substantial variation in both dividend yield and dividend payout, with no notable difference between the two sections. Based on the evidence in the table, the tax hypothesis is inadequate, by itself, to explain dividend behavior in the cross-section of countries presented. But other evidence in favor of a tax effect for some of these countries is available from firm-level data. A recent study examines the relationship between returns on equity and dividend yield in a group of developing market countries.[3] Unlike the evidence in Table 1, the firm-level results indicate that investors in some countries prefer to have earnings reinvested, which allows tax payments to be either deferred or taxed at the capital gains rate. The differences between the aggregate and firm-level evidence, however, are not as great as they first appear. Using firm-level data,

[3] Claessens, Dasgupta and Glen (1995)

tax effects were evident in only eight of nineteen countries studied; three countries exhibited a positive tax effect and five a negative tax effect. Like the aggregate data in Table 1, the firm-level results do not provide strong support for the hypothesis that tax rates dominate investor attitudes toward dividends.

Table 1

Tax Rates and Dividend Behavior[4]		
	Dividend Yield	Dividend Payout
Capital Gains Rate > Dividend Rate		
Colombia	4.7	52.4
India	1.4	29.7
Korea	1.3	29.0
Republic of Zimbabwe	6.4	31.2
Capital Gains Rate = Dividend Rate		
Indonesia	1.0	18.0
Mexico	2.0	20.1
Venezuela	1.4	16.5
Capital Gains Rate < Dividend Rate		
Argentina	1.9	24.8
Chile	5.6	49.0
Greece	5.6	63.3
Malaysia	2.1	50.9
Nigeria	8.6	62.3
Pakistan	4.4	50.3
Portugal	2.9	37.0
Taiwan, China	0.8	23.4
Thailand	3.0	42.3
Turkey	4.7	53.1

In addition to taxes, regulatory and other considerations may induce a preference in investors for dividend payments. For example, some investors — the proverbial widows and orphans — depend on dividend flows as a source of income. Theoretically, these investors could liquidate a portion of their portfolio periodically in order to satisfy cash needs, but doing so can be costly; it may be cheaper for a firm to pay dividends than for the shareholder to pay a brokerage fee in order to sell shares. From a regulatory point of view, financial institutions are sometimes prevented from holding shares that do not have an established dividend track record. And in other cases, financial institutions may be allowed to treat dividend income as

[4] Classifying tax systems requires judgement. In India, for example, capital gains (indexed for inflation) are taxed at 20 percent. Dividends are taxed at the individual's marginal rate, which varies from 20 to 50 percent, but the first Rs10,000 received as dividends are exempt from taxation; that amount was raised recently to Rs55,000. Source of figures is Coopers and Lybrand, International Tax Summaries.

realized income that can be spent, whereas capital gains income cannot be spent, at least not until it is realized.

The difference between tax rates investors pay on dividends and capital gains has also been used as the basis for two other practices firms employ to direct cash to their shareholders: share (or bonus) dividends and share repurchases. Distributing shares, rather than cash, as dividends is motivated by three arguments. The first and most compelling argument is based on the different tax treatment of dividends and capital gains in many countries. To the extent that share dividends allow the company to retain more earnings than otherwise, investors benefit from the reduced capital gains tax rate. The second argument is based on necessity. In many cases, firms have insufficient earnings to permit the payment of a cash dividend and the offer of free shares is meant to appease shareholders.

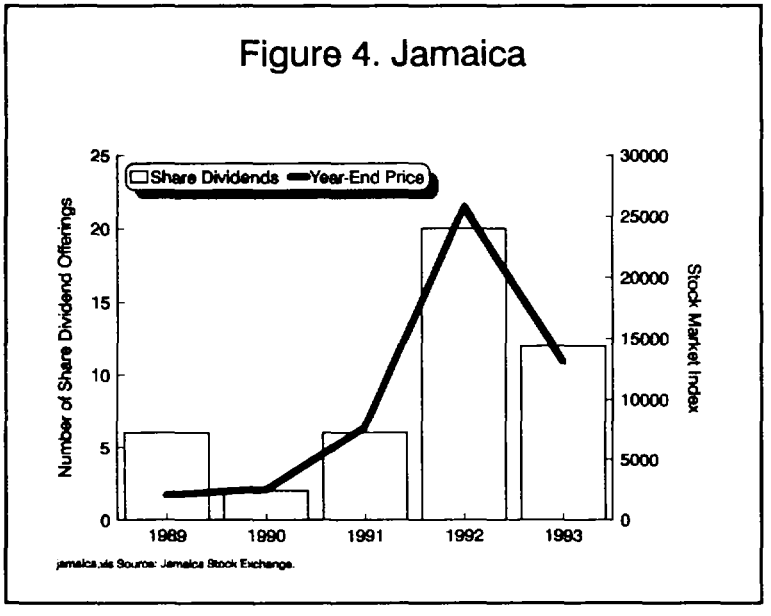
The last of the three arguments is based on the relationship between stock price and market liquidity. When the price of a company's stock is high, trading in the stock may become less liquid and, consequently, the stock will be less attractive to investors. By offering share dividends, firms effectively reduce the stock price, thereby restoring liquidity to the market for the stock and increasing shareholder welfare. A classic example of this liquidity-based argument is the Jamaican market where management believes that high share prices reduce investor interest, and therefore liquidity, in their stock. For that reason, significant stock price increases are often followed by the issuance of bonus shares (or stock splits), which dilute the value of the original shares and allow the price to drop, as illustrated in Figure 4.

In Jamaica, a tax scheme aimed at improving market liquidity has produced another tax-based incentive for issuing share dividends. Under a new law implemented in 1994, firms receive a direct tax credit for a portion of the value of any share dividends issued. The motivation behind the law is to promote the issuance of shares in order to keep prices affordable, thereby increasing market liquidity and encouraging widespread participation in the market. With this law, the country has provided both management and investors an incentive to issue share, rather than cash, dividends.

Another tax-induced alternative for firms with spare cash is to distribute that cash to investors through the repurchase of existing shares, normally through common stock-market transactions. This also has the effect of converting cash that would otherwise be paid as dividends into capital gains. But share repurchases are prohibited in some countries and, in others, firms can hold repurchased shares for only a limited period of time, after which the shares must be either resold or canceled. If canceled, there will be a net reduction of the company's capital. Examples of such decapitalizations were found in Chile and Mexico.

Evidence on Dividend Policy and Market Value

The third (signalling) hypothesis presented above on the relationship between stock prices and dividend policy, suggests a positive relationship between stock price and dividends. In the U.S., substantial empirical evidence suggests that dividend announcements affect stock prices in this manner: raising dividend payments increases stock price; reducing dividend payments



forces stock price down.[5] These findings are supported by case studies of individual firms which illustrate investor preferences for dividends. In a classic example, one firm tried to implement a zero dividend policy in favor of stock dividends, which would have been taxed at the (previously) lower capital gains rate. Investors objected vigorously to the dividend proposal and the plan was dropped.[6] This evidence suggests that, in the U.S., there are good reasons to believe that dividend policy is relevant for stock prices and that while the signalling theory has merit, it does not fully explain investor attitudes.

Little evidence on the signalling or irrelevance hypotheses exists for developing countries. No empirical work is available, for example, to verify the impact of dividend announcements on stock prices. Some anecdotal evidence, however, is suggestive. One firm that we interviewed in India attempted to eliminate its dividend payment in favor of reinvestment of earnings. Despite a serious public relations effort on its part, shareholder outcry against the proposal was sufficiently strong that the proposal was withdrawn by management. This suggests that dividend policy does matter to investors, an idea that was endorsed by most managements interviewed.[7] Still, in at least one country where we explored this issue, the Philippines, dividend payments are very small relative to stock prices and dividend policy is apparently less important there than in the other countries. What is peculiar about the Philippine case is that

[5] Asquith and Mullins (1982) found that stock prices rose by 3.7 percent when firms paid a cash dividend for the first time. Conversely, Dielman and Oppenheimer (1984) found that stock prices fell when dividends were cut or omitted.

[6] Sherfin and Statman (1984) describe the case of General Public Utilities.

[7] There is some difficulty in interpreting this example correctly. As noted in Table 1, the Indian tax code provides preferential treatment for dividends for many, but not all, investors. The outcry against the zero-dividend policy may have been largely tax-based.

the tax code in that country favors dividends over capital gains. Despite that, dividend payments have not assumed an important place in the market.

The nature of the shareholder structure may play a role in the relative importance of dividend policy on stock price. In many developing countries there is a limited shareholder base and investors are relatively well informed about the companies in which they invest. For those reasons, it may be easier for management to inform investors of their rational for changes in dividend payments. As a result, market reaction to dividend changes may more correctly reflect the underlying reason for the change than is the case in markets with more dispersed shareholder bases.

Direct Shareholder Influence on Dividend Decisions

Corporations come in a variety of shapes and sizes ranging from small single-owner enterprises, to large multinationals with thousands of shareholders. Even though each firm's management (through the board of directors) determines dividend policy, not surprisingly, the nature of the share ownership can play an important role in that decision.

Many firms begin their lives as family-owned enterprises, with complete decision-making power in the hands of the family. As these firms grow, external financing becomes more necessary and eventually equity is issued publicly, but often with a majority of shares maintained by the family. Dividend policy in this case will be determined by the needs of the family for cash, together with the needs of the business. Shareholder relations, while important, are not the primary consideration in dividend policy.

Of the countries in this study, Turkey provides the best example of an economy dominated by relatively closely held companies. In the typical case, group firms are organized within a holding company framework, and both holding company and subsidiary firms often have a proportion of their common shares held by the public. However, the proportion is likely to be fairly small, on the order of 15 to 25 percent.[8] Because long-term funds are extremely difficult to raise in this inflationary economy, many managements interested in expansion or modernization increasingly are being forced into widening their firms' shareholdership through new public offerings. Over time, therefore, one might anticipate a corporate ownership structure more closely aligned with other, more mature industrialized countries in Europe and North America.

In some countries, for example India, Mexico, Turkey and Zimbabwe, conditions have led to the establishment of conglomerates, often based on an original family-owned business. One interesting aspect of the conglomerate structure is that the dividend policy of each subsidiary, which itself may be publicly listed, is often determined by the central holding company based on the cash needs of other companies in the group. For example, all subsidiaries

[8] Turkey has a tax system that rewards public listing of a company. Firms that list their shares reduce their corporate tax rate; the higher the fraction traded publicly, the lower the tax rate. But the advantages only apply up to a certain percentage of shares listed, which is why there are more than one thousand publicly-listed firms in Turkey, but only about ten percent of those actually have their shares traded publicly.

may be required to pay the parent a dividend equal to some fraction of earnings, with the capital needs of each subsidiary then financed through additional parent and external funding.

Shareholder preference for dividends can greatly influence the rate at which dividends are paid. In its most obvious form, a single majority shareholder can dictate dividend policy and allocate as much of the company's earnings to dividends as the law allows. That was the case for one of the Chilean companies privatized in the 80s. Its foreign owner needed cash for other investments and required the company to pay out 100 percent of earnings, despite the company's significant investment needs and the objections of management. Subsequently, however, those shares changed hands and the new majority shareholder, also foreign, acceded to management's requests and reduced dividend payout by half.

Institutional investors are beginning to play an increasingly important role in emerging markets. This is especially true in those countries, such as Chile and a few other Latin American countries, that have initiated private pension plans. In the Chilean case, pension plans carry considerable clout in the domestic equity and debt markets and their preferences related to dividends enter into management decisions. As one might suspect, pension fund managers have a long-term view of their investment portfolio but, on top of that, face specific constraints on their investment decisions. By law, equity is not to exceed 30 percent of their total portfolio. To the extent that they have enough cash flow to satisfy their current needs and the equity constraint is binding, dividends received by the funds cannot be fully reinvested in equity. For that reason, some pension fund managers encourage firms to limit their dividends in order to reinvest the earnings and produce capital gains, a strategy that permits the funds to accumulate more equity than would otherwise be possible.

A similar preference for reinvestment of earnings is prevalent among Chilean asset management funds. Like all Chilean companies, those funds investing in equities have, by law, to pay 30 percent of their realized earnings as dividends to their shareholders. As a corporation, however, asset management funds are immune from taxes on both dividends and capital gains. So, in order to defer tax liabilities, fund shareholders generally prefer that fund earnings accrue in the form of capital gains rather than dividends. For that reason, fund managers encourage the companies in which they invest to retain their earnings.

There is disagreement over what type of investor is most interested in dividends: local individual investors, local institutional investors, or foreign investors. As mentioned, the argument centers on the question of whether investors are expecting growth or cash flow. In many countries, managements believe that local individual and institutional investors are interested in growth and, therefore prefer reinvestment of earnings. Foreign investors, however, are sometimes viewed as being more interested in dividends. The logic behind these beliefs is not entirely clear. It is true that foreign analysts covering developing country companies commonly ask management to divulge their policy on dividends and that prospectuses for new international equity issues are expected to spell out the company's dividend policy. Despite that, the appeal of developing country stock markets for most industrial country investors is the long-run growth potential they represent, not the short-term dividend cash flows they will produce.

A related question arises when listed companies in emerging markets are partially owned by multinational corporations (MNC) headquartered abroad. Local owners might have quite

different expectations with regard to dividend policy than do MNC shareholders. As a general rule, MNCs might be expected to prefer distribution of dividends to retention, since firms are allocating capital internationally. In two cases where this study inquired into this question, India and Jamaica, incomplete evidence suggests that MNC-affiliated companies do tend to pay out proportionately more than equivalent, wholly domestic firms.

In conclusion, generalizing investor attitudes toward dividends is difficult. The tax-based hypothesis should theoretically dominate other factors, but the available evidence suggests that taxes alone do not account for the substantial differences in dividend policies observed globally. Clearly, investors are willing to forfeit current dividends for expected future growth, but exactly what factors drive those expectations remains unclear. Management, being closer to the operations that produce the cash flows and resulting dividend streams must play an important part not only in deciding how much of the firm's earnings should be retained, but also how best to inform shareholders of the firm's potential. It is to this management function that we now turn.

IV. Management Perspective on Dividends

Although investors concentrate their attention on dividend yield, managements pay more attention to the impact of dividend payments on the firms's capital needs. By increasing dividend payout, firms reduce their access to retained earnings, often viewed as the lowest cost source of capital. For that reason, management may prefer lower dividend payout ratios, but must accept the realities imposed by shareholder preferences for at least some payment of dividends. The factors that enter into the decisions on payout target ratios and how much deviation from that target should occur are the topic of this section.

To start, we consider the behavior of dividend payout ratios over a recent period. In aggregate, dividend payout rates have been nearly stable over time for the universe of emerging markets. As presented in Figure 5, the payout ratio for a composite of all emerging markets followed by IFC's Emerging Markets Data Base ranged from 30 to 40 percent over the period 1986-94, with little variation from year to year.[9] By comparison, a global composite index of developed countries had a payout ratio of 66 percent in 1993, substantially higher than the level for any year presented in Figure 5. Among the major developed markets there were no substantial differences: the U.S. and Japan had similar ratios of 61 and 62 percent respectively, whereas the U.K. had a ratio of 72 percent. Clearly, emerging market firms retained, on average, substantially more of their earnings than did their developed country counterparts. Two possible reasons for the higher level of retention are investment opportunities and an overall lower level of capital market development that makes retained earnings a relatively more attractive source of capital. Both of those potential reasons are explored below.

The composite results in Figure 5 mask the substantial variation that exists in developing countries. In Figure 6, for example, the aggregate dividend payouts for Chile and Thailand are presented. In the Chilean case, dividend payout rates have risen consistently over time and at a remarkable rate. At the same time, dividend payout rates have declined substantially in Thailand. The interpretation of these two remarkably different behaviors is complicated. Both countries experienced high rates of economic growth over the period under examination and both became more open to foreign investors, but each country also has individual factors that influenced behavior.

At the beginning of the period, the Chilean economy was recovering from a serious economic downturn. As a result, firms were in the process of rebuilding and chose a low level of payout.[10] Also, during the 80s, Chile privatized a number of companies and some of those sales were financed by debt that the government made available to individual investors. As that

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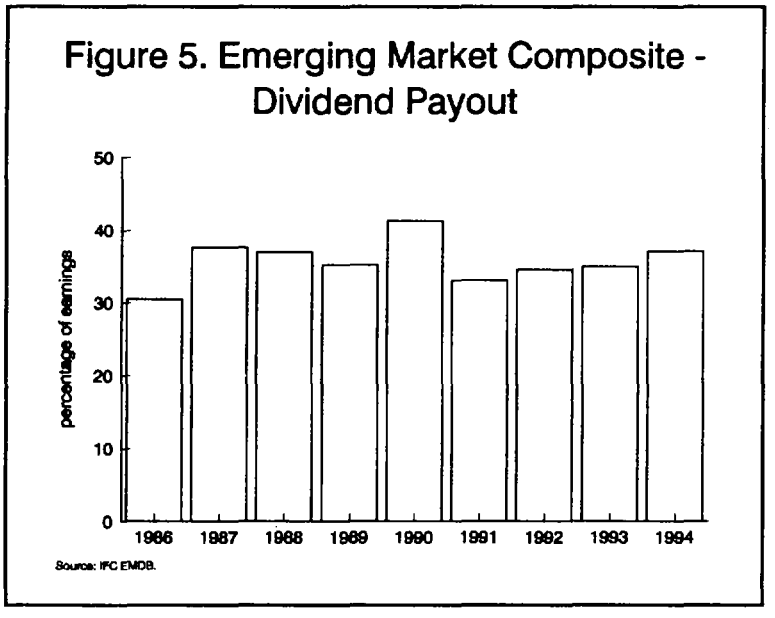
[9] IFC tracks a set of 25 developing countries in its Emerging Markets Data Base. For each of those countries the Data Base contains a variety of market and firm data. In addition, IFC compiles a series of country, regional and global indices that follow market performance.

[10] The payout ratio in both 1986 and 1987 actually fell short of the 30 percent government-mandated minimum. How the aggregate payout fell below the minimum required level is unclear. One source of the deficiency is the banks, which were required to retain equity in order to meet international capital adequacy standards.

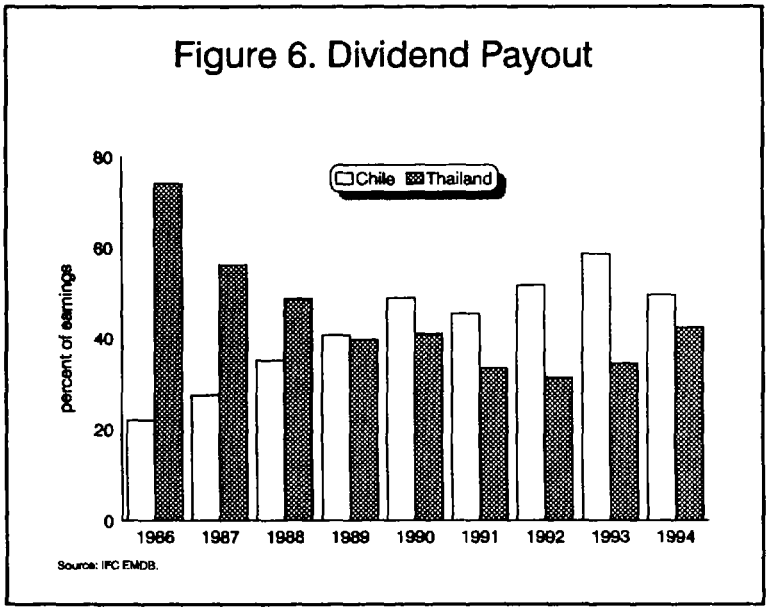


debt became due, investors demanded higher dividends in order to secure the cash needed for debt repayment. Moreover, the privatized firms were, on average, different in nature from the existing publicly-listed firms, with more utilities and mature companies which tend to pay higher dividends. Finally, as the economy became more open to portfolio flows, more Chilean firms gained access to international sources of capital, both debt and equity, which provided another reason to increase dividend payments to domestic investors.

Corporate earnings grew rapidly in Thailand during the decade of the 80s and management, evidently with agreement from investors who also expected high future growth rates, increased dividend payments at a rate much slower than the growth in earnings. By 1991, however, the era of high growth in corporate earnings had largely ended and payout rates have been adjusted slowly upward to reflect the new reality.

Retained Earnings as a Source of Capital

From a corporate perspective, retained earnings provide a relatively low cost source of equity. Most external sources, by comparison, are more costly. One would expect that management would attempt to exploit this low-cost capital to the extent possible, taking into account the demands of shareholders for dividends and other institutional constraints that it faces. The relationship between retained earnings as a source of financing for investment and dividend policy is examined in Figure 7, which compares dividend payout rates with the fraction of total investment that retained earnings represented in a group of developing countries. There is clearly a positive relationship between these two variables. In countries where a large percentage of earnings were paid to shareholders as dividends, retained earnings represented a large percentage of total investment, implying that relatively low amounts of capital were sourced from outside the firm. Conversely, firms that paid a lower percentage of earnings as dividends sourced more capital, relative to earnings, from outside the firm. This is in line with the hypothesis that retained earnings are a preferred source of capital and that firms that need

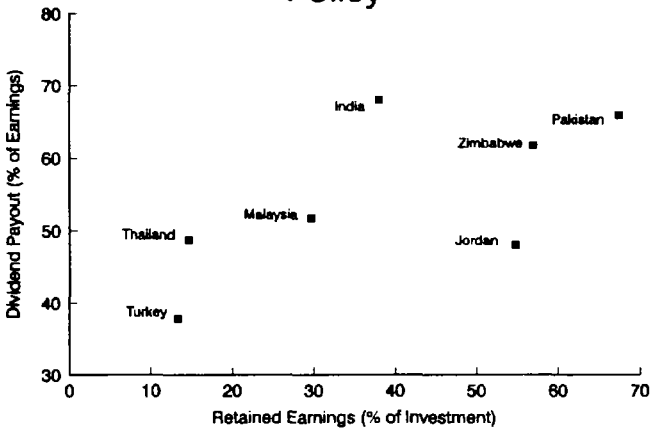


capital for investment tend to retain earnings rather than pay them out as dividends.

Another factor that one should consider in attempting to explain the use of retained earnings as a source of capital is the growth rate of firms. Intuitively, one might expect firms that are experiencing high growth rates to choose a lower dividend payout rate in order to finance that growth. Figure 8 provides a comparison of retained earnings as a source of investment capital with one measure of firm growth: (real) percentage change in net assets over time. The figure shows a negative relationship between the two variables: firms that are growing faster pay out lower levels of earnings as dividends, a finding that also supports the view that retained earnings are a preferred source of capital. Close inspection of the graph, however, shows that the relationship between growth and retained earnings is not perfect, which leads one to consider a third explanatory variable.

The third factor we consider as a possible influence on the use of retained earnings as a source of capital is the availability of alternative sources of capital, which is tied closely to the level of domestic capital market development. As external sources of capital become more readily available, firms should be more willing to employ them. One problem with this hypothesis is that measuring the level of capital market development is not easy. For example, the number of listed firms, trading volume and market concentration all provide useful insight into the level of market development, but no one measure can provide the complete picture, especially if one wants to include fixed-income markets in the analysis. Bearing that in mind, the chosen measure in this case is the ratio of stock market capitalization to gross national product, which measures relative (equity) market size. Figure 9 presents this measure together with retained earnings as a percentage of total investment. The measure fails to explain the use of retained earnings. India, for example, has a low level of market capitalization, but still uses retained earnings less than Jordan, which has a relatively high level of market development. Moreover, two developed countries not presented in the figure — Japan and the U.S.— have

Figure 7. Financing Investment and Dividend Policy



Source: IFC.

among the world's most developed stock markets, but also exploit retained earnings more than most developing countries do.

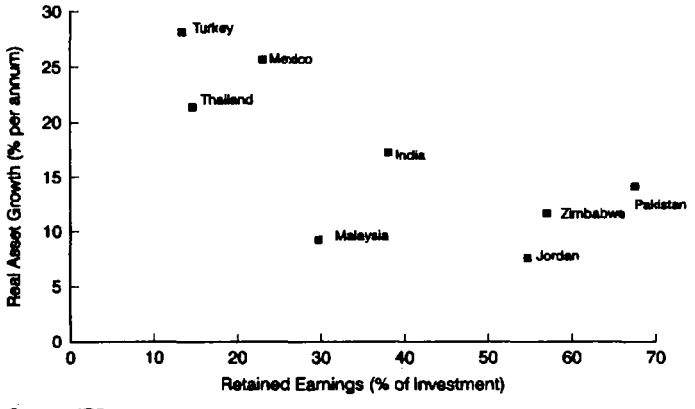
Firm and Industry Characteristics and Dividend Policy

Aggregate data provide a useful and interesting perspective on international differences in dividend policy and their relationship with other variables, but they also mask many of the firm and industry characteristics that may dominate dividend decisions. To capture those effects, one must look at the behavior of individual firms and the industries in which they operate.

Some industries, for example commodities producers, are subject to significant volatility in the market prices of their products. Other industries may be growing significantly faster or slower than the economy as a whole, which has an impact on both their need for capital and the future earnings flows that they can be expected to generate. These same factors could also exert a strong influence on the dividend policies of the firms within an industry. Having established that there are significant national differences in dividend behavior, one wonders if there are industry differences as well? Evidence on this question is presented in Figure 10, which shows average dividend payout ratios for a group of Indian industries for 1990 and 1994. The figure illustrates two points. First, at any point in time there can be significant differences in the dividend payouts of different industries; the automotive and apparel industries in 1990, for example. And second, that some industries alter their dividend policies dramatically over time; the automotive and chemical industries are good examples.

These industry averages, however, also hide substantial variation across firms within an industry. Firms in the same industry often have very different dividend policies and, although some firms that we spoke with follow the dividend policies of others in their industry, often no attempt is made to incorporate others' policies into their own dividend policy. It is true that the need for cash, which may at least partially reflect industry factors, plays an important part in

Figure 8. Retained Earnings and Growth



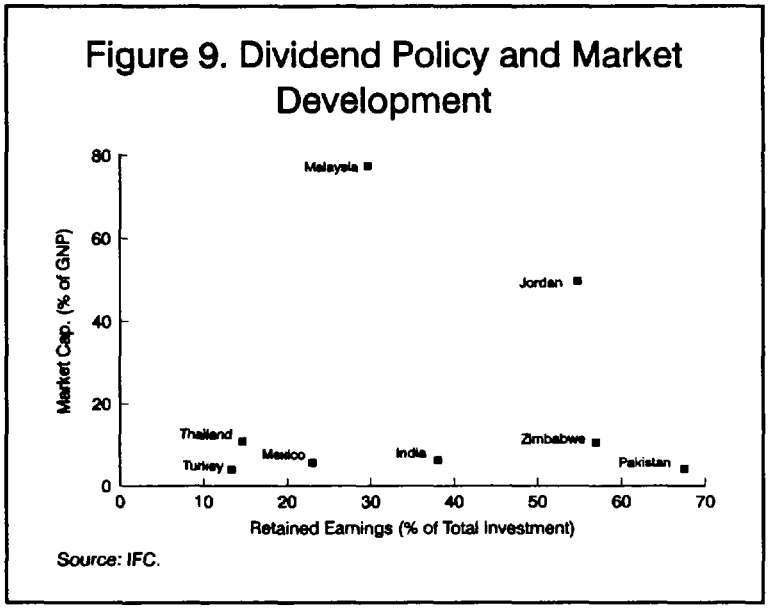
Source: IFC.

the dividend decision, but generalizations within an industry are difficult to draw. Moreover, in our interviews firms revealed no indication that an industry norm either existed or played an important role in their dividend decision.

Aside from possible industry effects, the nature of investment opportunities available to a firm should influence its dividend policy. Hypothetically, firms having better investment opportunities should be more likely to retain earnings than to pay them out as dividends. In order to investigate that possibility we examined the dividend policies and earnings of a set of firms in each of eight emerging market countries.[11] Using growth in earnings as the measure of firm growth, we found a positive correlation between growth and dividend payout in six of the eight countries, implying that firms with higher earnings growth rates retained fewer earnings than their slower growing counterparts. Using growth in net fixed assets as the measure of growth, the results are mixed; there was a positive relationship between growth and retention of earnings in four countries, a negative relationship in the other four. These results, which are generally statistically insignificant, indicate a weak link between growth and dividend policy; growth opportunities alone are insufficient to explain a firm's choice of dividend policy. That empirical finding also agrees with our field work. Some firms that we visited in high growth industries paid very high dividends owing to the demands of their shareholders, despite their need for substantial capital investment in order to finance growth.

In addition to growth, one might suspect that the uncertainty of a firm's future earnings should be related to dividend policy. Firms that operate in markets in which earnings are steady should be more willing to pay dividends than are firms operating in more volatile markets as,

[11] India (99), Jordan (37), Korea (94), Malaysia (99), Pakistan (106), Thailand (66), Turkey (45), and Zimbabwe (48). Numbers in parentheses indicate the number of firms in the sample. Data come from the IFC Economics Department Data Base on corporate finance.



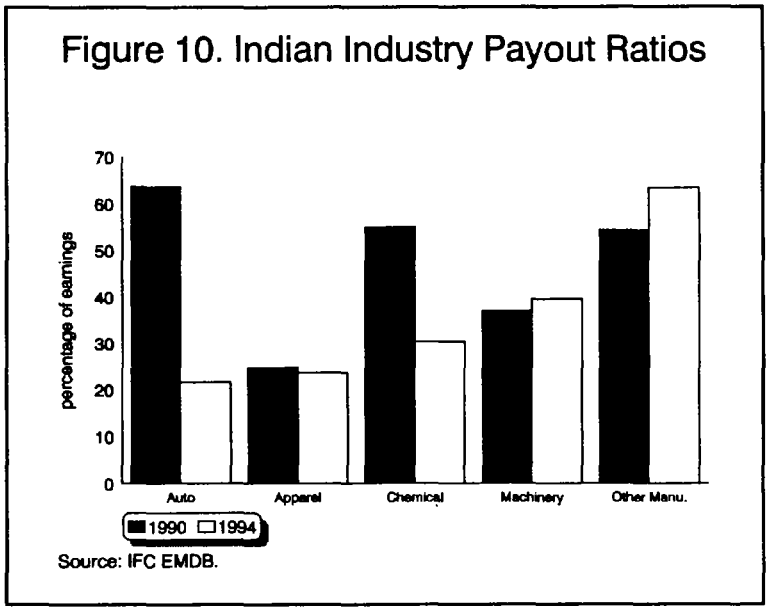
for example, producers of commodities. Again, we examined this issue empirically with our set of firms in eight developing countries. In this case, seven of the eight countries produced a negative correlation between the standard deviation of earnings and dividend payout, although none were statistically significant. These findings suggest that firms which have volatile earnings do reduce their dividend payout, but that the relationship is not strong.

Dividend Smoothing

As mentioned, the idea that firms smooth dividend payments over time is accepted as a stylized fact for some developed countries. In most of the developing countries that we visited, however, the concept of dividend smoothing was less well accepted. In those countries, management typically adopts a target dividend payout ratio and, for the most part, they attempt to maintain dividend payments in line with that target ratio regardless of short-term volatility in earnings. An example of this approach is evident in Figure 11, which presents the dividend payments for Madeco, a Chilean manufacturing company. The figure illustrates substantial volatility in the dividend payments over time, as well as a willingness to reduce dividends when earnings slump. In this particular case, corporate management has followed a policy of paying at least 50 percent of earnings as dividends; the average in recent years has been slightly more than 50 percent. Despite that, there is variation in the payout rate over time, with a particularly high payout rate in 1989 in anticipation of a 1990 change in the corporate tax rate.[12]

It is apparent from the figure that the smoothing hypothesis is not descriptive of Made co's dividend policy even though the correlation between dividend payment and earnings is not

[12] As in most countries, Chilean firms typically pay dividends in the year following that in which the earnings on which they are based are actually earned. For that reason, the figure combines dividend payments made in, for example, 1990, with earnings reported for 1989.



perfect. The targeting of a payout rate is also representative of most, but not all, other developing country firms that we contacted. Two exceptions to that rule are the Philippines and Thailand, where the idea of targeting a nominal dividend amount rather than a dividend payout ratio apparently prevails among firms. The reasons for this apparent difference are not clear.

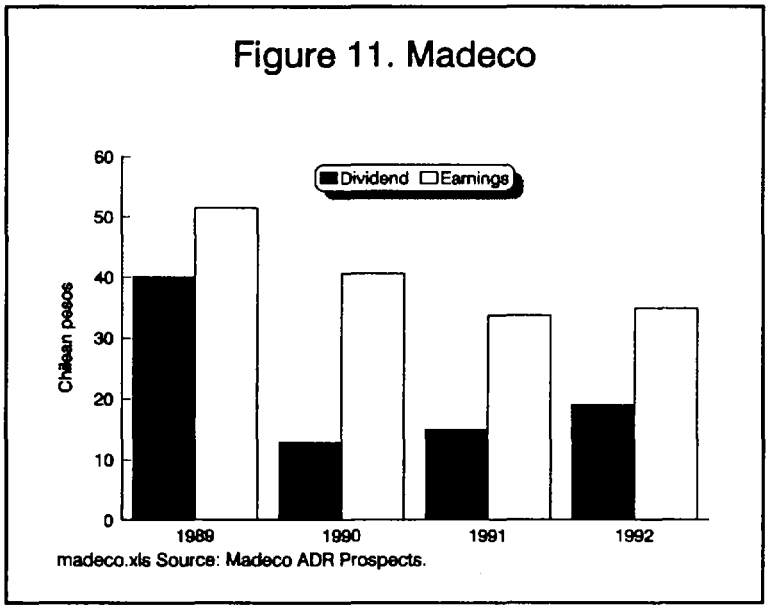
Environmental Factors

Aggregate and firm level data provide useful characterizations of dividend policy, but they alone fail to fully explain why such differences exist and how dividend policy is formulated at the firm level. The remainder of this section looks more closely at dividend behavior from a microeconomic perspective in order to identify environmental factors that are important in the dividend decision. The analysis begins by looking at the role of legal constraints, then moves on to taxes and accounting systems as factors important in determining dividend behavior.

Regulatory Constraints

Many governments have adopted legal restrictions on the payment of dividends in part, at least, to protect the interests of minority shareholders and creditors. Generally, firms are constrained to payment of dividends out of accumulated earnings and, in India and Mexico for example, even a portion of those earnings must be maintained as a reserve against unfavorable events. In the case of banks, some governments have also adopted the Bank for International Settlements capital adequacy guidelines, which require accumulation of certain levels of capital before dividends can be paid.

Governments have in some cases taken an additional step to protect shareholders and encourage interest in equity investments by dictating a minimum level of dividends that publicly-listed companies must adhere to. In Chile, as noted, firms are required to pay out at least 30 percent of earnings, unless shareholders agree unanimously to accept a lower level. In Turkey



the payout rule is more complicated, with firms required to pay the greater of 50 percent of earnings or 20 percent of paid-in capital, but they need not pay more than 75 percent of earnings. These restrictions, however, need not always prevent management from effectively retaining a larger portion of earnings. In both Brazil and Turkey firms are required to pay at least a minimum amount of earnings as dividends. In both cases, however, inflation rates have been high in recent years and firms wanting to circumvent the minimum dividend requirement can do so by delaying payment, thereby permitting inflation to reduce its real value.

As a shareholder, governments have also introduced dividend restrictions to protect their own interests. In the Philippines, for example, the government holds equity in some publicly-listed companies and, as a shareholder, requires that half of its share of earnings be paid to it in the form of cash dividends.

In other countries the constraints on dividend payments are aimed at preventing payments from being remitted abroad. In Zimbabwe, for example, until recently dividend payments available for remittance were severely restricted, especially for capital invested prior to independence.

Tax System

Aggregate data presented earlier show little relationship between tax rates and dividend behavior. For some firms, however, tax rates have played an important role in determining the dividend payout. One example comes from Mexico where dividends received by foreign investors were formerly subject to a 50 percent withholding tax. In the case at hand, the majority shareholder happened to be a foreign investor and given the combination of the withholding tax and local investment opportunities, the firm adopted a policy of paying no dividends, which it maintained for ten years. Recently, however, the government has repealed the dividend withholding tax and the firm is reviewing its dividend policy with an expectation to increasing

its payout to more closely resemble that of its main competitor, which pays 80 percent of its earnings in dividends.

Accounting Systems and the Effects of Inflation

Not surprisingly, the nature of a country's accounting system can have important consequences for the level of dividends paid. In most countries, dividend payments are limited to the level of earnings and those earnings are determined by the accounting standards adopted.[13] The more conservative the accounting standards, the lower are earnings and, consequently, dividends. Chile provides an interesting example. Under that country's conservative accounting standards, firms have significant depreciation expenses on assets. Those expenses reduce earnings, but they also build cash flow because they are non-cash expenses. As a result, some Chilean firms are able to pay 100 percent of earnings as dividends, but still maintain sufficient cash balances to finance working capital. Long-term investment, of course, must be financed from external sources as needed.

Somewhat related to accounting practices are the restrictions imposed on dividend payments by creditors in their debt agreements. For example one Mexican manager stated that he could not pay more than half of his company's earnings as dividends owing to a debt covenant. However, such agreements need not always be binding; the Mexican firm's management had adopted a target payout of only 30 percent.

Inflation, of course, can also have effects on dividend policy that are related to a country's accounting standards. A classic example is Turkey, where inflation rates of 50 to 70 percent are considered normal, and recent figures have been twice as high. Although some adjustment for inflation is allowed by the government, it is limited to only a part of the rise in prices of fixed assets, not including land. One consequence is that earnings are vastly overstated, so much so that managements take various steps to reduce the reported income figure to bring down taxes. Such steps clearly also have a tendency to diminish the amount of dividends, since they are typically tied to earnings. Another consequence of annually restating fixed asset values to reflect inflation is that companies end up with an offsetting account called a "revaluation account." Companies in Turkey are allowed to issue new "bonus" shares against this account at par, an action that can be considered a share dividend. Nothing "real" has happened through such an issue, except that the firm's capital account has been increased by the amount of the share issue and, in addition, the new shares have the effect of reducing share prices of the company on the stock market.

[13] There are exceptions. Where they exist, limitations on payouts as a proportion of reserves are typically enforced. For example, companies with no profits may be allowed to pay dividends, but the amount is determined by the adequacy of reserves.

Do firms issue new equity or debt at the same time that they pay dividends?

One theory of corporate finance suggests that firms tap first their lowest cost source of funding and then move on to other higher cost funds as different sources become exhausted. This pecking-order theory suggests that firms should exhaust all available earnings before going to more costly external funds. In reality, firms in developing countries often raise external capital at the same time that high levels of cash are being paid out to shareholders as dividends. One particularly noteworthy example of this is in Turkey where, as mentioned, firms are required to pay at least half of all earnings as dividends. In order to offset this, many firms respond to each dividend announcement with a rights issue for new equity. In order to prevent their equity positions from being diluted, shareholders are required to purchase the new shares being offered, in effect, repaying to the firm the dividends they had just received.

V. Conclusions

Dividend philosophy in emerging markets seems to be influenced by a number of factors and there is significant variation across countries, firms and time. The approach to dividend policy taken by many emerging market firms differs substantially from what is common in developed countries; dividend payout rates in developing countries are roughly two thirds that of OECD countries. Emerging market firms often do have a target dividend payout ratio, like their developed country counterparts, but they are generally less concerned with volatility in dividends over time and, consequently, dividend smoothing over time is less important.

Shareholders exert a great deal of influence on dividend policy. This is obviously true in those cases where there is a single shareholder with a majority interest in the firm, but it is also true for firms with well-diversified shareholder bases. To a large extent, in recent years, shareholders in emerging markets have passively approved a decline in dividend payments relative to the market value of their investments, an indication that they expect future growth in earnings and capital gains in return. But in some cases, Chile being an example, investors have sufficiently pressured companies that dividend payout rates as a fraction of total earnings have increased substantially over time.

As in so many other areas, governments play a major role in the dividend decision-making process. Armed with the belief that investors need protection from unscrupulous firms, governments have identified a number of ways in which they can ensure that investors, especially minority investors, are paid "their due" and that the interests of creditors are not overlooked. These regulatory restrictions have imposed binding constraints in many cases, but nimble firms have often found innovative means for circumventing those constraints when it is in their best interest. And despite the interventions of government, firms in emerging markets have managed to maintain dividend payout rates substantially below those of more developed countries. Notably, they have done this at a time when stock prices have soared, thereby reducing dividend yields to roughly half the level of a decade ago.

The evidence presented here provides insight into the dividend policies of emerging market firms, but it also illustrates the complexity of that issue and leaves many unanswered questions. A better understanding of dividend behavior in these countries will require much additional research, both at the aggregate and firm levels. Hopefully, this paper provides motivation for that work.

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