Determinants of dividend smoothing in emerging market: The case of Korea

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Abstract

Dividend smoothing is a well-established empirical fact in developed countries. This paper investigates the dividend smoothing behavior in Korea where the tax regime and institutional settings of the financial market are different from those of developed countries. The empirical evidence shows that the dividend smoothing decision is influenced not only by a firm’s characteristics, but also by macroeconomic factors such as tax and interest rates. Detailed results are as follows. First, application of the Lintner model shows that the extent of dividend smoothing in Korean firms is found to be less than that in the U.S. firms. Second, size, risk, growth and large shareholder ownership are found to be important determinants of dividend smoothing. Larger firms and lower growth firms smooth dividends more. Riskier firms tend to smooth more during the sample period while safer firms smooth dividends more for the post-liberalization period. These results are not consistent with the predictions of information asymmetry models. In addition, contrary to the agency theory based explanations of dividend smoothing, firms with concentrated ownership smooth dividend more. Finally, as for the effect of macroeconomic factors on dividend smoothing, both tax and interest rates are found to have significantly positive relationships with the degree of dividend smoothing. These findings suggest that institutional factors of financial market can play a critical role in understanding the dividend behavior in emerging markets.

1. Introduction

It is well-known that firms smooth their dividend payments relative to earnings. Lintner (1956) finds that firms in the US pay dividends smoothly to maintain a target long-run payout ratio. Lintner's finding of
interest rates in Korea. The evidence also reveals that the majority of Korean firms engage in dividend smoothing in Korea. The empirical evidence shows that the dividend smoothing decision is considerably affected by signaling needs and dividend signaling costs, whereas low growth firms with weak corporate governance are more likely to pay smoothed dividends to mitigate high agency cost. In fact, Michaely and Roberts (2012) document that privately held firms pay smooth dividends less than publicly held firms do. They suggest that ownership structure influences the pattern of dividend smoothing.

Finally, Korea has experienced unprecedented economic growth for the past four decades. This rapid economic growth may have had significant effects on the dividend policies of Korean firms. Signaling theory implies that firms with high growth opportunities pay dividends to convey this information to the outsiders. At the same time, these firms will also have a greater need to retain a higher proportion of earnings to support their valuable investment projects. An implication of this tradeoff between the requirements is that high growth firms are likely to be more sensitive to the tradeoff between dividend signaling needs and dividend signaling costs, whereas low growth firms will be significantly less sensitive to the tradeoff because they would not wish to use costly signals. As a result, to send a credible signal to the market, firms with higher growth potential are likely to smooth dividends more.

This study investigates cross-sectional differences in firms’ dividend smoothing behavior with particular attention on the impact of financial liberalization and tax changes on the degree of dividend smoothing in Korea. The empirical evidence shows that the dividend smoothing decision is considerably influenced not only by firm’s unique characteristics, but also by macro-economic factors such as tax and interest rates in Korea. The evidence also reveals that the majority of Korean firms pay smoothed dividends. However, the degree of dividend smoothing of Korean firms is less than that of US firms. For the
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