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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.

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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

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dividend smoothing has been confirmed by a number of studies since its publication.[1] This study contributes to the body of research in this field to investigate the pattern of dividend smoothing and its determinants in Korea where the tax regime and institutional settings of its financial market are different from those of developed countries.

The Korean financial market provides several interesting features for examining the pattern of dividend smoothing. One of the key features is that there is no capital gain tax on listed stocks while a tax of 15.4% is applied to the dividend income in Korea. Several studies relate dividend signaling to the taxation issue to show that dividends can be utilized as a credible signal for the value of a firm, due to the tax disadvantage of dividend payments (Bernheim, 1991; Bhattacharya, 1979; John and Williams, 1985). Rozycki (1997) finds that dividend smoothing can increase wealth for investor by reducing the present value of the investor's future expected income tax liabilities. As tax treatment of dividend income becomes more unfavorable, it is likely that this will motivate firms to smooth dividends even further.

Another interesting feature is that the Korean government has continued to liberalize the financial market as a part of economic reforms which have been conducted since the early 1990s. The interest rate liberalization was announced in 1991 and it was completed in 1995. Interest rate is a key consideration for deciding the level of dividend payments since it is directly associated with the financing cost and value of the firm. Bates et al. (2009) argued that financial constraints became an important factor of dividend policy and cash holdings. Furthermore, the Capital Market Promotion Act of 1968 in Korea added another role of interest rate in dividend policy that is specific to Korean firms. The act initially made it mandatory for listed corporations to pay annual dividends divided by the face value at a level equal to the interest rate on one-year time deposits.[2] Although this policy was not actually implemented, it has been traditionally understood that the interest rate was an important benchmarking rate in deciding the level of dividend payments in Korea. In this case, changes in the annual dividend payments may be related to changes in the interest rates instead of signaling the fundamentals of companies.

In addition, the ownership structure of Korean firms is characterized by a unique structure, referred to generally as a circular cross-investment. Therefore, the owner is capable of exercising ownership rights to control many companies in different industries even with a small proportion of voting rights. Consequently, there is the possibility of an agency problem, in which controlling shareholders expropriate value from minority shareholders. Poor corporate governance also exacerbates the agency costs of free cash flow. Hence, firms with weak corporate governance are more likely to pay smoothed dividends to mitigate high agency cost. In fact, Michaelly and Roberts (2012) document that privately held firms 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

[1] Fama and Babiak (1968), Laub (1976), Lee et al. (1987), Marsh and Merton (1986), Garrett and Priestley (2000), Kumar and Lee (2001), Allen and Michaely (2003), Brav et al. (2005), and Leary and Michaely (2011).

[2] Unlike US stocks, Korean stocks have a face value which performs an important role in deciding a firm's dividend policy.

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