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Corporate dividend policy in practice: Evidence from an emerging market with a tax-free environment

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ABSTRACT

Several theories have been proposed to explain why companies pay dividends. However, as of today, the dividend policy remains a puzzle as no convincing explanation has been given as to why firms pay cash dividends to their shareholders. This paper contributes to this debate by examining the dividend policy in an emerging market that has a tax-free environment. Specifically, we follow Brav et al. (2005) and examine this issue using survey and field interviews, in the particular context of the United Arab Emirates. Our results provide support for the proposition that dividend policy is conservative. We also find that dividends in the UAE are considered by managers as a residual cash flow, and are determined after investment decisions are made. When examining the determinants of dividend policy, we find that taxes are not important, that institutional investors are expected to play a role in disciplining managers, and that dividends may play a disciplinary role as well in controlling agency conflicts.

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1. Introduction

Firms' dividend policy is important on several grounds: it is important for investors looking for a source of stable income, for analysts that seek a valuation tool, and for managers because dividends represent a trade-off between returning cash to shareholders or reinvesting the money to finance the firm's growth opportunities. Even for lenders, dividend policy is of interest because the dividends that are paid to shareholders might jeopardize the repayments that they expect to receive.

Miller and Modigliani (1961) show that in a perfect world where there are no asymmetrical information, taxes, or agency problems, among other hypotheses, dividends do not affect the value of a firm because investors can create a 'home-made-dividend' to earn the dividend that the firm would be paying. However,

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when the restrictive assumptions of the Modigliani and Miller are relaxed, dividends in fact matter. In particular, dividends may matter because of differential tax treatment of dividends compared to capital gains. Also, as shown by Myers and Majluf (1984) and Miller and Rock (1985), information asymmetry between managers and outside investors may also have implications for dividend policy since managers make their investment decisions by following a pecking order of financing choices. As a consequence, managers prefer to finance the firm's growth opportunities with retained earnings first (hence lower dividend payments), before resorting to debt or equity issuance. Another view of the dividend policy is offered by Bhattacharya (1979) who conjectures that in the presence of asymmetrical information, managers may use dividends to signal the firms' future positive prospects by adopting high payouts.

Dividends may also affect firm value if one assumes that information asymmetry between agents (managers) and principals (outside shareholders) may result in conflicts of interest as suggested by Donaldson (1963), Jensen and Meckling (1976), and Jensen (1986). A high payout would in this case reduce the potential expropriation of principals by managers because it reduces the free cash flow available to these latter to spend on perks.

To summarize, several theories have been proposed to explain why companies pay dividends.¹ However, as of today, the dividend policy remains a puzzle since no convincing explanation has been given as to why firms pay cash dividends to their shareholders (Black, 1976). In recent years, empirical research has been conducted to explain the trends and determinants of dividend policy and has shown that corporate dividend payout policies vary across countries, and between developed and developing markets. For instance, Glen et al. (1995) find that payout ratios in developing countries are typically much lower than that of developed countries. In the same vein, Ramcharran (2001) report lower dividend yields for emerging markets. Additionally, La Porta et al. (2002), show on a cross section study of 4000 companies from 33 countries with different levels of minority shareholder rights that corporations tend to have, on average, higher dividend payout in countries where minority shareholders enjoy stronger legal protection. This suggests that the protection of minority shareholders has a positive impact on dividend payouts. More recently, adding to the dividend puzzle, Aivazian and Booth (2003) compare dividend policies of firms from emerging markets to those of a sample of US firms, and contrary to previous evidence in Glen et al. (1995) and Ramcharran (2001), conclude that, overall, payout ratios of firms from emerging markets are comparable to those of US firms.

The objective of this paper is to contribute to this debate by examining the dividend policy in an emerging market that has a tax-free environment. Emerging markets differ from those in developed countries in many aspects, and one expects dividend policies to obey to different dynamics. Indeed, emerging markets are characterized by less information efficiency, and are more volatile (Kumar and Tsetsekos, 1999). Emerging markets are also different with respect to their corporate governance institutions, taxation on dividends and capital gains, and corporate ownership structure. Finally, financial constraints on firms from emerging markets are heavier than in developed markets, which may affect the firms' dividend policy. All these differences suggest that dividend policy theories are worth re-examining in such a context as the findings will help enlighten the debate on comparative research on this issue.

Specifically, we follow Brav et al. (2005) and examine this issue using survey and field interviews, in the particular context of the United Arab Emirates (UAE hereafter).² We particularly investigate the financial executives' decisions on dividend policy and share repurchases of publicly listed firms in the UAE. Our motivation to examine this issue in this particular country is that we want to explore dividend policies in a tax-free environment, where there are no corporate taxes (except those paid by foreign banks and oil companies, none of which are publicly listed). Furthermore, there is no tax of any form on personal income, including dividends. Moreover, the prevailing institutional environment is a mixed legal regime that has a civil code and a common law component. Finally, like most other emerging markets, particularly in Asia (Chen et al., 2005), ownership is highly concentrated in the UAE and very heavily tilted toward family ownership. Our investigation will thus allow us to extend our results to other countries in the region. To the best of our knowledge, this is the first comprehensive survey, of its kind, applied to such a market.³ Our

¹ Please refer to Allen and Michaely (2003).

² See Appendix for a description of UAE background.

³ There are no empirical country studies on the dividend policy of firms operating in the region, but few studies have been conducted in the Far East region, namely Ang et al. (1997) Kato et al. (2002) and Chen et al. (2005).

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