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# Corporate governance and dividend policy in emerging markets

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**Abstract**

In a sample of 365 firms from 19 countries, I show that firms with stronger corporate governance have higher dividend payouts, consistent with agency models of dividends. In addition, the negative relationship between dividend payouts and growth opportunities is stronger among firms with better governance. I also show that firms with stronger governance are more profitable, but that greater profitability explains only part of the higher dividend payouts. The positive relationship between corporate governance and dividend payouts is limited primarily to countries with strong investor protection, suggesting that firm-level corporate governance and country-level investor protection are complements rather than substitutes.
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## 1. Introduction

In the United States, the debate surrounding dividend policy has traditionally centered on the question of why firms pay dividends, given that the tax disadvantage of dividends appears to be large. But in countries where investor protection is weak, a more

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fundamental question regarding dividend policy might be more relevant: How can shareholders hope to extract dividends from firms, given that the legal environment of the country and the governance mechanisms of individual firms offer investors relatively few protections? Agency theory suggests that outside shareholders have a preference for dividends over retained earnings because insiders might squander cash retained within the firm (see, e.g., Easterbrook, 1984, Jensen, 1986, Myers, 2000). This preference for dividends may be even stronger in emerging markets with weak investor protection if shareholders perceive a greater risk of expropriation by insiders in such countries.[1] La Porta et al. (2000) show that dividend payouts are higher, on average, in countries with stronger legal protection of minority shareholders. This finding lends support to what La Porta et al. (2000) call the "outcome" agency model of dividends, which hypothesizes that dividends result from minority shareholders using their power to extract dividends from the firm.

If protection of minority shareholders does have a positive impact on dividend payouts, then shareholder protection should help explain not just country-level differences in dividend payouts, but also firm-level differences in dividend payouts within countries. Indeed, while country-level investor protection is an important factor in preventing expropriation, firm-level corporate governance could carry equal or greater importance. And corporate governance practices can vary widely even among firms in the same country operating under the same legal regime. This paper uses firm-specific corporate governance ratings developed by Credit Lyonnais Securities Asia (CLSA) for 365 firms from 19 emerging markets to study the impact of firm-level corporate governance on dividend payouts. It is important to note, as do La Porta et al. (2000), that the outcome model does not hinge on investors holding specific rights to dividends. Rather, what is important is that the country's laws—or the company's governance practices—allow minority shareholders more rights in general, which rights may then be used to influence dividend policy. For example, observers have noted that Russian firms are more commonly electing independent directors to their boards, despite a legal system that does little to define or enforce board independence (Nicholson, 2003). Mark Mobius, elected as an independent director to the board of Russia's LUKoil in 2002, later acted on behalf of shareholders to propose a minimum-dividend policy that LUKoil's board approved in 2003 (Investor Protection Association, 2003).

Using the CLSA data, I first show that firms with higher corporate governance ratings have higher dividend payouts. The effect appears to be economically meaningful as well as statistically significant; regression results imply that a one-standard deviation increase in a firm's corporate governance rating is associated with an average 4% point increase in dividend payouts (the average payout ratio is about 30%). A move from the worst governance (in this dataset, Indonesia's Indocement) to the best governance (in this dataset, Hong Kong's HSBC) would imply, on average, a higher dividend payout ratio of some 22% points. This result is consistent with the hypothesis of the outcome agency model that investors that are afforded stronger rights use those rights to extract

[1] In a recent paper, Brav et al. (2003) find limited evidence for the agency theory of dividends in the U.S., at least from the perspective of corporate executives.

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