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Does political economy reduce agency costs? Some evidence from dividend policies around the world

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ABSTRACT

This study shows that firms in proportional-electoral countries pay out lower dividends and that the correlation between a firm's growth potential and dividend payout ratio is weaker in proportional-electoral countries. However, firms in proportional-electoral countries that cross-list in majoritarian system countries, tend to pay out higher dividends and the negative relation between growth potential and dividend payout tend to be stronger than their peers that do not cross-list. For a few countries that changed their electoral system towards a more proportional system, we observe a decrease in dividend payout ratio and a weaker relation between growth and dividends after the change. Overall these results indicate that a country's political system affects the severity of agency problems. Further, the effect of legal origin on dividend policy reverses once we include the political economy variables in the regressions. We also document that the electoral system not only affects the amount of dividends paid by a firm but also the form of payment.

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1. Introduction

An important strand of the global markets finance literature provides some insights into the linkage between the degree of investor protection in a country, which depends on its legal origin and enforcement, and the development of financial market, the financial and ownership structure of firms, and the severity of agency problems in that country (Modigliani and Perotti (1997); LaPorta et al. (1998, 2000a, b): Levine and Zervos (1998)). However, recent research suggests that political economy variables may indeed be a more reliable indicator of investor protection than a country's legal origin. For example Pagano and Volpin (2005), using a sample of 21 OECD countries, show that countries with a proportional electoral system have significantly weaker shareholder protection than those with a majoritarian electoral system.

Unlike legal origin, which is static in nature, the type of electoral system a country adopts can change over time. This dynamic nature of the electoral system better matches the change in law and financial regulations over time. By using simply the legal origin as a proxy for shareholder protection, prior studies do not allow for such a change in shareholder protection over time. Further, by using the historical measure of legal origin, prior studies basically assume that even with all the legal reforms or improvements civil law countries are willing to undertake, they will always lag behind common law countries in terms of investor protection and financial market development (Pagano and Volpin (2005)). On the contrary, as the political system also varies over time, it accommodates the change in shareholder protection over time. Apart from Pagano and Volpin (2005), other studies also

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emphasize the role of political economy in explaining differences in financial development and corporate governance (Beck et al. (2001); LaPorta et al. (2002); Rajan and Zingales (2003); Bushman et al. (2004)).

In this paper, we extend this interesting and evolving line of research on the role of political economy in investor protection and finance by examining how dividend policies can be used by a firm to commit itself to reduce the agency problem of free cash flows and how these policies vary with the political economy across countries. In addition, we examine how a change in the political economy, in terms of the country's electoral system of a country, can affect the dividend policy of firms. Pagano and Volpin (2005) document that the anti-directors' rights index of a country varies with its electoral system. We expect that the effect of electoral system is not limited to the legal regulation (e.g. anti-directors' rights) but also extends to its enforcement. A country's law and its enforcement together shape the agency costs investors face. A country's electoral system determines how a political party and politicians can win in an election and hence their campaign style and strategies. These campaign strategies, in turn, affect the degree of representation outside investors and minority shareholders have in the government and hence their welfare. Therefore, we anticipate a country's electoral system affects its agency costs. In this paper, we focus on one aspect of agency costs: the severity of the free cash flow problem. More specifically, we examine whether minority shareholders in countries with proportional electoral system suffer from higher agency costs of free cash flow. With poorer shareholder protection, proportional-electoral countries are likely to be associated with more severe agency problems as minority shareholders are less capable of exercising their rights to mitigate such problems.

Our results show that firms incorporated in countries with proportional electoral system pay out a smaller portion of their earnings as dividends. These results are consistent with the findings of Pagano and Volpin (2005) that countries with proportional electoral system have weaker investor protection law. Further, our results suggest that both the legal rule and its enforcement are less favorable to investors in countries with proportional electoral system. The poorer investor protection offered in proportional-electoral countries makes it difficult for minority shareholders in these countries to extract dividends from firms.

Consistent with the theory and findings in prior studies (Jensen (1986); Smith and Watts (1992) and Gaver and Gaver (1993)), we find that low-growth firms (i.e. firms that are likely to have more severe free cash flow problems and higher agency costs) make higher dividend payouts than high-growth firms. More importantly, we find that after controlling for legal origins and anti-director rights, such a relationship between a firm's growth potential and dividend policy is much weaker in a country with the proportional electoral system than in one with a majoritarian system. However, once we control for the electoral system and anti-director rights of a country, the effect of legal origin on a firm's dividend policy reverses. These results suggest that the effect of legal origin on dividend payout policy documented in LaPorta et al. (2000a) can, in fact, be attributed to the electoral system.

In addition, we examine a group of firms that cross-list their stocks in an overseas exchange where the proportionality score of the cross-listing countries differ from their domicile countries.[1] These cross-listing firms are subject to the laws in the cross-listing countries in addition to their home countries' regulations. Our results suggest that firms in proportional countries that cross-list in other exchanges tend to pay more dividends than their non-cross-listing peers. Also, the negative correlation between growth and dividend payout tends to be stronger for these cross-listing firms.[2]

As a country's electoral system can change over time, we also evaluate the relationship between changes in the electoral system and agency problem: we investigate how a change in a country's electoral system affects a firm's dividend payout policy. Using a small sample of countries that changed their electoral systems during our sample period, we find that for firms in countries that switch from a pure majoritarian (proportional) system to a mixed one their dividend payouts decrease (increase) and the relation between growth and dividend payout is weaker (stronger) for these firms after the change.[3]

We perform several robustness checks for our results. First, we repeat our analyses for the common and civil law countries separately.[4] Not surprisingly, the results continue to hold in both sub-samples. This suggests that within both common and civil law countries, the type of a country's electoral system affects the dividend policies. Second, we examine the impact of electoral system on the form of dividend payment. For this analysis, we expand our classification of dividend-paying firms to those paying stock dividends. Our results suggest that for firms in proportional-electoral countries, even if they choose to pay dividends, they are more likely to pay out stock than cash dividends. Third, our results are robust when we exclude U.S. firms (the country most dominant in our sample), use weighted least square for our analyses, and run regression analyses for each year separately. Accordingly, these findings confirm that a country's electoral system does have a significant impact on firms' dividend policies and consequently the agency costs investors face.

We also find that in addition to the electoral system the extent of direct government involvement in the economy and financial system, the cost of entry, and the risk of expropriation (political economy proxies used in Bushman et al. (2004)) all have a significant impact on the severity of agency problems. More specifically, we find that the state ownership of banks and firms, the cost of entry, and the risk of expropriation have a negative impact on the dividend payout ratio. Also, low-growth firms pay relatively low dividends in a country with an extensive state ownership of firms, high cost of entry, and high risk of expropriation. This evidence is consistent with the argument that governments can use their ownership and control over banks and firms to favor connected parties and expropriate assets from minority shareholders. These findings strongly suggest that the political system[5] has a significant impact on the agency costs in a country and the country-level dividend policies.

[1] In our sample, we do not observe any firm in a pure majoritarian country (i.e. Prop = 0) cross-list in a pure proportional country or any country with a proportionality score greater than zero. Moreover, the cross-listing tends to be unilateral: firms in countries with high proportionality scores cross-list their stocks in countries with lower scores but not the other way round.

[2] We thank an anonymous referee for suggesting this test to us.

[3] We acknowledge that the sample size for the change analysis is small. However, we are constrained by the number of countries that have changed their electoral system during our sample period. The cases we documented in the paper are all countries that have made such changes during our sample period.

[4] The proportionality scores of civil law countries vary from 1 to 3 whereas the proportionality scores of common law countries vary among 0, 1 and 3.

[5] We find similar results using a factor analysis of all the five political economy variables.

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