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The impact of government ownership on dividend policy in China

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ABSTRACT

We investigate the impact of State ownership on Chinese corporate dividend policy. We find that Chinese firms' dividend payout rates respond fairly quickly to earnings changes, and the average actual payout ratio for Chinese firms falls between the payout ratios for emerging-market and developed firms. These results are consistent with the dividend policies of developing economies in general. We also find that dividend payouts among dividend-paying firms, and the likelihood that a firm will pay a dividend, are increasing in State ownership. Our findings are consistent with the State's need for cash flow as a partial motivation for continued State ownership of a significant portion of the corporate economy, and support the agency and tax clientele explanations for dividend policy.

1. Introduction

Researchers have found that dividend-paying U.S. firms appear to pursue a stable dividend payout rate over time (Brav, Graham, Harvey, & Michaely, 2005). Researchers have also found that this characteristic of dividend policy applies in other countries as well (Chateau, 1979, Leithner & Zimmermann, 1993; McDonald, Jacquillat, & Nussenbaum, 1975; Partington, 1984; Robinson, 2006; Shevlin, 1982). Several theories have been developed to explain why firms might prefer to follow a stable payout policy. While much is known about dividend policy in the U.S. and Western economies, dividend policy in China is largely unexplored. Using firm data from the Chinese stock market, we examine dividend policy of Chinese firms from 1998 through 2008.

We find that Chinese firms' dividend payout rates respond fairly quickly to earnings changes, consistent with the dividend policies of developing economies in general. Moreover, the average actual payout ratio for Chinese firms is between the average payout ratios for emerging-markets firms and developed firms (Glen et al., 1995).

One may regard ownership by the State as similar to that by any large investor, but with key differences.[3] While payments of cash dividends attenuate the inherent agency problem in corporate organizations, dividend payments have also been associated with large shareholders using their power and position to appropriate the wealth of the firm from individual investors.

Consistent with the State's need for cash flow as a partial motivation for continued State ownership of a significant portion of the corporate economy, we find that the strong preference for cash dividend payouts among dividend-paying firms is increasing in State ownership. We also find that the likelihood that a firm will pay a dividend is increasing in State ownership. These findings provide support for the agency theory of dividend policy in that dividend payouts enable the State to extract disproportional benefits from corporate enterprises.[4] Alternatively, we find a diminished cross-sectional incidence of dividend payouts as State ownership declines, suggesting that the preferential tax treatment of capital gains in China provides at least a partial explanation of dividend policy among Chinese firms. Taken together, these results provide support for both the agency and tax clientele theories of dividend policy.

China is becoming increasingly important in the global economy. However, much remains unknown about the interactions among China's corporate policies, tax rules, and the role of the State. Our research contributes to the growing literature on the Chinese corporate economy by extending knowledge of the influence of the State on dividend payout policies in China.

2. Background

2.1. State ownership

China allowed stock markets to open in 1990 in Shenzhen and 1991 in Shanghai primarily to raise money for the State and for State-owned enterprises (SOEs), and the State continues to control most of the corporate economy (Areddy, Bai, & Leow, 2008; Joyce,

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[3] For brevity, we refer to the government of the Peoples Republic of China as the State. Similarly, we use the phrase “State control” for direct or indirect ownership by governmental entities.

[4] After all, investors must pay part of their dividend distributions to the State in the form of taxes.

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2008). Chinese firms are known for their “split-share structure,” in which two classes of stock are traded publicly and two classes are not. The publicly-traded shares include “A” shares that are listed, tradable, and denominated in renminbi (yuan), and “B” shares that are tradable and listed, but are denominated in Hong Kong dollars (in Shenzhen) and U.S. dollars (in Shanghai).[5]

Approximately two-thirds of the shares of most listed firms are non-tradable. Of the non-tradable shares, roughly half are “legal person” shares which are owned by other Chinese firms, SOEs, or non-bank financial institutions. The remaining non-tradable shares are State shares, owned by central or local government departments directly, or by SOEs. Despite the split-share structure reforms that began in 2005, roughly two-thirds of the listed firms with tradable shares remain State-controlled, either directly or indirectly.[6]

2.2. Dividend stability

The concept of dividend stability has changed over time. Originally, U.S. firms largely pursued a stable dividend payout ratio, or dividends/earnings (Lintner, 1956). This policy would inevitably lead to volatility in payments (dividends/share), depending on the speed with which dividend payouts adjust to earnings changes perceived as permanent. Recent research suggests, however, that dividend policy in the U.S. among dividend-paying firms now appears to follow a stable dividend per share rate, resulting in a smoothed time series of dividend payments regardless of EPS changes (Brav et al., 2005).

Research has provided substantial evidence that a stable dividend policy consistent with smoothed dividends per share is more common in developed economies generally (Chateau, 1979; Leithner & Zimmermann, 1993; McDonald et al., 1975; Partington, 1984; Robinson, 2006; Shevlin, 1982). In a study of Austrian firms, Gugler (2003) provides evidence that smoothing also occurs in government-controlled corporations in developed economies. The smoothing effect is less apparent in developing countries, where it is more common for dividends per share to rise or fall along with earnings (Annuar & Shamser, 1993; Ariff & Johnson, 1990; Kester & Mansor, 1996). More recent research indicates that many firms appear to be using share repurchases as a substitute for dividend payouts (Brav et al., 2005; Robinson, 2006). In Table 1, we report the number of Chinese firms conducting share repurchases. It can be seen that repurchases were rare prior to the push for market reforms in 2005.[7]

Table 1
Number of Chinese firms conducting stock repurchases by year.[a]

Year	No. of firms
1994	1
1995	1
1996	0
1997	0
1998	0
1999	5
2000	3
2001	3
2002	0
2003	0
2004	0
2005	16

[a] Number of firms depicted is the total number of firms that conducted share repurchases from among all Chinese listed firms, or out of about 1000 each year.

2.3. Dividend policy and large-block shareholders

The bird-in-the-hand, signaling, tax clientele, and agency theories have evolved to explain why a firm might prefer to follow a particular dividend payout policy. Despite the implications of the “dividend irrelevance” theory (Miller & Modigliani, 1961), the bird-in-the-hand theory holds that shareholders regard dividends as less risky than capital gains. As a consequence, firms believe they may maximize stock price by maximizing dividend payouts (Bhattacharya, 1979; Robinson, 2006). Although the bird-in-the-hand theory may reflect a belief held by firm managements, it has largely been discarded among researchers as a result of both the comparative rarity of high dividend payout ratios and the notion that price is more appropriately explained as a function of book value and abnormal earnings (Ohlson, 1995).[8]

According to the signaling theory, dividend payouts provide information to investors about management expectations of future performance (Bhattacharya, 1980; Miller & Rock, 1985; Ofer & Thakor, 1987). While it is clear that investors derive information from firms' dividend (and other) policies, it is not clear why a firm would choose signaling as a basis for determining dividend policy when less-costly methods exist for information transmission (Robinson, 2006).

The tax clientele theory maintains that the preference for dividend income deferral increases as dividends are accorded less-favorable tax treatment. Thus, investors in lower tax brackets may prefer cash dividend payouts, while investors with higher tax rates prefer capital gains. Rather than explain why a firm would be motivated to follow a particular payout policy, the tax clientele theory appears to explain how a firm may attract a particular investor clientele.

Research on the tax clientele effect has been mixed (Allen, Bernardo, & Welch, 2000; Litzenberger & Ramaswamy, 1979; Poterba & Summers, 1984; Stulz, 1990). Despite the tax advantages in the U.S. for capital gains for individual investors, research suggests that shareholders may prefer cash dividends for relatively small payouts (Brennan & Thakor, 1990). In contrast, even with equivalent tax treatment of dividends and capital gains, investors typically prefer the ability to defer taxation (Mann, 1989). In China, however, dividends are taxed as ordinary income, while capital gains are not taxed. Thus, a strong preference for deferral (i.e., capital gains, rather than dividends) should be evident among individual Chinese investors generally.

Agency theory provides another explanation for dividend payout policy. According to agency theory, dividend payouts attenuate agency conflict by depriving management of discretionary cash flows to appropriate and expend suboptimally (Crutchley & Hansen, 1989; Easterbrook, 1984; Goshen, 1995; Jensen & Meckling, 1976; Moh'd, Perry, & Rimbey, 1995; Robinson, 2006; Rozeff, 1982).

The implications of agency conflict for dividend policy may be complicated by the presence of a large blockholder (Holderness, 2003; Jensen & Meckling, 1976; Shleifer & Vishny, 1986). Large-block shareholders generate benefits for all shareholders through (possibly costly) monitoring of firm management (Holderness, 2003; Huddart, 1993). Evidence suggests that large blockholders may also be able to extract disproportionate benefits from investee firms, negatively impacting firm value (Barclay & Holderness, 1989; Gordon & Pound, 1993; Gugler & Yurtoglu, 2003; Holmen & Knopf, 2004; Truong & Heaney, 2007). However, the private benefits available to large blockholders may serve as compensation for their monitoring (Holderness, 2003; Huddart, 1993; Weiyu & Jinlan, 2008).

LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (2002) suggest that the largest shareholder often has effective control of the firm. The impact a large-block shareholder has on control, agency issues, corporate governance, and shareholder wealth are likely further amplified when the State is the blockholder. For example, one of the decisions a large shareholder can control is the payment of dividends (Shleifer & Vishny,

[5] Prior to 2001 only foreign investors could own “B” shares.
[6] Gul, Kim, and Qiu (2010) note that around 43% of the outstanding shares of their sample of Chinese firms are owned by the largest shareholder, and the likelihood the largest shareholder is government-related is around 66%.
[7] Split-share restrictions on share issuance and ownership still exist in China, even after the 2005 market reforms.
[8] Alternatively, price changes are largely explained by earnings levels and changes (Easton & Harris, 1991).