Research in International Business and Finance 42 (2017) 365–375

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Full length Article

Impact of taxation on dividend policy: Evidence from Pakistan

Naimat U. Khan[a,*], Qurat Ul Ain Shah Jehan[b], Attaullah Shah[c]

[a] *Assistant Professor at Institute of Management Studies, University of Peshawar, Pakistan*
[b] *Post-Graduate Scholar at Institute of Management Studies, University of Peshawar, Pakistan*
[c] *Associate Professor at the Institute of Management Sciences, Peshawar Pakistan*

ARTICLE INFO

Keywords:
Taxation
Dividend policy
Capital gains taxation
Pakistan

ABSTRACT

This paper analyses the impact of capital gains taxation (CGT) on dividend policy among firms that are listed at the Karachi Stock Exchange (now, Pakistan Stock Exchange or PSX). The reason for choosing the Pakistani market is the country's idiosyncratic taxation system regarding dividend and capital gains. In Pakistan, capital gains were tax-free and taxation of capital gains was levied for the first time beginning July 2010. This motivates us to study the special case of Pakistani market regarding the relationship between the imposition of capital gains taxation and the pattern of dividend payouts. For this purpose, we use both the static and dynamic panel data models (generalized methods of moments) to analyze dividend payment behavior for a sample of 284 non-financial firms listed at the PSX from the years 2006–2014. We use the dividends to total assets ratio as a dependent variable and a taxation dummy along with other control variables such as liquidity, leverage, profitability, last year's dividend and firm size, as explanatory variables. Results of the regressions show that capital gains tax has no impact on dividend payments, while profitability, leverage, and last year's dividend are the most significant determinants of dividend payments in the Pakistani market.

1. Introduction

Dividend policy is one of the most important issues in financial literature and a large amount of work has been done on it in developed and emerging markets (Lintner, 1956; Fama and French, 2001; Frankfurter et al., 2004; Brav et al., 2005; Banerjee et al., 2007; Dhanani, 2005; Jabbouri, 2016). Despite the extensive work done on dividend policy yet it is still a puzzle (Black, 1976); an unsolved mystery which needs to be solved. There are several internal as well as external factors that affect dividend policy of a firm. Internal factors include profitability, liquidity and investment opportunities while external factors are market growth, economic stability, change in taste of the consumer, legal settings and technological advancement (La Porta et al., 1998). Making decisions about dividend policy are censorious because they are linked with other investment and financial decisions as well (Lahiri and Chakraborty, 2014).

Miller and Modigliani (1961) presented the dividend irrelevance theory which states that in perfect market conditions the value of the firm is not dependent on dividend decisions; rather it depends on the firm's present and future earnings (Black and Scholes, 1974; Miller and Scholes, 1982). While in contrary, according to bird in hand theory given by Gordon in 1963, dividends do have an impact on firm's value and investors would rather choose periodic payments in the form of dividends rather than capital gains. Bhattacharya (1979) supports signaling theory which states that, under information asymmetry, dividend announcement plays an important role in communicating information related to the future of the firm (Lintner, 1956).

* Corresponding author.
E-mail address: naimtims@yahoo.com (N.U. Khan).

http://dx.doi.org/10.1016/j.ribaf.2017.07.157
Received 8 February 2016; Received in revised form 16 October 2016; Accepted 6 July 2017
Available online 08 July 2017
0275-5319/

Table 1
Performance of the companies listed on the PSX.

Years	No. of companies	Companies that announced annual reports	Profit making companies	Loss making companies	Dividend paying companies	Profit making companies that omitted dividends
2006	651 (100%)	565 (86.78%)	411 (63.13%)	154 (23.65%)	294 (45.16%)	117 (17.97%)
2007	655 (100%)	562 (85.80%)	366 (55.88%)	196 (29.92%)	267 (40.76%)	99 (15.11%)
2008	653 (100%)	551 (84.38%)	323 (49.46%)	228 (34.92%)	231 (35.38%)	99 (15.16%)
2009	651 (100%)	526 (80.80%)	271 (47.63%)	255 (39.17%)	186 (28.57%)	83 (12.75%)
2010	654 (100%)	519 (80.59%)	252 (39.13%)	104 (16.15%)	356 (55.28%)	163 (25.31%)
2011	638 (100%)	526 (82.45%)	351 (55.02%)	175 (27.43%)	248 (38.87%)	103 (16.14%)
2012	573 (100%)	517 (90.23%)	337 (58.81%)	180 (31.41%)	243 (42.41%)	94 (16.40%)

Note: Data mentioned in the above table is extracted from the annual reports of Pakistan Stock Exchange.

According to the tax preference theory, taxation plays a significant role in investors' decisions related to preference of capital gains over dividends. If taxation on capital gains is less than taxation on cash dividends, investors would choose capital gains rather than dividend (Berman, 1977). The impact of taxation on dividend policy is the point that has much been debated. That is the reason it has received much of academic attention. If taxes do have an impact on dividend policy of a firm, then any change in the taxation structure by the government would bring about change in the dividend policy of the firm (Wu, 1996). Dividends do have an impact on investor's tax liability but it does not change the taxes that they have to pay no matter they receive dividend or capital gains (Brealey et al., 2008; Khan et al., 2011).

One of the motivations for studying the impact of taxation on dividend policy on the PSX (hereafter PSX and KSE will be used interchangeably) is a unique taxation system in Pakistan. In July 2010, capital gains were taxed for the first time, before that capital gains were tax-free while taxation on dividend was up to 10%.[1] Previous researches show that there is a negative impact of taxation on dividend payouts in Pakistani markets (Arif and Akbar, 2013; Hassan et al., 2013).

Capital gain is considered as a substitute of dividend payments. Previous studies show that despite the fact that there was no taxation on capital gains before July 2010 and a tax-penalty of 10% withholding tax on dividend, yet about 50% of the listed firms paid dividends during the last decade (Naeem and Nasr, 2007; Khan, 2011). Now after implementation of capital gains, the demand for dividend should have increased as its counterpart (capital gains) is also taxed. The study expects an increase in the dividend payment after the implementation of capital gains taxation in July 2010. This argument is crudely supported by Table 1 which shows that percentage of dividend paying companies have increased after 2010 i.e., in the post-taxation period. In order to prove this argument of positive relationship between taxation on capital gains and dividend payouts after implementation of capital gains taxation, further statistical tests are needed after controlling for other relevant determinants of dividends. In order to achieve the objective, regression analysis is used for a sample of 284 non-financial firms listed on the PSX over the period of nine years from year 2006–2014.

The rest of the paper is organized as follows. Section 1 is introduction that covers the different theories related to dividend policy along with motivations behind the research. Section 2 contains background study of Pakistani market and relevant literature review is discussed in Section 3. Methodology and sample selection are explained in Section 4. Section 5 consists of the findings of the regression analysis. Lastly, Section 6 concludes the paper.

2. Background of the study

There were three stock exchanges in Pakistan; namely the Karachi Stock Exchange (KSE), Lahore Stock Exchange (LSE) and Islamabad Stock Exchange (ISE). In January 2016, the three stock exchanges were demutualized into a single stock exchange and named as the Pakistan Stock Exchange (PSX). The KSE is the biggest stock market as compared to LSE and ISE. It was established in 1947 within two months after the creation of Pakistan. There were 580 listed firms divided among 35 sectors at the end of 2012. According to economic survey of Pakistan for the year 2012, the PSX represented around 92 percent of the total volume traded on the three stock exchanges. The performance of the KSE is judged with the help of KSE-100 Index which was introduced in November 1991, comprising of 100 companies that are selected on the basis of market capitalization. It is important to mention that KSE-100 index is used as benchmark index even after the formation of PSX in January 2016. PSX allows trading of shares, bonds, and future contracts (Malik and Shah, 2016). The PSX has seen several episodes of booms and crashes (Malik and Shah, 2016, 2017). Still, PSX is acknowledged to be among the top securities exchanges in the the emerging markets and is a target market of many local and foreign investors (Ali and Afzal, 2012). This argument is also supported by statistics which showed bullish trend in the KSE-100 index for last one decade (Shah and Shah, 2015). For example, in beginning of year 2000, the Index was only 1457 points, then it jumped to 15,122 in April 2008 before it was hit by Global Financial Crisis (Akhtar and Khan, 2016). After a short span of bearish trend in 2008-09, it got momentum and reached 16,905 points at the end of 2012. The index values at the end of 2013, 2014 and 2015 were 25,579 points, 32,148 points, and 36,228 points respectively. Currently, the KSE-100 index is traded at 41,253 points at the beginning of October 2016 (www.psx.com.pk). In Pakistan, companies are governed under Companies Ordinance 1984; various sections (such as

[1] Detail about rates of CGT in given in Section 2 'Background Study' of this paper.