International Review of Economics and Finance 27 (2013) 445–464

Contents lists available at SciVerse ScienceDirect

International Review of Economics and Finance

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

Cash dividend policy, corporate pyramids, and ownership structure: Evidence from China[☆]

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ARTICLE INFO

Article history:
Received 21 September 2011
Received in revised form 28 December 2012
Accepted 7 January 2013
Available online 23 January 2013

Keywords:
Ownership structure
Control chain
Cash dividends
Ultimate shareholder
Internal capital markets

ABSTRACT

This paper investigates how the state-controlling ownership and the ownership through corporate pyramid structures affect the dividend policies of publicly listed firms in China. We find that the state-controlled firms in China pay higher dividends (measured by the dividend yield and the dividend payout ratio) than the privately controlled firms. We also find that as the control chain of the firm lengthens, the firm pays lower dividends. We conclude that the privately controlled firms in China pay lower dividends than the state-controlled firms because the former are more capital-constrained in obtaining external equity and long-term debt, other things being equal, and depend more on internal equity to finance growth. The negative association between the length of the control chain and dividends comes from a greater use of investable funds among Chinese firms under corporate pyramids, which is one of the features of the internal capital markets for firms under pyramid structures.

1. Introduction

This paper investigates how the state-controlling ownership and the ownership through corporate pyramid structures affect the dividend policies of the publicly listed firms in China. First, regarding the state ownership, unlike public equity markets such as those in the U.S. and the U.K., the government bodies in China retain the controlling ownership in most of the firms listed on the Shanghai and Shenzhen stock exchanges. Second, unlike the U.S. and U.K., in China stock ownership is highly concentrated in many companies with a large fraction of the stocks of listed firms not fully circulated as non-tradable shares prior to the ownership reform which started in 2005. A third difference between China and both the U.S. and the U.K. is that both government and private investors in China control a large number of listed firms through pyramid structures (Fan, Wong, & Zhang, 2005; Zhu, 2006). China's stock market is an emerging market that attracts a large number of institutions and investors from the U.S. and Europe. These institutions and investors are concerned about the cash dividend policy of the firms in which they invest, since dividends constitute part of the return on their investment, and dividend policy affects the attractiveness and price of the stock. Previous papers have concluded that the existing theories of dividend policy did not have much explanatory power for the dividend decisions of the firms in China (Deng, Li, Liao, & Wu, 2013; Lee & Xiao, 2003). How do the differences mentioned above between China and the U.S. and the U.K. affect the firms' dividend policy? This question motivates our research.

☆ We would like to thank the participants of the 2010 Financial Management Association Annual Meeting, and seminars at Tsinghua University, Jiangxi University of Finance and Economics, and Fudan University. Special thanks go to two anonymous reviewers and the editor Carl Chen for their helpful comments and suggestions. Chao Chen is grateful for the financial support from the National Nature Science Foundation of China (No. 71072004). All remaining errors are our own.
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1059-0560/$ – see front matter
http://dx.doi.org/10.1016/j.iref.2013.01.003

We test two hypotheses about the cash dividend policy in China. *The capital constraint hypothesis* concludes that state-owned enterprises (SOEs) pay more dividends than non-state-owned enterprises (NSOEs), because NSOEs are more capital-constrained, which affects the funds available to pay cash dividends. In China, NSOEs have more difficulty raising both equity and debt capital than SOEs. Debt financing is more difficult for NSOEs because the banks, which are historically state-controlled, are more biased toward lending to SOEs and public debt markets are almost nonexistent (Brandt & Li, 2003; Gul, 1999). Equity financing is more difficult for NSOEs because the government decides which firms issue shares, and SOEs are favored over NSOEs in the allocation of rights to issue new shares (Green, 2003). Our tests show that consistent with the capital constraint hypothesis, SOEs pay more cash dividends than NSOEs. The second hypothesis, *the internal capital market hypothesis*, concerns whether longer control chains among Chinese listed companies affect the firms' payment of dividends. Longer control chains—i.e., corporate layers in the pyramid structure—can result in investable funds more fully utilized within firm pyramid groups, a well-known benefit of the internal capital markets for the firms in corporate pyramids (Stein, 1997; Williamson, 1985). If longer control chains enable a higher utilization of investable funds across the firms under the control chain, then longer control chains should be associated with lower surplus funds and fewer dividends. Consistent with the internal capital market hypothesis, we find that the length of the control chain is negatively related to the payment of cash dividends.

Our results show that in China, the state ownership of listed firms has significant influence in predicting firms' dividend policies. Thus, we provide evidence of the change in the firms' dividend policies in socialistic economies when the state publicly controls the listed firms. We differ from Chen, Jian, and Xu (2009), and Lee and Xiao (2003), who viewed dividend payments among firms in China as a form of tunneling, particularly by the state-owned firms. We provide the evidence that is not consistent with the tunneling motive for issuing dividends. Our results also contribute to the empirical implications of the internal capital market theory. Most of the studies on pyramid ownership focus on firm performance or market value. This paper extends the topic on pyramid ownership to consider dividend policy, and examines the relationship in an emerging market context.

The remainder of this paper is organized as follows. Section 2 reviews the literature related to the cash dividend policy and presents our hypotheses, and Section 3 reports data and samples. Empirical analyses and results are presented in Section 4. Section 5 concludes this paper.

2. Background and hypothesis development

2.1. Background

The scholarly research on dividend policy has produced a large body of theoretical and empirical literature, especially following Miller and Modigliani's (1961) (M&M) publication of the dividend irrelevance hypothesis. M&M showed that in perfect capital markets, the value of a firm was independent from its dividend policy; thus, dividend policy should be irrelevant in corporate finance decisions. In practice, market imperfections exist such as taxes, transaction costs, asymmetric information, and agency problems; and the challenge is quantifying the impacts of these market imperfections on the theory and practice of dividend policy. These market imperfections have provided the basis for the development of various theories of dividend policy including tax-preference, clientele effects, signaling, and agency costs. This is a vast body of literature. We will not summarize the theories and research but refer the reader to recent literature surveys on dividend policy (Al-Malkawi, Rafferty, & Rekha Pillai, 2010; Baker, 2009). In our empirical tests below, we control for traits that have been found to influence dividends in previous studies. From a conceptual standpoint in deriving our hypotheses, the strand of this literature most related to our discussion is the agency relationships associated with dividend policy.

The importance of agency relationships in China derives from the ownership traits among Chinese firms. The institutional background and especially high ownership concentration distinguish Chinese listed companies from their counterparts in the U.S. and the U.K. In financial markets such as those in the U.S., ownership is highly diverse, and market power can force management to distribute cash dividends to meet the cash demand of investors. It is not the same case in China. Shareholders in China, especially minority shareholders, have less power to force management or controlling shareholders to implement dividend policies that reflect minority shareholders' wishes when they differ from management people or controlling shareholders (Lee & Xiao, 2003). In addition, the market monitors managerial decisions in the U.S., while in China, the managers' decisions and activities are more opaque.

2.2. Hypothesis development

Chen et al. (2009), and Lee and Xiao (2003), suggested that many Chinese listed companies increased dividend payments because of the differential pricing for tradable and non-tradable shares during the initial public offering (IPO) of these listed companies. Such companies might use high-dividend payments to divert proceeds from an IPO or rights issue to controlling shareholders' pockets. These two papers discussed cash dividend policy as being dominated by the tunneling incentive of controlling shareholders. However, more than half of China's listed firms do not pay cash dividends, which implies that for most firms, this incentive–if it exists–is not sufficiently powerful to result in dividend payments. In order to encourage the listed firms in China to pay cash dividend to investors, the China Securities Regulatory Commission (CSRC) even includes several years of payment of cash dividends as a requisite for seasoned equity offerings (SEOs). Therefore, the key factor affecting dividends among Chinese listed firms is not the tunneling motive. Below we provide empirical evidence for this conclusion.