

Economic Fluctuation and Dividend Policy in China

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ABSTRACT

In contrast to Western economies, it has been decades since China experienced what could be described as a recession. Rather, China's economy is subject to growth rate fluctuation, or yearly changes in a consistently positive growth rate. We investigate the impact of economic growth rate fluctuation on the dividend policy of Chinese listed firms.

We find that both dividend payments and dividend likelihood in China generally rise and fall with economic activity. Our findings also suggest that dividend payments and dividend likelihood are both increasing in the largest shareholder's percentage ownership, although both payment amount and likelihood are increasing at a lower rate when economic growth diminishes. Approximately two-thirds of listed firms are State-controlled in China. Our results provide support for the contention that the State maintains a controlling stake in much of the corporate economy in part to extract unique benefits, consistent with the agency theory of dividend policy.

Keywords: *dividend policy, economic fluctuation, State ownership, China*

INTRODUCTION

Changes in economic conditions are often treated as extraneous variables in financial economics research. However, economic fluctuations have significant impact on management decision-making (Zarnowitz 1985, Mascarenhas and Aaker 1989). When faced with changes in economic conditions, firms may modify financial policies, including those concerning dividends. In China, the role of the State in corporate decision-making must also be considered.¹ We investigate how economic conditions and large-block shareholder ownership affect the dividend policies of Chinese firms.

The decision to pay dividends, and the amount to be paid, are two different parts of dividend policy that we include in our analysis. Previous research has found that both dividend amount and dividend likelihood are increasing in State ownership (Wang et al. 2010). We find that both dividend payouts and dividend likelihood generally rise and fall with overall economic growth. Our findings also suggest that dividend payout amounts and the likelihood of dividend payments are both increasing in the largest shareholder's percentage ownership, although both are increasing at a lower rate when economic growth diminishes.

China has become a global economic power and a major trading partner of developed economies worldwide. Although China has not suffered what would typically be described as a recession in many years, there have been periodic slowdowns in economic growth rates. Our study may enrich the finance literature by increasing understanding of how large-block shareholdings and changes in economic conditions affect dividend policy.

¹ For brevity, we refer to the government of the Peoples Republic of China as the State.

The next section contains a brief discussion of the Chinese corporate economy and previous research on dividend policy. Our research models are then presented, followed by results. We conclude with a brief summary.

BACKGROUND

State Ownership

Unlike the dispersed ownership typical of British and American stock markets, or the concentrated cross-shareholding ownership of German and Japanese markets, a very large proportion of shareholders equity in China is owned by the State. The early role of the Chinese securities market was to provide financing for struggling State enterprises, rather than to effect an efficient allocation of resources. The stock market scale was initially small and the government tightly controlled important industries through a system of quotas. Through divestiture, equity carve-out, restructuring, and various other methods, high-quality assets were spun off from State-owned industries. These spin-offs were listed on the market as new companies, with the original State-owned organizations becoming the new firms' major shareholders.

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) (Aredy et al. 2008, Joyce 2008). Chinese listed firms are known for their "split-share structure," in which two classes of stock are tradable and two classes are not. Publicly-traded "A" shares are denominated in renminbi (yuan), and "B" shares are tradable and denominated in Hong Kong dollars (in Shenzhen) and U.S. dollars (in Shanghai).

Of the non-tradable shares, roughly half are "legal person" shares, owned by other Chinese firms, SOEs, or non-bank financial institutions. The remaining non-tradable shares are State shares, owned by government departments or by SOEs. Approximately two-thirds of the shares of most listed firms are non-tradable, and roughly two-thirds of the listed firms with tradable shares are State-controlled, either directly or indirectly.²

Dividend Policy and Large-Block Shareholders

Several theories have evolved to explain why many firms evidently prefer to follow a particular dividend payout policy, despite "dividend irrelevance" (Miller and Modigliani 1961). These include the bird-in-the-hand theory (Bhattacharya 1979, Robinson 2006), which holds that investors prefer the certainty of dividends over the risk of capital gains; accordingly, firms may maximize stock price by increasing dividends. However, the relative scarcity of large regular dividend payouts argues against this concept.

Signaling theory maintains that dividend payouts are used to signal management beliefs about future performance (Miller and Rock 1985, Ofer and Thakor 1987, Robinson 2006). Although there is little doubt that investors infer information from many corporate activities (including dividends), it is less likely that firms pay dividends to convey information when more public and less expensive means exist to reveal management expectations.

Two remaining theories about dividend policy are complicated by the presence of a large blockholder (Jensen and Meckling 1976, Shleifer and Vishny 1986, Holderness 2003). For example, the

² Gul et al. (2010) report that the likelihood the largest shareholder is government-related (within their sample of Chinese firms) is around 66%.

tax clientele theory suggests that investors tend to prefer capital gains over dividends because dividend income generally receives a less-favorable tax treatment than gains (Litzenberger and Ramaswamy 1982, Poterba and Summers 1984, Stulz 1990, Allen et al. 2000, Brennan and Thakor 1990, Mann 1989). However, when the State is the largest blockholder (generally the case in China), the taxation of corporate dividends enables the State to appropriate benefits that are disproportionately large compared to those available to individual investors (who must pay taxes on their dividends).

Agency theory maintains that dividend payouts deprive firm managements of resources that might otherwise be wasted on suboptimal investments (Jensen and Meckling 1976, Rozeff 1982, Easterbrook 1984, Crutchley and Hansen 1989, Moh'd et al. 1995, Goshen 1995, Robinson 2006). Consistent with this reasoning, research has found that large-block shareholders may extract disproportionate benefits from investee firms (Barclay and Holderness 1989, Gordon and Pound 1993, Gugler and Yurtoglu 2003, Holmen and Knopf 2004, Truong and Heaney 2007). Previous research also reports that large blockholders generate benefits for all shareholders through monitoring of firm management (Huddart 1993, Holderness 2003).³ A large-block shareholder has significant influence on agency issues, corporate governance, and the payment of dividends (Shleifer and Vishny 1997); it has also been suggested that the largest shareholder has effective control of the firm (LaPorta et al. 2002). Thus, although the State may provide the firm with favorable trade, regulatory, or taxation opportunities unavailable to competitors, the State may selectively discourage profitable endeavors or force the firm to make suboptimal investment or human resource allocations.⁴ Previous research reports that dividend payments in China are increasing in both State and largest-blockholder ownership, consistent with the above “tax clientele” and “agency” theories of dividend policy (Wang et al. 2010).

Dividend Policy and Economic Fluctuation

Classical economic fluctuation concerns the absolute volatility of economic output; e.g., gross domestic product (GDP) declines during an economic downturn. *Growth* economic fluctuation, however, is based on changes in the economic growth rate. For example, the economic growth rate might decline, but not necessarily the GDP. The present Chinese economy experiences economic growth fluctuation.

Previous research on economic fluctuation theory has mainly focused on normative economics and case studies. These studies suggest that firm activities (such as financing, investing, operations, and dividend policy) adjust with economic fluctuation (Dhalla 1980, Greer 1984, Zarnowitz 1985, Mascarenhas and Aaker 1989). Other studies explore the impact of economic fluctuation on mergers and acquisitions (Nelson 1959, Weston and Mansinghka 1971, Reid 1971, Weston et al. 1972, Melicher and Rush 1973, Chung 1982, Melicher et al. 1983), the relationship between economic fluctuation and investment (Huizinga 1993, Carpenter et al. 1994), and the impact of economic fluctuation on capital structure (Hatzinikolaou et al. 2002).

Table 1: Chinese GDP growth rate, by year, from 1998-2008.

<u>Year</u>	<u>GDP yearly growth rate (%)</u>
1998	7.80%

³ Similarly, research on controlling shareholders and dividend policy in Chinese firms argues that dividend payments are either a real return for all shareholders, signifying high profitability and good performance, or a way for controlling shareholders to “tunnel out” company resources (Yuan 2001, Liu and He 2004, Li et al. 2005, Tang and Luo 2006).

⁴ It is not unusual for upper management in Chinese corporations to come from government, and the Communist Party has significant influence over personnel decisions and corporate policies at most firms (Tomasic and Andrews 2007, Moskow and Lemieux 2008).

1999	7.60%
2000	8.40%
2001	8.30%
2002	9.10%
2003	10.00%
2004	10.10%
2005	10.40%
2006	11.60%
2007	13.00%
2008	9.60%

From a peak of 14.2% in 1992, the Chinese economic growth rate subsequently dropped continuously, settling at 7.6% in 1999. The Chinese economy began to develop steadily again in 2002, but the consumer price index and inflation rate gradually increased as well. In response, the Chinese government enacted a series of macroeconomic policies, presenting companies with more economic challenges. In table 1, we report annual growth rates for the Chinese economy between 1998 and 2008 inclusive, obtained from the Chinese Statistics Bureau. The Chinese economy exhibits no negative annual GDP growth during this period; however, declines in the overall positive growth rate occurred in 1999, 2001, and 2008.⁵

Owners of State shares in China are representatives of public interests, responsible for exercising control over their firms and maintaining State-owned investments at maximum value. State shareholders thus have additional responsibilities beyond those of shareholders in entrepreneur-controlled firms. As a result of the multiple objectives and bureaucratic costs that apply to State-owned firms, we expect that State shareholders will adjust dividends in response to economic fluctuations while maintaining higher payouts, consistent with the agency explanation of dividend policy.

MODEL AND DATA

The Lintner (1956) model has been found to perform as well as or better than other models of the dividend-setting process (Fama and Babiak 1968, Benartzi et al. 1997). Research using variants of this framework includes McDonald et al. (1975), Chateau (1979), Shevlin (1982), Partington (1984), Leithner and Zimmermann (1993), Dewenter and Warther (1998), Robinson (2006), Wang et al. (2010), and others.

Lintner (1956) theorizes that the “target” dividend payment for firm i at time t (DIV_{it}^*) is a percentage (r_i) of earnings,

$$DIV_{it}^* = r_i EPS_{it} , \quad (1)$$

and the actual dividend payout change over a prior year ($DIV_{it} - DIV_{it-1}$) is a function of the difference between the prior payment and the current target payout:

$$DIV_{it} - DIV_{it-1} = \alpha_{0i} + c_i (DIV_{it}^* - DIV_{it-1}) + \varepsilon_{it} . \quad (2)$$

In the Lintner (1956) format, the intercept α_{0i} is a payout growth term, and c_i captures the stepwise movement over time from actual payouts toward the target payout; ε_{it} is a random error term. Substituting (1) into (2),

$$DIV_{it} - DIV_{it-1} = \alpha_{0i} + c_i r_i EPS_{it} - c_i DIV_{it-1} + \varepsilon_{it} ; \quad (3)$$

after rearranging terms and simplifying, the model becomes

⁵ Similarly, no quarters of negative GDP growth were found; these untabulated are available from the authors upon request.

$$DIV_{it} = \alpha_t + \beta_{1t} EPS_{it} + \beta_{2t} DIV_{it-1} + \varepsilon_{it} \quad (4)$$

where $\beta_{1t} = c_t r_t$ and $\beta_{2t} = 1 - c_t$ (Lintner 1956).⁶

Using (4) as a basis for our tests, we add variables to control for leverage, industry fixed effects, and distortions related to firm size. We also add a parametric variable for the percentage ownership of the largest shareholder (typically the State), and a qualitative variable to capture the incidence of a negative growth fluctuation:

$$DIV_{it} = \alpha_0 + \alpha_1 DIV_{it-1} + \alpha_2 EPS_{it} + \alpha_3 BIG_{it} + \alpha_4 DOWN_t + \alpha_5 BIG_{it} * DOWN_t + \alpha_6 LEV_{it} + \alpha_7 LnASSET_{it} + \sum_{k=1}^{K-1} \alpha_{7+k} IND_k + \varepsilon_{it} \quad (5)$$

where

- BIG_{it} = the percentage ownership of the largest shareholder (generally the State) of firm i in year t , $t \in \{1998, 1999, \dots, 2008\}$;⁷
- $DOWN_t$ = a qualitative (1, 0) variable that = 1 if the GDP rate is lower compared to the previous year;
- LEV_{it} = the debt-to-assets ratio;
- $LnASSET_{it}$ = the natural log of total assets; and
- IND_k = qualitative variables to control for ($K = 12$) industries.

Following the estimation of model (5) above, we further examine the impact of the largest shareholder on dividend policy by estimating the likelihood of cash dividend payouts with the LOGIT model

$$CD_{it} = \beta_0 + \beta_1 CD_{it-1} + \beta_2 EPS_{it} + \beta_3 BIG_{it} + \beta_4 DOWN_t + \beta_5 BIG_{it} * DOWN_t + \beta_6 LEV_{it} + \beta_7 LnASSET_{it} + \sum_{k=1}^{K-1} \beta_{7+k} IND_k + \varepsilon_{it} \quad (6)$$

where all variables are as defined previously,

- CD_{it} = 1 if firm i pays a cash dividend in year t , $t \in \{1998, 1999, \dots, 2008\}$, and 0 otherwise, and
- CD_{it-1} = 1 if the firm paid a cash dividend in the previous year, and 0 otherwise.

We begin with a sample comprised of all firms listed on both the Shanghai and Shenzhen stock exchanges that have sufficient ownership, earnings, and other financial data for empirical analysis, and exclude firms whose financial data are unavailable. Ownership data are collected from the China Wind Financial Database, and accounting data are retrieved from the China Stock Market and Accounting Research (CSMAR) database.

Table 2 provides descriptive statistics for our research variables. Our initial sample consists of roughly 1,024 listed firms and 12,685 firm-years covering the period 1998 through 2008. Data for all of the variables summarized in table 2 are drawn from this initial sample, except for the DIV_{it} (dividends per share) variable. Consistent with previous research on dividend policy, we exclude firms that have not paid dividends for at least two consecutive years for OLS tests of model (5). This latter constraint provides the test sample of 4,776 firm-years from which the DIV_{it} statistics in table 2 are calculated.

⁶ Previous research also standardizes the variables in model (4) by the number of shares outstanding (Lintner 1956, Fama and Babiak 1968, Lasfer 1996, Dewenter and Warther 1998, Robinson 2006, and others).

⁷ Because the growth rate is an exogenous economic variable common to all firms in a given year, we pool data over sample years to capture variation in economic conditions.

Dividend-paying firms paid, on average, 0.1471 yuan/share each year they paid dividends. Because CD_{it} is a qualitative (1, 0) variable calculated on the entire sample, the mean CD_{it} of 0.5194 suggests that just over half the firm-year observations represent a firm paying a dividend in a sample year. The mean and median values of the BIG_{it} distribution (0.4123 and 0.3964), combined with a minimum (maximum) of 0.0004 (1.0000), suggest a distribution that is only slightly skewed.

Table 2: Descriptive statistics of variables for subsequent tests, from 12,685 firm-year observations of Chinese listed firms from 1998-2008.^{ab}

Variable	Mean	Median	Min.	Max.	Std. Dev.
DIV_{it}	0.1471	0.1000	0.0025	3.0000	0.1352
CD_{it}	0.5194	1.0000	0.0000	1.0000	0.4996
EPS_{it}	0.1998	0.1843	-3.3990	6.4284	0.4184
BIG_{it}	0.4123	0.3964	0.0004	1.0000	0.1701
$DOWN_t$	0.3288	0.0000	0.0000	1.0000	0.4698
LEV_{it}	0.4724	0.4759	0.0002	0.9994	0.1867
$LnASSET_{it}$	21.1737	21.0494	14.9374	27.8091	1.0405

a. Financial variables (e.g., dividends and earnings) are expressed in renminbi (yuan).

b. Variable definitions:

- DIV_{it} = dividends per share for firm i in year t , $t \in \{1998, 1999, \dots, 2008\}$;
- CD_{it} = 1 if firm i pays a cash dividend in year t , and 0 otherwise;
- EPS_{it} = earnings per share;
- BIG_{it} = the percentage ownership of the largest shareholder (generally the State) of firm i in year t ;
- $DOWN_t$ = a qualitative (1, 0) variable that = 1 if the GDP rate is lower compared to the previous year;
- LEV_{it} = the debt-to-assets ratio; and
- $LnASSET_{it}$ = the natural log of total assets.

From the mean BIG_{it} value of 0.4123 in table 2, it is likely that the largest shareholder in many firms has outright voting control (a BIG_{it} value > 0.5). It also can be argued that the State, the largest shareholder in roughly two-thirds of Chinese listed firms, may control their investments with far less than 50% of outstanding voting shares. However, control is not necessary for our pooled cross-sectional tests of the impact the largest shareholder has on the dividend response to economic fluctuation.

RESULTS

Table 3 contains coefficient estimates and t-statistic p-values for OLS estimation of model (5). Because of extensive multicollinearity found between the independent variables $DOWN_t$ and $BIG_{it} * DOWN_t$ (VIF test > 5), we estimate the model first by omitting $BIG_{it} * DOWN_t$ (panel A) and then re-estimate the model after instead omitting $DOWN_t$ (panel B). Both models have high explanatory power ($R^2 > 49\%$) and goodness-of-fit (F-statistic p-values = 0.0000). In both panels, coefficients on earnings and prior dividends (EPS_{it} and DIV_{it-1}) are positive and statistically-significant (p-values = 0.0000), consistent with previous dividend research based on the Lintner model (Lintner 1956, Fama and Babiak 1968, Dewenter and Warther 1998, Robinson 2006). In both panels, coefficients on the debt-to-assets ratio (LEV_{it}) are negative and statistically-significant (p-values = 0.0000), suggesting that the fixed costs and risk imposed by debt reduce the dividend payments of dividend-paying firms. More importantly, the coefficient on the ownership percentage of the largest shareholder (BIG_{it}) is positive and

statistically-significant (p-value = 0.0000). This finding is consistent with the view that the State maintains large ownership stakes in Chinese firms partly to provide a source of cash flow.

Table 3: Results from pooled cross-sectional OLS estimation of model (5), depicting coefficient estimates and p-values, for 4,776 firm-year observations of Chinese listed firms from 1998-2008.^{ab}

	Panel A		Panel B	
	Coefficient	P value	Coefficient	P value
Intercept	-0.0331	0.2452	-0.0359	0.2069
DIV _{it-1}	0.4266	0.0000	0.4270	0.0000
EPS _{it}	0.2330	0.0000	0.2327	0.0000
BIG _{it}	0.0495	0.0000	0.0599	0.0000
DOWN _t	-0.0163	0.0000		
BIG _{it} *DOWN _t			-0.0345	0.0000
LEV _{it}	-0.0486	0.0000	-0.0481	0.0000
LnASSET _{it}	0.0015	0.2736	0.0014	0.3153
IND _k	Controlled		Controlled	
Adjusted R ²	0.4948		0.4948	
F statistic	293.27	0.0000	293.33	0.0000
N	4776		4776	

a. Coefficient p-values are two-tailed against the null that the coefficient value = 0.

b. Variable definitions:

- DIV_{it} = dividends per share for firm i in year t, $t \in \{1998, 1999, \dots, 2008\}$;
- EPS_{it} = earnings per share;
- BIG_{it} = the percentage ownership of the largest shareholder (generally the State) of firm i in year t;
- DOWN_t = a qualitative (1, 0) variable that = 1 if the GDP rate is lower compared to the previous year;
- LEV_{it} = the debt-to-assets ratio;
- LnASSET_{it} = the natural log of total assets; and
- IND_k = qualitative variables to control for (K = 12) industries.

The coefficient on DOWN_t in panel A of table 3 is negative and statistically-significant (p-value = 0.0000), suggesting diminished dividend payments during slower periods of economic growth. In panel B, the coefficient on the interaction BIG_{it}*DOWN_t is also negative and statistically-significant (p-value = 0.0000). Moreover, the absolute value of the negative coefficient on BIG_{it}*DOWN_t (-0.0345) in panel B is less than the coefficient on BIG_{it} (0.0599). This suggests that the largest shareholder prefers greater cash payouts, but tends to reduce resource extraction somewhat during periods of reduced growth. Alternatively, when growth rates have increased (thus both DOWN_t = 0 and BIG_{it}*DOWN_t = 0), cash dividend payouts are increasing in the ownership percentage of the largest shareholder at a higher rate.

Table 4 depicts coefficient estimates and t-statistic p-values from LOGIT estimation of model (6), using all 12,685 firm-year observations from our initial sample. As before, we estimate the model first after omitting the BIG_{it}*DOWN_t interaction variable (panel A); we then repeat estimation of (6) after instead omitting DOWN_t (panel B). The explanatory power of the models is high; the pseudo-R² is better than 44% in each panel and model χ^2 p-values = 0.0000. Results in both panels A and B indicate that the likelihood of dividends being paid is increasing in earnings, prior dividend payments, and the percentage ownership of the largest shareholder, and decreasing in leverage (p-values = 0.0000).

Table 4: Results from pooled cross-sectional LOGIT estimation of model (6), depicting coefficient estimates and p-values, for 12,685 firm-year observations of Chinese listed firms from 1998-2008.^{ab}

	Panel A		Panel B	
	Coefficient	P value	Coefficient	P value
Intercept	-10.3966	0.0000	-10.5260	0.0000
CD_{it-1}	1.6178	0.0000	1.6153	0.0000
EPS_{it}	6.0053	0.0000	6.0180	0.0000
BIG_{it}	0.7568	0.0000	1.1130	0.0000
$DOWN_t$	-0.3954	0.0000		
$BIG_{it} * DOWN_t$			-0.9519	0.0000
LEV_{it}	-2.7406	0.0000	-2.7453	0.0000
$LnASSET_{it}$	0.4391	0.0000	0.4383	0.0000
IND_k	Controlled		Controlled	
Pseudo R^2	0.4418		0.4415	
Model χ^2	6661.0394	0.0000	6671.1734	0.0000
N	12685		12685	

a. Coefficient p-values are two-tailed against the null that the coefficient value = 0.

b. Variable definitions:

CD_{it}	=	1 if firm i pays a cash dividend in year t, $t \in \{1998, 1999, \dots, 2008\}$, and 0 otherwise;
CD_{it-1}	=	1 if the firm paid a cash dividend in the previous year, and 0 otherwise;
EPS_{it}	=	earnings per share;
BIG_{it}	=	the percentage ownership of the largest shareholder (generally the State) of firm i in year t;
$DOWN_t$	=	a qualitative (1, 0) variable that = 1 if the GDP rate is lower compared to the previous year;
LEV_{it}	=	the debt-to-assets ratio;
$LnASSET_{it}$	=	the natural log of total assets; and
IND_k	=	qualitative variables to control for (K = 12) industries.

The coefficient on $DOWN_t$ in panel A is negative and statistically-significant (p-value = 0.0000), consistent with a decreased likelihood of dividend payments in periods when economic growth diminishes. In panel B, the coefficient on $BIG_{it} * DOWN_t$ is negative and statistically-significant (p-value = 0.0000). However, the absolute value of the negative coefficient on $BIG_{it} * DOWN_t$ is less than the positive coefficient on BIG_{it} . This suggests that dividend likelihood increases in the ownership percentage of the largest shareholder, although it increases at a lower rate when economic growth diminishes.

DISCUSSION

In contrast to Western economies, it has been decades since China experienced what could be described as a recession. Rather, China's economy is subject to growth-rate fluctuation, or yearly changes in a consistently-positive growth rate. We investigate how the dividend policy of Chinese firms changes with fluctuation in the growth rate of the overall economy.

Approximately two-thirds of China's listed firms are State-controlled, either directly or indirectly; thus, the State is usually the largest shareholder of most firms in China. We find that both dividend payouts and dividend likelihood generally rise and fall with overall economic growth. Our findings also suggest that dividend payouts and dividend likelihood are both increasing in the largest shareholder's

percentage ownership, although both are increasing at a lower rate when economic growth diminishes. These results provide support for the contention that China maintains a controlling stake in much of the corporate economy in part to extract cash benefits, consistent with the agency theory of dividend policy.

Our research is potentially rich in policy implications in that we highlight economic fluctuations and large blockholdings as issues policy-makers may wish to consider before issuing comprehensive regulations governing corporate payouts. We also identify the association between large blockholdings and economic fluctuations as a fruitful area for future research on dividend policy in emerging markets. Because all economies undergo periodic growth changes, our research is potentially significant not just for transitional economies but also for the U.S. and Western economies in general.

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