Jurnal Keuangan dan Perbankan, Vol. 12, No.1 Januari 2008, hal. 76 – 83
Terakreditasi SK. No. 167/DIKTI/Kep/2007

OWNERSHIP STRUCTURE AND THE CORPORATE GOVERNANCE ROLE OF DIVIDENDS

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Abstract: *This paper reviewed the theoretical and empirical literature on the relationship between ownership structure and dividends. Agency theory suggested that dividend was served to reduce agency problems between owners (or large controlling shareholders) and managers (or minority shareholders) by reducing the amount of free cash flow and increasing monitoring by external parties. It also proposed that ownership concentration and composition might mitigate or exacerbate agency problems. We might expect substitutability or complementary relationship existed between dividend and ownership concentration/composition. Empirical evidence showed that the relationship between dividend and managerial or large shareholdings could be negative (i.e., consistent with substitute argument), positive (i.e., consistent with complementary argument) or non-linear (i.e., consistent with entrenchment hypothesis). In addition, the literature suggested that family controlled firms might expropriate minority shareholders by paying lower dividends or mitigate moral hazard conflicts by distributing more cash. Empirical research on this issue, however, provided mixed findings.*

Keywords: *dividends, corporate governance, ownership structure, monitoring*

There are numerous definitions of corporate governance proposed by financial economists. These definitions generally refer to the existence of conflicts of interest between insiders (e.g., managers or controlling shareholder) and outsiders (e.g., dispersed shareholders or minority shareholders) arising from the separation of ownership and control in modern corporations. Such corporate governance problems cannot be effectively resolved by complete contracting due to the significant uncertainties, information asymmetries and contracting costs in the relationship between capital providers and insiders. Therefore, some mechanisms are needed to control moral hazard problems, such as the threat of takeover, the managerial labour market, large shareholders (i.e., external mechanisms), boards of directors, insider ownership, compensation packages, debt and dividends (i.e., internal mechanisms).

There is a growing interest in understanding the interaction between dividend decisions and the governance of corporations. The important role that dividend policy can play in corporate governance is derived basically from agency theory. In particular, dividends can assist dispersed (or minority) shareholders in monitoring managers (or large controlling shareholders). Dividends serve to reduce

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agency problems between owners (or large controlling shareholders) and managers (or minority shareholders) by reducing the amount of free cash flow (Jensen, 1986; La Porta et al., 2000) and forcing insiders to raise funds in the capital markets more frequently, thus subjecting insiders to outside scrutiny (Easterbrook, 1984; Rozeff, 1982).

THE MONITORING ROLE OF DIVIDENDS

Insider Ownership and Dividend Policy

The finance literature suggests that dividends may help reduce agency problems. The seminal studies of Rozeff (1982) and Easterbrook (1984) provide agency cost explanations of why firms pay dividends. In particular, Rozeff suggests that dividend payments are part of the firm's optimal monitoring mechanism and these payments help to reduce agency costs. In his model, firms choose a dividend payout ratio that minimises their total costs (i.e., agency costs and transaction costs of financing). Agency costs decrease with dividends, while transaction costs increase with dividends. The minimisation of total costs results in a unique optimal dividend payout for a given firm. Meanwhile, Easterbrook argues that dividend payments force managers to raise funds in the capital markets more frequently than they would without dividend payments. Therefore dividends cause managers to be frequently scrutinised by external professionals such as investment bankers, lawyers and public accountants. This in turn forces managers to act in line with shareholders' interests, thereby reducing agency costs of equity. Easterbrook also suggests that substitution exists among agency-cost control mechanisms. In particular, Easterbrook states "Because all forms of controlling agency costs are themselves costly, we would expect to see substitution among agency-cost control devices" (p.657).

Another argument based on agency costs explanation for dividends is suggested by Jensen (1986). Like Easterbrook (1984), Jensen argues that managers cannot be perfectly monitored and may choose to maximise their utility rather than maximise shareholders' interests. Jensen also suggests that cash is the asset that managers can misuse most easily. Therefore, any funds remaining after financing all positive net present value (NPV) projects (i.e., "free cash flows") may cause a conflict of interest between managers and shareholders. Jensen's analysis implies that dividend payments benefit outside shareholders because they serve to reduce free cash flows from manager control. Another way to reduce the amount of free cash flows under management control is by increasing debt, which requires an increase in routine interest payments. Dividend and debt interest payments thus may control agency costs by decreasing the free cash flow available to managers to invest in marginal or negative NPV projects and manager perquisite consumption.

There has been a substantial number of empirical studies that lend support for the agency costs explanation of dividends. For example, Rozeff (1982), Crutchley and Hansen (1989), Moh'd, Perry and Rimbey (1995); Crutchley et al. (1999), Chen and Steiner (1999) and Short et al. (2002) examine the relationship between dividends and managerial or insider ownership. They find that firms establish a higher (lower) dividend payout ratio when managers or insiders hold a lower (higher) fraction of the equity, which is consistent with the agency costs explanation for dividends. That is, dividends are less important in reducing agency problems when managers have large equity holdings, aligning their interests better with outside shareholders. In addition, Rozeff (1982) also finds that firms with higher firm-specific risks and high growth firms pay smaller dividends, which is consistent with his model. Rozeff's model also receives support from Dempsey and Laber (1992) who replicated Rozeff's analysis using samples from different periods of time and from Crutchley and Hansen (1989) who find that dividends are negatively related to the firm's flotation costs. Meanwhile, Jensen et al. (1992) and Noronha et al. (1996) find that insider ownership, dividends and debt financing are substitute mechanisms in controlling agency costs which is consistent with Easterbrook's (1984) argument. Finally, Agrawal and Jayaraman (1984) report that dividend payout ratios of all-equity firms are significantly higher than those of leveraged firms, which suggests that dividends reduce free cash flow problems and thus supports Jensen's (1986) hypothesis.

There is, however, evidence that insider shareholdings are positively related to dividends. Specifically, Fenn and Liang (2001) suggest that when the interests of managers and shareholders are less aligned, managers will tend to over invest rather than return free cash flows to shareholders. Thus, insider shareholdings are positively related to dividends, and Fenn and Liang' results support this hypothesis for the subset of firms with the highest degree of agency costs.

Moreover, a few studies (e.g., Farinha, 2003; Schooley and Barney, 1994) attempt to examine whether the relationship between dividends and managerial shareholdings is non-monotonic. Schooley and Barney extend Rozeff's (1982) model, and suggest a non-monotonic relation between dividend payout ratio and managerial shareholdings. The authors argue that this non-monotonic relationship is consistent with the monitoring rationale for dividends and the managerial entrenchment hypothesis (Morck et al., 1988; Short and Keasey, 1999). In particular, when managerial shareholdings are low, an increase in ownership equity tends to reduce agency costs. As agency costs decrease, dividends tend to decrease because dividends become less important as a tool used for mitigating agency costs. At higher levels of managerial shareholdings (where managers are entrenched), agency costs tend to increase with an increase in the ownership percentage. As a result, increased monitoring via higher dividends becomes more necessary. A U-shaped relationship between dividends and managerial ownership is also reported by Farinha (2003) who examine a sample of U.K. firms.

Large Shareholders and Dividend Policy

The relationship between large shareholders and dividends stems from Easterbrook's (1984) argument, which suggests that a negative relationship exists between large shareholders and dividends. In particular, firms that have large shareholders, especially when these shareholders participate in the management of their firms, have less need for monitoring by outside professionals. As suggested by Jensen and Meckling (1976) and Fama and Jensen (1983), when ownership and control are separated, firm's decisions are the result of the relative power of investors and corporate insiders, whose interests may not coincide. When ownership is concentrated, large shareholders have powerful incentives to monitor and control managers. Accordingly, closely-held firms tend to have lower dividend payouts than identical firms that are more prone to manager-owner agency conflicts.

Concentrated voting power, however, gives large shareholders the ability to influence the strategic decisions of the firm, including dividend policy. As large shareholders' preferences for dividends may be affected by several factors such as tax and monitoring motive, this may cause the relationship between dividends and large shareholders to be less predictable. For example, large shareholders may choose a policy to pay higher dividends so that managers can be monitored by appropriate parties or a policy to pay lower dividends if this is consistent with their tax preferences. Eckbo and Verma (1994) suggest that due to different shareholder tax rates, information asymmetries and agency costs, shareholders may have disagreement over dividend policy. Accordingly, dividend policies reflect a compromise solution where the interests of various heterogenous shareholder groups are represented by the group's voting power.

Alternatively, a positive relationship between large shareholders and dividends is suggested by Shleifer and Vishny (1986). In their model, dividends serve as a side payment to large shareholders, such as institutional or corporate investors (who, in the U.S., have a tax preference for higher dividends), to entice them to hold their shares and to monitor managers.

Mixed findings, however, are prevalent in research into the impact of large shareholders on dividend policy. In particular, Zeckhauser and Pound (1990) examine the dividend payout ratio for firms with and without large shareholders (i.e., a single outside shareholder owning more than 15 per cent of equity) using a sample of 286 U.S. firms. They find that the presence or absence of large shareholders seems to make no significant difference in payout ratios across opaque industries (those that are difficult to monitor such as aerospace, computers, drugs, etc.) or transparent industries (those that are easy to monitor such as apparel, petroleum, publishing, etc.). The result does not support the notion that large shareholders and dividend payouts are alternative forms of monitoring. Short et al. (2002) investigated the impact of institutional ownership and managerial shareholdings on dividend policy on a sample of UK firms. They found that high institutional ownership leads to dividend increases, while high managerial ownership reduces dividend payouts. The authors argue that institutional investors control agency problems not directly by monitoring managers, but by forcing management to raise external funds more frequently which subjects them to the scrutiny of capital markets.

Despite the obvious benefit of monitoring, the presence of large shareholders can have a negative impact. Large shareholders who own sufficient voting rights to control firms (i.e., controlling shareholders) may represent their own interests, which need not coincide with the interests of other shareholders (i.e., minority shareholders). La Porta et al. (2000) suggest that dividend payments are an ideal device for limiting minority shareholder wealth expropriation because they guarantee a pro-rata payout for all shareholders and remove corporate wealth from controlling shareholders. The authors hypothesis a relationship between dividend policies and the level of legal investor protection in one of the following two ways: dividends are the outcome of an effective system of legal protection where minority shareholders use their legal powers to force controlling shareholders to pay dividends (the outcome model), or dividends are a substitute for legal protection that relies on the firm's need to raise external financing. In other words, firms that need to raise external financing are not able to sell securities without providing routine dividend payments (the substitute model).

Under a strong legal protection system, minority shareholders use their legal power to force controlling blockholders to distribute more cash, thus preventing insiders from expropriating company earnings. For example, shareholders might vote for directors who offer better dividend policies and sell shares to potential hostile raiders who then obtain control over non-dividend paying companies (La Porta et al., 2000). The system also makes rent extraction such as asset diversion legally riskier and more expensive for insiders, thus raising the relative attraction of dividends. The outcome model thereby predicts that dividend payout ratios are higher in countries with good shareholder protection. On the other hand, the substitute model predicts the opposite. In addition, the outcome model further predicts that in countries with good shareholder protection, companies with better investment opportunities should have lower dividend payout ratios, whereas the substitute model does not make this prediction. The authors empirically examine a sample of 33 countries with different levels of minority shareholder rights and found supporting evidence for the outcome model.

Family Control and Dividend Policy

Agency theory provides mixed predictions about the dividend behaviour of family controlled firms. Families potentially reduce owner-manager agency problems through better monitoring of managers or direct involvement in management. Gugler (2003) argues that neither major conflicts of interest nor large asymmetries of information between management and ultimate owners are present in family- firms. This reflects the fact that managers and large family shareholders are often the same persons, or that large family shareholders have enough incentive and power for efficient direct monitoring. As a result, agency theory prescriptions regarding monitoring can be redundant in family firms (Randøy and Goel, 2003). Dividends and/or dividend stability in family firms can therefore be less valuable (as tools to reduce agency costs), and owner-managers are likely to cut dividends when necessary. In contrast, several recent studies (e.g., Gomez-Mejia et al., 2001; Steier, 2003) suggest that agency problems in family firms can be more severe than previously believed, suggesting that dividends can play a significant role in controlling agency costs in family firms.

In addition, it is widely held that controlling families have strong incentives to expropriate wealth from minority shareholders, especially when their control exceeds their ownership rights (Claessens et al., 2000; Faccio et al., 2001; Shleifer and Vishny, 1997). Families are also keen to maintain control of their firms to protect their highly valuable private benefits of control. These arguments (referred to as the expropriation argument) predict that families prefer a lower dividend payout policy to preserve cash flows that they can potentially expropriate, or to maintain control. Alternatively, La Porta et al. (2000) argue that under a strong legal protection system, minority shareholders use their legal power to force controlling blockholders to distribute more cash. The system also makes rent extraction, such as asset diversion, legally more risky and more expensive for insiders, thus raising the relative attraction of dividends. This argument thereby predicts that under a strong legal protection system, minority shareholders will force families to pay (higher) dividends.

Despite extensive evidence relating to dividend policy and ownership structure, both in the US and internationally, surprisingly little is known about the interaction between family control and dividend policy. A small number of studies which have examined the dividend policy of family controlled firms in Western Europe have produced mixed results. Gugler (2003) found that firms controlled by families in Austria do not engage in dividend smoothing, choose lower target payout levels, and are less reluctant to cut dividends than those controlled by the state, banks, and foreigners. However, since the ownership structure in Austria is extremely concentrated, Gugler analyses only closely-held firms. In contrast, Silva et al. (2004, p. 140) report that, in Germany, family control does not seem to have a significant impact on dividend policy. Chen et al. (2005) also find little relationship between family ownership and dividend policy in a sample of listed Hong Kong firms.

Evidence from the U.S. has been provided by Villalonga and Amit (2006), who, using a sample of Fortune 500 firms, primarily observe the value of family firms. The univariate tests in their study reveal that family firms have significantly lower dividend rates than non-family firms, which is consistent with the argument that owner-manager conflicts are lower in family firms. This finding, however, should be interpreted cautiously as the researchers do not control for other variables that may affect dividends such as firm size, growth opportunity and risk.

Important evidence on the link between expropriation by large shareholders and dividends is provided by two studies: Faccio et al. (2001) and Gugler and Yurtoglu (2003). Faccio et al. (2001) found that group-affiliated corporations in Western Europe (about half of them are family controlled), pay significantly higher dividends than those in East Asia. This result implies that dividends dampen rent extraction in Western Europe, but exacerbate it in East Asia. The authors particularly examine two arguments in relation to dividends and expropriation. The first is that a corporation with lower ownership and control rights ratios will pay lower dividends since the controlling shareholders seek to keep control of the firm's resources. Alternatively, in corporations with lower ownership and control rights ratios, controlling shareholders could refrain from expropriation by committing to higher dividend payouts, thus sustaining their firm's stock market valuation and future access to capital. Faccio et al. suggest that the trade-off between the above arguments depends on how tightly a corporation is controlled and empirically find that when investors strongly anticipate that expropriation will occur within a corporation with higher incentives to extract rent, higher dividends will be paid as the firm competes for capital.

In addition, Gugler and Yurtoglu (2003) examine whether the rent extraction hypothesis has implications for the level of dividends being paid in Germany. They find that larger holdings of the largest shareholders are associated with reduced dividends, whereas the larger holdings of the second largest shareholders increase dividend payouts. This suggests that the presence of other large shareholders in the firm helps to reduce rent extraction by controlling shareholders.

CONCLUSION

The relationship between ownership structure and dividends stems from agency theory. In particular, it suggests that dividends serve to reduce agency problems between owners (or large controlling shareholders) and managers (or minority shareholders) by reducing the amount of free cash flow and increasing monitoring by external parties. It also proposes that ownership concentration and composition may mitigate or exacerbate agency problems. As such, substitutability or complementary relationship between dividends and ownership concentration/composition can be expected. Empirical evidence shows that the relationship between dividends and managerial or large shareholdings can be negative (i.e., consistent with substitute argument), positive (i.e., consistent with complementary argument) or non-linear (i.e., consistent with entrenchment hypothesis). Moreover, agency theorists argue that family controlled firms may pay lower dividends preserve cash which can be expropriated or pay higher dividends to mitigate moral hazard conflicts with minority shareholders. Empirical evidence on this issue, however, is inconclusive.

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