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The Influence of Corporate and Country-Level Governance on Firm Payout Policies: A Summary of Worldwide Market

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Abstract: Since the pandemic in 2020, many firms paused or reduced their dividend payout as shifting to a defense strategy. However, the total dividends payout in the second quarter of 2022 by S&P500 firms is 11.8% more than that in the period of 2021 and share buyback spending is 11.7% higher. Thus, the company's payout policy is still a significant concern for investors. This research summarizes several findings on the interaction of payout policy with corporate governance and with country-level governance and discusses the dependence between these two factors. This research finds that country-level governance is positively related to a firm's payout policy, and because of the correlation between firm-level and country-level governance, the interaction between firm-level governance and dividend policy varies with legal strength: in weak legal regimes, stronger corporate governance leads to higher dividend payout, and in strong legal regimes, they correlate in the opposite way, as the shock repurchase is preferred over dividend.

Keywords: Payout policy, Corporate governance, Country-level governance

1. Introduction

Corporate-level governance, usually led by the company's management team and board of directors, is a general term to describe the structures, practices, and processes through which a company is directed. Similarly, country-level governance is also a general term referring to the system and processes through which a country is governed, and public policy is formulated and implemented. Since the initial proposition of the dividend puzzle which claims that the corporate dividend policy has no consequence for the shareholder's interest, academia has been researching about the interaction between payout policy and the two factors: firm-level and corporate-level governance [1]. However, due to the ambiguity and subjectivity in the definition of the two governances, the variety of the statistics they used to represent the two types of governance may result in significantly different conclusions. This paper aims to summarize the literature's findings and draw a conclusion on the quantified relationship between payout policy and firm-level and country-level governance. This paper will first individually discuss the interaction of payout policy and the two independent factors, then integrate them into one composite model. Then the correlation between the two factors will be discussed. This study aims to help investors make more informed decisions and provide insights for companies to adjust their payout structure, ensuring that management acts in the best interest of shareholders and reducing agency costs.

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2. Corporate Governance as an Impact on the Firm's Payout Policy

2.1. Review on the Statistical Measurement of Corporate Governance

When discussing the indeterminate relationship between dividend payout and firm-level governance, La Porta et al.'s work in 2000 is a milestone in the field. It proposed two hypothetical theories of dividend payments, the first one is the "outcome" theory, claiming a positive relationship between governance and dividends, with the reasoning that dividend payout can restrict the excess cash holding which is beneficial for management's interest [2]. The second one is the "substitution" theory, claiming a negative relationship between dividend payout and corporate governance. It states that a higher dividend payout is a compensation for poor management governance to maintain a stable relationship between management and shareholders.

With the theories established, considerable literature tries to find the effect of firm-level governance and country-level governance in an empirical method. In the U.S. market context, Chang et al. conclude that findings on firm-level governance and payout policy from the U.S. samples fall into three categories: positive, negative and no relationship [3]. The one supporting non-relationship uses the managerial stock incentives as the representation of the firm-level governance, Fenn and Liang believe that the managerial team's interest can be aligned with shareholders' interest by management stock ownership and stock options [4]. They choose the percentage of stocks and stock options proportional to the total shares outstanding. They find only companies with severe agency problems will strengthen their payout after increasing managerial share ownership, but in most cases, managerial stock ownership won't provide an incentive to increase or decrease payout or share repurchase. In the group supporting positive relationships, Chang, Kang, and Li use institutional ownership as the representation [5]; Herron uses a composite statistic Gov41 as the independent variable, this variable was originally designed by Aggarwal et al. [6-7]; Francis et al. uses the legislative enactment of anti-takeover as the measurement of corporate governance, as the enactment of these laws is seen to be weakening the corporate governance [8]. Finally, Jiraporn and Ning, use the Governance Index (GINDEX) (created by Gompers, Ishii and Metrick) to quantify corporate governance [9-10]. This index is designed based on the logic that more provision that reduces shareholder rights will grant more governance power to the management.

Among all those measurements of corporate, this report is in favor of the Gov41 index. Simple measurements like managerial stock ownership, institutional ownership or passage of antitakeover laws can't fully represent the governance power, a well-established variable can cover more information. There are several reasons for choosing Gov41: a. Comprehensive Coverage: The index covers a broad range of corporate governance aspects, it integrates 41 corporate-level attributes, which span four categories: board, audit, anti-takeover provisions, and compensation & ownership. Such comprehensive coverage ensures that the index captures as many dimensions of corporate governance as possible, providing a holistic view of a company's governance power. b. Commonality Across Jurisdictions: The selected governance attributes are common to both U.S. and non-U.S. firms, making the index applicable and comparable across different countries. This commonality is crucial for research that compares corporate governance practices globally. c. Quantitative Assessment: Gov41 assigns a binary score which is from 0 to 1 to each governance attribute based on whether the company meets the certain standard on that attribute. This approach allows for a quantitative assessment of governance quality, facilitating comparisons across firms and overtime. Additionally, tracking this index over time can reveal trends in corporate governance improvements or deteriorations. d. Relevance to Institutional Investors: Aggarwal et al. show that the level of governance, as measured by Gov41, is positively associated with international institutional investment. This suggests that Gov41 captures attributes of governance that are valued by these investors, further validating its relevance and utility. e. Empirical Support: The study's findings, such

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as the observed changes in the GOV41 index across countries within the researching period and its association with institutional ownership changes, provide empirical support for the index's ability to reflect governance improvements and its significance to investors.

2.2. Relationship between Corporate Governance and Payout Ratio

After examining the payout practices of a dataset comprising 1,880 companies from 21 countries during the period 2004 to 2008, Herron's work corroborates the outcome hypothesis proposed by La Porta et al., which pertains to the influence of both firm-specific and national governance factors. In countries with weaker legal frameworks, enhancements in firm-specific governance are correlated with an increased dividend payout ratio. Specifically, a one standard deviation increase in the Gov41 index is linked to a 10.8% increase in dividend payout ratios. It is said that shareholders in weak legal regimes tend to use additional rights to secure higher payouts. Conversely, in jurisdictions with robust legal systems, shareholders utilize increased shareholder rights to preferentially choose a tax-efficient way of earning, which is share repurchases over fixed dividends. A one standard deviation enhancement in the Gov41 index correlates with an 11.5% reduction in dividend payout ratios and a 39.1% increment in repurchase payout ratios in strong legal regimes. Given the financial flexibility that shares repurchases give the corporations and the tax benefits they offer shareholders, these outcomes align with the outcome model.

3. Country-Level Governance as an Impact on the Firm's Payout Policy

3.1. Review on the Statistical Measurement of Country-Level Governance

In the field of studying country-level governance and dividend payout, La Porta et al. was the first mover in 1998. The literature proposed nearly the same hypothesis theory as the one in their 2000 literature: the outcome theory and the substitution theory. Specifically for the relationship of payout and country-level governance, La Porta et al.'s finding supports the outcome theory, it observes a higher dividend payout ratio in strong governance regimes. Additionally, the finding reveals a negative relationship between payout ratios and investment opportunities that only exists in strong governance regimes but will not exist in weak governance regimes.

The statistical measurement of country-level governance is the legal origin. The measure includes the efficiency of the country's judicial system, laws, corruption, expropriation risk which refers to the outright confiscation or forced nationalization by the government, and the likelihood of contract repudiation by the government. Besides, the literature uses an estimate of the quality of a country's accounting standards, which plays a crucial role in governance because it ensures the company disclosures to be interpretable and contracts between managers and investors to rely on verifiable measures of firms' income or assets.

3.2. Relationship between Country-Level Governance and Payout Policy

This paper supports Herron's result of country-level governance. It tested 1880 companies in 21 countries from 2004 to 2008, and its result is consistent with the outcome model from La Porta et al. mentioned above. It concludes that there is a significant relationship between country-level legal protections in determining firms' payout policies. Specifically, in countries with strong legal frameworks, firms with stronger governance structures prefer to share repurchases over dividends as a method of returning value to shareholders. This preference suggests that such firms lean towards more tax-efficient and flexible payout methods when they operate in environments with robust legal protections for investors. In weak legal regimes, dividends and share repurchases are less admired as

firm-level governance improves. But generally, country-level governance is positively related to payout policy.

4. Interaction between Firm-Level Governance and Country Level Governance

One problem raised when studying the relationship is the correlation between country-level governance and firm-level governance. These two core factors are internally correlated, Chang et al. has argued on the independence of the two factors [11]. It uses the ISS41 index (data from the Institutional Shareholders Service database and constructed by the method from Aggarwal et al. in 2011) as the measurement of firm-level governance and ASD (anti-self-dealing index) as the country-level governance. They find that when country-level governance is in a relatively weak spot, firm-level governance becomes more dominant in determining the payout ratio. In contrast, when country-level governance is strong, it will prominently impair the role of firm-level governance. In other words, firm-level governance is more like a minor factor, as it has been strongly affected by country-level governance.

5. Conclusion

This research summarizes several kinds of literature and studies the relationship between firms' payout policies and corporate and country-level governance, revealing that governance frameworks significantly influence dividend and share repurchase strategies. At the corporate level, governance impacts payout behaviors differently across legal strength: In weak legal regimes, stronger corporate governance leads to higher dividend payouts, while in strong legal systems, firms with higher governance prefer share repurchases. Country-level governance also plays a vital role, and a stronger legal framework encourages firms to pay out more dividends. However, as firm-level governance is prominently affected by the country's legal strength, researchers should be concerned about the model's efficiency when doing cross-country comparisons. Future studies about payout policy could link firm performance with corporate governance, as firm performance has an influence on stock price, and based on the dividend discount model, the stock price could be estimated by the dividend payment.

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