Short Communication
Volume 12:S4, 2021

Business and Economics Journal

ISSN: 2151-6219 **Open Access**

How the Market Dividend Payouts External Governance and Mechanisms Control the Family Firms

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Abstract

This study examines how three external governance mechanisms interact with the internal family-governance system to influence dividend payout decisions. The findings indicate that family businesses deliver fewer dividends when the market prefers dividends. Contrarily, family firms release more dividends under greater monitoring from institutional investors and debt holders. The study expands various theories and generates policy implications.

Keywords: Dividend payout • Family firms • Institutional investors • Emerging market

Introduction

Unlike developed markets, emerging markets feature in principal-principal conflicts where family-controlled firms may expropriate minority shareholders by keeping cash within the firm for their private interests. From the open-system perspective, most corporate governance studies overly focus on a ubiquitous connection between corporate governance mechanisms and firm performances but overlook how the interrelationship between the organization and diversified environments generates variations in the effectiveness of various governance disciplines [1]. Therefore, this study brings three external governance mechanisms, including market preference, institutional investors, and debtholder monitoring, into the picture to understand how these external forces shape the dividend payout policies of the internal system.

The first external force is market preference from the catering theory: When investors put a premium on dividend-paying firms, managers cater to market preference by paying dividends, otherwise, managers pay lower or eliminate dividends [2]. From the aspect of an owner-manager who has a substantial allocation of his assets invested in the family firm, the owner-manager may tend to take out more dividends from the firm to the family to diversify the concentrated risk. These reasoning's imply that when the controlling family interacts with outside investors' preference for dividends and higher premiums, the family-controlled firms tend to issue more dividends to maximize the value of their holdings and the cash compensation. Therefore, we propose hypothesis 1(a): The catering incentive has a positive impact on dividend payouts for family-controlled firms in emerging economies. On the other hand, family-controlled firms in the emerging markets have more incentives than other investors to form coalitions to extract private benefits and pay lower dividends. Additionally, family-dominated firms in emerging markets have little interest in pleasing individual investors and responding to their preferences in dividends [3]. Moreover, dividend income is included in individual income tax with the highest marginal rate In Taiwan, and this can be another obstacle in issuing dividends to outside investors. Thus, we propose a competing hypothesis 1(b): The catering incentive has a negative impact on dividend payouts for family-controlled firms in emerging economies.

The free cash flow theory suggests that institutional investors prefer dividends to be released to reduce agency costs. Taiwan's tax regulation exempts institutional investors from taxation for dividend incomes. Furthermore, institutional investors need ongoing funds to support their routine operational activities [4]. Based on these arguments, institutional investors will push family businesses to pay more dividends. Accordingly, we propose the following hypothesis 2(a): Institutional ownership has a positive impact on the dividend payouts for family-controlled firms in emerging economies. Contrarily, institutional investors have become a powerful force for corporate governance by pushing managers to behave in the long-run interest of the investors [5]. In this case, they work as a substituting monitoring mechanism and reduce the need to demand high dividend payouts. Consequently, we propose a competing hypothesis 2(b): Institutional ownership has a negative impact on the dividend payouts for family-controlled firms in emerging economies.

With a higher proportion of debt, family-controlled firms may disgorge more cash to their investors to establish a positive reputation and to offer quality signals that the company can meet debt contracts despite the substantial dividends. Thus, we propose hypothesis 3(a): A higher proportion of debt has a positive impact on dividend payouts for family-controlled firms in emerging economies. However, debtholders may impose restrictions on dividend payouts to cover the risk of default. Furthermore, family firms with high fixed financial costs are less willing to issue dividends [6]. Therefore, we propose a competing hypothesis 3(b): A higher proportion of debt has a negative impact on dividend payouts for family-controlled firms in emerging economies.

Data and Methodology

Taiwan's stock market is an ideal setting to test how these external governance mechanisms can protect minority shareholders from expropriation by the controlling family shareholders for two reasons: First, 80% of Taiwanese businesses are controlled by family members. Second, individual investors account for 67% of the trading volume based on the latest 2020 report of Taiwan Stock Exchange Corporation. The sample is composed of publicly-traded family firms from the database Taiwan Economic Journal. We use panel data to run pooled regressions and adopt standard errors clustered by both time and firm to avoid the issue of over-estimating the significance of parameters [7]. This study adopts two-stage least squares approach to manage the possible endogeneity problem and considers alternative payouts such as repurchases for robustness checks.

Conclusion

This study examines the effects of three external governance mechanisms on payout policies under the context of family-controlled businesses in an emerging market. Findings reveal that family-controlled firms and market preferences work as substitutes and issue fewer dividends. Nonetheless, internal family governance and external debtholders as well as institutional investors work as complements and deliver more dividends. This study validates an open-system perspective of corporate governance. It also helps to expand the catering theory which argues that the market preference

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Received: 06 August 2021; **Accepted:** 20 August 2021; **Published:** 27 August 2021

dominates the dividend payout behavior. From a practical viewpoint, investors who seek firms that release high dividends should search for the ones with higher institutional ownership and debt ratios while keeping controlling family expropriation at bay. From the perspective of regulators of emerging markets, effective external mechanisms should be established to prevent internal majority shareholders from expropriating minority shareholders by dividend policies. Future studies may investigate the interaction effects of various internal and external governance mechanisms on broader firm performances and make comparisons between emerging economies and developed economies.

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How to cite this article: Teng, Chia-Chen. “How the Market Dividend Payouts External Governance and Mechanisms Control the Family Firms”. *Bus Econ J* S4 (2021): 001.