Global Journal of Arts Humanity and Social Sciences ISSN: 2583-2034

GSAR PUBLISHERS
GLOBAL SCIENTIFIC AND ACADEMIC RESEARCH

Glob. J.Arts.Humanit.Soc.Sci
ISSN: 2583-2034
Vol-2 Iss-9, page 672-676

Effect of institutional quality on dividend policy of Southern African countries

BY

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Article History
Received: 31/08/2022
Accepted: 04/09/2022
Published: 06/09/2022

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Abstract

South Africa's economy ranks as the second biggest in Africa and the highest industrialised, technically sophisticated, and diverse in the continent. South Africa is one of just eight African nations with a sustainable economic background. After the lifting of over a decade of sanctions imposed in 1996, South Africa's gross domestic product nearly quadrupled to its absolute peak of 416 bn US dollars in 2011. Institutional quality play a very important role in shaping corporate dividend policies. Numerous corporate finance literature works have endorsed the impact institutional quality in making firms' dividend decisions. Considering their importance in the corporate world, the current study intends to comprehensively determine whether institutional quality affect financial policy. There is limited research in the domain of institution quality and dividend policies in the context of Southern Africa.

Keywords: Dividend policies, and institution quality

Introduction

A number of scholars have investigated factors affecting dividend decisions and most of these studies focused on firm-level characteristics (Chang et al.,2016; Ahmad et al.,2018). Limited studies investigated institutional quality effect on dividend payout. Institutional environment has great influence on the firm level because government has great influence and controls a number of resources in developing countries (Pan and Tian, 2020). Institutional quality is broadly classified into corruption, voice & accountability, government effectiveness, Regulatory quality, and Rule of law. corruption has a significant influence on corporate decisions including investment and financing (Nguyen and Van Dijk, 2012; Smith, 2016). Even the recent research rarely focused on the association of effects of corruption on dividend policy although, Hossain et al. (2021) and Tran (2021) whose empirical results shows a positive relationship between corruption and dividend policy.

Every development phase in government attracts corruption according to Song *et al.* (2021). Earlier scholars experienced challenges in to measurement corruption variables because of lack of data on corruption (Song *et al.*, 2021). The world today is not unaware of corruption, the advent of the international country risk guide (ICRG), in addition to other corruption indexes, has played an important role in bringing corruption to the global policy agenda and provided a useful platform for cross-country research in the field (Peyton and Belasen, 2012). Corruption has been pervasive in developing economies (Peyton and Belasen, 2012) such as Southern African region.

Corruption has two broad hythothesis, that is grease the wheels' hypothesis and sand in the wheels' hypothesis. The former assumes corruption has a positive significant influence while the latter views it has having a negative significant influence. Grease the wheels' hypothesis views corruption as playing mitigating role in poor-performing institutions in emerging economies (Méon and Weill, 2010). It is viewed as a significant tool influencing the activities of economic development. Corrupt officials avoid bureaucracy and red tape when engaging in corrupt practices (Méon and Weill, 2010). Moreover, Dreher and Gassebner (2013), states that it also helps in ignoring complex legislations of inefficient institutions hence fostering economic development in developing economies. Moreover, corruption may enhance investments in the private sector and serve as a buffer to counter poor strategies, thus fostering economic growth in countries with weak legal infrastructure (Cooray and Schneider, 2018).

Usage of corruption proceeds, that is either investing or consuming and the location of usage of money places of money also is a factor in determining the impact of corruption on the economy (Cooray and Schneider, 2018). Three types of corruption are looting dividend collection, and rent scrapping (Cooray and Schneider, 2018). Looting induces devastation that triggers investment of bribery payment on domestic projects or on foreign ventures. Similarly, rent scraping either creates capital outflow because of decline in capital gains or it helps initiates new or expanding projects. Dividend collecting relies on corporations' progress in profit generation, which motivates policymakers to promote policies which support investment. Furthermore, to reduce political risks like risks of closure business can turn to (O'driscoll and Hoskins, 2006, 2003). Despite high corruption, Huang *et al.* (2013) found among the 13 Asia-Pacific countries, economic development of China and South Korea show significant growth despite higher degrees of corruption. Similarly, Kato and Sato (2015) have found support for "grease the wheels" hypothesis in Indian firms. Moreover, Dreher and Gassebner (2013) argue that when corruption becomes an effective way of mitigating the adverse effects of complex and lengthy regulatory business policies operating in strongly controlled economies, it supports the philosophy of "grease the wheels".

Contrary, ''sand in the wheels''hypothesis is of the view that corruption is harmful to the financial operations.For example, some of the earlier scholars have reported negative association of corruption on growth and investment (Aghion *et al.*, 2004; Blackburn *et al.*, 2006; Lee and Ng, 2009). Similarl findings were reported by Gächter and Schulz (2016). Corruption is known to reduce financial development due to the interest of many persons in undisclosed briberies for illegal approval (Cooray and Schneider, 2018; Shleifer and Vishny, 1993). There is a proof especially banking sector profitability is more affected by the negative impact of corruption (Arshad and Rizvi, 2013). Consequently, extensive government control of banks increase political interest in the allocation of funds, which negatively affects both economic growth and financial sector expansion of a country (Barth *et al.*, 2004; La Porta *et al.*, 2002).

Modigliani and Miller (1958) stated that opportunities of investment are the only affecting factor of corporate investment decision. Prior scholars have proved that corporate financial decisions are not only affected by firm-level specific factors (Boubakri *et al.*, 2013; Chen *et al.*, 2006, 2017; Jensen and Meckling, 1976; Jiang *et al.*, 2011) but also by country-level factors, for instance, shareholder protection (Xiao, 2013) and national culture (Zhang *et al.*, 2016). In recent times, the consequences of corruption on corporate financial decisions has attracted much interest from researchers (Tran, 2019, 2020a;).

In some instances for example in international scenario, Caprio et al., (2013) find corruption increases the risk of expropriation leading to firms making more investment to reduce cash holding. Hossain et al. (2021) find that firms increases dividend payment as shielding strategy.

According to the United Nations Conference on Trade and Development (UNCTAD) Economic Development in Africa Report 2020, an estimated $88.6 billion (3.7% of Africa's GDP), leaves the continent as illicit capital flight, every year. This is a major drain of capital and revenues in Africa, increasing their annual financing gap, and undermining their ability to achieve the SDGs. The report depends on the corruption rates according to Corruption Perceptions Index (CPI), and Afrobarometer. The CPI is published by Transparency International Association. It ranks states "by their perceived levels of public sector corruption". There are 180 ranks (180 more corrupt- 1 less corrupt), and each state's score of corruption is out of 100 (0 more corrupt- 100 less corrupt).

Botswana - Corruption Rate:

Botswana is considered the least corrupt Southern African nation, ranking 45th out of 180 countries, and scoring 55/100 in CPI 2021. However, its score has been declining since 2012, when it scored 65/100. In fact, it lost 5 points since 2020, meaning that people in Botswana perceive it to be getting more corrupt over the years. According to Afrobarometer, only 58% of people in Botswana feel that the country is going in the right direction.

Namibia - Corruption Rate:

Namibia is the second least corrupt state in the Southern African region, ranking 58th out of 180 states in the CPI. It scored 49/100, dropping two points from the previous year. Furthermore, according to the Afrobarometer, only 7% of the respondents in the survey reported experiencing a situation where public officials demanded bribery in exchange for public service. It is important to note that Namibian government officials reject the CPI ratings. They deem it as biased against Sub-Saharan states. They argue that the focus should be on factual corruption data and how countries are dealing with corruption.

South Africa - Corruption Rate:

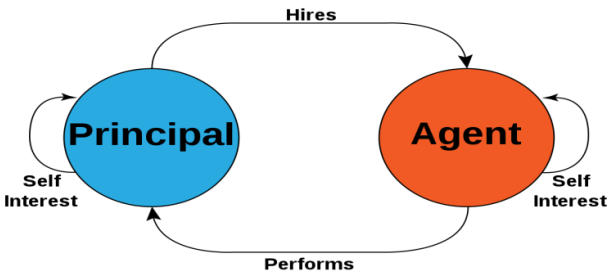
According to CPI 2021, it is the third least corrupt state in the Southern African region, with a score of 44/100. It is the 70th out of 180 states in corruption. It saw neither improvement nor deterioration in its score from the previous year. According to Afrobarometer, 60.5% of South Africans believe that the government was doing "very badly" at fighting corruption, and another 15.4% believed that it was doing "fairly badly". Moreover, corruption ranked second in the list of most important issues facing the country. Three out of four South Africans say people risk retaliation or other negative consequences if they report incidents of corruption.

Corruption is the acts of exploiting public power and position to gain personal interest in a way breaking the rules of the game (Jain, 2001). Corruption is committed by public officials and politicians who control public power. Main causes of corruption documented in prior studies include level of rents and market structure (Ades & Di Tella, 1999); legal (in)effectiveness (Herzfeld & Weiss, 2003); legal, political, and socio-economic characteristics (Paldam, 2002; Treisman, 2000) and quality of institutions (Acemoglu, Johnson, & Robinson, 2001). From macroeconomic perspective, several studies find that corruption tends to harm economic efficiency. In a pioneering research, Mauro (1995) finds a negative impact of

corruption on investment which, in turn, decreases national economic growth. Brunetti, Kisunko, and Weder (1998), Doh and Teegen (2003), and Zakharov (2018) also report that high corruption is one of the most detrimental for investment. Investigating corruption across 26 African countries, Lambsdorff and Cornelius (2000) find supporting evidence for the negative association between corruption and economic performance at the macro level (i.e. economic growth and FDI). Méndez and Sepúlveda (2006) examine the impact of corruption on long-run economic growth under different measures of political freedom across 130 countries. Their research findings show that there is a non-monotonic relationship between corruption and economic growth in free countries after controlling many other economic variables. Although many previous empirical studies show that corruption dampens economic growth from macroeconomic perspective, the relationship between corruption and firm performance is a debatable topic. On one hand, corruption tends to have a positive effect on firm performance through two channels namely "grease money" and "protection money" (Xu et al., 2017). With "grease money" channel, firms bribe public officials or agencies to mitigate red tape and have better access to scarce resources (Wei & Kaufmann, 1999). With "protection money" channel, bribery helps firms decrease the risks of state predation (e.g. firms' property right are protected effectively and their tax rates are lowered). Cai et al. (2004) use entertainment and travel costs in Chinese firms to measure corruption and find that some components of entertainment and travel costs create significant positive returns in spite of their overall negative impact on firm productivity. Svensson (2003) and Wang and You (2012) show that bribery payment is positively correlated with firm growth in Uganda and China. On the other hand, examining the effect of corruption on firm growth in Vietnam with a sample including 741 private firms and 133 state-owned firms, Nguyen and Van Dijk (2012) find that corruption is detrimental for growth of private firms and this relationship is not significant in the sub-sample of state-owned firms. Based on the World Bank database of enterprises surveys, Sharma and Mitra (2015) find corruption is positively linked with export performance and product innovation. Despite mixed evidence for the relationship between corruption and firm growth in prior studies, we argue that a corruption environment is a good opportunity to investigate how corruption affects corporate dividend policy. According to Jensen and Meckling (1976), managers tend to use firm resources for their own benefits instead of maximizing owners' wealth since corporate ownership and control are separated. Consequently, shareholders are likely to force managers to pay dividends as a means to reduce excessive cash which managers can use to fund unprofitable projects (Jensen, 1986; Rozeff, 1982). In a corruption environment, managers need more free cash flows available to make unofficial payments (Pinkowitz, Stulz, & Williamson, 2003). Recently, Thakur and Kannadhasan (2019) also find that cash holdings are positively related to corruption. When managers are more flexible to use corporate cash, they may take this chance to expropriate shareholders by diverting cash into unprofitable projects that serve their own interest. Recognizing this agency problem, shareholders have high incentives to force managers to pay dividends as a mechanism to reduce agency costs. Therefore, we hypothesize that corruption positively affects dividend policy.

H1. Corruption is positively related to both the decision to pay dividends and payout ratio.

Principal agency Theory



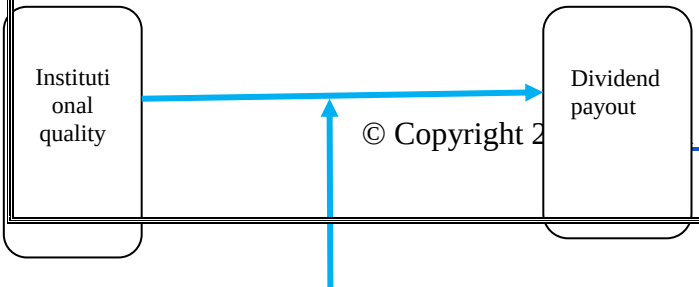
Agency relationship exist between two in which one party(agent) represent the other(principal) in daily transactions. Principal hires an agent to make most of the decisions on his behalf, including but not limited to financial decisions. Principal entrusts his resources but with no interventions on the daily basis. Agent makes decisions without bearing risks.

Agency theory which express that in what manner the executive, and manager (agents) perform in the best interest of owners, and shareholders (Principals) of an organization. Theory consider the relationship wherever in a deal ''one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent'' (Jensen and Meckling, 1976: 308). The AT developed by Jensen and Meckling (1976). AT point out the cost arises due to conflict of interest among manager, debt holders, and equity holders. Jensen and Meckling (1976) considered the conflict between the shareholder and manager and between shareholders and bondholders as major type of conflict those will leads to agency problem thus agency cost. They further stated that agency problem also relative with debt in the shape of risk shifting. Agency theory with the view that the managers issue debt instead of shares and bond themselves to payout future cash flows it is not possible if they distribute the earning in shape of dividend. Through this, they make a promise to debt provider that they will pay the principal plus interest if they fails to do so the debt provider put the firm in bankruptcy court. Consequently, debt decrease the agency costs connected with free cash flow by reducing the cash flow that have to be available for spending based upon the decision of the manager. This influence of debt reflecting it as the determining element of company financial mix (Jensen, 1986) The agency theory highlighted that if the company uses more debt as compared to equity company can get the benefits of tax as the interest payments are tax-deductible. In contrast, the theory said that more leverage also involve more cost. The more levered firms have more bankruptcy cost. Though theory in the view that any firm can only attain the optimal capital structure and maximize the value by matching debt costs with their benefits (Jensen, 1986). The agency theory propose that the firms which having more profitable assets use large portion of their earning for debt payments thus this will increase their credit rating and they

can increase their debt capacity. In the same way those firm having high profit as compared to their investment can also get benefits of debts and lessen the issues regarding free cash flow (Jensen, 1986). Thus, agency theory answers that there is positive connection between profitability of firm and its leverage. Moreover, according to this theory, agency costs related with debt are lesser for firms those having more tangible assets which demonstrate a positive relationship between asset's tangibility and leverage of firm. On the other hand, agency theory reveals that contrary relation between growth opportunities of firm and its level of debt underlining that the underinvestment issue is more serious for firms those are in growing stage this leads them to be less leveraged firms (Frank and Goyal, 2005). Capital Structure Theory MM With No Corporate Taxes The first modern theory of capital structure proposed by the financial economist named "Modigliani and Miller (1958) known as MM model. In this theory, they said that without the corporate taxes there is no possibility for optimal capital structure means that any firm no need to tangle with the issue of capital structure decision. Since it is assume that the value of firm remain unchanged whatever the firm have more or less leverage without considering the corporate taxes. Modigliani and Miller reveals that in absence of corporate taxes the value of firm remain same doesn't matter that the firm is leveraged or all financed with equity. They conclude that if a firm use more debt financing then its equity become more risky and costly and the firm going towards the bankruptcy. The theory taking the assumptions that there is no transaction, agency, and distress cost considering all debts are riskless and both companies and individuals can borrow unlimited amount at risk-free rate. MM.

The desire for personal gain is often understood as the primary cause of public sector corruption, but this is an oversimplification of the complex relationships between individuals and the State. There are several theories that help to deconstruct these relationships. Two of the most popular theories on corruption in the economic literature are the principal-agent model and the related agency problem (see, e.g., Klitgaard, 1988; Shleifer and Vishny, 1993). The principal-agent model assumes that agents (public officials) serve to protect the interests of the principal (whether the public, parliament or supervisors). However, in reality, the interests of the agents often diverge from the interests of the principal, and while the former can prescribe the pay-off rules in the principal-agent relationship, there is an informational asymmetry to the advantage of the agent, which could be used by him or her for personal benefit (Groenendijk, 1997). In this context, an agency problem occurs where the agents choose to engage in a corrupt transaction, in furtherance of their own interests and to the detriment of the interests of the principal. To limit the agency problem, the principal can design incentives and schemes (e.g. monitoring, bonding, and oversight) to curb the agent's potential abuses (for a further discussion on how the principal-agent theory is applied in practice, see Module 13 of the E4J University Module Series on Anti-Corruption).

Conceptual Framework of the study



Key

Agency theory

Model specification

In this study, we adopt the following model to test the expropriation hypotheses, i.e., the negative relationship between local corruption and dividend payouts as follows:

DPR = $\alpha + \beta_1 Corrupt_{it} + \sum Control_{it} + u_i$

We also control both industry fixed effects and year fixed effects in our regressions.

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