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TEMPLATE[1]:

Do We Need A Mandatory Dividend Regulation? The Case of the Indonesian Capital Market

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Abstract

This study examines the dividend life-cycle hypothesis and the propensity of non-financial firms listed on the Indonesian Stock Exchange (IDX) to pay dividends, in light of a recent idea by the IDX to regulate dividend payments. Using several proxies of the life cycle, the results consistently show that Indonesian listed firms follow the dividend life-cycle hypothesis. Our results recommend that if the authority insists on regulating dividend payments, the regulation should take into account the firms' lifecycles. Firms should only be required to pay dividends when they reach a certain stage and/or meet defined characteristics, according to their stage or characteristics.

JEL classifications: G35 G32

Keywords: Dividend life-cycle; dividend policy; propensity to pay dividends; earned/contributed capital; IndonesiaStock Exchange.

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1. Introduction

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This paper aims to contribute to the mandatory dividend policy debate, at the regulatory level in Indonesia's capital market. The IDX states that there are many firms that have not paid dividends although they report positive net incomes.[2] After 1997, only half of the listed firms paid dividends. Despite the growing number of listed firms on the IDX, the percentage of firms that pay dividends seems to remain the same. The IDX's authority finds this to be an unfavorable situation, especially for good corporate governance practices and ultimately for Indonesia's investment climate. They argue that paying dividends is one of the indicators of good corporate governance practice, and investors do not only want capital gains but also dividends. Therefore, in early 2013 the IDX proposed to enact a stricter regulation on the payment of dividends, that included: (1) The minimum frequency for paying dividends in a particular period of reported positive net income, (2) the minimum amount of net income to be distributed as dividends, and (3) the sanctions for non-compliance.[3] Despite lacking empirical evidence, the authority seems to insist on making such a regulation. Yet, implementing this regulation is not a clear-cut issue, and there are pro and contra arguments from the stakeholders.

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2. Literature Review and Hypotheses Development

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3. Data and Methods

3.1. Data and Sample

We use information from the firms' annual reports to find their accounting and ownership data, the Bloomberg database for market data, and the IDX's summary of company performance for dividend information. Following Fama and French (2001), we exclude highly regulated industries,

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[2] *BEI Target Aturan Dividend Selesai Tahun ini,* republika.co.id. ("IDX targets dividend regulation to finish this year"). Republika Online, 23rd of February 2013.

[3] *BEI Target Aturan Dividen Selesai Tahun Ini* ("Indonesian Stock Exchange aims to finalize regulations on dividend payments this year"), Republika Online, 23rd of February 2013.

such as the financial and utility industries, and we also exclude firms with negative equity. The number of firms that meet our requirements is different for each year, due to newly listed firms. After excluding the financial and utility industries, firms with negative equity, those with incomplete financial statement data, and those with extreme values, the final number of our sample for 1995 is 132 industrial firms and this number had become 309 by 2011. Our final sample is 2,600 firm-years.

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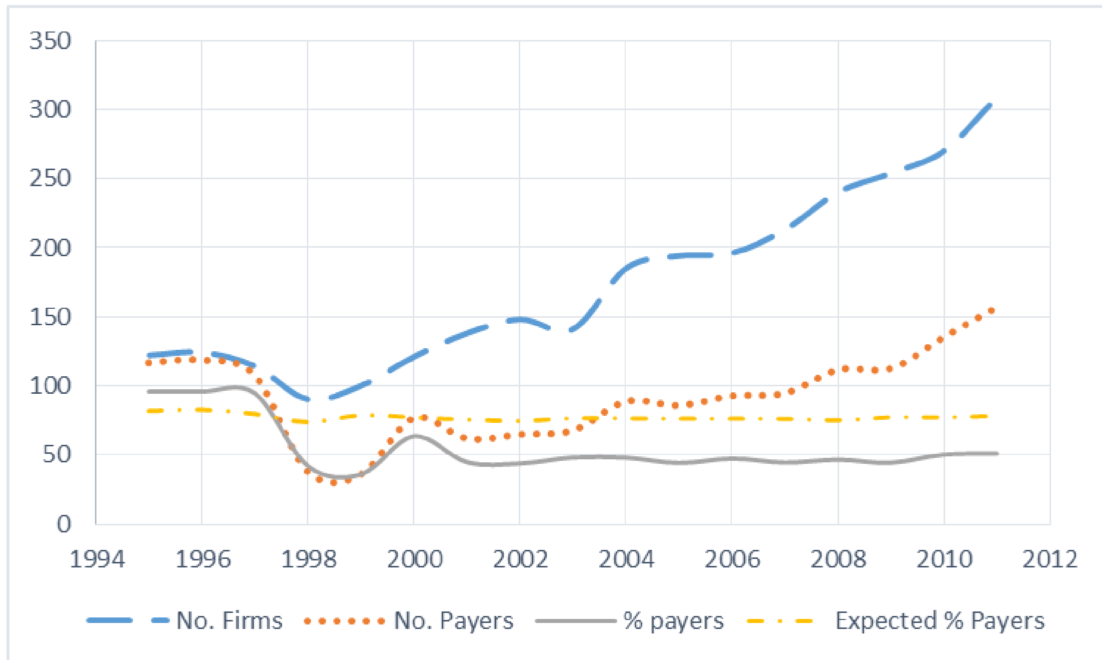
4. Empirical Results

As our dependent variable is a categorical variable, which is a dummy variable taking the value of one if the firm paid a dividend and zero otherwise, we follow Von Eije and Megginson (2008) and test the life-cycle hypothesis using a panel probit regression with random effects. The standard error calculation is adjusted for the clustering of firms. Table 5 presents the main results that indicate the impact of life-cycle measures on the propensity to pay dividends. First we estimate each of our life-cycle measures (*RE/TA, Log Age, FCF/TA,* and *LC-index*) on the dummy dividend payment (*DDIV*) separately (Specifications 1 – 3). The results show that *RE/TE* and *Age* have a positive coefficient and significance at the five percent level. In Specification 3, we have a positive coefficient for *FCF/TA*, but the coefficient is not significant. In Specification 4, we include the three life-cycle measures in the estimation, and all of them have a positive and significant coefficient. Finally, we estimate our life-cycle index (*L-C Index*) in Specification 5. The result shows that the *L-C Index* has a significant positive coefficient as well. These findings suggest that the propensity of firms listed on the IDX to pay dividends tends to follow their life cycle. The more mature the firm is, the higher the propensity to pay. Next, we used the index for the new analyses.

Figure 1. Dividend Paying Firms on the Indonesian Stock Exchange (IDX) 1995-2011.

Figure 1 describes the number of dividend payers in the period from 1995 to 2011, compared to the total number of firms on the Indonesian Stock Exchange (IDX). We excluded the financial and utility industries, and firms with negative equity.



Source: Authors computation.

Table 5. Baseline regression. Propensity to pay a dividend and the firm's life cycle

DDIV	(1)	(2)	(3)	(4)	(5)
RE/TE	0.171**			0.178**	
	(2.29)			(2.35)	
Log Age		0.0335**		0.0353**	
		(2.12)		(2.36)	
FCF/TA			0.749	0.741*	
			(1.63)	(1.66)	
L-C Index					0.217**
					(2.34)
ROA	2.372***	2.211***	2.081***	1.959***	2.187***
	(3.37)	(3.35)	(3.17)	(2.99)	(3.26)
M/B	0.0756***	0.0445*	0.0402	0.0461*	0.0877***
	(2.73)	(1.73)	(1.55)	(1.83)	(3.05)
Cash/TA	2.832***	3.042***	2.947***	3.082***	2.733***
	(3.70)	(3.95)	(3.79)	(4.02)	(3.52)
Size	44.88**	47.44**	53.14**	55.78**	40.84**
	(2.17)	(2.31)	(2.26)	(2.41)	(2.19)
Debt/TA	-0.0170***	-0.0199***	-0.0192***	-0.0192***	-0.0175***
	(-4.70)	(-5.14)	(-5.02)	(-5.05)	(-4.85)
Largest SH	0.390*	0.339	0.340	0.336	0.405*
	(1.68)	(1.31)	(1.31)	(1.31)	(1.76)
HHI Inds.	-1.775**	-1.642*	-1.759*	-1.698*	-1.854**
	(-2.11)	(-1.85)	(-1.94)	(-1.91)	(-2.17)
Constant	4.119***	2.657***	4.558***	3.891***	2.359***
	(5.94)	(3.24)	(6.21)	(5.23)	(3.02)
Year FE	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes
AIC	2184.6	2211.1	2220.4	2219.5	2163.0
BIC	2436.4	2463.2	2472.5	2471.6	2426.5
rho	0.594	0.614	0.635	0.615	0.564
No. of Groups	309	309	309	309	309
N	2,600	2,600	2,600	2,600	2,600

z statistic in parentheses. * p< 10%, **p < 5%, ***p < 1%

Dependent variable is DDIV = dummy variable equals one if the firm pays a dividend and zero otherwise. RE/TE = retained earnings to total equity; Log Age = natural logarithm of the firm's age; FCF/TA = free cash flow to total assets; L-C Index = life-cycle index; ROA = return on assets; M/B = market value of equity to its book value; Size = firm's market capitalization to total market capitalization; D/TA = long term debt to total assets; Cash/TA = cash holdings to total assets; Largest SH = the percentage of shares of the largest shareholder; HHI Inds. = HHI of total assets industry k. Standard error is adjusted for clustering of firms.

5. Summary and Conclusion

This study explains the recent concern of the IDX as to why many firms have not paid dividends. Even though the number of dividend payers is actually increasing, the percentage of firms that pay dividends is relatively stagnant. At the same time, we find that the amount of the dividends paid is increasing, indicating a dividend concentration that is similar to what happens in other countries. As shown in our results, we argue that the reason is due to the changes in the firms' characteristics through their life cycle.

Our results make an important contribution to the dividend policy literature in Indonesia and corporate governance regulations, as we provide relatively new evidence in a broader account using the dividend life-cycle framework. As Lease et al. (2000) suggest, the investment opportunities, agency conflict, asymmetric information and shareholders' tax of a firm all follow the firm's life-cycle, and these factors shape the optimal dividend policy of the firm. Firms cannot be forced to pay dividends with a 'one-policy-for-all' regulation. Therefore, the regulation of dividend payments, if any, should be flexible, taking into consideration which stage each firm is at. If the regulation forces firms in their growth stage to pay dividends, they will incur another agency cost due to suboptimal investments, and this will further raise their costs of capital as they are forced to take more external financing while their information asymmetry and floatation costs are still high, and finally it will harm the shareholders themselves. On the other hand, firms in the more mature stage could expropriate minority shareholders and increase their agency conflict if they pay no or few dividends. The dividend regulation, therefore, should address the issue of those firms that are at the stage where they are capable of paying dividends but do not do so. Thus, if the regulator finally decides to apply the mandatory dividend rule, they should consider the firms' life cycle. The results from our life-cycle index, which we composed for this study, could give a hint that we cannot merely rely on the positive earnings reported by the firms to require them to pay dividends. One should carefully look at each firm's retained earnings accumulations, free cash flows, and age.

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