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The Impact of Political and Macroeconomic Variables on the Dividend Policy: Evidence from an Emerging Economy

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Abstract:

This study aims to examine the impact of political and economic factors on the corporate decision of dividend payout. The data is used from year 1999 to 2019 for the 110 listed non-financial firms of Pakistan and data for political and economic indicators is obtained from the website of World Bank. The econometric estimation technique ARDL (Autoregressive Distributed Lag Models) is used to analyze the data. The findings suggest that the decision of paying dividend is significantly affected by the economic factors and political factors cause the change of perception of management thus making them to take decisions that can mitigate political risks, thus the findings contribute significantly in the existing literature. The policy makers and top management of the firms should account for the political and economic situation while devising the dividend policy, particularly in the emerging economies.

Keywords: Pakistan, Autoregressive Distributed Lag Models (ARDL), corporate decision, political and economic factors, dividend payout, non-financial firms

INTRODUCTION

The cognizance of the significant impact of political conditions of the country on the business activities has resulted in numerous studies incorporating the related variables. The reason for the conscious effort is the consideration that political instability can immensely contribute to the business activities of firms even in the developed countries like US (Click, 2005), as it is the direct

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threat to their foreign investments, so it is important to analyze the country political and economic conditions before any investment. The political factors have a great impact on the decisions taken by the management (Vaaler, 2008) and influence the decision of cross border investments (Alfaro et. al., 2008).

This study aims to understand how political stability and quality of regulations can influence the manager's perception about the conditions of business activities and ultimately devising the dividend payout policy (Brav, et. al. 2005). The management adopts more conservative dividend strategies in the time of high political risk to cope with the problem of capital availability. This indicates that good and stable political set up is responsible for good governance in any country thus developing capital market and enhancing the dividend payments to the investors. The World bank has provided with six indicators that represents the quality of governance in the country. Among those six, two factors (Political Stability and Regulations' Quality) are considered to analyze their impact on dividend payments in an emerging economy.

Along with political factors, economic conditions and the financial policies of the country also have notable effect on growth, financing, and operations of the companies as the policies of the companies are determined by both internal and external variables. There are numerous macroeconomic variables that affect the functioning of firms directly or indirectly. The political and economic instabilities can create many problems in the functioning of the businesses, thus have impact on all the financial decisions taken by the corporate sector. This increases the need for studying the political and economic factors in the context of corporate decision making.

This paper aims to document the effect of macroeconomic and political variables (Inflation, Money Supply, Political stability, Regulatory quality) and how they affect the corporate decisions about dividend payout in Pakistan. Thus the specific objective of the study is to see the impact of macroeconomic and political factors on the dividend policy of the non-financial firms in an emerging economy. The first research question is whether the political factors have an impact on the dividend policy in Pakistan. The second research question is whether the economic factors have an impact on the dividend policy in Pakistan. The impact of firm related variables (Profitability, Size, Leverage, Liquidity) is also analyzed along with macroeconomic and political variables. This study is important and exclusive as macroeconomic and political perspective is included to understand how dividend policy is designed in an emerging economy. There are no evident studies analyzing the impact of political and economic factors on dividend policy in developing countries and it is important to analyze these factors in case of an emerging economy as there is notable evidence in prior literature how dividend policies differ in developing and developed countries. There are less number of studies available in the context of Pakistan so this study fulfills the gap in the literature in the context of an emerging economy. Being and emerging economy we see a lot of instability in the political and economic spheres in Pakistan, and the related factors have a significant effect on the corporate sector of Pakistan, so studying these factors is very important in emerging economies like Pakistan. This is a highly significant study in this context.

LITERATURE REVIEW

The dividend policy is renders as one of the top unsettled issues in the Corporate Finance literature and it is not possible to define dividend policy by only one factor, so it is important to consider the external factors along with internal factors (Black, 1976; Allen & Michaely, 2003; Abor & Bokpin, 2010). The firm related or internal variables are in control of the management, but external factors are not controllable, and it is important to incorporate external both macroeconomic and political factors as they have significant impact on the operations of firms and policies (Belke & Heine, 2006; Basse & Reddemann, 2011; Broadstock et al., 2011).

The strong political institutions of any country allow the investors to receive higher dividend via having strong rights as the stakeholders of the firms (Brav et al., 2005; Choy et al., 2011; Huang & Zhu., 2015). The presence of strong political institutions can have a significant impact on the operations of the company leading to its success or failure and presence of strong political rights in the country make managers consider their demand for dividend while formulating the dividend policies (Roe, & Siegel, 2011; Brav et al., 2005; Al-Jaifi et al., 2017). The countries with weak political institution led to increased financing cost of the firms which can result in adoption of conservative dividend policy by the firms. The regulation quality aims to make required procedure less time taking. This will help the investors to save cost and fulfill the requirements simultaneously. The ease of doing business will build the trust of investors and will enhance the investment and dividend payments so it’s crucial to check its impact on the design of dividend policies.

There are numerous macroeconomic variables that affect the functioning of firms directly or indirectly, so it is important to have information and insight about the magnitude of economic factors to make effective corporate decisions including dividend as the dividend payout is affected by the fluctuations in economic variables like inflation, monetary policy, and real growth (Belke & Heine, 2006; Basse & Reddemann, 2011). The study conducted in United States of America have proposed that inflation have a positive impact on dividend of the firm (Basse & Reddemann, 2011). The market always response to unexpected increase to inflation though the reaction can be of very low magnitude and this inflation can affect the perception of the investors thus causing the increase in the dividend payout (Schwert, 1981; Brigham & Daves, 2010). The investment and financing decisions of corporate sector in the developing countries are mostly dependent on monetary policy, real interest, and Foreign direct investment as this is the tool to addresses many problems at once like price stability, unemployment, smooth business cycle and growth (Khadaroo & Seetanah, 2008; Kahn, 2010).

Although extensive literature is available on how different firm related factors including profitability, ownership structure, size, risk, age, leverage, growth of firm and prior dividend payments affects the dividend decisions (Ali et al., 1993) but the findings of research are not aligned thus making it disputable which factors should be selected by corporate firms to design effective dividend policy. The firm related factors to determine dividend for this study includes Profitability, Size, Leverage and Liquidity as mixed impact of these variables is found in prior literature and studies conducted elsewhere is not reliable, so these variables need to be studied along with economic and political factors to have better insight for corporate sectors and policy makers. Profitability, the ability of firm to produce positive cash flows and it is used as measure of efficiency and success of the business, is considered very important in determining dividend in prior literature. There is mixed evidence in the previous studies and these inconclusive results make it an important determinant to study in case of an emerging economy, Pakistan. The investment decisions of the firms are very much dependent on the size of the firms and large size tend to pay more dividend due to their financial stability and availability of funds (Arif & Akbar, 2013) but sometimes these firms pay less dividend as they are financing the growth via debt and dividend payments are reduced for paying debt services. The amount of debt can decide the dividend payments for the company and companies having cash flows other than debt sources usually pay more dividends, but opinions differ regarding its impact in existing literature. The inverse relation was proposed by many researchers while many also observed a positive relation between leverage and dividend payout. Liquidity is also one of the determinants of dividend policy with inconclusive opinion about its impact on dividend policy. The highly liquid firms tend to pay less dividend and liquidity is kept high by some firms to efficiently pay for their debt services claims and no relationship was also found between the dividend decisions and liquidity.

Attig et al. (2021) check the impact of economic policy uncertainty (EPU) on dividend policy using data from 19 countries and find a positive association between the two. They conclude that dividends are used to mitigate agency problems during high EPU periods. There, study a number of factors which moderate the relationship between the EPU and dividend policy, like firm's free cash flows and governance quality.

Trakarnsirinont et. al. (2023) argue that political uncertainty factors have a major impact on the corporations. They analyze the effect of political uncertainty on the financial performance of the firms in Thailand. They find that the political unpredictability influences firm performance in a developing country. Based on the above literature this study argues that political and economic factors have a major impact on the financial decisions of a firm, thus while discussing the corporate finance decisions these factors should not be ignored and more studies should be conducted focusing these factors in the developing economies context.

This paper aims to document the effect of macroeconomic and political variables (Inflation, Money Supply, Political stability, Regulatory quality) and how they affect the corporate decisions about dividend payout in Pakistan. The impact of firm related variables (Profitability, Size, Leverage, Liquidity) is also analyzed along with macroeconomic and political variables. This study is important and exclusive as macroeconomic and political perspective is included to understand how dividend policy is designed in an emerging economy. In conclusion the two basic hypotheses of the study can be:

H1: Firm related factors have a significant impact on the dividend payout of the firms.

H2: Economic factors have a significant impact on the dividend payout of the firms.

H3: Political factors have a significant impact on the dividend payout of the firms.

MODEL, METHODOLOGY AND DATA

The secondary data from 1999 to 2019 is considered for the study. The data of listed 110 non-financial firms of Pakistan is used to study the impact of variables and firms are selected and selection is based on the payment of dividend since 1999 to the shareholders. There are more than 500 companies from 35 sectors are listed in Pakistan Stock Exchange. Out of these only 110 non-financial companies are selected for this study based on the data on dividend payment. Financial companies are not selected based on the difference in the structure of financial statements. For operationalization of variables we follow the commonly used formulas in the literature.

To find the impact of macroeconomic, political factors and firm related factors on the dividend policy the ARDL method is used. ARDL comes up with many prime benefits such as it provides consistent results regarding small samples according to Monte Carlo. ARDL econometric technique resolves the problems of serial correlation and endogeneity because of the proper inclusion of lags. This method reduces the problem of endogeneity because it is free of residual correlation moreover because of the property of no serial correlation it considers the issue of endogeneity. Of all the estimation techniques ARDL is one of the latest techniques with many advantages. The framework can be written as follows:

$$\begin{aligned}\Delta lnDP_t = \alpha_1 &+ \alpha_{INF} LnINF_{t-1} + \alpha_{PI} LnPS_{t-1} + \alpha_{MS} LnMS_{t-1} + \alpha_{PRO} LnPRO_{t-1} \\ &+ \alpha_{SIZE} LnSIZE_{t-1} + \alpha_{LEV} LnLEV_{t-1} + \alpha_{LIQ} LnLIQ_{t-1} + \alpha_{INV} LnREG_{t-1} \\ &+ \sum_{U=0}^{v} a_{INF}\, \Delta LnINF_{t-c} + \sum_{k=0}^{m} a_{PI} \Delta LnPS_{t-c} + \sum_{l=0}^{n} a_{MS} \Delta LnMS_{t-c} \\ &+ \sum_{c=0}^{d} a_{PRO}\, \Delta LnPRO_{t-c} + \sum_{e=0}^{f} a_{SIZE} \Delta LnSIZE_{t-c} + \sum_{w=0}^{b} a_{LEV} \Delta LnLEV_{t-c} \\ &+ \sum_{h=0}^{g} a_{LIQ}\, \Delta LnLIQ_{t-c} + \sum_{s=0}^{r} a_{INV} \Delta LnREG_{t-c} + \Delta_{1i}\end{aligned}$$

Where DP = Dividend Payout, INF = Inflation, PS = Political Stability, MS = Money Supply, PRO = Profitability, SIZE=Size of firm, LEV = Leverage, LIQ = Liquidity, REG = Regulatory Quality

RESULTS AND DISCUSSION

The study conducts different tests for data analysis. Like, for checking the stationarity of data, unit root test is conducted. The purpose of applying unit root is to avoid spurious regression problems. In this study, Augmented Dickey-Fuller (ADF) test is used to check the stationarity of data. If the results of unit root test indicate that variables used in the study are stationary at either level or first difference, then ARDL approach should be used instead of other cointegration technique and this method also allows to analyze both long term and short-term relationship. The results of unit root test are given below:

Table 1. Stationarity of Data

Variables	Augmented Dickey-Fuller (ADF) Test					
	Intercept			Intercept and Trend		
	t-stats	P-Value	Unit-root result	t-stats	P-value	Unit – root result
DP	-16.99091	0.0000	I (0)	-2.303757	0.0000	I (0)
Inflation	-4.756410	0.0023	I (1)	-4.526583	0.0140	I (1)
MS	-3.503282	0.0212	I (0)	-5.589493	0.0008	I (0)
Profitability	-47.61212	0.0001	I (0)	-47.60246	0.0001	I (0)

Size	-8.254350	0.0000	I (0)	-8.422808	0.0000	I (0)
Leverage	-46.19370	0.0001	I (0)	-20.70091	0.0000	I (0)
Liquidity	-5.946128	0.0000	I (0)	-6.2524000	0.0000	I (0)
PS	-3.394262	0.0245	I (1)	-4.408392	0.0127	I (1)
REG	-4.479772	0.0024	I (0)	-4.702462	0.0067	I (0)

The results of Unit root indicate that all variables are stationary at level or first difference thus ARDL estimation technique is applied for this study. The value of Akaike Information criteria is used to choose optimal lag length. The lag length selected for this study is 1. The stationarity and descriptive statistics (not reported here) of the data shows the normal behavior of the data.

The results of ARDL recorded in the tables shows that size of the firms positively affect the dividend payout ratio and is in accordance with the many prior studies. The profitability also has positive relationship with the dividend payments as the firms earning more profits tends to give more dividend to attract the investors. The results show that the leverage is not positively associated in determining the dividend payments of companies, but some studies also support the opposite of this result. The liquidity and dividend payout are negatively related as the firms with more liquid assets tends to keep more rather than giving away as dividend whereas some studies also suggest the positive relationship.

The significant negative relationship of Political stability and Regulatory quality with dividend policy shows that when political conditions are unstable companies offer more dividend to attract investors. These results are in accordance with the substitute hypothesis in which it is stated that companies will pay more dividends to maintain strong bond with shareholders and for substituting the weak regulatory and governance system.

According to the results, there is a positive relationship between dividend and inflation and these results are in accordance with the study of the (Basse & Reddemann, 2011). This can be explained in the way that the revenue is affected by inflation and thus increasing the earnings and dividend, respectively. The trend in the market can also influence the management decision to increase dividend for attracting investors.

The significant positive relationship of money supply with dividend payout indicates that when there is money in the system and capital is readily available, the firms tend to pay more dividend whereas in the presence of restrictive monetary policies it becomes difficult for the firms to pay dividend along with maintain their liquidity needs as (Kahn, 2010) also stated that business activities are influenced by the monetary policies of the country. The results of ARDL analysis are given in table below:

Table 2. ARDL Model

Variables	**Results of Autoregressive Distributed Lag Models (ARDL)**		
	Coefficients	**t-statistics**	**Prob.**
Dividend Payout	0.141123	0.85104	0.0097*
Size	8.157161	2.256535	0.0373**
Leverage	5.183412	0.724789	0.0421**

Profitability	0.294361	1.56415	0.0374**
Liquidity	6.674123	2.106534	0.0173*
Political stability	-0.08	-1.16	0.122
Regulatory Quality	-0.09	-1.12	0.132
Inflation	0.294731	2.167525	0.0362**
Money supply	7.124532	1.526345	0.0053*

*, ** represent 1% and 5% significance level respectively.

CONCLUSION AND POLICY RECOMMENDATION

This paper is an attempt to investigate the role of political, macroeconomic, and firm related variables on the dividend payout by using ARDL approach. The results depict that indicator of political stability and regulatory quality are not positively related to dividend paid as stated in hypothesis because in the countries like Pakistan where governance is not strong and there is no political stability, companies use dividend to retain and attract investors. The study corroborate the findings of Trakarnsirinont et. al. (2023). This also shows that the dividend policy also affects the agency problem of the firms particularly in the periods when there is more uncertainty as also concluded by Attig et al. (2021). The argument is related to agency theory related to decision making by the management on behalf of the principal.

The dividend policy remains unresolved issue of the corporate finance for decades and this study is an attempt to analyze the firm related factors also along with political and economic variables to study their influence on dividend policy. In case of Pakistan, liquidity and leverage have negative relation with dividend policy whereas size and profitability have positive relationship with dividend policy according to this theory. There is mixed prior literature about all these fundamentals of firms and how they affect the dividend policy. The findings of this study are in line with the findings of Brigham & Daves (2010).

The economic factors are also discussed in this study that how they influence the policies of firms as firms are not working in isolation and any change in the surroundings causing fluctuation in money and availability of money can adversely affect the businesses. The positive relationship is found between inflation and dividend policy and same is true for money supply. The expansionary or contractionary monetary policy can affect the way management decide to utilize the retained earnings. Similarly, inflation can cause increase in dividend payments so it is evident that any surroundings or environment whether political or economic can influence the business functions especially in the emerging markets where the pattern is missing, and countries and firms experience the extreme fluctuations. There is need for more studies with much larger sample to have the better insight of these fluctuations in emerging economies. Regarding the economic factors Belke & Heine (2006); Basse & Reddemann (2011) support the findings of this study.

The practical implication for the management of firms is to access and mitigate the risk due to political or economic conditions before going for any investment, venture, or investments. The political and economic factors should thoroughly be analyzed before making the financial decisions. The limitations of study are that data of only one emerging economy is used and moderating variables are not accounted for in the relationship between the variables. The scope of study can be enhanced by considering other emerging economies for comparing and better understanding of political and economic variables in the cross-country study. Moderating variables can also be included in futures studies, like firms' cash flows and governance factors. For prospects researchers can include number of other political indicators to study their relationship with other corporate decisions about investing and financing.

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