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Economic Reforms, Corporate Governance and Dividend Policy in Sectoral Economic Growth in Pakistan

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1. INTRODUCTION

Economic reforms are inevitable for the development of an economy like Pakistan. During the last two decades, Pakistan has passed through phenomenal economic changes and reforms. In the 1990's, we had seen privatisation plans initiated by the government as a major economic reform. Similarly, to demonstrate the seriousness of the government in encouraging foreign investment flows in Pakistan; there has been a perceptible liberalisation of the foreign exchange regime. Allied to these efforts, the trade regime was opened up and the maximum tariff rates were cut down to 25 percent with only four slabs and the average tariff rate was lowered to 14 percent. The financial sector too, was restructured and opened up to the foreign competition. Foreign and domestic private banks currently operating in Pakistan have been able to increase their market share to more than 60 percent of assets and deposits.

Central to the economic reforms process is a clear progression towards deregulation of the economy. Prices of petroleum products, gas, energy, agricultural commodities and other key inputs are mostly determined by market. Imports and domestic marketing of petroleum products have been deregulated and opened up to the private sector. More importantly, taxation reforms have been prominently on the government's agenda, with no real reforms undertaken. This is another area where policy makers and business community has innumerable grievances and dissatisfaction with the arbitrary nature of tax administration.

The previous military government had introduced a concept of better economic governance. Transparency, consistency, predictability and rule-based decision-making had begun to take roots. Discretionary powers were significantly curtailed. Freedom of press and access to information has had a salutary effect on the behaviour of decision makers. The other pillars of good governance are: (a) devolution of power to the local governments who will have the administrative and financial authority to deliver public services to all citizens, and (b) an accountability process which will take to task those

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indulging in corruption through a rigorous process of detection, investigation and prosecution.

During this earlier period, economic growth was mainly led by consumer goods, with food and pharmaceuticals showing the strongest contribution. Intermediate goods—building materials, fertilisers, industrial chemicals, petroleum products, and other raw material—posted a speedy recovery. Domestic textile industry has been reshaped in recent years with growing scope and depth in terms of products and business strategies. But no matter how obvious the growth is, we unfortunately cannot measure it since the large part of the sector is undocumented. More disturbing is investors' disinterest in textile manufacturing which calls for drastic steps to encourage them. Certainly pessimism regarding global demand is a major issue hurting investment prospects in textiles, and due to energy shortage is the most dominant factor in discouraging additional investments in the sector.

Meanwhile, Pakistan's corporate sector has yet to introduce good governance reforms and optimal dividend policy. The code of corporate governance has been introduced in Pakistan in 2002 but only 5 percent companies have adopted governance practices. Similarly, in case of setting up optimal and consistent dividend policy, only few companies have their consistent dividend policy. In developed economies, corporate governance and consistent dividend policy are important parameters for sustainable economic growth. The dividend policy is always an appealing topic for academics. There are several studies on this subject, but none has studied the role of dividend policy and corporate governance in the presence of economic reforms on sectoral economic growth in Pakistan. This paper tries to establish a link between economic reforms, dividend policy, corporate governance and sectoral growth in the presence of existing pitfalls of the Pakistan's economy. This has not been addressed in the existing economic literature in Pakistan. This paper tries to fill this gap for Pakistan's sectoral growth.

2. LITERATURE REVIEW

Good governance is vital for the development of a healthy and competitive corporate sector. A strong corporate sector boosts "sustained" and "shared" economic growth, i.e. growth that can withstand economic shocks and benefit all stake holders. Countries can, therefore, benefit immensely from corporate governance framework as a tool to address factors leading to sagging economic activity. The most important decision, at corporate level, which emanates from corporate governance mechanism, is the dividend policy. The equitable distribution of economic resources through board of directors can be achieved in developing countries like Pakistan which encourages economic growth. While finance theory largely supports the irrelevance of dividend policy in perfect capital markets, [Modigliani and Miller (1961)]; most people regard payout policy as controversial. Specially, in the presence of taxes and transaction costs, payout policy is regarded as a puzzle. Nevertheless, most firms do pay dividends.

The overall state of Pakistan's economy is stagnant, because in recent years Pakistan has encountered broad economic challenges mainly because of energy crises. The policy-makers have not been able to implement appropriate policies, which resulted

in a sluggish GDP growth. Critical differences between Pakistan and emerging countries that have recently adjusted successfully through economic reforms, such as India, Chile, Brazil and Turkey—lies in Pakistan's inability to grasp the seriousness of the economic crisis and lack of commitment to the needed policy reform i.e., poor governance. It would be imperative to know as to what drove other countries—notwithstanding their political constraints—to improve their governance and steadfastly implement difficult, but necessary, policy reforms and, thus, determine what Pakistan can learn from their experience to improve governance.

Pablo, *et al*. (2008) investigate the extent of the institution with better practices of corporate governance is related to the economic growth in Brazil. The evidence suggested that companies who adopt better practices of corporate governance have better performances (collect more benefits) in the economic growth cycle than those companies that do not adopt them. Sulesa, *et al.* (2010) found a negative relationship between investment opportunity set and dividend policy is weaker for firm with larger board size and larger number of independent directors representing the board. Arun (2005) investigated the impact of good governance practices in financial institutions on the economic growth of a country through financial development in Bangladesh. The role of corporate governance was found to be significant in the performance of banking sector in Pakistan in both conventional and Islamic banks [Rehman, *et al*. (2010)].

Burki, *et al*. (2007) suggested that there is an impact of corporate governance changes on banking efficiencies in Pakistan. Apart from the financial sector, Rehman, *et al*. (2010) explored the influence of corporate governance practices on return on equity in pharmaceutical sector of Pakistan. The concept of dominance of family business is characterised in Pakistani markets where they developed as group and their performance is distinguished from firms which are not under such group as in the case of Japan. Ramiz, *et al*. (2012) studied a positive and significant impact of board size on return on asset and return on equity in the banking sector of Pakistan. The explanation regarding the signalling theory given by Bhattacharya (1979) and Williams (1985) suggested that dividends accompany information asymmetry between managers and shareholders by delivering inside information of firm's future prospects.

Agarwal, *et al.* (1996) identified a negative relationship between board independence and firm's performance. The presence of institutional nominees is a unique feature of Indian corporate governance and there has been a powerful corporate lobby in favour of removing them from boards. While this would reduce the accountability of Indian boards even further, the reports argue that a more active approach to corporate governance on the part of institutional investors requires larger changes in the nature of the FIs' ownership and control by government, greater autonomy for institutional managers, and the active development of a market for corporate control. Several other studies conducted in different countries showed the same relationship. Recent studies suggest dividends' role as monitoring mechanism, which allows minority shareholders to control the managers or larger shareholders' decisions. The development of capital markets is related to minority shareholders protection [Dragota (2006)]. Hence, dividend policy serves as a mechanism for capital market development thereby contributing to

overall economic growth. Myers' (1984) pecking order description of the capital structure decision implies a link between the firm's dividend payout and its investment requirements and earnings variability. Dividend payout behaviour of U.S. firms as observed by the researchers supported their argument [Jensen, Solberg, and Zorn (1992); McCabe (1979); Rozeff (1982)].

Although dividend payouts are a function of firm specific variables such as investment requirements and earnings variability, Lintner (1953) hypothesises that dividend policy also is influenced by an industry effect. This effect could be interpreted as common correlations with determinants of dividend payout by firms in the same industry, but Lintner suggests an effect of dividend leadership analogous to price leadership or wage leadership. Such an industry effect, if it exists, presumably stands apart from other firm-specific variables that affect payout decisions of the member firms within an industry and causes industries to have varying dividend policies. Some evidence suggests that there is significant variation in dividend payout ratios among industries [Baker (1988); Michel (1979)].

3. RESEARCH DESIGN

3.1. Data Collection

Our study explores the relationship between economic reforms, dividend payout ratio, corporate governance and sectoral economic growth in Pakistan. The analysis covers a period of ten years from 1998 to 2008. This study is related to two major sectors of Pakistan, Large Scale Manufacturing Sector (LSM) and Financial Sector (FS). The reason behind selecting these two sectors is the major contribution of these two sectors in total GDP. The financial sector of Pakistan contributes approximately 52 percent of the total GDP while the Large Scale Manufacturing (LSM) contributes 24 percent. The sample sectors are amongst the biggest sectors in Pakistan. There are a large number of companies in each sector. However, we have included only those companies whose data are available and published by State Bank of Pakistan in its annual reports. The breakdown of the sample by sectors and years given in Table 1. The total number of observations is 3,643. The 84.30 percent observations belong to LSM, because LSM is the largest sector in Pakistan. But in recent year's financial sector (FS) is also growing very rapidly, the contribution of FS observations in this sample is 15.70 percent.

The reason for choosing this particular period is the variation and introduction of economic reforms in Pakistan, which are reflected in the macro-economic indicators. For example, in Pakistan, we have experienced a high economic growth in last decade (1998–2008) and afterward a sharp decline too. The data is collected from the annual reports of State Bank of Pakistan, and Federal Bureau of Statistic: Pakistan. We applied two-stage regression analysis for this study to avoid the possible endogenous relationship among GDP growth and sectoral economic growth. Since the sectoral economic growth may influence on the overall GDP growth, hence likely to be endogenous variable.

Table 1

Sample Break Down

By Sector

Industry	Frequency	Percent
Large Scale Manufacturing		
Textile	1322	36.29%
Chemical	285	7.82%
Engineering	301	8.26%
Sugar	240	6.59%
Paper and Board	85	2.33%
Cement	101	2.77%
Fuel and Energy	190	5.22%
Tabaco	25	0.69%
Jute	41	1.13%
Vanaspati and Allied Industry	38	1.04%
Misc. Industry	443	12.16%
Total Manufacturing	**3071**	**84.30%**
Financial		
Public Banks	46	1.26%
Private Banks	175	4.80%
Foreign Banks	58	1.59%
Specialised Banks	44	1.21%
Insurance Companies	78	2.14%
Leasing Companies	17	0.47%
Investment Banks	14	0.38%
Modarba	49	1.35%
Mutual Funds	30	0.82%
DFI's	11	0.30%
Exchange Companies	41	1.13%
House Finance	3	0.08%
Venture Capital	6	0.16%
Total Financial	**572**	**15.70%**
Total Sample	**3643**	**100.00%**

By Year

Year	Frequency	Percent
1998	413	11.34%
1999	412	11.31%
2000	248	6.81%
2001	227	6.23%
2002	220	6.04%
2003	210	5.76%
2004	197	5.41%
2005	206	5.65%
2006	418	11.47%
2007	539	14.80%
2008	553	15.18%
Total	3643	100%

3.2. Two Stage Regression Model

The variables included in this analysis are: dividend payout Ratio (DPR), sectoral economic growth (SG), ownership concentration (OWCEN), board Independence (BDIND), board size (BS), gross domestic product (GDP), interest rates (IR), and foreign direct investment (FDI). The dividend payout ratio (DRP) is defined as the total dividend paid by a company either in term of cash or stock in a given year. Sectoral economic growth is the growth rate of a particular sector in a given year. The interest rates (IR) are the annual nominal interest rates in Pakistan. The Foreign direct investment growth is the annual growth rate in FDI in Pakistan. Gross domestic product growth is the annual growth in country's gross domestic product. Board independence is the proportion of independent directors in the board, if a proportion is greater than 0.5 then assigned a value 1 otherwise 0. Board size is the number of directors in the board. Ownership concentration is the proportion of majority shareholders in a company, if the proportion is greater than 0.5 then assigned a value of 1 otherwise 0.

First Stage Regression Model

In first stage regression, GDP annual growth is regressed on lagged GDP annual growth rate, dividend payout ratio, annual interest rate, foreign direct investment annual growth rate, ownership concentration, board size and board independence. At this stage, we estimate GDP annual growth and use it in the second stage as an explanatory variable.

$$\text{GDP growth} = \alpha_1 + \beta_1 \text{DPR} + \beta_2 \text{lagGDPGrowth} + \beta_3 \text{IR} + \beta_4 \text{FDIGrowth} + \beta_5 \text{OWCEN} + \beta_6 \text{BDIND} + \beta_7 \text{BS} + \epsilon_1$$

Second Stage Regression Model

In second stage, estimated GDP annual growth rate is used as an explanatory variable along with dividend payout ratio, annual interest rate, foreign direct investment, ownership concentration, board independence and board size to estimate sectoral economic growth.

$$\text{SG} = \alpha_1 + \beta_1 \text{DRP} + \beta_2 \text{GDP}_{\text{EGrowth}} + \beta_3 \text{IR} + \beta_4 \text{FDIGrowth} + \beta_5 \text{OWCEN} + \beta_6 \text{BDIND} + \beta_7 \text{BS} + \epsilon_1$$

The expected signs are as follows: $\beta 1 > 0$, $\beta 2 > 0$, $\beta 3 < 0$, $\beta 4 > 0$, $\beta 5 < 0$, $\beta 6$ and $\beta_7 > 0$, ϵi is the error term, where $i = 1, 2, 3$, $\epsilon_I \sim N(0, \sigma^2)$. The models follow the assumptions of classical linear regression and some variations of it. The significance of this model will be further analysed by applying ANOVA (Analysis of Variance).

4. EMPIRICAL RESULTS

Table 2 shows the descriptive statistics of the study. The mean GDP growth rate and interest rate over the period of ten years are 5.39 percent and 9.25 percent respectively. The trend of GDP growth over the sample period is mixed. The study period have three different phases in term of political, economic and global changes. Initially during 1998–2001, the GPD growth in Pakistan is on the declining side due to various geo-political changes within the country and globe. The political government was taken over by military commander in late 1999 which created a severe political crisis in the country. The impact of that political crisis was shown in the country's economy by large. The situation becomes worse by 9/11 which affected the world economy very badly.

Table 2

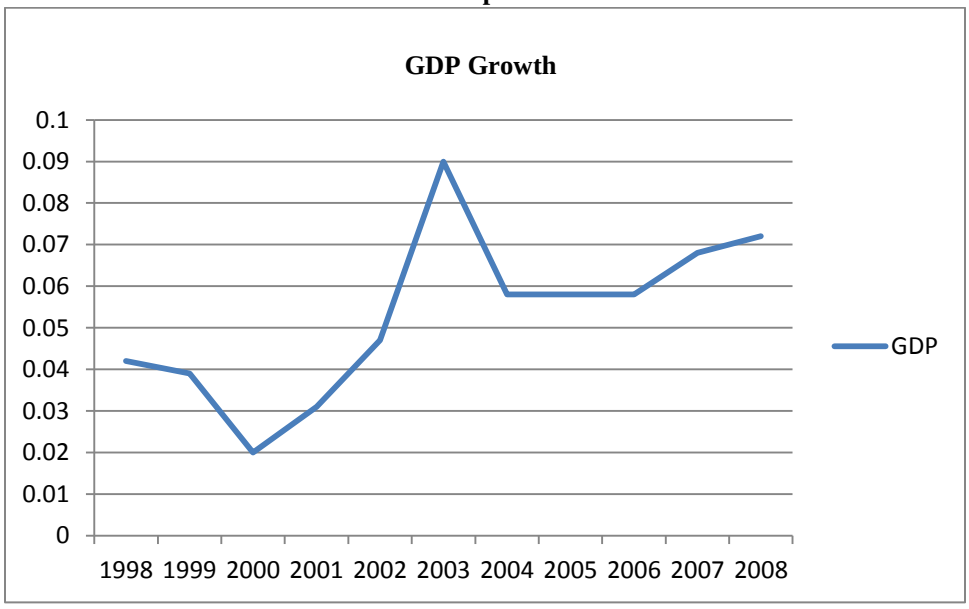
Descriptive Statistics

Variables	N	Mean	Median	Std	Q1	Q3
SEC_GDP	20	7.80%	6.90%	6.53%	4.80%	9.30%
GDP	10	5.39%	5.80%	1.88%	3.90%	7.20%
INT	10	9.25%	9.50%	1.80%	7.50%	10.00%
FDI	10	–2.60%	26.50%	80.10%	–19.10%	44.80%
DRP	3643	2.64%	0.00%	9.31%	0.00%	2.30%
OWNCON	3643	0.92	1	0.25	1	1
BI	3643	0.629	1	0.48	1	1
BS	3643	8.6	8	2.6	7	11

After a hopeless situation in late 1990's and early 2000, Pakistan' economy was then stabilised a bit by introducing a stable political system and more precise industrial and economic policies. Those positive changes were reflected in the country's GDP, and in mid-2000 Pakistan had achieved its historic growth rate in GDP. The financial sector at that time was in boom and major contributor in total GDP. The interest rates are more stabilised and Pakistan was emerging as a new economy at that time.

The last phase in late 2007 and early 2008 was also a shift of political and economic change in the country. Almost nine years of military regime dominated by Musharaf was ended in 2008. From the very first day, the new political government in Pakistan faced severe economic and security concerns. The impact of that economic crisis was reflected on the gross domestic product growth rate and interest rate. The GDP growth rate was declined again with an increase in discount rate. The following graphs are shown the trend of GDP growth and interest rates during the study period.

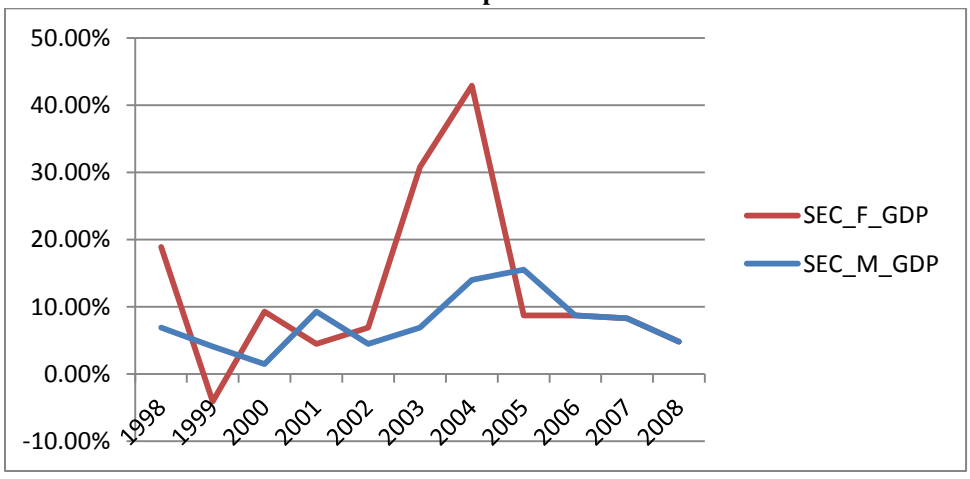
Graph 1



Graph 2

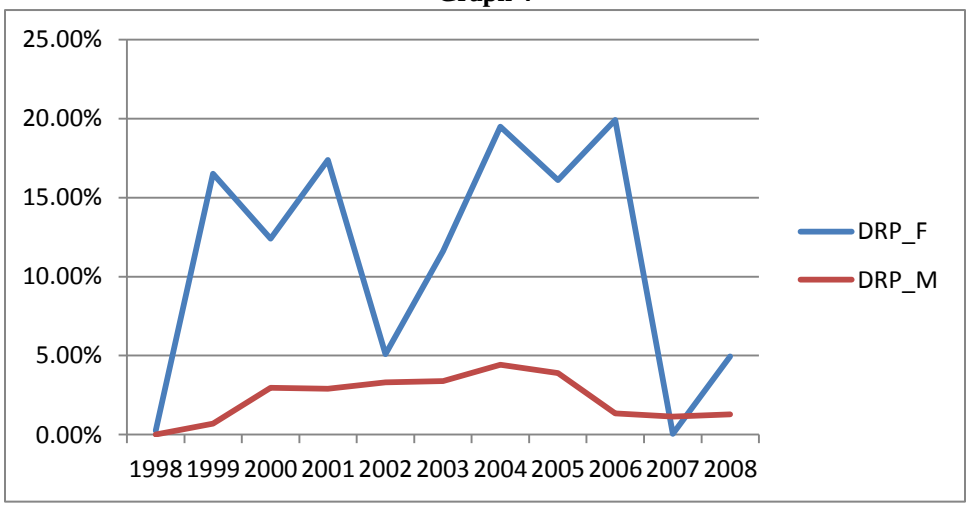
The mean sectoral economic growth of LSM and FS is 7.8 percent which is higher than the overall mean GDP growth rate but with high variation. The mean of sectoral economic growth (SEG) is mostly contributed by financial sector. The SEG of large scale manufacturing sector (LSM) has showed a much consistent trend as compared with SEG of financial sector (FS) during the last decade. In few years, the sectoral economic growth of LSM has declined from its average sectoral economic growth of 7.68 percent. But in most years, the SEG of LSM was closer to its average. On the other hand, the financial sector (FS) has experienced it's boom time during the last decade. Financial sector has started with a negative SEG in 1999 then achieved its highest SEG in mid-2000 and then a sharp declined in 2007. The average SEG of FS was 12.7 percent during 1998–2008. The comparative trends of both SEG are show in the following graph.

Graph 3



The mean dividend payout ratio in both sectors is 2.64 percent which is not very high ratio, but variation in DPR is very high. The reason behind a low average of DPR is textile sector. But the variation in dividend payout ratio shows that the other firms in the sample have very high percentage of dividend. It has been considerably noticed that the dividend payout ratio of textile sector is very low during the last decade. The high dividend payout ratio in financial sector is one of the important indicator of financial sector growth and its contribution in total GDP. The average dividend payout ratio of financial sector during 1998–2008 was 11.24 percent whereas DPR of LSM was 2.3 percent.

Graph 4



The average FDI growth rate during the study period is –2.60 percent which seemingly not in line with the given GDP growth rate at the same time 80.10 percent standard deviation is observed in FDI. The average board size in both sector's firms is 8, whereas on average there is an ownership concentration in both sector firms with some board independence which is very unlikely.

Table 3

Pearson Correlation

Variables	SEC_GDP	GDP	DRP	FDI	INT	OWNCON	BI	BS
SEC_GDP	1	0.094***	0.092***	0.06	–0.073***	–0.004	0.026	0.021
GDP		1	0.040**	0.12	–0.02***	0.002	0.081	0.012
DRP			1	0.01*	0.05*	–0.003	–0.028**	–0.043**
FDI				1	0.032	0.01	0.049	0.031
INT					1	0.045	0.02	0.008
OWNCON						1	0.339***	0.164***
BI							1	0.57***
BS								1

* Signifinance at the level of 10 percent (One- tail test).
** Signifinance at the level of 5 percent (One- tail test).
*** Signifinance at the level of 1 percent (One- tail test).

Table 3 gives the Pearson Correlation among all variables. The highest correlation is among Board Independence and Board Size (r=0.57) and it is significant at 1 percent level of significance. It is theoretically in line with the literature that higher the board size higher is the board independence. The correlation coefficients between ownership concentration with board size and board independence are positive and significant at 1 percent level of significance which is very unusual. There is a negative and significant relationship between dividend payout ratio and board independence (r=–0.028). The correlation between sectoral growth and interest rate is also negative and significant (r=–0.073).

To analyse further, we run two stage-regression to find out the impact of economic reforms, corporate governance variables and dividend policy on sectoral economic growth (SEG). In first stage-regression, we estimated model 1, and then used the results of model 1 in second stage regression. In Table 4, first stage-regression result shows that the overall model is significant at 1 percent level of significance. The co-efficient of lag GDP growth rate is highly significant at 1 percent, which shows an impact of lagged GDP on GDP growth rate. The interest rate co-efficient is negatively significant at 5 percent level of significance, showing its negative impact on the economy growth. The dividend payout rate has positive and significant impact on GDP growth rate. All three governance variable ownership concentration, board independence and board size has positive but non-significant impact on over all GPD growth. The adjusted R^2 of first stage regression is 18 percent.

In second stage-regression, result shows that the overall model is significant at 1 percent level of significance.

The GDP_E coefficient is positive and significant at 1 percent level of significance. This shows that growth in GDP can contribute into an individual sectoral economic growth of a country. The interest rate coefficient is negative and significant at 10 percent level of significance. It is consistent with the literature that interest rates are negatively associated with economic growth. High interest rates increase the cost of doing business for a company which results in low profits. The FDI has a positive but insignificant impact on sectoral economic growth. The role of economic reforms in determining the sectoral economic growth is established from the results of this study. Both GDP growth and interest rate are the part of economic reforms and both have significant impact on sectoral economic growth.

The result also shows that there is a positive and significant impact of dividend policy on sectoral economic growth. The companies having consistent and high dividend payout ratio experience high economic growth. A consistent dividend policy plays an important role in building confidence among investors. There is general trend in case of Pakistan's capital market, investors are more willing to invest in those companies and sectors whose dividend payout ratio is higher than others. The results of this study also support this argument.

Among three corporate governance variables, ownership concentration and board independence have positive and significant impact on sectoral economic growth, which is very unlikely for ownership concentration. There is a positive but insignificant impact of board size on sectoral economic growth. The adjusted R^2 of second stage regression is 25 percent.

Table 4

Two Stage-Regression

Variables	Predicted Signs	Co-efficient	t-statistics	P-value
Panel A: First Stage-Regression				
Intercept	?	0.034	19.70	0.000***
lag_GDP	+	0.410	25.37	0.000***
FDI	+	0.160	1.60	0.150
INT	–	–0.012	–3.02	0.02**
DRP	+	0.005	2.08	0.036**
OWNCEN	–	0.006	1.92	0.51
BI	+	0.001	4.31	0.23
BS	+	0.100	3.37	0.19
N			3,643	
F-Statistics			128.890	0.000***
Adjusted R^2			18%	
Panel B: Second Stage-Regression				
Intercept	?	0.012	1.250	0.211
GDP_E	+	1.280	8.940	0.000***
FDI	+	0.020	1.100	0.310
INT	–	–0.008	–1.840	0.064*
DRP	+	0.064	6.190	0.004***
OWNCEN	–	0.020	4.180	0.071*
BI	+	0.032	5.190	0.016**
BS	+	–0.005	–0.099	0.320
N			3,643	
F-Statistics			24.350	0.000***
Adjusted R^2			25%	

The dependent variable in first stage-regression is GDP. The dependent in second stage-regression is SEC_GDP.lag_GDP is a lagged value of GDP in first stage, whereas GDP_E is the fitted value of GDP from first stage.

* Signifinance at the level of 10 percent (One- tail test).

** Signifinance at the level of 5 percent (One- tail test).

*** Signifinance at the level of 1 percent (One- tail test).

5. CONCLUSION

In Pakistan, we had gone through phenomenon economic and structural changes during the last decade. The decade was important for Pakistan in term of political and economic changes in the country. That is the very reason, we have chosen that period for our study. The main objective of this study is to identify any relationship between sectoral economic growth, economic reforms, corporate governance and dividend policy. The study tries to establish a link between different but important indicators of an economy. To setup an optimal dividend policy is an important issue for any firm.

The results of this study have three aspects, first, the impact of economic reforms on sectoral economic growth. In economic reforms variables GDP growth and interest rates have positive and negative impact respectively on sectoral economic growth while FDI has no impact. This shows low interest rates and high economic growth contribute in sectoral economic growth. If economy is growing then its effect will be reflected in the industry's progress as well. The second aspect of the analysis is dividend policy. Dividend policy has always been an important factor to study for a company's performance and its growth. It has a positive impact on sectoral economic growth. The high dividend payout ratio leads to high growth in a respective sector. The reason behind

this argument is that high dividend payout ratio is always an attraction for th investors to invest in those companies or sector who have high dividend payout ratio. The argument is very well supported by our results i.e., historical figures showed that there was a very high dividend payout ratio in FS, on the other hand, a very low dividend payout ratio in LSM. In result of that, FS has contributed significantly very much in sectoral economic growth and overall GDP as compared to LSM.

The last and the third part of the analysis looks at the impact of corporate governance practices on sector growth. The result shows that board independence has an important role in the progress and growth of LSM and FS. While, unlikely, our results suggest that ownership concentration is also an important factor for the growth of these sectors. The result shows an indifferent impact of board size on sectoral economic growth. Overall economic reforms, corporate governance and dividend policy are important ingredients for sectoral economic growth of Large Scale Manufacturing and Financial Sectors. Further studies can extend this phenomenon for others sectors.

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