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 growth of an economylike Pakistan.Infact, their role is mostsignificantto examinethe economy ofPakistan. During the last decade, Pakistan has passed through phenomenal economic changes and reforms. In the 1990's, we had seen privatization plans initiated by the government as a major economic reform. Similarly, to demonstrate the seriousness of the government in encouraging foreign investmentflows in Pakistan; there has been a major and perceptible liberalization of the foreign exchange regime. Allied to this effort, the trade regime was opened up and the maximum tariff rateswere cut down to 25 percent with only four slabs and the average tariff rate waslowered to 14 percent.The financial sector too, was restructured and opened up totheforeign 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 beenprominently on the government's agenda, with no real reforms undertaken.This is another area where policy makers business community has innumerable grievances and dissatisfaction with the arbitrary nature of tax administration.

Above of all the previous government has 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 included information has had a salutary effect on the behavior 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 indulging in corruption through a rigorous process of detection, investigation and prosecution.

During this earlierperiod, economic growth was mainly led by consumer goods, with food and pharmaceuticals showing the strongest contribution. Intermediate goods – building materials, fertilizers, 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. Given a larger employment intensity of services sector, we believe that the sector's 52 percent contribution in domestic economy and employment has further increased. 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; due toenergy supplies is the most dominant factor in discouraging additional investments in the sector.

This paper will try to cover some ignored areas in the context of Pakistan. The dividend policy is always a very appealing topic for academics. Many papers have been written on this subject, but no one studied the impact of firm performance and ownership structure on dividend payout ratio. The paper tries to study the impact of economic reforms, corporate governance and dividend policy on economic sectoral growth of Pakistan.

This paper tries to develop a model between economic reforms, dividend policy, corporate governance and sectoral growth in the presence of existing pitfalls of the Pakistan'seconomy. This is a relativelynew approach and has not been addressed in the existing economic literature. In Pakistan, few studies have looked at this phenomenon without comprehensively incorporating the role of good governance in different models and in different scenarios but no one tried to combine these factors in one model.

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 allstake 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,(Mod. 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 pay dodividends.

The overall picture of Pakistan’s economy is very poor,because in recent years Pakistan has encountered broad economic challenges mainly because ofenergy 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. Pakistan can generate a greater bounce in its economy than India by improving its governance. It has occurred before in the country's difficult economic history and could happen again. (Dr. ShahidJavedBurki, Dawn, 12th October 2010).

A recent article published in *Dawn* providesan overview of the Pakistan economy and points out the same fact as:

"Going by the current performance of the economy, the external sector outlook, fiscal deficit and energy crisis would continue to challenge problem solving skills of economic governors as they did in the past. After the release by the US of $1.18 billion stuck-up Coalition Support Fund and sustained increase in worker remittances, exchange rates are now somewhat stable. On the other hand, bankers worry that despite release of the CSF, the external sector does not look stable. But continuous fall in exports pose a risk to the balance of payments position. However, some say that falling exports are regional phenomenon. The stagnant level of tax collection and shelving of dozens of tax evasion cases show FBR's inability to influence, constrained by the upper level. However structural change made in state-owned enterprises like PIA and Pakistan Steel Mills create hopes among government officials for large inflows of non-tax revenues." Though the economy seems to have been recovering from economic malaise, the inability to fix energy crises, tax collection and circular debt problem seems to exhibit non-existence of good governance (Dawn, 3rd September 2012, Economic and Business Review).

Literature points that the development of the stock market depends on the introduction of good practices of corporate governance, what in its own would make the country economic growth more dynamic. A study by(Pablo Rogers, 2008) investigates 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.(Pablo Rogers,2008)

Sulesa et al (2010) found a negative relationship between investment opportunity set and dividend policy is weaker for firm with lager 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 avery important in the performance of banking sector in Pakistanin 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 characterized 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. (Nishat, et al. (2004)).Agarwal, et al. (1996) identified a negative relationship between board independence and firm's performance.

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 signaling theory given by Bhattacharya (1979) and Williams (1985) suggested that dividends accompany information asymmetry between managers and shareholders by delivering inside information of firm future prospects.

The issue of corporate governance of financial institutions must get due importance along with the decision of financial liberalization or else liberalization would only add to the woes of thousands of depositors along with inefficient banking system.(MazrurReaz and Thankom Arun,2005).

The corporate governance in the context of large private sector companies in India against a regulatory background is changing rapidly(JairusBanaji and Gautam Mody,2011). Based on over 170 interviews with a very wide range of business representatives, including CEOs, non-executives, fund managers and audit firms, the two reports whichmake up the study highlight the ineffectiveness of boards in Indian companies, the lack of transparency surrounding transactions within business groups, the divergence of Indian accounting practices from international standards, and the changing role of, and controversy surrounding, institutional shareholders. Respondents concurred on the failure of the board as an institution of governance in Indian companies, despite the large presence of non-executives.

The authors argue that regulatory intervention needs a much stronger definition of ‘independence’ for directors, in line with best practice definitions now adopted in the US and UK, as well as the mandatory introduction of nomination committees. In the accounting field, the most serious lacuna is the lack of consolidation of accounts, even if 51% may be too high a threshold for consolidation in the Indian context.

Finally, the presence of institutional nominees is a unique feature of Indian corporate governance and there has been a powerful corporate lobby in favor 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

Laura et.al (2008) exploresthe link between capital markets development and economic growth. Their study examined the correlation between capital market development and economic growth in Romania using a regression function and VAR models. The results show that the capital market development is positively correlated with economic growth, with feed-back effect, but the strongest link is from economic growth to capital market, suggesting that financial development follows economic growth, economic growth determining financial institutions to change and develop. Several other studies conducted in different countries showed the same relationship. Recent studies in Finance 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 behavior 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) hypothesizes 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).

It is not clear from these studies, however, whether an industry effect persists after other determinants of dividend payout have been controlled. If, as seems likely, firm-specific determinants cluster similarly within groups of like firms, then such commonalities could serve to drive much of the industry separation detected in prior research. Our paper presents tests for industry growth on the dividend decision.

3- Research Design:

3-1 Data Collection

Our study explores the relationship between economic reforms, dividend payout ratio, corporate governance and sectoral economic growthin Pakistan. The analysis covers a period of ten years from 1998 to 2008. This study will cover two major sectors of Pakistan, Large ScaleManufacturing Sector and Financial Sector. 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% of the total GDPwhile Large Scale Manufacturing (LSM) contributes 24%.

The sample sectors are one of the biggest sectors in Pakistan. There are number of companies included in each sector. The collection of data though is a difficult task. So the study is included only those companies in each sector in the sample whose data is available and published by State Bank of Pakistan annual reports. The breakdown of the sample by sectors and years is as under. The total number of observations is 3,643. The 84.30% 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%.

Table-I

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%
Specialized 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%**

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 data publishing reports of State Bank of Pakistan, and Federal Bureau of Statistic Pakistan of all sectors listed in Karachi Stock Exchange. We will run two-stage regression analysis for this study to avoid the possible endogenous relationship among two growth variable including GDP growth and sectoral economic growth. Since the sectoral economic growth may influence on the overall GDP growth, hence likely to be endogenous variables. Therefore, we will estimate the first stage model as follow:

3-2 Model

The variables included 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. 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.

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

And then the second stage model, by using the fitted values of the possible endogenous variable.

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

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, ϵ_I ˜ N (0, $б^2$). The models follow the assumptions of classical linear regression and some variations of it. The significance of this model will be further analyzed by applying ANOVA (Analysis of Variance).

4- Empirical Results

Table-II

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

Table -II shows the descriptive statistics of the study. The mean GDP growth rate and interest rate over the period of ten years are 5.39% and 9.25% respectively. The results show less variation during this period in both variables. The mean sectoral economic growth of LSM and FS is 7.8% which is higher than the overall mean GDP growth rate but with high variation. The mean dividend payout ratio in both sectors is 2.64% which is not very high ratio, but variation in DRP is very high. The average FDI growth rate during the study period is -2.60% which seemingly not in line with the given GDP growth rate at the same time 80.10% 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-III

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% (One- tail test)

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

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

Table-III gives the Pearson Correlation among all variables. The highest correlation is among Board Independence and Board Size (r=0.57) with significance at 1%. Subsequently followed with unlikely positive correlation between ownership concentration and board independence (r=0.33) and between ownership concentration and board size (r=0.164) and both are significant at 1% level of significance. There is a negative and significant between dividend payout ratio and board independence (r=-0.028) which is in line with the literature. The correlation between sectoral growth and interest rate is also negative and significant (r=-0.073).

To analyze further, we run two stage-regression to find out the impact of economic reforms, corporate governance variables and dividend policy on economic sectoral growth. In first stage-regression, we estimate model 1, and then use the results of model 1 in second stage-regression.

In table-IV, first stage-regression result shows that the overall model is significant at 1% level of significance. The co-efficient of lag GDP growth rate is highly significant at 1%, which shows an impact of lagged GDP on GDP growth rate. The interest rate co-efficient is negatively significant at 5% 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%.

Table -IV

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%	

Variables	Predicted Signs	Co-efficient	t-statistics	P-value
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, where as GDP_E is the fitted value of GDP from first stage

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

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

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

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

The GDP_E coefficient is positive and significant at 1% 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% level of significance. The FDI has a positive but insignificant coefficient. The result also shows that there is a positive and significant impact of dividend policy on sectoral economic growth. 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%.

5- Conclusion:

The study tries to establish a connection between different but important indicators of an economy. In Pakistan, we had gone through phenomenon economic and structural changes during the last decade. The last decade (1998-2008) is very important for Pakistan in term of political and economic changes in the country. That is the very reason, we have chosen the same 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 result shows that all three factors, economic reforms, corporate governance and dividend policy have significant impact on sectoral economic growth of Large Scale Manufacturing and Financial Sector. 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 in good shape then its effect will be reflected in the industry's progress as well.

The second part of the analysis focuses 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.

Dividend policy has always been an important factor to study for a company's performance and its growth. This study is also established this factor as an important one while assessing the determinants on sectoral economic growth. It has a positive impact on sectoral economic growth which is very unlikely with literature.

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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