Corporate Earnings Retention Practices in Africa: Does Being Foreign Really Matter?

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Contents

List of tables

List of figures

List of abbreviatons and acronyms

AfMNCs   African MNCs
FDI   Foreign Direct Investment
ILO   International Labour Organization
MNCs   Multinational Corporations
UNCTAD   United Nations Conference on Trade and Development
WDI   World Development Indicators

Abstract

This paper examines the earnings retention practices of incorporated firms in Africa. It hypothesizes that foreign and local firms operating in Africa have similar retention policies, and by extension similar tendency for capital exports. It makes use of robust descriptive and empirical methodology involving 444 (and 293 for the empirical analysis) listed firms, in 13 exchanges over the period 2005–2018. The results show that corporate earnings retention is context sensitive; and that being foreign is indeed a deciding factor. The empirical evidence, based on the application of system dynamic GMM estimation procedure, further reveals that: firms with majority foreign interests are less likely to pursue aggressive earnings retention policies; earnings retention declines with increase in foreign interests; for foreign firms mostly, increase in the burden of effective tax payment significantly undermines earnings retention capacities of firms; and for local firms largely, increased investments in fixed assets provides a viable policy option for improving access to the external markets for corporate finance. The results also show that growth-oriented foreign and local firms are more likely to employ aggressive earnings retention policies to minimize their exposure to external capital markets. The paper concludes that, indeed being foreign matters in the earnings retention and internal capital markets debate in Africa, although firm-specific characteristics simultaneously play significant role in moderating the incentive of foreign companies (particularly the MNCs) to retain rather than repatriate profits. Evidence from this study therefore calls for the need for policy and capital control emphases to be shifted to deal with how firms (foreign and local) manage their internal capital market operations. The interactive impact also suggests that tax payment remains a functional mechanism for moderating the negative impact of tax on corporate earnings retention behaviour.

Key words: *Earnings retention; Internal firm characteristics; Capital export; Foreign firms; Africa.*

JEL classification codes: *C26, D22, D25, F23, F21, G32, G35, L25, O16*

1. Introduction

An age-long debate around investment flows in Africa is that foreign firms are exploitative and that multinational corporations (MNCs) have since the colonial era played imperialistic rather than developmental roles in Africa's affairs. Seminal works such as Walter Rodney's (1972) "How Europe Underdeveloped Africa" and Powell's (1992) "The Scramble for Africa" contains vivid accounts of events that laid credence to this claim. Walter Rodney had, for example, argued that the development gap between the West and Africa was caused by the exploitation of the latter by the former. Empirical efforts at further validating this claim revealed two major ways through which such exploitation could have taken place. The first is that foreign firms serve primarily as an effective channel for meeting the raw material needs of parent and affiliate companies in less resource-endowed western countries (Cao &Alon, 2021; Sauerwein, 2020; Radley, 2020; Ekumankama et al., 2019; Bijaoui, 2017; Taylor, 2016; Roemer, 1979). In the case of France's relationship with Africa, for example, Svikaworks (2017) clearly documents how French companies heavily exploit uranium, manganese ore, cocoa, mineral fuel, wood, fruits, and fish from Francophone West African countries. The second, which hinges on the internal capital market argument, is that foreign businesses are attracted to the African markets by higher expected returns on investments and the relatively lax capital account controls (Garcia-Bernardo, 2021; Yasuda & Kotabe, 2021; Alami, 2018; Venables, 2016; Demirhan & Masca, 2008; Oneal & Oneal, 1988). For the second point, a common argument is that the existence of weak governance and institutions makes it easier for foreign-owned businesses and MNCs to flight greater proportion of their earnings.

In this paper, we interrogate the foregoing debate by contending that the emergence and influence of African MNCs (AfMNCs) might have altered the investment landscape in Africa; and that foreign and local firms are both likely to export capital. Both face investment environments that are considered too risky for capital and profit retention. To explore this new premise, we apply firm-level data to comparatively examine the earnings retention practices of foreign and locally firms in Africa. In doing this, we recognize that dividend payouts and internal capital market financing have featured prominently in profit retention and profit repatriation literature (Tran, 2021, 2020; Lundan, 2006). Empirical evidence is, however, lacking on whether the practice is influenced more by firm-specific characteristics or by the nationality of the firms.

The contemporary nature of the debate on earnings retention is tied to the fact that profit repatriation is second to illicit financial flows in terms of the quantum of capital outflows from Africa. The first edition of the Honest Account (sponsored by Global Justice Now – a British-based think-tank) published in 2014 revealed that MNCs profit repatriation stood at about US$46.3 billion or about 24% of the total capital Africa's outflows of US$191.9 billion. The 2017 edition of the same report showed a similar trend—indicating that financial outflows from Africa outweighed the inflows by as much as US$41.3 billion annually, and that, for that period multinational company profits constituted as much as 16% of the total capital exports of US$202.9 billion (Curtis & Jones, 2017). This argument is not new, considering that a 1972 ILO (International Labour Organization) report had back then showed "that foreign-owned manufacturing firms received 73% of total pre-tax profits in 1967, but produced only 51% of gross output" (cited in Udofia, 1984:361).

Given the overwhelming control of the business space, it is not surprising that profit repatriation via dividends, profit shifting, and interest payments continue to dominate the discourse on the fundamental framing of MNC engagements in Africa (Tran, 2021; Muchira, 2017; Udofia, 1984:361; Onimode, 1978:225). As Muchira (2017) puts it, 'money is leaving Africa partly because Africa's wealth of natural resources is simply owned and exploited by foreign private corporations'. It is equally not surprising that countries such as Algeria and South Africa have tended to put in place regulations to guide earnings retention and discourage capital export practices among MNCs. The 2006 Algerian investment legislation tagged the 49/51 investment law, for example, imposed a 51% ceiling on local involvement in 'all projects involving foreign investments'—a law intended to "seeks to diversify local economic production and profit while limiting deficits of the public trust and requires a ploughing back of profits to restrict capital flights and ensure additional local economic growth" (US Department of State, 2015).

While existing empirical and policy debates have focused on the role of foreign businesses and MNCs in the foregoing, our paper attempts to draw attention to the possibility of AfMNCs engaging in similar capital export practices. As argued earlier, this shift finds merits in the growing influence of AfMNCs, especially since the start of the 21st Century. At the moment, AfMNCs play significant roles in a considerable number of economic sectors. For example, in cement production, Dangote Cement Plc., an AfMNC based in Nigeria, is the largest cement producer in Africa, with production facilities spread across nine other African countries (Akinyoade & Uche, 2017). Similarly in the telecommunication sector, AfMNCs such as MTN of South Africa, Orascom Telecom of Egypt, Safaricom of Kenya, and Globacom of Nigeria are dominant players. In the retail sector, Shoprite of South Africa dominates the entire regional retail space. Although the multinational business space has since assumed this dimension, the capital export narrative around foreign businesses and MNCs remains unaltered. This is so despite the realities on the ground suggesting that AfMNCs if left unchecked have equal likelihood of exporting capital away from their home countries. The chairman of Dangote Group, Alike Dangote, confirmed this in an interview with Bloomberg,

where he indicated that from 2020, 60% of the Group's future investments would be outside Africa, with an expected commitment of US$50 billion in Europe and USA by 2025 (Lacqua & Wallace, 2017). This will amount to a huge capital export if and when this proposal is executed.

Using earnings retention lens, therefore, we interrogate the broader literature on foreign businesses and capital exports in Africa. We do this by providing comparative answer to a bothering question on whether being foreign really matters for corporate earnings retention practices in Africa. While empirically focusing on earnings retention, we note that our findings could be limited when it comes to generalizing on the capital export behaviour of firms operating in Africa. In the context of this study, therefore, we define capital export narrowly to be an act of repatriating profits from local sources where they are generated to overseas sources.

The a priori expectation, based on the pecking order theory, is that both classes of firms have incentives to retain earnings for the purposes of enhancing their internal capital markets. Graham and Harvey (2001) posit that the assumption underlining the theory is that the use or preference for external financing is dependent on the availability or otherwise of internal funds, and that firms only go for external financing when internal capital is insufficient. In the international scene, the financial substitution theory presupposes that firms' markets for internal capital are veritable sources of funds in countries that have weak financial systems and weak institutional (Fisch & Schmeisser, 2020; Buchuk et al., 2020; Ezeoha & Cattaneo, 2012; Aggarwal & kyaw, 2008). In the case of Africa, where the financial markets is underdeveloped and inefficient, foreign firms may be slower in adjusting to deviation in long-term debt ratios (Ezeoha, 2017) and as an alternative may tend to deepen reliance on their respective internal capital markets vis-a-vis earnings retention.

Other studies that upheld MNCs as having higher tendency for earnings retention than local businesses are Tahir et al. (2021), Hennart (2010), Huizinga et al. (2008), Mathewsand Robinson (2008), and Desai et al. (2004). Huizinga et al. (2008) find that that MNCs use equity as well as internal debt to provide resources to their foreign subsidiaries; Hennart (2010) established that foreign firms can expand without capital importation, by relying on the domestic markets for internal and external finance; and Desai et al. (2004) posit that "multinational affiliates are financed with less external debt in countries with underdeveloped capital markets or weak creditor rights, reflecting significantly higher local borrowing costs". Mathewsand Robinson (2008), on their part, concluded that attempt to re-direct funds towards more profitable business units or subsidiaries can lead to greater reliance on internal capital.

Our study makes significant contribution by integrating AfMNCs and local firms into the foregoing debate. To achieve the aim, the paper is structured as follows: Section 2 summarizes the logic of earnings retention in Africa. Section 3 is on the analytical procedure, whereas Section 4 presents the descriptive results and sampled empirical backings. Section 5 concludes the paper, and highlights the policy and empirical implications of the results.

2. The logic of earnings retention in Africa

Africa's place in the global business environment is paradoxical. The continent is perceived to be a fertile ground for investments but at the same time very unsafe for long-term savings and capital retention. Arguably more than most other regions, Africa is endowed with rich mineral resources and agricultural land and promises one of the highest returns on investments (Ndikumana& Starr, 2016; Ezeoha & Catteneo, 2012; Anyanwu, 2006). The fact also that the continent offers among the least protection on investments (Collier &Pattillo, 2000), due largely to high risks of expropriation (Cao &Alon, 2021; Akhtaruzzaman et al., 2017; Zghidi et al., 2016) and higher prevalence of corruption and conflicts, makes her unsafe for long-term capital retention. The consequences of this paradox manifest in a number of ways. First, investors compete for space in selected economic sectors where investment returns are higher—mostly the mineral resource and trade sectors. Second, in the bid to attract foreign capital necessary for development, many African countries have in recent times collapsed stringent capital controls and investment regulations, not only to ease foreign investment entry, but also to facilitate profit repatriations. The liberalization policies that followed introduced high level of economic openness and loosely restrictive trade flows. The push for foreign investments is, however, done without emphasis on putting in place the quality institutional and governance structures required to optimizing the developmental impact of foreign investments. This has resulted to a situation where, according to evidence from Klein and Olivei (2008), such liberal policies failed to impact significantly on financial system development and the governance institutions in place. The presence of weak institutions, which has becomes a common feature of most African countries, not only intensifies the problem of resource exploitations, but also increases the risk of expropriation of private (often foreign) businesses—a situation that de-incentivizes long-term earnings retention.

In the bid to motivate big businesses to retain and reinvest their earnings, countries like Algeria and Tanzania enforce strict capital account regulations. On the other hand, burdened by corruption and the quest for foreign capital inflows, most of the countries have in recent times relaxed their capital control regulations to allow for the liberalization of the economic space, as well as "reform of sectoral legislation on land, banking, taxation, customs regimes or other aspects" (Cotula et al., 2009). In recent times, investments rules in most of the countries have changed and sumptuous incentives provided almost to a point of near-zero restrictions against foreign capital

flows. In countries like Mauritius and Rwanda, government's dispositions towards unrestrictive foreign capital flows are an explicit economic policy choice. A 2006 United Nations Conference on Trade and Development (UNCTAD) review of the investment policy in Rwanda, for example, pictured this unrestrictive feature when it emphasized that the country "has put in place one of Africa's most open FDI regime as it does not place restrictions on foreign direct investment(FDI) entry and establishment. All foreign investments are allowed without screening or restriction of amount or sector, and foreign investors are granted national treatment for most intents and purposes" (UNCTAD, 2006). In similar vein, Kenya's Foreign Investment Protection Act of 1964 provides as much protection to foreign investors as it does for domestic investments, with a guarantee against expropriation of private property enshrined in the Constitution. The protections even include foreign investors' rights to repatriate after-tax profits and non-incremental aspects of their capital.

Similarly, other countries such as Kenya, Nigeria, and South Africa have the option of providing sumptuous incentives for local MNCs. The logic behind this approach is that supporting domestic large businesses is a more guaranteed approach to sustainable and inclusive economic development at local level (Ponte et al., 2007). Put succinctly, the claim is that local businesses are less susceptible to capital exports and have higher incentives to retain and invest earnings in a way that support local economic growth and development. While this may be true, getting firms to retain and reinvest sizeable portion of their residual income either by stringent capital controls or by incentivizing local businesses is weakened by the prevalence of debased institutions. Although weak institutions may not necessarily deter investment flows, they do facilitate capital exports through political risks, abuse of political power, and lax regulations (Rapanyane & Ngoepe, 2020; Gankou et al., 2016; Ndikumana, 2016). As evidenced in Rapanyane and Ngoepe (2020), regulatory and governance structures in most African states indeed create room for arbitrage behaviours, state capture, rent-seeking, and tax manipulations by large-scale firms, regardless of being foreign or local. Recent evidence on state capture and rent-seeking in Africa appear to indict local MNCs as much as it does foreign MNCs (Hansen, 2020; Bhorat et al., 2017).

Evidence also abound on how corruption greases the wheel of investments in institutionally weak countries (Martins, et al., 2020; Xu et al., 2017; Dreher & Gassebner, 2013; Barassi & Zhou, 2012; Méon & Weill, 2010). Méon and Weill (2010), for example, found corruption to be positively correlated with operational efficiency in countries where institutions are weak and 'extremely ineffective'. This kind of result is even more robust for resource-seeking foreign investments for which African countries are comparatively preferred destinations (Leite & Weidmann, 1999). The paradox of influx of resource-seeking foreign direct investments and the persistent challenges of capital export, which find merits in studies such as Ndikumana and Starr (2016) and Ndikumana (2016), is largely a defining tide in the foreign businesses–Africa relations.

In an atmosphere of high risk, firms are expected to act by limiting the scale and tenure of their investments. It is equally rational for firms in such environment to adopt aggressive dividend policies as a strategy for mitigating external shocks and

political risks (Huang et al., 2015). A high dividend policy in this sense results to low capital retention and the likelihood of capital flights to safe heavens. Although the probability of this happening may be higher for foreign MNCs, local MNCs are not in any way immune from exercising care. To protect their capital, local MNCs may have the tendency to finance overseas operations and engage in over-invoicing of international trade transactions. From a developing country's perspective, retained earnings literatures is therefore connected with wider issues of profit repatriation, profit shifting, capital exports, and capital flight.

The undeveloped nature of Africa's financial market provides another important justification for a shift of emphasis to retained earnings and firm's internal capital markets. This is so considering that, more than the case in other regions, most firms in Africa finance their operations via internal markets (Ezeoha, 2017). Figure 1, based on data from the World Bank's World Enterprise Survey, indicates that the proportion of investments financed via internal capital is highest in sub-Sahara African region (at 74.8%). At the same time, the proportion of investments financed by banks (at 10%) in the region is the least among the different regions (World Bank, 2018). In South Africa specifically, it is also shown that foreign firms finance about 70% of their investments from profits that were generated locally.

Figure 1:   Proportion of firms' internal and bank-based financing compared across regions
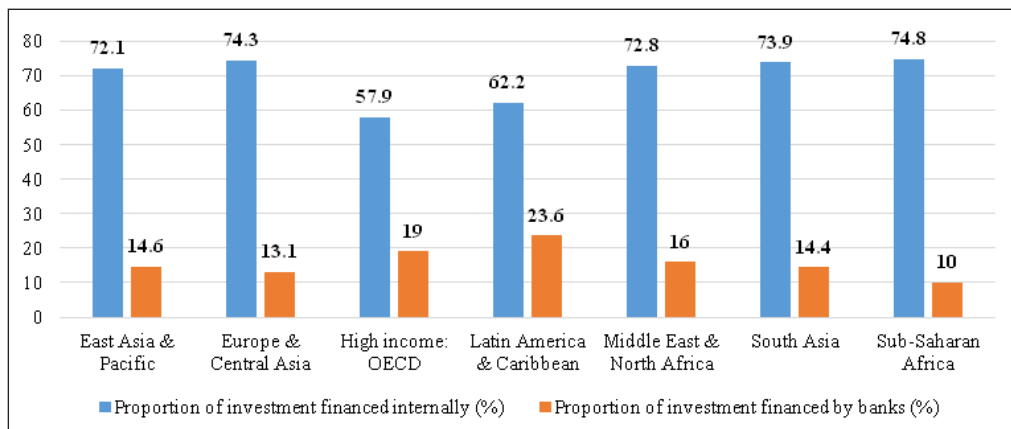
Source: Authors' construction based on data from World Bank's World Enterprise Survey (2018).

Given that earning retention mirror investors' perception of the safety of the investment environment and the capacity of state protection via strong institutions, the decision to reinvest may also be a reflection of context specific factors. Among such factors, as shown in previous studies, is the level of financial system development, rule of law, and property rights regulation (Ezeoha, 2017). Validating this claim is important as it is likely to lay a strong empirical basis for rethinking government-business and public-business relations in Africa. The case of capital flight, for example, has been described as "the single biggest threat to the continent's developmental

goals" (Ndikumana& Boyce, 2008). The reason for this is because, in the words of Christensen (2009), "capital flight impacts negatively on capital-scarce economies: the loss of domestic savings leads to lower levels of internally-funded investment, and the loss of tax revenues flowing from those savings leads to lower revenues available for public expenditure on health, education, and public infrastructure".
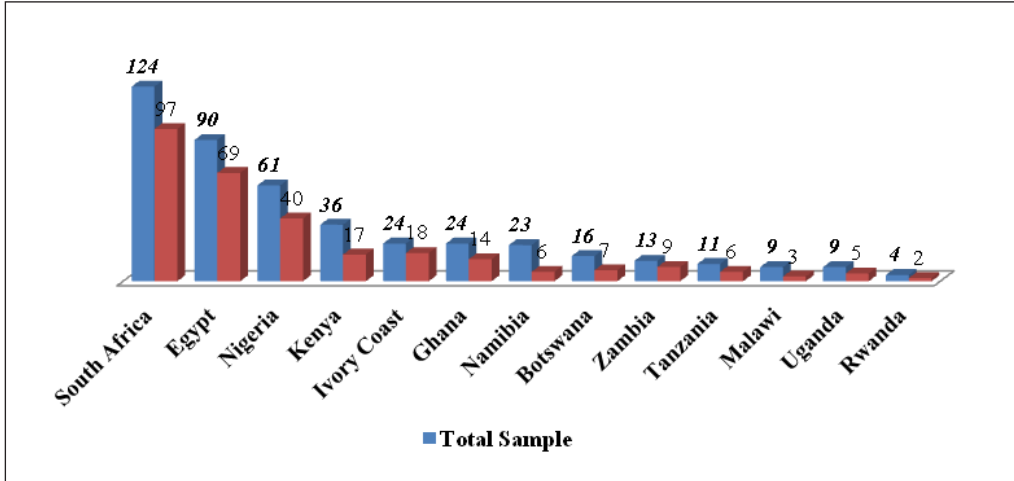
3. Methodology

Data and variable definition

The data used in this study are generated from two related sample sets covering the period 2005–2018. The choice of the study period is informed by the need to accommodate moments of global financial crisis of 2007–2009, as well as the 2011 and 2015 recessions that affected most resource-rich African countries. Broadly, the inclusion criteria are that the firms must have data throughout and within the balanced panel of 2005 to 2018; and that the firms must have been incorporated and listed in the first-tier securities markets in their respective host country before 2005. Our main sample frame comprises of 444 companies quoted in 13 African stock exchanges, including South Africa, Nigeria, Egypt, and Kenya. The first sample set, which is used mainly for descriptive purposes, is dominated by firms in the manufacturing, services, resource-based, and mining sectors. The sub-sample provides us with an opportunity to comprehensively analyse the differences in the earnings retention practices of foreign and local firms, and among MNC categories (e.g., African MNCs, South African MNCs, and Fortune 500 listed MNCs operating in the African continent). The second sample set narrowed the number of firms to 293, by including only those operating in the non-financial sectors. This is to eliminate the usual biases associated with mixing financial and non-financial firms in a study on corporate financing decision. This latter set is applied to empirical analysis to test the comparative impact of foreign ownership and firm-specific characteristics on earnings retention practices. The two sample sets are illustrated further in Figure 2.

The respective variable definitions and proxies are contained in Table 1. The choices of the independent variables are informed both by the theoretical underpinnings of the arguments on whether earnings retention is driven more by nationality or by firm-level characteristics. The agency theory, for example, supports the inclusion of the foreign ownership and mineral resource dummies, whereas the pecking order theory provides basis for the inclusion of profitability and growth variables. In similar vein, the choice of corporate tax, tangibility, and firm-size find merits in the postulations of the trade-off theory and transaction cost theories of corporate capital structure decisions. The proposition of the agency theory indicates that foreign firms are faced with more complex agency problems, and as such should have higher incentives for external debt financing to serve as a monitoring tool against managerial excesses (Holderness, 2003). In similar vein, the transaction cost theory postulates that internal capital market becomes a viable

source when it is cheaper to transfer funds within a firm's corporate structure (Ezeoha, 2017; Fier et al., 2013). The choices of the variables are equally in line with the approach adopted in earlier studies (e.g., Yusof & Ismail, 2016; Gupta & Banga, 2010; Desai et al., 2004).

Figure 2: Number of companies in the two sample sets

Table 1: Variable definitions

Dependent Variable	Independent Variables
Earnings retention	• Firm size (*Sz*)–Defined as the natural logarithm of total revenue.
	• Asset tangibility (*Tan*) – Measured as log(100 + ratio of fixed to total assets).
	• Financial leverage ratio (*Lev*) – Measured as log(100 + ratio of debt to equity).
	• Effective tax rate(*Tax*) – Measured as log(100 + proportion of income tax paid by a company to the total taxable income).
	• Firm growth (*Gw*) – Measured as log(100 + ratio of working capital to sales).
	• Foreign ownership(*Fd*) – Firm-level dummy, taking the value 1 for foreign-owned firms and 0 for the locally owned.
	• Mineral resource dummy (*Rd*) – Firm-level dummy, taking the value 1 for firms in the mineral resource sector and 0 otherwise.
	• Financial development – Country level dummy, taking the value 1 if the interest rate is greater or equal to the cut off mark of 5.89% and zero if otherwise. Interest rate spread (defined as lending rate minus deposit rate) is applied as a proxy for financial development.
	• Property rights regulation and governance dummy – Country-level dummy, taking the value of 1 if the ranking is below the cut off mark of 3 and zero if otherwise. The original data source is WDI Database; and the variable is defined in terms of the rating scale of 1=low to 6=high.

Note: Except for the variables that proxy financial development and property rights, data for the rest of the firm-level variables are sourced from the Thomson Reuters DataStream. The data source for financial system development and property rights regulation is the World Development Indicators (WDI) Database. Because of the country-level nature, the two are employed as bases for regrouping the firms, and not as variables in the analytical equations.

The empirical model

Our baseline equation, which is drawing from the underlying principles of ordinary least square regression principles, goes that earnings retention is a function of both the nationality of a firm and its specific characteristics such as size, effective tax rate, industry of operations (captured using asset tangibility), firm-size, firm-growth, financial leverage ratio, and a dummy on whether or not the firm is resource-based. The arising equation follows that:

$$\text{Earnings Retention}_{it} = \alpha_0 + \sum_{i=1}^{J} \beta_i \text{ (Ownership, Resource, Size, Growth,} \qquad (1)$$

$$\text{Leverage, Tax, Tangibility})_{it} + \varepsilon_{i,t}$$

where, β_i represents the coefficients of the major independent variables, respectively, α is the constant term, and $\varepsilon_{i,t}$ is the white noise.

The random effects form of Equation 1, which accounts for the inter-firm variations in the influence of nationality and internal attributes of firms on corporate earnings retention practices, is provided below:

$$ER_{i,t} = \alpha_0 + \alpha_1(Fd_{it}) + \alpha_2(Rd_{it}) + \sum_{j=1}^{J} \beta_i \left[Sz_{it} + Gw_{it} + Prof_{it} + Tan_{it} \right. \qquad (2)$$

$$\left. + Tax_{it} \right] + \mu_{it} + \mathcal{E}_{it}$$

For the final estimations, the system dynamic generalized method of moments (system dynamic GMM) is adopted. The choice of the estimation model is based on the existing evidence that it is more robust and efficient in the presence of multicollinearity problem (Arellano & Bond, 1991). Unlike the traditional two-stage regression model, the system GMM gives room for robust exogenous instruments to be generated using the difference GMM and the lagged values of the exogenous variables (Blundell & Bond, 1998). Along this line, Asiedu and Lien (2011) recommend that the first different of all the exogenous variables be used by the difference and system estimators as standard instruments; and the lags of the endogenous variables applied to generate the system GMM-type instruments described in Arellano and Bond (1991). We make use of the two-step version of the model as a way of controlling for the correlation of errors over time, simultaneity and measurement errors, as well as the problem of

heteroscedasticity (Antoniou et al., 2008). The equation of the system GMM, based on the two-step robust error technique, is specified as follows:

$$ER_{i,t} = \alpha_0 + \alpha_1(ER_{i,t-\tau} - ER_{i,t-2\tau}) + \alpha_2(Fd_{it}) + \alpha_3(Rd_{it}) + \sum_{j=1}^{J} \eta_i (\lambda_{j,i,t} \quad (3)$$

$$-\lambda_{j,i,t-2\tau}) + \sum_{i=1}^{k} \varphi_i \, Fd_{\cdot \cdot} \lambda_{i,t} + (\mu_{it} - \mu_{it-\tau}) + \mu_{it}$$

where, $ER_{i,t}$ represents earnings retention in company i at time t; Fd represents the proxy for foreign ownership dummy, assuming 1 if foreign and 0 if local; Rd represents the proxy for mineral resource dummy assuming 1 if firm operates in mineral resource industry and 0 if otherwise. λ is a vector of firm-specific variables (such as size, growth, profitability, effective tax rates, and asset tangibility). While the sigma sign represents the lag order of the series, L stands for the lag operator. $\alpha_2-\alpha_3$, η_i, and φ_i are the coefficients of the independent and the multiplicative variables; α_0 and $\mu_{i,t}$ are, respectively, the constant term and the white noise.

In the first round of our analysis, which is largely descriptive, average earnings retention rates for all the sampled 444 companies are compared graphically. Next, the averages for local and foreign firms are computed to examine how the earnings retention rates compare between the two. To shed more light on the characteristics of earnings retention practices among foreign firms, the next step compares the retention practices across groups of MNCs — namely: MNCs headquartered in Africa, South AfMNCs, and Fortune 500 MNCs with operational presence in Africa.

In the second round of the analysis, tabular descriptive results are presented and the t-test statistics computed to determine whether the observed differences in earnings retention between local and foreign firms are significant at conventional levels. The mean values compared are for local and foreign firms, mineral and non-mineral firms, financial and non-financial firms, across groups of MNCs (African, South African, and Fortune 500), and across major MNCs operating in Africa. A final round of the analysis empirically examines whether similar factors drive earnings retention for both local and foreign firms. This is done using a total of 293African quoted non-financial firms (out of the main sample frame of 444 firms) and a system dynamic GMM model. In the main sample frame, though, Nigeria, Egypt, Kenya, and South Africa accounted for about 70% of the overall sample size.

4. Results and discussion

Descriptive results

This section reports the descriptive results comparing the retention practices of local and foreign firms in Africa. Figure 3 presents trends in earnings retention rates for all the 444 sampled firms. It shows that, for the years 2005 to 2018, the rate ranged from 52% to 64%. Another interesting observation is the manner in which both earnings retention recorded a drastic decline during the period of global financial crisis (i.e., 2007–2011). This is contrary to the postulation of the financial substitution theory, which stresses that internal capital market substitute for weak and inefficient financial markets (Ezeoha & Cattaneo, 2012; Aggarwal & kyaw, 2008).

Figure 3: Average earnings retention rates for all samples
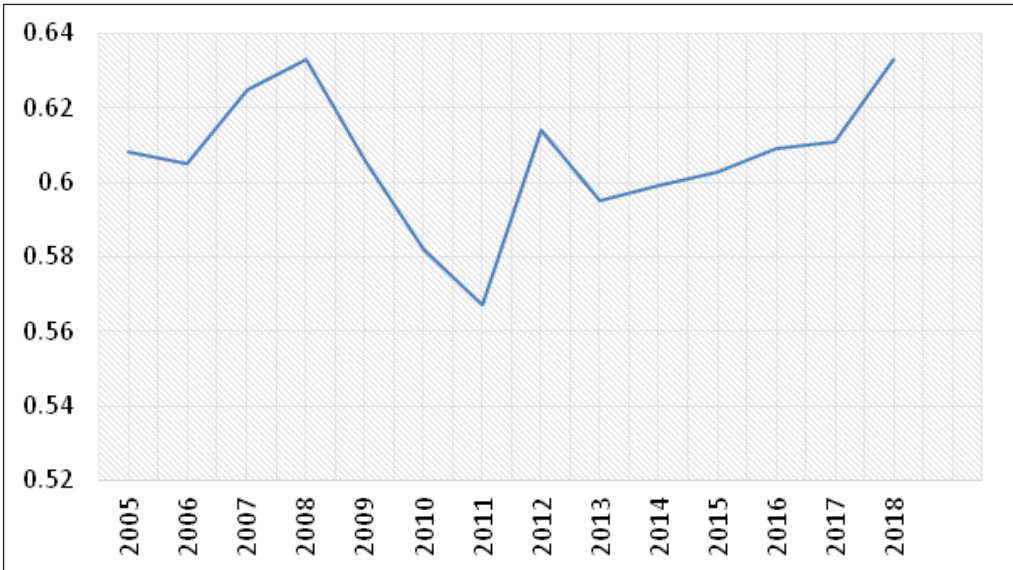
Figure 4 compares the retention practices of local firms and those of foreign firms. The graphical evidence indicates that, on the average, local firms have higher retention rates than foreign firms, although the two maintained rates above 50% (64.2% for local firms and 54.4%for foreign firms). What this means is that the claim of foreign firms generally deploying active dividend policies is therefore not supported by our data. This does not, however, rule out the fact that some of the companies in the sample (both foreign and local) recorded 0% retention rate and some recorded 100% dividend payout over the studied period. For example, among the sampled 444 firms, 81 recorded 100% retention rates, out of which 19 are foreign firms and 62 are local; 69 firms recorded 0% retention rate, of which only 15 are foreign and 54 local.

Figure 4: Average earnings retention rates of domestic and foreign firms compared
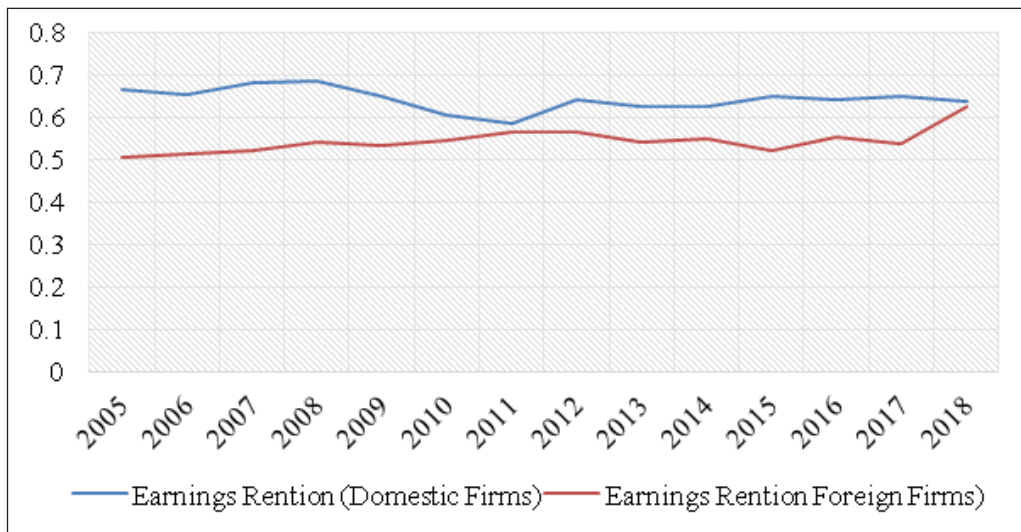
Figure 5 presents a clearer picture that isolates the different categories of MNCs in the region. As shown in the figure, MNCs of African and South African origins share similar patterns of retention practices, compare to the relatively unstable patterns for Fortune 500 firms.

Figure 5: Earnings retention rates of groups of MNCs compared
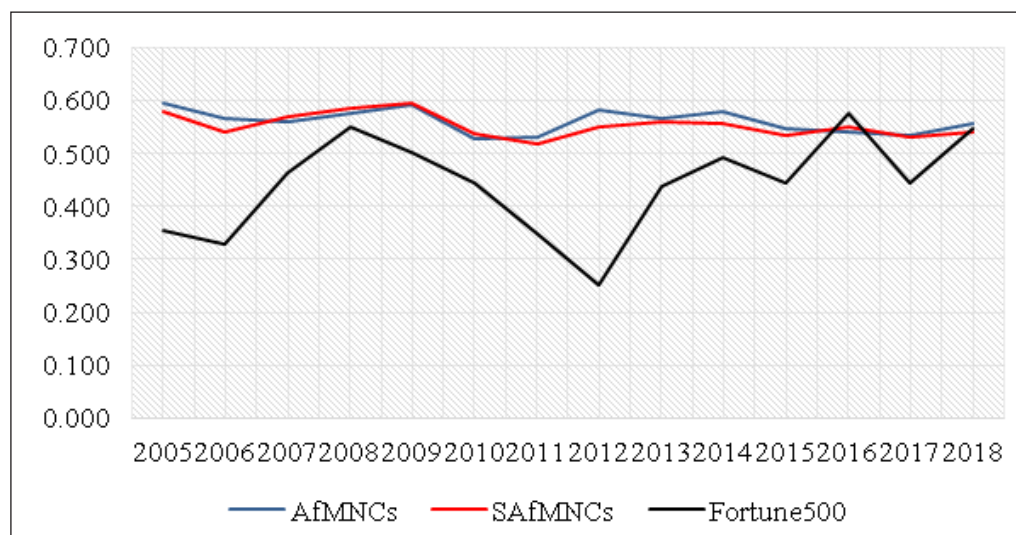
Overall, the descriptive results, in terms of the mean and the standard deviations, as well as the correlation coefficients of the research variables are reported in Table 2 and Table 3, respectively.

Table 2: Descriptive statistics on the means standard deviations of the research variables

Variable	Observations	Mean	Std. Dev.
Mineral dummy	4,102	0.119	0.324
Foreign dummy	4,102	0.287	0.452
Retained Earnings	3,531	1.166	18.161
Firm Size	3,994	3.400	1.117
Asset Tangible	4,036	1.101	5.029
Effective Tax Rate	3,641	24.570	171.351
Profitability	4,004	10.417	18.627
Financial Leverage	4,015	2.306	13.782
Firm Growth	3,840	5.837	207.628
Log of Retained Earnings	*4,102*	*2.003*	*0.023*
Log of Firm Size	*3,924*	*3.421*	*1.106*
Log of Asset Tangible	*4,102*	*2.004*	*0.017*
Log of Effective Tax Rate	*4,090*	*2.064*	*0.111*
Log of Profitability	*4,100*	*2.038*	*0.060*
Log of Financial Leverage	*4,100*	*2.008*	*0.025*
Log Firm Growth	*4,045*	*2.006*	*0.133*

Table 3: Correlation matrix of the research variables

	Log Retained Earnings	Log Firm Size	Log Tangibility	Log Effective Tax	Log Profitability	Log Leverage	Log Firm Growth	Mineral dummy	Foreign dummy
LogRetained Earnings	1								
LogFirm Size	-0.028	1							
LogTangible	-0.010	0.117***	1						
LogEffective Tax	-0.003	-0.034***	-0.080***	1					
LogProfitability	0.013	-0.029	-0.100***	0.188***	1				
LogLeverage	-0.006	-0.032***	-0.006***	0.001	-0.099***	1			
LogFirm Growth	0.076***	-0.118***	-0.008	0.023	0.012	-0.019	1		
Mineral dummy	0.011	0.119***	-0.047***	0.087***	-0.026	-0.001	-0.009	1	
Foreign dummy	-0.003	0.299***	0.076***	-0.072***	-0.127***	0.0125	-0.039***	-0.001	1

Test of mean differences across MNC categories

To test whether the recorded differences in earnings retention practices of local and foreign firms are significant at conventional levels, we carried out a t-test of mean difference. The results presented in Table 4 and Table 5 reveals a number of interesting patterns. First, the average retention rate of local firms at 64.2% is statistically different from that of foreign firms at 54.4% (t-statistic =11.432, P<t> = 0.000). This implies that in real terms both groups of firms maintain different retention policies and it is most likely that local firms retain more than foreign firms. We find no significant difference in earnings retention between mineral resource-based and non-mineral resource-based firms. Across the three groups of MNCs, AfMNCs have the highest average retention rate of 56.1%; South African MNCs have 55.4%, as against 44.3% for Fortune 500 firms operating in Africa. These results are found to be significantly different from the overall retention rate. By implication, all the categories of MNCs have average retention rates below that of local firms' average.

Table 4: Descriptive and t-test results based oncomparing local and foreign firms

		All	Local Firms	Foreign Firms	Mineral Resource Firms	Non-mineral Resource Firms	Finan-cial	Non-Finan-cial
RE/Equity	μ	1.162	0.975	1.489	2.044	1.064	0.692	1.269
	σ	10.291	2.137	14.199	8.223	10.493	1.695	11.367
	t-		-1.869*		-2.224**		1.687*	
	Statistic		(0.062)		(0.026)		(0.092)	
Earnings Retention	μ	0.606	0.642	0.544	0.613	0.606	0.634	0.6
	σ	0.305	0.295	0.305	0.317	0.301	0.284	0.307
	t-Statistic		11.432***		-0.479		-3.221***	
			(0.000)		(0.632)		(0.001)	
Observations		6216	3827	2196	605	5418	1113	4910
Average No. of Firms		444	273	171	43	378	80	351
Year		2005-2018	2005-2018	2005-2018	2005-2018	2005-2018	2005-2018	2005-2018

Table 5: Descriptive and t-test results based on MNCs' group comparison

		All Firms	SA MNCs	AfMNCs	Fortune 500
RE/Equity	μ	1.162	0.85	0.869	0.946
	Σ	10.291	0.793	1.176	2.916
	t-Statistic		0.892	0.946	0.363
			(0.372)	(0.344)	(0.717)
Earnings Retention	μ	0.606	0.554	0.561	0.443
	σ	0.305	0.244	0.248	0.321
	t-Statistic		4.919***	4.731***	8.910***
Observations		6216	755	932	248
Average No. of Firms		444	54	67	18
Year		2005–2018	2005–2018	2005–-2018	2005–2018

Empirical results

The post-estimation results, as reported in tables 6 and 7, show that the conditions for efficient system dynamic GMM estimations are all met. First, the requirement that the number of cross-sectional elements should be greater than the number of time elements is met (the panel datasets used for our analysis has N = 293, while T = 14). Second, the null hypothesis of no sign of serial correlation between the level and the lagged forms of the dependent variable is rejected at both the first order (AR1) and the second order (AR2). In all the estimation equations, the probability values of both are greater than 5%. In similar vein, the null hypothesis of over-identifying restrictions is not rejected in all the estimation equations. This is evident in the results of the Sargan test (x^2) for over-identifying restrictions, wherenone of the probability values is significant at any of the conventional levels.

On theresults of the system GMM, as reported in Table 6, the coefficient of the lagged composite earnings retention measure is significant and within the range of 0 and 1 in all the equations. The negative sign is, however, an indication that generally firms operating in Africa may not have the tendency for reserve accumulation. In all the cases, the dummy variable that captures the rate of foreign ownership in a firm appears with the a priori negative sign—thus confirming that firms with majority foreign interests are less likely to pursue aggressive earnings retention practices. The evidence suggests that, as foreign interests increase in a firm, the tendency to retain more of the firm's earnings declines. On the impact of a firm operating in the mineral resource sector, the coefficient of the proxy is positive and significant in the baseline estimation equation. This is an indication that the rate of earnings retention is higher for firms in the mineral resource sector; and that such firms are more likely to finance their operations largely through their internal capital markets. For them, therefore, the financial substitution and pecking order theory appear to explain more their corporate financing decision.

Table 6: System dynamic GMM results on the determinants of earnings retentions

	All Sample	All Sample	By Firm Nationality	
			Local Firms	Foreign Firms
	(1)	(2)	(3)	(4)
Retained earnings(L1)	-0.010	-0.010	-0.007	-0.007
	(-35.99)***	(-50.06)***	(-41.79)***	(-122.06)
Foreign ownership	-0.052	-0.002		
	(-4.12)***	(-3.83)***		
Mineral resource(dummy)	0.018	0.018	0.025	-0.005
	(42.70)***	(59.49)***	(60.54)***	(-7.11)***
Effective tax rate	0.003	-0.001	0.001	-0.004
	(3.71)***	(-2.55)**	(0.77)	(-16.75)***
Asset tangibility	-0.041	-0.026	-0.069	0.001
	(-1.43)	(-0.96)	(-2.00)**	(0.37)
Firm size	0.002	0.001	0.003	0.006
	(7.31)***	(9.91)***	(27.37)***	(70.10)***
Firm growth	0.023	0.021	0.034	0.011
	(12.52)***	(19.15)***	(42.24)***	(44.24)***
Profitability	-0.017	0.019	0.015	0.017
	(-9.37)***	(23.72)***	(19.91)***	(76.24)***
Financial leverage	-0.001	0.003	-0.007	0.014
	(-0.13)	(2.24)**	(-3.46)***	(15.97)***
Foreign ownership^Tax	-0.005			
	(-3.07)***			
Foreign ownership^Size	-0.002			
	(-5.04)***			
Foreign ownership^Growth	-0.014			
	(-6.77)***			
Foreign ownership^Leverage	0.006			
	(1.23)			
Foreign ownership^Profitability	0.041			
	(12.59)***			
Constant	2.050	1.984	2.056	1.918
	(34.53)***	(35.96)***	(29.67)***	(299.4)***
Wald X2	20964***	26765***	22704***	53758***
Sargan X2	114.42	106.56	93.340	74.930
	(0.741)	(0.882)	(0.328)	(0.838)
AR1	-1.698	-1.697	-1.476	-1.009
	(0.090)	(0.090)	(0.140)	(0.313)

Table 6 Continued

			By Firm Nationality	
	All Sample	All Sample	Local Firms	Foreign Firms
	(1)	(2)	(3)	(4)
AR2	0.303	0.689	-0.304	-1.150
	(0.762)	(0.491)	(0.762)	(0.250)
No. of instruments	143	138	97	97
No. of groups	283	283	202	82
No. of observations	3,268	3,268	2523	1053

Notes:*** represents prob≤0.01, ** represents prob≤0.05, and * represents prob≤0.00. The Z-values of the standard errors are in the parenthesis. The major instruments for the system dynamic GMM model include: lagged values of the dependent variable (retained earnings), and first differences of the independent variables.

Concerning the role of firm-specific characteristics, the impact of effective tax rate is significantly negative in the baseline equation—with the results suggesting that a percentage increase in effective tax rate would lead to a 0.1% increase in the rate of retained earnings. However, as comparatively shown in columns (3) and (4) of Table 6, this negative impact appears more for foreign than for local firms. Whereas, for example, the coefficient turns positive and non-significant for the latter, in the former it remains stably negative and significant at all conventional levels (with β = - 0.004***). This is consistent with the propositions of trade-off and transaction cost theories, and tend to suggest that the chances of foreign firms retaining more earnings reduces as the proportion of their taxable income increases. As a general practice, evidence from the estimations equation does not prove that asset tangibility impacts significantly on earnings retention of quoted firms operating in Africa. Specifically, the coefficient of tangibility is only significant (and negative) in the local firms' equation (seecolumn (4) of Table 6). Unlike the case of foreign firms, the results show that a percentage increase in the rate of asset tangibility can cause about 6.9% decline in local firms' retained earnings. This is consistent with the transaction cost argument that local firms might be more disposed to accumulating collateral values strategically for borrowing purposes (Dewaelheyns & van Hulle, 2010); and that local firms with adequate collateral values are likely to substitute for external capital market financing in Africa.

In column (1) of Table 6, the coefficient of firm size is generally positive and significant at conventional levels. The indication is that a percentage increase in firm size (measured as the natural log of sales) is capable of generating an average of 0.1% corresponding increase in the rate of earnings retention. By implication, larger firms are more likely to retain greater percentage of their earnings, and are also more likely to rely on the internal capital markets. Comparatively, though, the positive impact is found to be more for foreign firms (β = 0.006***) than for local firms (β = 0.003***). Whereas a percentage increase in firm size, measured as natural log of total turnover in foreign firms, could bring about a corresponding increase in retained earnings by 0.6%, for local firms, the corresponding increase averages just 0.3%. Consistent with

the pecking order and the trade-off theories, this result suggests that, as a firm grows bigger, it pushes towards minimizing its exposure to external capital markets shocks by relying more on the internal capital markets. Consistent with the earlier evidence from Nachum (2010), this trend is supported by the fact that foreign firms are usually in a better position to enjoy access to more consolidated internal capital markets.

The coefficient of firm growth is found to be generally positive and significant—meaning that the complementary role of retained earnings in supporting firm growth is largely proven. Although the impact is similar, the results however suggest that it is higher for local firms than for foreign firms. Whereas for the former, a percentage increase in the growth rate of a firm can generate a corresponding 3.4% increase in the rate of retained earnings, for the latter, the corresponding rate of increase averages 1.1%. This result suggests that, due to difficulty of access to external capital markets in Africa, retained earnings remain the most readily available means of financing growth of local firms in most of the countries (Yartey, 2009). The supportive impact of profitability is confirmed generally, and specifically in the case of both foreign and local firms. Consistent with the pecking order theory of corporate financing, a percentage increase in rate of profitability is capable of generating a corresponding 1.5% increase in retained earnings for local firms and 1.7% increase for foreign firms.

The results, as reported in Table 6, further show that, for financial leverage, the impact is generally positive, but nationality sensitive. For foreign firms, a percentage increase in the rate of financial leverage generates a corresponding 1.4% increase in retained earnings. For local firms, a percentage increase in leverage ratio rather generate up to 0.7% decrease in the rate of retained earnings. By implication, the substitutive impact of debt financing, as well as the proposition of the pecking order theory is supported here only in the cases of local firms. It also points at the likelihood of foreign firms relying significantly on Africa's financial markets to complement the much touted access to multinational internal capital markets.

Turning to the equation with interactive terms (reported in column (1) of Table 6), the coefficient of the interaction between effective tax rate and the foreign ownership dummy is negative and significant—suggesting that, indeed the negative impact of corporate tax payments intensifies (especially for foreign firms) as the rate of foreign ownership increases. In similar vein, the coefficients of the interaction between firm size and foreign ownership is negative and significant, which is an indication that the positive impact of firm size on earnings retention shrinks as foreign ownership interests increase. The same trend is recorded for the interaction with firm growth, where the result shows that the observed complementary relationship between growth and earnings retention rate decreases as the level of foreign ownership interests increases. On the interaction with profitability, the arising result shows that the supported role of profitability in inducing earnings retention practices actually increases with the rate of increase in foreign ownership interests.

To account for the role of financial system development and quality of governance institutions and property rights regulation, we reclassify our sample into two separate groupings. For each, we run comparative system dynamic GMM estimations. Columns

(1)and(2) of Table 7 compare the results for financially more versus financially less developed African countries, whereas columns(3)and(4) compare groups of countries with higher versus lower institutional quality and property rights regulations. Suffice it to mention that, in all the cases, the necessary conditions for an efficient system dynamic GMM estimation are met.

On the first grouping, reported in columns (1) and (2) of Table 7, the impact of foreign ownership on earnings retention is found to be higher in financially less developed than it is in financially more developed countries (β = 0.074*** against β = 0.010***), although both are positive and significant at conventional levels. For the second grouping, reported in columns 3 and 4, the impact is positive for firms operating in countries with higher, but negative for firms in countries with lower institutional quality and property rights regulation. This result is consistent with the earlier evidence from Rapanyane and Ngoepe (2020) and Ndikumana (2016), which uniformly confirmed that foreign firms are less likely to retain capital in institutionally weak and politically unstable environments. The results associated with the control variables are also in line with a prioriexpectations. For example, the impact of a firm being mineral resource-based is positive in financially less developed countries, but non-significant in financially more developed countries. This confirms our earlier result that resource-based firms rely more on internal than external capital market financing. Being resource-based also impacts positively in countries with higher governance quality and property rights regulations, but negatively in countries with lower governance quality. The negative impact of effective tax rate on earnings retention is found to be more in countries with less developed financial markets—suggesting that, in the absence of robust external options, higher corporate tax burden can indeed mount pressure on the internal capital market sources. Firm size has positive impact on the earnings retention of firms operating in countries with higher governance quality and property rights regulations, but negatively in those with lower governance quality. Financial leverage substitutes for internal capital market financing in countries that are less financially developed. It, however, plays a complementary role in countries that are more financially developed.

Table 7: System dynamic GMM results on the determinants of earnings retention – along levels of financial markets and institutional development

	By host country's level of financial development		By country's quality of governance& property rights rule	
	Less developed	More developed	High quality	Low quality
	(1)	**(2)**	**(3)**	**(4)**
Retained earnings(L1)	-0.048	-0.007	-0.011	-1.137
	(-110.17)***	(-8.35)***	(-33.62)***	(42.11)***
Foreign ownership	0.074	0.010	0.010	-0.237
	(8.05)***	(8.73)***	(7.23)***	(-0.18)
Mineral resource(dummy)	0.112	-0.000	0.032	-0.039
	(12.21)***	(-0.26)	(39.62)***	(-3.00)***
Effective tax rate	-0.012	-0.001	0.000	0.000
	(-22.56)***	(-1.18)	(0.26)	(0.24)
Asset tangibility	-0.232	-0.011	0.392	0.142
	(-3.38)***	(-1.93)**	(0.132)***	(1.20)***
Firm size	0.011	0.004	0.001	-0.006
	(16.24)***	(16.71)***	(7.67)***	(-6.33)***
Firm growth	0.036	0.042	0.030	0.056
	(62.93)***	(26.55)***	(19.08)***	(16.90)***
Profitability	0.026	0.005	0.010	0.037
	(63.21)***	(4.51)***	(12.16)***	(11.32)***
Financial leverage	-0.013	-0.004	0.004	0.004
	(-8.33)***	(3.05)***	(-3.72)***	(0.17)
Constant	2.586	2.024	1.203	1.494
	(18.27)***	(137.06)***	(4.51)***	(6.14)***
Wald X2	554197***	19293***	14658***	848***
Sargan X2	42.194	93.939	72.105	77.446
	(0.999)	(0.154)	(0.839)	(0.707)
AR1	-1.382	-1.342	-1.472	-1.107
	(0.167)	(0.180)	(0.141)	(0.268)
AR2	1.121	-0.067	1.169	-0.094
	(0.263)	(0.945)	(0.242)	(0.925)
No. of instruments	93	93	96	96
No. of groups	53	283	207	201
No. of observations	561	2441	2416	855

Notes:*** represents prob≤0.01, ** represents prob≤0.05, and * represents prob≤0.00. Z-values of the standard errors are in the parenthesis. The major instruments for the system dynamic GMM model include: lagged values of the dependent variable (retained earnings), and first differences of the independent variables.

5. Conclusion and policy implications

The results of our study show that corporate earnings retention in Africa is foreignness-sensitive. The results reveal that being foreign is a deciding factor in corporate earnings retention practices in Africa, although the claim of foreign firms deploying active dividend policies and maintaining lower retention rates may have been over stressed. The average retention rates for both classes of firms are over 50% for the period studied. Another institutional variance in the practices of both classes of firms is that local firms' retention policies seem more stable, and that across groups, MNCs of African origin appear to maintain stable retention practices than MNCs of Western origin. No doubt, this practice might have arisen from the institutional framing of AfMNCs, whereby a number of them operate intra-regionally through non-quoted subsidiaries and affiliates.The results also suggest that the retention practices are firm-specific, especially as there is no clear evidence of uniform industry patterns. Anglo American, a British multinational mining company, which has operational presence in West and South African countries, is observed to have the highest average retention rate of about 70.4%. On the other hand, Nestle, a Swiss multinational food and drink processing company with operational presence in countries in West and Central Africa, has one of the least retention rates of less than 21%.

From an empirical perspective, the foreign ownership dummy is found to appear with a negative coefficient, thus providing a basis for concluding that firms with majority foreign interests are less likely to pursue aggressive earnings retention practices; and that, as foreign interests increase in a firm, the tendency to retain more of its residual earnings declines. Among quoted firms operating in Africa, increase in effective tax rate contribute significantly in undermining the capacity of firms to retain much of their net earnings, and this is mostly the case with foreign firms. It follows, therefore, that increase in tax burden might be a key factor constraining earnings retention practices of MNCs and other foreign businesses operating in the region. As revealed in our study, that asset tangibility is found to significantly impact on earnings retention practices of local firms (but not for foreign) is an evidence of collateral values taking a central position in the corporate financing decision of local firms in Africa.

The evidence from our study equally suggests that, as firms grow larger, they tend to rely more on the internal rather than the external markets for corporate finance; and we found this trend to be more pronounced for foreign firms. The tendency that a firm with higher growth potentials would move towards minimizing its exposure

to the shocks in the external capital markets by relying more on retained earnings is found to be more valid in the case of local firms. This is not unconnected with the fact that, in most African economies, retained earnings are the most readily available means of financing growth of local firms. On the effects of financial leverage on the earnings retention practices, the arising evidence suggests that, for local firms, the substitutive role of debt financing is proven; but for foreign firms, the role of debt financing is rather complementary. On the role of corporate tax payments and firm size, the negative impact of corporate tax payments is found to intensify (especially for foreign firms) as the rate of foreign ownership increases; and the positive impact of firm size on earnings retention shrinks as foreign ownership interests increase in a firm. Similar interactive results are recorded on the role of firm size and profitability.

The foregoing results underscore the conclusion that the nationality of a firm is an important consideration in the earnings retention and internal capital markets debate in Africa; and that firm-specific characteristics play a significant role in moderating foreign firms' incentives (particularly the MNCs) to retain rather than repatriate profits. The foregoing results, therefore, call for the need for national policy and capital control policies to be shifted to deal with how firms (foreign and local) manage their internal capital market operations.The interactive impact also suggests that tax payment can serve as a functional mechanism for moderating the negative impact of tax on corporate earnings retention behaviour.

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