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The Dividend Puzzle A Progress Report by Steven V. Mann (1989): A Review with Insights from Philippines' New Corporate Tax Law

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Abstract

This research reviews the progress of the "dividend puzzle" in the finance literature. The article tracks the theoretical evolution of dividend policy and its conceptual and practical differences throughout the years. As such, this paper gives an updated literature discussion on the dividend policies of corporations, its impact to investor preferences, and the linkage to corporate taxes. This literature review implies that the "dividend puzzle" remains unsolved and continues to be an intriguing subject matter as academicians and practitioners alike cannot exactly explain the behavior of investors and corporations as seen in the decades of corporate dividend policies. Furthermore, this article ends with a brief update regarding Philippine's new Corporate Tax Law (CREATE Law) and author's brief perspective on dividend policies.

Keywords: dividend puzzle, corporate dividend policy, corporate tax rate, Philippines

1. Introduction

The name Fischer Black is often encountered in option pricing lessons and the famous Fischer Black Prize in Finance. As an American economist, he presented the dividend puzzle as to why companies pay their stockholders' dividends. Dividends paid to stockholders come from company earnings. Thus, dividend growth requires corresponding growth in earnings. If company desires earnings growth, then the firm should retain earnings and reinvest them in the business operations. Thus, the higher the percentage of earnings retained, the higher the earnings growth. Depending on which angle one would start with, it can be noticed that there is a thin line of compromise when deciding to give out dividends--- hence, an intriguing puzzle in the corporate world.

The purpose of this research is to update the literature as regards the current status of Black's "dividend puzzle", based on the contributions of repeated research and debates that has progressed throughout the years. This article also aims to examine this "dividend puzzle" in the context of the recent trends in the corporate dividend policies in the international scale.

Moreover, this research discusses "dividend puzzle" from an investor's perspective and in the specific country-level context of newly enacted corporate tax laws. This paper contextualizes the discussion of dividends and corporate taxes in light with the newly enacted CREATE Law under President Duterte in the Philippines.

2. Critical Review

In this review of corporate dividend policy, we particularly focus on Steven Mann (1989) progress report on Fischer Black's dividend puzzle in 1976. What has happened after Mann's progress report on this "dividend puzzle"? With the recent advancement in the corporate world, has the puzzle been resolved?

2.1 Unraveling Black's Dividend Puzzle

The journal under review presented some of the dividend policy literature that tried to unravel Black's dividend puzzle. The first one is the "dividend irrelevance theory" of Miller and Modigliani stating the irrelevance of dividend policy under the assumption of perfect markets, (Mann, 1989). Hence, dividend payments do not affect firm value. The "bird-in-the-hand hypothesis" favors dividends and such hypothesis posits that dividend payments are less risky as these are currently available than mere anticipated future capital gains. The "signaling theory" notes the existence of information asymmetry wherein management has superior understanding of the firm's intrinsic value than outside investors. Therefore, dividends are used to send their inside information about current earnings and future growth opportunities, (Mann, 1989).

Moreover, as cited , Elton and Gruber claimed that investors who sees favorable capital gains tax treatment would prefer companies with low dividend payouts or even none at all (Mann, 1989). This is for the reason of differing tax bracket levels hence, if income tax rate is greater than the capital gains tax rate, high dividend payments would add to shareholders' tax liability (Mann, 1989). Another proposition that attempts to unravel dividend puzzle is about the "dividend clientele effect hypothesis", positing that investors select favorable dividend policies corresponding to their tax brackets (Mann, 1989).

2.2 Tax Effects of Dividends

In the further investigation of the tax effects of dividends, two related issues were pointed: 1) the dividend clientele effect and 2) the extent of tax influence on the dividend yield-stock price relationship. The dividend clientele hypothesis asserts that firms attract investors based on their dividend payout policy (Graham and Kumar, 2004). Investors who like dividend income likes to invest in firms that pay higher dividends and vice versa. The study of Elton and Grube also revealed that rational clientele seem attracted to firms which has dividend policies that is favorable to their tax levels (Mann, 1989). These dividend clienteles are divided in a way that those in high tax brackets focus their portfolios on low dividend yield while those in low brackets focus on high dividend yields (Mann, 1989).

Studies show that dividend clientele exist on dividend capture strategies. Dividend capture strategy is employed by buying stocks just before the ex-dividend day and then trading it immediately thereafter for a profit. The ex-dividend date is very important as this sets the ownership to such dividends. Some investors just buy the stock to chase its dividends.

As of this present writing, will this strategy be practical or even attractive? Well, from the perspective of this current article’s author, it depends. Dividend declaration would normally give a positive signal that a company is earning well, has free cash flows and willing to reward stockholders for patronage. Hence, the stock prices are high immediately before the ex-dividend date, as many investors are attracted to the signals mentioned above.

The increased risk was also factored-in to explain these stock price increases (Mann, 1989). This is further explained with the risk of greater loss if such stock would decline in value right after ex-dividend date, hence would have less market demand. As such, dividend capture strategy is quite risky as one would need higher capital given the higher prices and the larger lots of stocks involved to offset the transaction costs involved in the buying and selling at days’ length.

2.3 Dividend Yields, Stock Returns and Asset Pricing

The corporate dividend literature discusses the relationship between dividend yields, stock returns and asset pricing. It was found that there is no clear link between dividend yield and stock returns (Mann, 1989). Two empirical studies, that of: 1) Black and Scholes and 2) Miller and Scholes, found that dividend yields do not affect share’s market value. Based on further readings, though dividend yields do not necessarily dictate share market value, these dividend yields can be used to estimate the stock’s intrinsic value. The proponents of Discounted Dividend model further posited that investors have different expectations and that firms should make at least an estimate of their intrinsic value before deciding on important matters such as new share issuances, share repurchases and others.

Empirical studies directly tested the information content of dividends hypothesis. Results showed that investors respond to declarations of unexpected dividend changes (Mann, 1989). Hence, a positive stock price result is linked with unexpected increases in dividends and the opposite is true for unexpected cuts in dividends. The inference is that unexpected dividend raise should signify favorable information about the firm's prospects and should relate to an increase in stock prices.

On the contrary, some studies showed that dividends send mixed signals on the growth and earning potential of the company. Logically, if the firm has better investment opportunities, shareholders will want the company to withhold more earnings, hence, lesser dividend pay-outs. However, if investment opportunities are poor, shareholders should prefer a high payout or conveniently the “bird-in-the-hand” hypothesis.

3. Research Progress in the Dividend Policy Literature (1989 and beyond)

At this juncture, this paper presents the latest progress in the dividend policy both from the tenets of corporate finance and behavioral finance literature from three aspects on 1) information content of dividends and signaling theory; 2) agency cost theory and; 3) tax effects of dividends.

3.1 Signaling Theory and the Information Content of Dividends

One of the major contributions to dividend signaling theory is Lintner's (1956) partial adjustment model. It was first to proposed that companies make partial adjustments thereby pursuing stable dividend policies by smoothing dividend payments (Lintner, 1956). It was further revealed that the reason why corporate managers are hesitant to cut back on dividends is to avoid transmitting bad signals to the market (Lintner, 1956).

An empirical study investigating U.S. and Japanese firms and their corporate dividend policies revealed proof supporting Lintner's speed of adjustment (Dewenter and Warther, 1998). Moreover, their study discovered that dividends of U.S firms were much smoother recently than compared before. Responding to firm's poor performance, they also found out that Japanese companies halted dividends more quickly than U.S. corporations (Dewenter and Warther, 1998).

Another survey research offered evidence directly from corporate managers by surveying their insights regarding dividends (Baker et al., 2002). Similarly, research findings are in strong consistence with Lintner's model and stressed the importance of continuing dividend. Furthermore, Baker replicated this study across different countries such as Baker et al. (2006) in Norway, Baker et al. (2008) in Canada, Baker and Powell (2012) in Indonesia, Baker and Kapoor (2015) in India and Baker et al. (2018) in Turkey. These repeated studies consistently back up Lintner's proposition (Baker et al., 2002).

Another crucial subject matter under dividend signaling is with regards the information content of dividends which falls under the asymmetric information debate. This notion emphasizes that corporate managers have an information advantage as regards their firms' prospects. Thus, cash dividend declarations are used in relaying to the public their expectations about their firm's prospects. Simply put, the hypothesis states that dividends are used as giving signals to investors—dividend announcement are seen as positive while dividend cutbacks are negative.

In an empirical study entitled "Dividend clienteles and the information content of dividend changes", it provided evidence that expected dividend yield affects the price responses to dividend pronouncements which is consistent with dividend clienteles (Bajaj and Vijh, 1990).

Another study results revealed that omission announcements leads to a fall in the stock price while dividend initiations yields an increased stock price (Michaely, Thaler, and Womack, 1995). In contrast, a study rejected the notion that fluctuations in dividends can signal information about the firm's future earnings (Benartzi, Michaely, and Thaler, 1997). The study strongly posits that dividends do not signal about future performance but rather suggests a strong historical and current connection between dividend changes and firm's profitability (Benartzi, Michaely, and Thaler, 1997).

Taken in another light, Jensen and Johnson (1995) focused specifically on announcements about dividend cutbacks. Their investigation showed that companies tend to cut dividend to imply the start of corporate restructuring and surviving a financial distress, which could lead to improved liquidity and better debt management (Jensen and Johnson, 1995). They further suggested that reducing dividends do not automatically signal a deterioration in earnings (Jensen and Johnson, 1995).

A more recent study of Liu and Chen (2015) settled with the notion that it is probable for corporate managers to stop using dividend changes in signaling their asymmetric information about future earnings prospects especially if investors cannot identify the signaling purpose and do not find dividend changes as useful tools in predicting the firm's future earnings (Liu and Chen, 2015).

These studies show the long-standing debates regarding dividend smoothing and information content which formed the foundation of dividend signaling theory. Up until this present writing, there is no one theory that comprehensively explains the impact of dividend information to the irrational behavior of investors.

3.2 Agency Cost Theories

Dividends also function as a monitoring tool for managerial actions. This function is primarily based from the grounds of Easterbrook (1984). He argued that dividend policy has a role in regulating agency-related issues by enabling the capital market to monitor the firms' activities and performance (Easterbrook, 1984). The study of Hansen, Kumar, and Shome (1994) also illuminated evidence of the use dividend-based monitoring scheme to control agency problems in the context of U.S. regulated electric utilities. In this light, another study posited that for mature and stable firms with limited growth opportunities, high dividends and leverage can have substantial benefit in controlling the "free cash flow" problem (Barclay et al., 1995).

Aside from agency-principal conflict discussed above, empirical studies also investigated dividend role in mitigating principal-principal conflict. This conflict arises when there is a substantial ownership by large families. The counterpart of principal-agency problem is when company wealth is expropriated by the few owners among the controlling interest. Hence, a conflict between controlling versus minority shareholders (who are both principal arises, further known as the principal-principal conflict.

In this regard, the study of La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000), suggested that external investors and existing shareholders may seek wealth protection from corporate laws against undue expropriation. Moreover, it was suggested that dividend cash payments can be employed in reducing the principal-principal conflict through the assurance of dividend payouts to all shareholders thus ultimately transferring corporate wealth to rightful shareholders (La Porta et al., 2000).

The third type of agency problem is the conflicting interest between shareholders and bondholders. As dividends are paid to stockholders, bondholders may view such transfer as an expropriation of their wealth. In contrast to this belief, an earlier study of Long, Malitz, and Sefcik (1994) posited that there is no evidence showing that dividend policies were manipulated by firms to steal corporate capital from new bondholders to enrich shareholders.

In this issue, a recent study posited that the positive relationship between unexpected dividend changes and the premium on bond and abnormal stock returns during dividend declaration dates implicates that information content of dividends significantly influences the wealth transfer effect in the U.S. bond market (Tsai and Wu, 2015).

3.3 Tax Effects of Dividends

The literature has presented differing views on the tax effect of dividends. The empirical study of Barclay, Smith & Watts (1995) entitled “Determinants of Corporate Leverage and Dividend Policies”, found out that the company’s extent of investment opportunities is the single most significant basis of a company’s dividend yield and leverage decision. Hence, it is not about purely taxes nor considerations on dividend clientele (Barclay et al., 1995).

As another support, Kalay and Michaely (2000) found in their study that the well-known tax models was not able explain their evidence of obtaining a significant positive dividend yield coefficient.

Another study in U.K’s major changes in dividend taxation system by Bell and Jenkinson (2002), concluded that taxation affects the valuation of dividend in the U.K. However, the extant literature has not yet approached an overall scholarly consensus regarding the tax effect of dividends as there exists major differences in each countries’ tax rates and brackets.

4. Dividend Policy in the context of Philippines’ New Corporate Tax Law

Investors’ portfolio preference and their position in the income tax brackets are the central issues in tax effect of dividends. Taking these discussions to the present time and in Philippine context, the present author sees the same patterns between the tax treatment of dividends and capital gains.

Under the newly enacted CREATE Law, capital gains from corporations that are not traded in the PSE are taxed at a straight 15%, for all kinds of taxpayers, individuals or corporations, resident or non-resident alike. But for capital gains realized on the sale of shares listed and traded on the stock exchange, the tax is at at 0.6% of the gross selling price. Dividends on the other hand, are tax exempt if received from domestic corporation for resident corporations but are subject to 10% if received by resident individuals. The rates are higher for nonresident corporations 15% to 25% and 20% and 25% for NRA-ETB and NRA- NETB respectively (Tax Reform, Department of Finance, 2021).

Let us look at which is the better option whether dividends or capital gains with the first premise that we are investing in a domestic corporation and we are resident taxpayers. First scenario: if an individual is investing in a domestic corporation’s listed and traded shares, capital gains are much cheaper at 0.6% compared to the 10% tax on dividends. But this would change in the second scenario if such domestic corporation is not listed and traded in the stock exchange as investors incur higher capital gains tax at 15% compared to the 10% tax on dividends. Simply put, dividends work best for individual investors invested in shares not listed and traded in stock exchange. For a resident corporation, capital gains tax would come slightly higher even at 0.6% as compared to the 0% or tax exemption on its receipt of dividends from a domestic corporation's listed and traded shares. Hence, resident corporations would prefer dividends instead of capital gains. For the second premise of being nonresident individuals and corporations, the verdict is clear: tax on dividends is much expensive compared to the flat 15% capital gains tax. Tax treatments on dividends would still depend on which kind of investor's perspective and on whether the stock is traded in the stock exchange or not.

5. What can be Learned from the Current Dividend Policies of Selected Companies?

Dividend policy is quite intriguing as different companies that are epitome of success on their own fields employed different pay-out policies. The vast literature in dividend policy seemed to fail in explaining what single factor affects dividend policy.

In the international scale, just the first quarter of 2021, the top two biggest companies in the world are Apple Inc and Saudi Aramco. Looking closely at Apple Inc's dividend history, its corporate dividend policy has evolved dramatically through the years. The company went from no dividend declarations under the leadership of Steve Jobs, to their first dividend announcement in 1987 (two years after Steve Jobs was ousted in 1985), then moving forward to its constant dividend from 1988 to 1995 (Apple Inc, n.d.). Afterwards, with the comeback of Steve Jobs in 1996, Apple Inc. once again cut their dividend. After 17 years, and just right after the death of Steve Jobs in 2014, Apple resumed their first dividend. Through the years, Apple Inc. also reduced its dividends from $3.29 (in 2014) to $0.47 and somehow just maintains their dividend rate of less than $1 thereafter up to the present (Apple Inc, n.d.).

Saudi Aramco is another company worth mentioning. It is one of the biggest market capitalization firms in the world and pays back generous dividends to shareholders. Just for 2020, Saudi Aramco paid 281,835 million SAR dividends to its institutional and individual investors (Slav, 2020).

These companies are just two examples of companies paying dividends but on different extents. One with a very minimal but constant dividend, while the other with generous bulk dividends. Nonetheless, their strong market position cannot be undermined.

On the opposite end, there are also companies which has never paid dividends but likewise, their successful competitive advantage and market position cannot be rebutted. Take the case of Google, Berkshire Hathaway and Amazon. Google has never paid dividends to its stockholders (Nasdaq, n.d.-d) Berkshire Hathaway shares both BRK.A and BRK.B of Warren Buffet do not pay dividends (Nasdaq, n.d.-b; Nasdaq, n.d.-c). Similarly, Amazon, the largest multinational company do not have dividend payouts (Nasdaq, n.d.-a). These successfully big and powerful companies have never paid dividends to their shareholders from inception, yet they continue to grow and are likewise very attractive to investors.

6. Conclusion

This article contains practical debates on corporate dividend policy, from a review of older articles that are relevant to the current knowledge. This gives a literature discussion on the dividend policies of corporations with a focus on *"The Dividend Puzzle: A Progress Report*", by Steven Mann which was published in Quarterly Journal of Business and Economics in 1989. This research paper discusses the progress of Fisher Black's Dividend Puzzle, as to what answers have been provided by the extant literature and what needs to be studied further in an attempt to resolve this dividend puzzle, taking into consideration the recent trends in corporate policies in the 21st century and in the specific country-level context of corporate tax laws.

The extant literature on dividend policy consistently reveals that investors have different preferences. Some prefer dividend yields as a form of passive income while some prefer longer capital growth and appreciation. For dividend investors, bird-in-a-hand assumption works best. Though, the notion of informative content of dividends is shown in many of the empirical studies mentioned above, interpreting these signals is still a highly subjective part.

It should be noted that even up to this present writing, this "dividend puzzle" remains intriguing and unsolved considering how successful companies adapt different dividend policies. Practitioners and academicians alike cannot concretely formulate what is the best dividend policy and debates regarding its impact to firm value still gathers contradicting results. The literature on behavioral finance could be further explored in attempting to explain the differing preferences of rational investors with regards these corporate policies. Indeed, dividend policies are very important corporate decisions, and having said that, the inclination is still towards the notion that there's no one-size-fits-all dividend policy. After all, dividend policy continues to rest with management judgement, so "it depends" could still be the answer to this dividend puzzle—both from a corporate view and from an individual investor perspective.

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