Why Do Firms Pay Dividends? : A Literature Review

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Abstract

Dividend policy is one of the most long lasting issues in modern corporate finance. Decisions regarding dividend payout and retention are mainly relies on the dividend policy of the firm. Stock price of the firm also affected by payout ratio. Numerous studies have been conducted to unearth the answer to the question of why firms pay dividend? Several Factors like operating cash flows, tax, information asymmetry, agency conflict, firm size affects the dividend decisions. This study will help to gain deep understanding of existing literature relating to the dividend payout policy and its determinants. It aims at providing an understanding of the previous research work done on dividend payout policy by various researchers. For this purpose several numbers of studies, conducted within a time period of 1980 to 2014 has been reviewed. It is found that some factors are positively related with dividend payout and are affecting their stock prices in positive direction for one country while they are negatively related for other countries. Majority of studies revealed that dividend has positive relation with cash flow, transparent information environment and size of the firm. It is also found that dividend is inversely related to financial leverage, growth opportunity, level of asymmetric information and managerial ownership. While kai li(2008) concluded that information asymmetry has no relation with dividend. These factors should be considered by management while formulating dividend policies for their firms.

Keywords
Determinants of Dividend, Dividend Payout Ratio, Agency Problem, information asymmetry.

Introduction

Dividend policy seems to be the most complicated aspects in finance. It led to emergence of a number of competing theoretical explanations. Three decades ago, Black (1976) in his study on dividend wrote, “The harder we look at the dividend picture the more it seems like a puzzle, with pieces that just don’t fit together”. Dividend policy is related with the decisions concerning dividend distribution and profit retention. It is among one of the important policies in the corporate policies. Dividend policy is a tool which is used to reduce the differing interests of the shareholders and managers because managers prefer to retain earnings but on the other hand shareholders are more interested in getting dividends. Mangers seek to retain the earnings as they prefer to maintain higher control over the resources. This issue gives birth to agency problem. Jensen (1986) and Rozeff (1982) have argued that the firms could use dividend payout policy to alleviate the agency problems. They said, if dividends are not paid to the shareholders, these resources might be used by managers for their private benefits. The firms may get benefitted by knowing about how they can control the agency costs by handling the Dividend policy. Jensen (1986) has concluded that, the managerial control over the resources would reduce if dividend is paid to the shareholders. Stouraitis and Wu (2004) argued that the overinvestment problems of corporations could be squeezed by dividend distribution. Dividend policy not only assists in reducing the agency costs but also acts as an indicator of the firm’s valuation to shareholders. Miller and Modigliani (1961) have proposed the dividend irrelevance hypothesis showing that, in a perfect capital market where there is no arbitrage opportunities are available, dividend policy does not affect firm value. In practice, however, capital market is neither perfect nor complete due to various factors such as tax structure, information asymmetries, transaction costs and agency problems. These market imperfections have significant impacts on corporate dividend policies, which, in turn, significantly affect the stock price because investors are concerned about their return on investment. A vast number of theoretical and empirical studies have been developed to explain why and how firms pay dividends. Despite several decades of research no agreement has reached about the rival theoretical approaches to dividend policy.

The literature offers various explanations for why firms pay dividends? In 1956, John Lintner led the first step for the modern understanding of dividend policy. Issues of dividend policy range very widely, as Black (1976) said it a puzzle, Miller and Modigliani (1961) talked about its irrelevance, De Angelo et al. (1996) appreciated its relevance. Dividend payout and retention ratios are still attracting researchers even though a lot of research has been done on them. It has been a subject of research since many years from past to present (e.g. Lintner, 1956; Gordon, 1959; Miller and Modigliani, 1961; Mancinelli and Ozkan, 2006; Amidu and Abor, 2006; Zhou and Ruland, 2006). Since stock prices and company's future growth are affected by dividend. Before taking a decision on the when and the how of dividend payout different variables are needed to be taken into account by management. Researchers often follow different procedures (empirical and/or theoretical), to underline factors which are expected to affect dividend policy and payout decisions. Several studies had conducted to examine the impact of various factors on dividend policy and payout ratios. Several researches came out with different conclusion. Miller and Modigliani (1961) have proved the irrelevance of dividend policy to share value in a perfect and efficient capital market. Rozeff (1982) and Easterbrook (1984) argued that dividend payments can be used as a tool to reduce agency costs of external equity. Fama and French (1998) have reported that, considering other effects constant , actual firm values and dividend payouts are positively correlated. Easterbrook (1984) Claimed that agency-cost treatment predicts that, there is an increase in profits with increase in dividends lag and they are not related with future profits. Bradley et. al. (1998) observed that firms with higher expected cash flow volatility, have lower payout ratio when they control for leverage, property level diversification and their size. Their findings were contradictory to agency cost explanation but were in agreement with information based explanation of dividend policy. Eckbo and Verma,(1994) conducted an empirical research and showed that dividend decreases as managerial ownership increases. Mehrani, Moradi and Eskandar (2011) found that managerial ownership and dividend payment policy were negatively associated. Julio and Ikenberry (2004) contend that the increase in dividends was merely a result of a change in firm composition over the studied time period. A range of firm and market characteristics have been proposed as potentially important in determining dividend policy.

In this study, we thus explore and understand the previous research work done on Dividend Payout by various researchers. The dividend payout can be affected by firm's size, tax structure, firm's ownership structure, business risk, operating cash flows, age of the firm, information asymmetry, agency conflict and level of leverage etc. This study will contribute to provide an insight into the work done relating to the trends, dynamics and determinants of dividend policy. This study is basically a review of literature. This literature offers various explanations for why firms pay dividends? Table 1 shows the work done by various researchers.

Table 1

Author Name	**Year**	**Title of the Study**	**Research Objectives**	**Research Methodology**	**Findings**
James M. Poterba and Lawrence H. Summers	1984	New Evidence that Taxes Affect the Valuation of Dividends	To examine the effects of dividend taxes on investors' relative valuation of dividends and capital gains. To examine the relationship between dividends and stock price movements during different tax regimes.	Share price daily data for 16 large U.K. firms obtained from the London Business School Sample period – 1955 to1981 For estimation after-tax CAPM has used , Regression method and Time Series analysis has been used for Dividend Valuation	Taxes affect the equilibrium relationship between dividend yields and market returns. Taxation of dividends reduces their relative valuation by investors. Dividend taxes are recognized by investors and affect the ex ante returns which they demand
Louton, David A	1991	Dividend policy: Relationships with investment and risk	To find out empirical relationship between dividends and investment	Sample Period 1953-1989 Study employed Granger causality methods on a series of 38 annual observations per firm. With that Vector auto-regression, Time series analysis Chi square and f- test has been used	They found a stronger relationship between changes in OLS beta and changes in dividend payout, than there is between changes in standard deviation of returns and changes in dividend payout. It infer that changes in dividend payout policy may contribute to increased systematic risk.

Seongho Park	1996	An Empirical Examination Of Corporate Dividend Policy	To examine the response of market prices to dividend changes.	For 3700 individual firms data has obtained from the COMPUSTAT . Sample period - 1950 to 1993 Dickey- Fuller regressions andtime-series analysis has been done.	The stock market responds more strongly to dividend increase announcements of the firms with information asymmetry than those of the firms without information asymmetry. And the market's differential reactions are not related to firm size.
Yakov Amihud and Maurizio Murgia	1997	Dividends, Taxes, and Signaling: Evidence from Germany	To see whether dividend news conveys information about companies' values or not?	For 200 companies which were actively traded on the Frankfurter Borse data was collected from online database Genios. Final sample includes 255 events of dividend increase and 51 events of dividend reduction. Sample period - 1988 to1992 An event study was conducted.	In Germany it is found that dividend convey information about companies' current earnings. Dividends are positively related to earnings changes

Kathryn L. Dewenter and Vincent A. Warther	1998	Dividends , Asymmetric Information and Agency Conflicts: Evidence From a Comparison of Dividend Policies of Japanese and U.S. firms	To examine the Impact of Information asymmetries and Agency Conflicts on corporate dividend policy of Japanese and U.S. firms	U.S. companies which were listed in 1983 Standard and Poor's (S&P) 500 . Japanese companies which were listed in 1983 Morgan Stanley Capital International Index were selected . Data collection source – COMPUSTAT ,Global Vintage Database Time period- 1982 to 1993	Japanese firms, specifically keiretsu – member firms, confront less information symmetry and fewer agency conflict than U.S. firms. lower level of information asymmetry and agency conflict in Japanese firms suggest that dividend don't act as a signal of information. Japanese firm's dividends are more responsive to earning changes.
Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer, and Robert W. Vishny	2000	Agency Problems and Dividend Policies around the World	To identify basic elements of the agency approach to dividends, to understand its key implications, and to evaluate them on a cross section variation.	Data relating to 4,000 firms from 33 countries around the world collected from World Scope Database. Regression has applied on a cross section of companies that Control for tax and industry effects.	It outline 2 agency model to dividend. Outcome model predict that firm are forced to pay dividends because minority shareholders pressure corporate Insiders to disgorge cash and Substitute model predict that insiders who are interested in issuing equity in the future distribute dividends to establish a reputation for decent treatment of minority shareholders.
Malcolm Baker, Jeffrey Wurgler	2004	Appearing and disappearing dividends: The link to catering incentives	To identify a link between propensity to pay dividends and catering incentives	Fama- MacBeth logit regressions was used Sample period - 1963 to 2000	Propensity to pay decreases when a proxy for the stock market dividend premium is negative and increases when it is positive.

ODED SARIG	2004	A Time-Series Analysis of Corporate Payout Policies	To conduct a time-series analysis of corporate payout policies that accounts for the dynamic nature of corporate decisions and for the interaction among investment decisions and payout policies.	Data collected from COMPUSTAT for a sample consist of 156 firms. Sample period - 1950 to 1997. Estimation is done with a Vector Autoregressive (VAR)model of investments to capture both the dynamics of the decisions as well as the joint determination of multiple corporate decisions.	Corporate investment decisions lead payout policies. An increases in corporate total payout are associated with long-term subsequent increases in earnings. Changes in the composition of corporate payout away from share repurchases .
Sanjay Deshmukh	2005	The Effect of Asymmetric Information on Dividend Policy	To study the effect of asymmetric information on dividend policy and issue cost. To examine dividend policy in the presence of predicted issue costs.	Sample consists of manufacturing firms (SIC 2000-3999) that trade on either the NYSE or the AMEX. Sample period - 1988-1992. Regression, Tobit model and applied to both dividend-paying and non-dividend-paying firms.	Dividends are inversely related to the level of asymmetric information. Dividends are positively related to both analyst following and cash flow, but negatively related to growth opportunity. The results confirm that issue costs increase with the level of asymmetric information. Other things equal, dividends are negatively related to predicted issue costs and are consistent with the implications of the pecking order theory.

Abdulrahman Ali Al-Twaijry	2007	Dividend policy and payout ratio: evidence from the Kuala Lumpur stock exchange	To identify the impact of different factors on dividend policy and payout ratios	Sample of the study is cross-sectional and consists of 300 Malaysian companies randomly selected from the Kuala Lumpur Stock Exchange (KLSE). Sample period - 2001 to 2005 T-test, pearson correlation and mean comparison analysis has applied .	Current dividends are affected by their pasts and their future prospects .Company's level of leverage has a negative relationship with the dividend payout ratio. Age has no impact on the amount paid for each share. Whereas company's size has a positive relationship with the dividend payout ratio.
Andrew Ang, Jun Liu	2007	Risk, return, and dividends	To find the relation among expected Returns, stock volatility, and price–dividend ratios.	ARCH or stochastic volatility models, Black, Scholes, and Merton has been used for analysis	The return is a function of Price–dividend ratios and dividend growth rates. Return volatility determines Price–dividend ratios and vice versa. Using dividends and price–dividend ratios, volatility process of the stock can be computed.
Kai Li and Xinlei Zhao	2008	Asymmetric Information and Dividend Policy	To examine the relation between the qualities of firm's information environment and firm's dividend payout and repurchase policy.	Data collected from COMPUSTAT, CRSP, and IBES. Sample period - 1983 to 2003 Correlation matrix and logistic regression has used to examine the likelihood of making dividend payments.	Firms with more transparent information environments pay out more dividends. There is no positive association between information asymmetry and repurchase activities.

Hammad Hassan Mirza	2010	Ownership Structure And Cash Flows As Determinants Of Corporate Dividend Policy In Pakistan	To explore the impact of firm specific characteristics on corporate dividend behavior in emerging economy of Pakistan.	Data of 100 companies listed at Karachi Stock Exchange (KSE) has been analyzed using Ordinary Least Square (OLS) regression. Sample period - 2005 to 2007	Managerial and individual ownership, cash flow sensitivity, size and leverage are negatively whereas, operating cash-flow and profitability are positively related to cash dividend. Timely payment of dividend has a positive impact on reputation of company in equity market.
Khaled Hussainey	2011	Dividend policy and share price volatility: UK evidence	To examine the relation between dividend policy and share price changes in the UK stock market.	Publicly quoted companies in the UK has been taken for study. Sample period - 1998 to 2007 Correlation and Multiple regression analysis was used to measure the periodic effect of dividend policy on stock price volatility.	Negative relationship between the payout ratio of a firm and the volatility of its stock price, a negative relationship between dividend yield and the volatility of stock price. On the other hand Debt showed a significant positive relationship with price volatility, suggesting that the more leveraged a firm is, the more volatile the stock price will be. While size had a significant negative relationship with price volatility.

Hamid Ullah	2012	The Impact of Ownership Structure on Dividend Policy Evidence from Emerging Markets KSE-100 Index Pakistan	To study the determinants of the corporate dividend policy in the context of agency relation.	Data for Random sample of 70 firms listed on Karachi Stock Exchange has been collected . Sample period - 2003 to 2010. Stepwise multiple regression has used to investigate for the relationship of ownership variables with the dividend payouts.	There is negative relationship between the dividend payouts and managerial share ownership with the explanatory power of 18%. Where there has positive relationship between the dividend payout and institutional ownership with explanatory power of 23.3%.
Matthias Nnadi	2012	Determinants of Dividend Policy: Evidence from Listed Firms in the African Stock Exchanges	To examines the factors influencing dividend of listed firms in the 29 stock exchanges in Africa	Analysis is based on a panel data set of 1,742 listed firms in the 29 stock exchanges in Africa Sample period-1998 to 2009 Tobit model has used for analysis	Firm's age is positively related to its dividend policy. Mature firms with less growth and investment opportunities are more likely to pay dividends. But level of financial leverage inversely affects the dividend decision.
Indri Erkaningrum F.	2013	Interactions Among Insider Ownership, Dividend Policy, Debt Policy, Investment Decision, And Business Risk	To investigate the interaction among insider ownership, dividend policy, debt policy, investment decision, and business risk	The samples of the research are 137 manufacturing companies listed in the Indonesia Stock Exchange . sample period - 2006 to 2010 The three stages least square simultaneous equation model is used to analyze the interaction among insider ownership,	Insider ownership, debt and business risk give negative impact to dividend. Insider ownership and business risk have negative influence on investment, whereas profitability and sales growth have positive influence on investment.

				dividend policy, debt policy, investment decision, and business risk.	
Michelle Hanlon , Jeffrey L. Hoopes	2014	What do firms do when dividend tax rates change? An examination of alternative payout responses	To investigate whether investor-level taxes affect corporate payout policy decisions.	Monthly dividend data collected from CRSP, COMPUSTAT Sample period – Jan 1980 to June 2013 linear probability model has been used to allow for interpretation	Corporations responded by paying special dividends in advance of the tax rate increase and by shifting regular dividends into the expected lower-taxed-period. Immediately before the expected tax increases, firms altered the timing of their regular dividend payments by shifting what would normally be January regular dividend payments into the preceding December.
Yordying Thanatawee	2014	Ownership Structure and Dividend Policy: Evidence from China	To study the impact of ownership structure on dividend policies	Database of firms listed on the Shanghai Stock Exchange (SSE) provided by the Emerging Market Information Service (EMIS). The sample consists of 3,500 firm-year observations. sample period – 2007 to 2011. logit regression and tobit model was applied to analyze factors affecting the dividend payouts.	Magnitude of dividend payouts has a positive relationship with the ownership by the largest shareholder, ownership concentration, and government ownership but a negative relationship with the ownership by institutions and foreign investors.

Conclusion

Numerous studies relating to dividend policy have been administered. Existing literature offers explanations to find the answer why firms pay dividends? What are the factors affecting dividend decision? After reviewing above literature it is found that various factors affect dividend decision and stock price differently for different countries. Some factors are positively related with dividend payout and their stock prices for one country while they are negatively related for other countries. James(1984) revealed that investors are more conscious about dividend tax. Tax paid on dividends negatively affect the shareholders and reduces their ex ante return Michelle(2014) explained that Corporations are responded by paying special dividends in advance of the tax rate increase and by shifting regular dividends into the expected lower-taxed-period. Yordying (2014), Hamid ullah(2012) found that institutional ownership has a positive relation with dividend payout while Erkaningrum(2013) found dividend payout is inversely related with Insider ownership . Few Studies revealed that Size and age of firm also affect dividend decision and bring price volatality. Matthias (2012) studied that dividend policy and age of the firm are positively related with each other. Firms, which are in maturity stage of their life cycle and having less investment opportunities prefers to pay dividends. Khaled (2011)found there is a negative relation between firm's size and price volatility.While Seongho Park(1996) argued that market's differential reactions are not related to firm size. Louton(1991) & Erkaningrum(2013) revealed that business risk has a inverse relation with dividend. It is found that information asymmetry has strong impact on dividend payout. Sanjay Deshmukh(2005) disclosed that level of asymmetric information and dividend are negatively related. Kai Li (2008)& Kathryn (1998) concluded that firms having more transparent information environments are paying more dividends. Seongho Park(1996) stock market responds more strongly to dividend increase announcements of the firms with information asymmetry than those of the firms without information asymmetry. Through this study we tried to provide a light on the pathway to discover what makes share price volatile and what factors should be considered by management while formulating dividend policies for their firms. For this purpose several numbers of studies, conducted within a time period of 1980 to 2014 has been reviewed which is in itself a limitation of this study. However, we found that most of the studies was conducted in developed countries and had focused on listed companies. Therefore the conclusions reached may not be applicable in developing countries with different corporate cultures and economic frameworks. In spite of being already a much researched area, Dividend payout and retention ratio are still attracting researchers.

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47) The impacts of recent tax legislation on dividend policy and investment A Dissertation GEORGE RYAN HUSTON Submitted to the Office of Graduate Studies of Texas A & M University in partial fulfillment of the requirements for the degree of DOCTOR OF PHILOSOPHY May 2007 Major Subject : Accounting. (2007), (May).

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