

Why Do Firms Pay Dividends?

Justifications for Dividend Payments and Firm Value Implications

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Abstract - Under the assumptions of perfect capital market and investor rationality, Miller and Modigliani (1961) concluded that dividend policy is irrelevant to firm value. However, capital markets are less than perfect in the real business world. Consequently, in the presence of realistic capital market imperfections such as information asymmetry, agency costs, taxes, and irrational investor behaviour, dividend policy creates a means to enhance shareholder value. This paper seeks to discuss the main theories that explain why firms pay dividends and the impact of such distributions on the value of the firm.

Keywords - Dividends, market imperfections, dividend payments, firm value.

I. INTRODUCTION

The question of why firms pay dividends and the impact of dividend distributions on the value of a firm has been the subject of considerable debate for several decades. Based on either a behavioural or empirical approach, studies have provided rationales to address the issue of why firms pay dividends and the impact of such disbursement on the value of a firm. However, as of today, corporate dividend policy still remains a puzzle as a mix of opinion continues to exist about the impact of dividend policy on firm value (Black, 1976; Brealey *et al.*, 2008).

The theoretical framework of the impact of dividend distributions on firm value revolves around two schools of thought, which have divergent views. The first school of thought is the dividend irrelevance hypothesis put forward by Miller and Modigliani (1961). The authors argued that in a perfect capital market with investor rationality, the dividend policy has no impact on shareholders' wealth and, is, therefore, irrelevant. Under a perfect capital market, information is costless and available to everyone, no distorting taxes exist, floatation and transaction costs are non-existent, and no contracting or agency cost exist (Lease *et al.*, 2000). An alternative school of thought is the dividend relevance theory, which suggests that a properly managed dividend policy is critical to the value of the firm (Graham & Dodd, 1934; Lintner, 1962; Gordon, 1963). In other words, dividend policy is relevant to firm value in that firms that pay a higher dividend enjoys a lower discount rate for future cash flows and thus have a higher value.

To help resolve the dividend puzzle, behavioural finance theorists have advanced several paradigms to explain the relevance of dividend policy to corporate value in the context of capital market imperfections. They argued that in the real business world, capital markets are less than perfect and investors are not rational. Thus, in the presence of realistic market imperfections such as information asymmetry, agency costs, taxes, and irrational investor behaviour, the argument for the relevance of dividend policy to corporate value may seem realistic (Friend & Puckett, 1964; Brennan, 1970; Bell & Jekinson, 2002; Allen & Michealy, 2003; Dimitrios & Dimitrios, 2007).

This paper provides an extensive and accessible overview of the main theories that explain why firms pay dividends and also review the main empirical evidence on these theories. The paper noted that as dividends may not enhance firm value in the context of perfect capital markets, the rationale for dividend relevance to corporate value has been sought in the various capital market imperfections. Specifically, the paper discusses how the distribution of company profits in the form of dividends can mitigate the problem of asymmetric information between corporate insiders and outside shareholders by signalling to the market the firm's future positive prospects. In addition, high dividend payout reduce the potential for expropriation of principals by managers by limiting the cash available for managers to squander on negative net present value (NPV) projects, such as building of perks. Moreover, firms pay out dividends to attract institutional investors to their shares. Finally, dividend payments reduce uncertainty about future cash flows, and hence reduce the firm's cost of capital. The reduction in uncertainty about future cash flows influences the value of the firm.

The following sections of this paper are organized as follows. Section 2 outlines the four main theories that explain why firms pay dividends and its relevance to corporate value, while Section 3 reviews the main empirical research conducted to date to test the dividend relevance theories. Finally, Section 4 summarizes and concludes the work.

II. THEORETICAL EXPLANATIONS OF WHY FIRMS PAY DIVIDENDS

Capital markets are less than perfect in the real business world. In the presence of market imperfections such as information asymmetry, agency costs, taxes, and irrational investor behaviour, financial economists have offered several theories to explain why firms distribute dividends to shareholders and the impact of such disbursements on the value of the firm. This section discusses the main theories that explain why firms pay dividends.

A. *Signalling Theory*

The signalling theory of dividend relevance is based on market imperfection due to information asymmetry. Information asymmetry arises when a group possess superior information about a firm's current situation and future prospects that other groups do not have. The signalling model for paying dividends developed by Bhattacharya (1979), John and Williams (1985), and Miller and Rock (1985), suggests that given the presence of information asymmetry between managers and shareholders, dividend payments can be used to signal asymmetric information to investors about the state of affairs of the business, earnings growth and future prospects of the firm; dividend increases (decreases) convey favourable (unfavourable) information about future cash flows of the firm. In other words, firms commit to pay dividends in order to signal to investors' private information about their bright future.

In order for dividends to convey information, managers must have access to knowledge about the firm not available to outsiders, but which can be signalled to the market via the dividend policy. In a symmetrically informed market, all interested participants have the same information about a firm. This implies that information is costless and available to everyone equally in a perfect market. However, one important capital market imperfection in the real business world relates to the information structure. Corporate managers ("insiders") and shareholders ("outsiders") do not have the same (symmetric) information in a realistic business world. Arnold (2002) opined that capital markets are imperfect in the sense that information is neither costless nor universally available to all shareholders. Accordingly, managers will have access to information about their firm over and above the amount of information that is disclosed to the market. This creates an imbalance between managers and shareholders conventionally known as 'informational asymmetry'. Information asymmetry between managers and outside investors may have implications for dividend policy since managers make their investment decisions by following a pecking order of financing choices (Myers & Majluf, 1984; Miller & Rock, 1985). Thus, information asymmetry between managers and investors may cause securities to sell at prices other than their true values.

The central theme of all the signalling models, therefore, is that managers have private information about

future prospects and choose dividend levels to signal that private information. Bhattacharya (1979) developed a model in which dividends are seen as a costly means of removing information asymmetries in the market concerning a firm's true value. An important assumption of this model is that if the payoff is insufficient to cover the dividends, the firm must resort to external financing. In John and Williams (1985) model, a dividend signal is said to exist where corporate insiders distribute a taxable dividend in equilibrium and thereby reveal to outside investors the true present value of their firm's future cash inflows. The argument for simultaneously paying cash dividends and raising new capital is that dividend payments reduces the under-pricing of securities issued to obtain new outstanding finance. Firms therefore use dividends to signal future prospects despite the tax disadvantages of dividends compared to capital gains in some countries such as the U.S.A., U.K. and Nigeria. Miller and Rock (1985) developed a dividend information model in which cash dividends operate as a signal of future operating cash flows of the firm. The basic story of the Miller and Rock model is that firms shave investments to increase dividend payouts and thus signal high earnings (Allen & Mischealy, 2003). The signalling theory explains why firms pay out so much of their earnings as dividends even if that means cutting back on investments.

In summary, the signalling theory argues that if managers have information that outside investors do not have, the payment of dividends enhance firm value because managers employ dividend policy as a 'costly-to-replicate' vehicle for conveying positive private information to market participants. Managers use dividends to signal the firm's future positive prospects by adopting high payouts (Bhattacharya, 1979). Accordingly, investors perceive a dividend increase (decrease) as a signal of managements' confidence that earnings will appreciate (depreciate) in the future, sending the share prices upward (downward). As a result, dividend changes serves as a signal of predicted earnings, thereby impacting share price.

B *Agency Theory of Dividend policy*

Agency costs stems from agency relationship due to separation of ownership and control between various stakeholders of the firm. Agency conflicts arise in firms because corporate decisions are made by managers (agents) on behalf of the firm's owners (principals). The first conflict of interests that could affect dividend policy is between shareholders (principals) and managers (agents). The separation of ownership and control may result in conflicts of interests between agents and principals because management may not always act in the best interests of the firm owners (Donaldson, 1963; Jensen & Meckling, 1976). Jensen (1986) argued that, managers motivated by compensation and human capital considerations have incentives to overinvest free cash flows even in the absence of profitable investment opportunities (free cash flow hypothesis). Managers may invest in unprofitable investments such as lavishing resources

on corporate jets and hunting trips as well as by investing in unjustifiable acquisitions and expansions. This problem induces shareholders to incur agency costs to monitor managers' behaviour. The costs associated with this potential conflict of interests include expenditures for structuring, monitoring and bonding contracts between shareholders and managers, and the residual losses due to imperfectly constructed contracts (Jensen & Meckling, 1976).

The second conflict of interest that could affect dividend policy is between shareholders and bondholders. In this case, shareholders are considered as the agents of the bondholders' funds (Al-Malkawi *et al.*, 2010). Equity holders may try to expropriate wealth from debt holders (Jensen & Meckling, 1976; Myers, 1977). This wealth expropriation could come in the form of excessive dividend payments, either by reducing investments by the shareholders in order to increase dividends (investment-financed dividends) or by raising debt to finance the dividends by the shareholders (debt-financed dividends). In both cases, if the increase in dividends is unanticipated by debtholders, then the market value of debt will depreciate and the market value of equity will appreciate. As a result, bondholders prefer to put constraints on dividend payments to secure their claims while shareholders prefer to have large dividend payments (Ang, 1987).

The agency problems could be alleviated either by increasing managers' equity ownership in the firm which would better align managers' interests with the interests of the shareholders (Jensen & Meckling, 1976) or through the use of complex contractual arrangements between management and shareholders (Barnea *et al.*, 1981). However, these remedies create substantial costs to the shareholders. Dividend payments play a role in controlling equity agency problems by limiting managers' ability to misuse excess funds and also by facilitating capital market monitoring of the firm's activities and performance. Higher dividends payout reduces the discretionary internal cash flow and forces the firm to seek external financing from capital markets, which in turn subjects the firm to higher scrutiny and discipline of capital market regulators (Grossman & Hart, 1980; Easterbrook, 1984; Jensen, 1986). Easterbrook (1984) noted that this capital market monitoring reduces agency costs and leads to appreciation in the market value of the firm.

Furthermore, increase in dividends will help reduce the overinvestment problem by reducing the free cash flow under management discretion which might otherwise have been wasted in non-value maximizing project and thus increase the market value of the firm. This is because the less discretionary cash that management has, the harder it is for them to invest in negative NPV projects (Allen & Mischealy, 2003). To the extent that shareholders are rewarded by cash dividends and capital expenditures are financed by the new issue of shares or by debt, the company dividend policy acts as a monitoring device which reduces the agency conflict between managers and the shareholders of the firm thereby

diminishing the agency cost of equity (Grossman & Hart, 1980; Jensen, 1986). In a similar vein, a higher dividends payout helps control the impact of widespread ownership (Rozeff, 1982). Manos (2002) noted that the more dispersed the ownership structure, the more acute the free rider problem and the greater the need for outside monitoring. The payment of dividends therefore acts as a monitoring device, like a bonding cost or an auditing cost which mitigates the deadweight costs of agency conflicts between managers and shareholders thereby diminishing the agency cost and thus enhances shareholder value.

In summary, the core of the agency problem as discussed by Jensen (1986) is the inability of dispersed shareholders to prevent corporate management from expropriating their wealth due to conflicts of interests, diversification of risk and different time horizons. Since it is harder for management to renege on a debt commitment relative to a dividend commitment, then a more effective mechanism to impose discipline is to increase the level of debt (Grossman & Hart, 1980; Jensen, 1986). The payment of dividends is one way to reduce this conflict because high payouts to shareholders limit flexibility and inefficient managerial investments. Dividends therefore represent an effective mechanism for monitoring managers' potential to misuse excess funds. Thus, high dividend payouts help to resolve agency problems and thereby increase firm value to its shareholders.

C. The Tax/Cientele Effect Theory

Under the assumptions of a perfect capital market without taxation or information asymmetries, Miller and Modigliani (1961) contend that the dividend paid by a firm does not influence its market value since it will be matched with an equivalent capital loss. One of the implications of the dividend irrelevance hypothesis is that no distorting taxes exist. However, in the real business world, taxes exist and may have significant influence on dividend policy and the value of the firm. Furthermore, there is often a differential tax treatment of personal income from dividends and capital gains in most countries, such as the U.S.A. Thus, the influence of taxes may affect the demand of dividends because most investors are interested in *after-tax* return. Similarly, taxes may also affect the supply of dividends when managers are seeking to maximize shareholder wealth by increasing the retention ratio of earnings (Al-Malkawi *et al.*, 2010).

Taxation is therefore an important cost associated with dividend payments. Dividend policy is affected by three tax rates: (a) corporation tax (b) dividend income tax and (c) capital gains tax. Evidence from literature suggests that investors' preference or aversion to any dividend policy depends on the relationship among the three tax rates (Dimitrios & Dimitrios, 2007). The tax effect theory asserts that investors select firms whose dividend policies suit their tax preferences (Elton & Gruber, 1970; Miller, 1977; Miller & Scholes, 1978). This implies that the taxation of dividends and

capital gains on shares is likely to influence the preference for receiving cash either in the form of dividends or capital gains. For example, investors prefer cash dividends to capital gains when the dividend tax rate is smaller than capital gains tax rate. In contrast, investors prefer “home-made” dividends (generated through liquidating part of their shareholding) to cash dividends when the rate of capital gains tax in some countries is lower than the top income tax rate. Thus, a low dividend payout ratio lowers the cost of capital and increases the stock price.

On the other hand, the clientele-effect of dividends hypothesis suggests that pre-existing dividend clientele might play a role in dividend policy. Dividends can therefore be used to influence the class of shareholders attracted to a particular firm. Miller and Modigliani (1961) noted that market imperfections such as transaction costs and differential tax rates might influence investors to choose securities that reduce these costs. As a result, taxes and transaction costs may create investor clienteles such as tax minimisation clientele, for example, institutional investors. Given this favourable tax treatment, clienteles such as institutional investors tend to be attracted to invest in dividend-paying shares (Allen *et al.*, 2000). Institutional investors are also often subject to restrictions in institutional charters (such as the “prudent man rule”) which prevent them from investing in non-paying or low-dividend stocks. This Legal restriction makes dividends appealing to institutional investors (Brav & Heaton, 1997; Al-Malkawiet *et al.*, 2010). This clientele will increase the value of the firm to all shareholders, since it monitors the management and thereby increases the firm’s value.

In a nutshell, the central theme of the tax/clientele effects of dividends hypothesis is that dividends are taxed at a higher rate than capital gains, and as a result shareholders prefer a dividend pattern that matches their desired consumption pattern. Thus, the tax-effect hypothesis suggests that taxable investors who have favourable tax treatment on capital gains will prefer to invest in lower dividend-stocks. Conversely, the clientele-effect hypothesis suggests that the different tax treatment of dividends and capital gains might influence clienteles such as institutional investors to invest in high dividend-paying stocks because they have relative tax advantages over individual investors.

D. The Bird-in-the-Hand Argument

The bird-in-the-hand or risk reduction theory is the traditional argument in favour of dividend relevance to firm value. This theory advanced by Graham and Dodd (1934) and extended by Gordon (1959, 1963) and Lintner (1962) asserts that by paying dividends the firm brings forward cash inflows to shareholders, thereby reducing the uncertainty associated with future cash flows. Dividends represent a more reliable form of returning profit to shareholders than capital gains because share prices are highly variable. Distribution of cash through dividends therefore increases firm value because

dividends represent a certainty while capital gains are uncertain. The traditionalists assert that investors value the dollar which they receive from cash dividends more than the dollar they receive from capital gains. In this context, Graham and Dodd (1934) argued that a dollar of dividends has, on average, four times effect on stock price as a dollar of retained earnings.

The basic argument in favour of the bird-in-the-hand theory is that investors’ place value on the tangible nature of dividends relative to a possible capital gain. Dividends are perceived to be less risky than capital gains, because capital gains depend not only on the profitable reinvestments of earnings by the company, but also upon movements in the overall stock market (Kester & Robins, 2011). Gordon (1959) opined that the existence of uncertainty about the future suffices to make the price of shares vary with the dividend policy adopted; and in particular, the more generous the dividend policy, the higher the price of share. Investors’ perception of lower risk reduces the discount factor and increases the market value of shares. Because dividends are less risky than capital gains, the proponents of this theory argue that firms should adopt high dividend payouts in order to maximize their share price.

Notwithstanding the persuasiveness of the bird-in-the-hand argument, the theory has been criticized by some researchers who are of the view that the firm’s required rate of return is independent of its dividend policy because investors are indifferent between dividends and capital gains. Miller and Modigliani (1961) present a plausible argument against the bird-in-the-hand argument by contending that a firm’s risk is influenced by the riskiness of its operating cash flow, but not by the way the firm distributes its income. Consequently, Miller and Modigliani nicknamed this theory the “bird-in-the-hand fallacy”. Bhattacharya (1979) also argued that if the riskiness of a firm’s cash flow determines a firm’s risk, then the reasoning behind the bird-in-the-hand hypothesis is fallacious because an increase in dividend payout will not enhance a firm’s value by reducing the riskiness of future cash flows.

To summarise, the relevance of dividend policy to corporate valuation is due to capital market imperfections. Theories such as the signalling power or information content, agency theory, tax/clientele effect, and the bird-in-the-hand argument, have been put forward to explain why dividends can influence the value of a firm in a world characterised by market imperfections. The signalling theory suggests that managers choose dividend payment levels to signal to investors about the future earnings prospects of the firm. The agency theory argues that dividends help to discipline managers and reduce agency costs associated with separation of ownership and management. The tax/clientele effect asserts that managers use dividends to influence the class of shareholders attracted to their firms. Finally, the “bird-in-the-hand” explanation argues that dividend payments increase firm value because dividends represent a “certainty” while

future share appreciation (capital gains) is uncertain. These four theories of dividend relevance contrast with the dividend irrelevance hypothesis of Miller and Modigliani (1961) which asserts that a firm's dividend policy is irrelevant to share price valuation as investors can create a 'home-made dividend' by buying and selling the company's securities. The dividend relevance theories discussed above have been subject to ample empirical investigation. The next section reviews the empirical evidence on these theories.

III. EMPIRICAL EVIDENCE ON THE DIVIDEND RELEVANCE THEORIES

There is an extensive body of empirical literature on the impact of dividend distributions on corporate value. As such, it is practically impossible to review all the empirical studies of dividend policy. This section, therefore, focuses exclusively on the main empirical studies on dividend relevance to firm value.

A. Empirical Studies of the Signalling Hypothesis

The signalling hypothesis of dividend relevance has been widely addressed in the empirical literature, especially in countries with developed capital markets. The great majority of these empirical studies have attempted to quantify how share prices respond to the announcement of changes in dividends in order to determine whether share prices move in the same direction with dividend change announcements. The earliest empirical study of the signalling hypothesis was conducted by Petit (1972). The author examined the response of share prices to dividend announcements using a sample of 625 New York Stock Exchange (NYSE) quoted companies that generated 698 announcements of dividend changes over the period January 1964 to June 1968. His findings suggested that stock prices react significantly to dividend announcements. Similar to Petit (1972), Laub (1976) and Petit (1976) also reported that dividends convey information about future earnings prospects beyond those predicted by past earnings. These findings are consistent with the dividend signalling hypothesis.

The publication of Petit (1972) study spawned many subsequent studies that have investigated the impact of dividend announcements on share prices from a variety of different perspectives and in a selection of different circumstances. For example, a number of studies have examined stock market reaction to the announcement of changes in regular dividends (Charest, 1978; Aharony & Swary, 1980; Woolridge, 1983; Baraj & Vijh, 1995). These studies generally reported that share prices follow the same direction as the dividend change announcements. Specifically, the results of these studies show that dividend announcements do convey valuable information, and that the market reacts positively to the announcement of dividend increases and negatively to the announcement of dividend decreases. Other studies have examined the market response to the announcement of major changes in a firm's dividend policy

such as a dividend initiation and/or omission. The findings of these studies are consistent with the proposition that changes in existing dividend levels are both preceded and followed by distinctive earning patterns (Asquith & Mullins, 1983; Beneshet *et al.*, 1984). In general, there is strong empirical support for this hypothesis.

Despite the significant number of studies that documented evidence that dividends convey subtle information to capital markets, there is still considerable controversy about whether abnormal reaction in share prices can be attributed to dividend announcement alone. Researchers have uncovered the fact that dividend news is not disclosed in isolation, but is instead published at the same time as other data such as earnings data, earnings forecast, capital expenditure announcements, etc. The impact of complex signals on share values has been examined extensively in the literature and a new strand of the signalling literature-based upon *interactivesignals*- has rapidly developed (Kane *et al.*, 1984; Liljeblom, 1989; Easton, 1991; Lonie *et al.*, 1996; McCluskey *et al.*, 2006; Al-Yahyaee *et al.*, 2011; Ozo & Arun, 2019). The results of these studies indicated that unexpected earnings and dividend announcements appeared to induce abnormal returns and when dividends and earnings were both increased, the stock market reaction was more favourable than only when one variable increased in isolation, although the dividend signal appeared to dominate. In particular, the results show that dividends and earnings announcements are indeed interpreted in relation to each other, and that the interaction or corroborative effect was statistically significant.

Another strand of empirical studies of the dividend signalling hypothesis has examined whether dividend changes enable the market to predict the future earnings of a firm. For example, while some studies failed to find support that dividend changes convey information about future earnings (Watts, 1973; Gonedes, 1978; Benatrzi *et al.*, 1997); others report that dividends convey information about future earnings prospects beyond that predicted by past earnings (Laub, 1976; Petit, 1976). For example, Watts (1973) examined the relationship between unexpected dividend changes and positive future earning changes and subsequent excessive stock returns, using earnings, dividend and share returns data for a sample of 310 U.S. companies during the period 1946 to 1967. The author concluded that dividends have trivial information content about future earnings. More recently, Nissim and Ziv (2001) found that dividend changes and earnings changes are positively correlated. Overall, the empirical support for proposition that dividend changes convey information about future earnings is mixed and inconclusive.

B. Empirical Studies of the Agency Costs Explanation

The agency costs explanation for dividend relevance has been extensively addressed in the empirical literature. Rozeff (1982) was the first to establish an empirical

relationship between agency costs and dividend policy. The author employed a sample of 1,000 non-regulated firms in 64 different industries from 1974 to 1980. The author used two variables as proxies for agency costs and finds that these variables are important determinants of dividend policy. Specifically, the author documented that firms establish higher dividend payouts when insiders hold a lower fraction of the equity and/or greater number of shareholders owns the outside equity. This evidence lend credence to the view that dividend payments is part of the firm's optimum monitoring/bonding package and serve to reduce agency costs. Other researchers have also examined the agency costs explanation for paying dividends by studying the relationship between ownership structures, dividend policy and leverage (Crutchley& Hansen, 1986; Jensen *et al.*, 1992). These studies find support for the agency cost hypothesis, and suggested that the benefits of dividends in reducing agency costs are smaller for companies with lower dispersion of ownership and/or higher insider ownership.

Another strand of the empirical test of the agency conflicts between managers and shareholders have examined the free cash flow hypothesis. The free cash flow hypothesis suggest that increase in dividend payments reduce the cash flow that would have been otherwise invested in negative NPV projects. Lang and Litzenberger (1989) examined the free cash flow hypothesis employing the framework of the principal-agent conflict developed by Berle and Means (1932) and extended by Jensen (1986), and found that cash flow has strong explanatory power; this evidence is consistent with the free cash flow hypothesis. In contrast, Denis *et al.* (1994) examined the relationship between dividend yield and Tobin's Q on a sample of 5,992 dividend increases and 785 dividend decreases over the period 1962 to 1988. The authors reported evidence inconsistent with the free cash flow hypothesis. Other researchers such as Howe *et al.* (1992) and Yoon and Starks (1995) also reported evidence that challenge the findings of Lang and Litzenberger (1989) in that they found no relationship between Tobin Q and stocks reaction to dividend announcements. More recently, Lie (2000) examined the free cash flow hypothesis using a large sample of special dividends, regular dividend, and self-tender offers. He reported evidence inconsistent with the free cash flow hypothesis. However, recent evidence from more than 4000 companies from 33 countries around the world including some emerging markets indicates that firms pay more dividends in countries where shareholders have better protection, suggesting support for the agency cost explanation for paying dividends (La Porta *et al.*, 2000). In general, empirical evidence on the free cash flow hypothesis of the agency costs explanation for paying dividends is at best mixed.

C. Empirical Studies of the Tax/Clientele Effect Hypothesis

The empirical work on the tax argument focuses on two main issues: the tax-effect and the clientele-effect. The tax- effect hypothesis is based on the proposition that

dividends are taxed at a higher rate than capital gains. As a result, taxable investors will demand superior pre-tax returns from stocks that pay a large proportion of their income in the form of highly taxed-dividends. In contrast, the tax-clientele hypothesis suggests that clienteles such as institutional investors tend to be attracted to invest in dividend-paying stocks because they have relative tax advantages over individual investors (Allen *et al.*, 2000; Al-Malkawi *et al.*, 2010).

The tax-effect hypothesis is often studied by employing the Brennan's (1970) model, which involves examining the relationship between dividend yields and stock returns (Black & Scholes, 1974; Litzenberger&Ramaswamy, 1979; Miller & Scholes, 1982; Porteba& Summers, 1984; Kalay&Michealy, 2000). For example, Black (1974) tested the Brennan's model and reported that low or high-dividend yield stocks do not affect the returns of stocks either before or after taxes; this evidence is inconsistent with the tax effect hypothesis. In contrast, Litzenberger and Ramasawamy (1979) extended the Brennan's model and classified stock into yield classes using a monthly dividend yield definition. The authors found evidence of a tax effect. In particular, the results of their study show that the coefficient on the dividend yield variable is positive and highly significant. Miller & Scholes (1982) challenged Litzenberger and Ramaswamy's results and argued that the positive yield coefficient was driven by information bias. To determine whether the positive dividend yield is due to information effects, Black and Scholes (1982) attempted to correct for information bias and tested the tax-effect using the same sample employed by Litzenberger and Ramaswamy. The authors found that the dividend yield coefficient was not statistically different from zero. However, Kalay and Michealy (2000) carried out a similar test, excluding all weeks containing dividend omissions and found a positive and significant dividend yield coefficient; this result is inconsistent with the findings of Miller and Scholes (1982). In general, empirical support for the tax-effect hypothesis is at best mixed and inconclusive.

Researchers have taken different paths in the examination of the clientele-effect hypothesis. One strand of empirical testing has examined investors' portfolios and their demographic attributes including taxes (Al-Malkawi *et al.*, 2010). Petit (1977) and Scholz (1992) examined the portfolio positions of individual investors, and reported evidence consistent with dividend/tax-clientele hypothesis. In particular, Petit (1977) reported a positive relationship between investors' ages and their portfolios' dividend yield. The authors also found a negative relationship between investors' income and dividend yield. In a similar vein, Scholz (1992) found that differential tax treatment of dividends and capital gains influences investors' decisions in choosing between higher-or-lower-dividend yield portfolios. However, Lewellen *et al.* (1978) found only very weak evidence in support of the clientele effect hypothesis using a sample constructed from same database used in Petit's (1977).

Another strand of empirical tests of the clientele effect hypothesis has examined the tax characteristics of marginal investors by studying the movement of stock prices around the ex-dividend days. One of the earliest studies on ex-dividend day pricing was published by Campbell and Beranek (1955). The authors documented that ex-dividend behaviour of stock prices has an impact on the portfolio decisions of investors. The authors reported evidence that on average, ex-day stock prices drop by less than the amount of dividends. Elton and Gruber (1970) provided a more detailed empirical investigation of the clientele effect hypothesis when they tested a method of determining marginal stockholder tax brackets and its implications on corporate investment policy, dividend policy, and the assumption of market rationality. Using a U.S. data for the period April 1966 to March 1967, the authors documented evidence of a statistical relationship between the dividend policy of firms and the tax brackets of their shareholders. In particular, the authors reported that shareholders with higher income tax brackets were associated with low dividend shares and those with lower income tax brackets were associated with high dividend shares. This evidence lends credence to the tax-induced clientele effect hypothesis which states that investors in high tax brackets favour capital gains over dividend policy.

Empirical studies of the clientele effect hypothesis via the examination of the ex-dividend day behaviour of share prices have also been carried out in countries other than the U.S., but with mixed results (Lakonishok & Vermaelen, 1983; Booth & Johnston, 1984; Dasilas, 2009). Lakonishok and Vermaelen (1983) employed the Elton and Gruber (1970) approach to examine the effect of major tax reform on ex-day behaviour on the Canadian Stock Market. The authors documented that the ex-day price was less correlated to dividend yields and was not affected by the change in taxation differences of ordinary income and capital gains. The authors concluded that the effects are more likely to be a short-term trading effect than a tax clientele effect. Booth and Johnston (1984) extended the work of Lakonishok and Vermaelen (1983) and examined the ex-dividend day price ratio for Canadian firms quoted on the Toronto Stock Exchange over four different tax regimes between 1970 and 1980. The authors reported that the ex-dividend day price ratio was significantly different from one. The authors concluded that the ex-dividend day price ratio does not provide much evidence in support of dividend tax clienteles. More recently, Dutta *et al.* (2004) examined the ex-dividend day price and volume behaviour in the Canadian Stock Market. Unlike previous studies, the authors provided evidence on the co-existence of both tax and short-term trading effects. The authors found evidence of short-term trading which is consistent with the dividend capturing activities around the ex-dividend day.

Finally, another strand of empirical testing has studied the relationship between dividend changes and clientele changes. These empirical studies attempt to investigate whether the observed increase in firm's stock

trading volume was as a result of investors in various tax clienteles adjusting their portfolios. Empirical support for the existence of clientele trading is mixed (Richardson *et al.*, 1986; Dhaliwal *et al.*, 1999; Seida, 2001). For example, Richardson *et al.* (1986) examined the relationship between observed increase in firms' stock trading volume and tax clienteles by employing a sample of 192 US firms that initiated dividends for the first time during the period 1969 through 1982. The authors found weak evidence between increased trading volume and clientele effect. However, Dhaliwal *et al.* (1999) investigated institutional shareholding changes following a dividend initiation. The authors found that there was an increase in institutional ownership subsequent to dividend initiations, consistent with the dividend clientele hypothesis. Overall, the empirical evidence of the tax argument is mixed.

D. Empirical Studies of the Bird-in-the-Hand Argument

Empirical studies of the bird-in-the-hand explanation for paying dividends are generally very limited. However, some researchers have examined the hypothesis using regression models to estimate the influence of dividends and retained earnings on share price. Gordon (1959) and Fisher (1961) examined the bird-in-the-hand hypothesis and found that dividends have greater influence on share price than retained earnings. Fisher (1961) reported results consistent with Gordon (1959) using data from the UK during the period between 1949 and 1957. In contrast, Diamond (1967) examined the effect of dividends and retained earnings for a sample of 255 US firms during the period 1961 and 1962. The results show only weak evidence for the argument that investors prefer dividends to capital gains. This result is similar to those reported by Friend and Buckett (1964).

Other researchers have studied the bird-in-the-hand theory by investigating the views of corporate managers' involved in the administration of dividend policy of their firms. Evidence from survey research has tended to be dismissive of the bird-in-the-hand explanation of dividend relevance (Baker & Powell, 1999; Baker *et al.*, 2002; Baker *et al.*, 2008; Ozo *et al.*, 2015). However, survey evidence from an emerging market indicates that publicly listed firms in Barbados had a strong sense of dividends being a reward for investing, quite separate and distinct from capital gains, suggesting support for the bird-in-the-hand explanation for paying dividends (Robinson, 2006). Based on the studies above, the evidence on the bird-in-the-hand explanation is at best mixed.

IV. CONCLUSION

Under the assumptions of perfect capital markets, Miller & Modigliani (1961) concluded that dividend policy is irrelevant to corporate value. However, in the real business world, capital markets are less than perfect. The survey of literature presented in this paper revealed that in the presence of realistic capital market imperfections such as information asymmetry, agency costs, taxes, and irrational investor

behaviour, dividend policy creates a means to enhance shareholder value. Specifically, dividends serve as a signalling device to mitigate information asymmetry between corporate insiders and outside shareholders. By signalling asymmetric information to the market, dividend payments reduces the under-pricing of securities issued to raise new outstanding finance thereby increasing firm value.

Also, the distribution of company profits to shareholders in the form of dividends represents an efficient way of resolving agency problems between managers and shareholders. High dividend payouts reduce overinvestment and expropriation of shareholders by diminishing the cash available for managers to invest in unjustifiable acquisitions and expansions, and other unprofitable investments. As a result, dividends represent an optimal way to discipline managers and reduce agency costs and thus increase the value of the firm.

Furthermore, dividends can enhance firm value because evidence from the literature suggests that investors (notably institutional investors) prefer dividends over capital gains, and would most likely invest in dividend-paying firms (Brav & Heaton, 1997). Since legal restrictions make dividends attractive to institutional investors, paying dividends might be a suitable way to encourage institutional investors to invest in a firm. As a result, firms distribute dividends to attract institutional investors to their shares. Managers maximize the value of their firms to its shareholders through these investments.

Finally, distribution of earnings in the form of dividends can enhance firm value because dividend payments reduce the uncertainty associated with future cash flows. The reasoning here is that investors place more value on the tangible nature of cash dividends relative to a possible capital gain. Dividends represent a certainty while future share appreciation is uncertain. Thus, the more generous the dividends paid by a firm the higher would be the share price.

While most of the empirical studies found evidence consistent with the basic hypothesis of the dividend relevance argument, some researchers have documented results that were not supportive of the dividend relevance hypotheses. Consequently, the impact of dividend policy on firm value still remains one of the most controversial topics in finance calling for further theoretical and empirical research.

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