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PAST AND FUTURE TREND OF DIVIDEND POLICY

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ABSTRACT

"The harder we look at dividend picture, the more it looks as a puzzle, with pieces that just don't fit together" Black (1976). Brealey and Myers (2002) have stated, "dividend policy is one of the top ten puzzles in finance." The questions of "Why the corporations pay dividends?" and "Why the investors pay attention to dividends?" have perplexed both financial economists and several researchers from academia from years. However, the answers to these questions are understandable. "Dividends represent the performance to the investor who puts his money in the company at risk. Companies pay dividends to prevailing shareholders to inspire others to purchase new ordinary shares at higher prices. Investors take dividends into account because only through these dividends or the vision of dividends do investors receive a return on their investment or the opportunity to sell their shares at a higher price in the future".

Keywords: *Dividend Policy, Financial Economists, Shareholders, Investor, Risk.*

Introduction

In fact, the answers to these questions are not obvious at all. Though many of these observations were made two decades earlier, financial economists are still wrestling with the "dividend puzzle." There is also another aspect of this academic failure to solve the puzzle. The academics' point of view regarding dividends, and whatever that thought has produced, has gone completely unnoticed on the evolution of dividend payments in modern societies. The dividend payment behaviour, popularly known as dividend policy, did not simply appear out of nowhere. It evolved with modern corporation over a period of four centuries. The details of this evolution are recorded in several publications. Among them is an article by Franfurter and Wood (1997). The evolution of dividend theory from eminent researchers is discussed in the next section. Maintaining the behaviour of dividend payments in a historical perspective one wonders how and why the academic model of dividend policy could ignore this evolution.

Initial Research on Dividend Policy

Linter (1956), Miller and Modigliani (1961), Bhattacharya (1979) and Miller and Rock (1985) have proposed "corporate dividend policy is designed to reveal a company's earnings outlook to its investors". Linter's research was the first dividend study in 1956, which examined executives' behaviour to understand how they got to dividend policy. "He discovered that a prevalent percentage of dividends is a reference point for management. Business administration has generally shown a strong unwillingness to reduce dividends. He found that managers generally have reasonably conclusive mark-up rates. Over the years, dividends gradually expand to a persistent adjustment rate, so that the actual payment ratio is close to the marking payment ratio". Miller and Modigliani (1961) provide the theoretical foundations of payment policy and conclude that" dividend policy is irrelevant in a frictionless world with uninterrupted capital markets. Since then, research has discovered how market imperfections create an environment in which payment policy affects the value of the company".

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Fama and Babiak (1968) claim, “companies set their target dividend level and try to meet it”. In addition to the reporting approach, Jensen and Meckling 1976, “there may be an interrelation between the dividend payment policy and the agency costs of the company”. “Clarifying dividend policy has been one of the most important challenges for financial economists. Despite numerous studies, we still need to fully understand the factors that influence dividend policy and how these factors link together. The recent and well-known study on the dividend policy of Allen and Michaely (1995)”. They reach that "much more empirical and theoretical research on the issue of dividends is needed before harmony can be achieved". Brealey and Myers (2002) observed the fact that “dividend policy is one of the top ten important unresolved problems in corporate finance”.

In general, the theoretical background for explaining the dividend behavior and the level of payout decision over the preceding two decades has been subjugated by agency theory, asymmetric information and signaling theory. Recently, many researchers identified catering theory and lifecycle theory (Denis & Osobov, 2008; Ferris et al., 2009).

Conceptual Background

Some well-known theories have been proposed on dividend smoothing (Lintner, 1956), dividend clientele effect and effect of tax (Miller and Modigliani, 1961), dividend signaling (Miller and Rock, 1985), agency cost (Jensen, 1986) catering explanation for dividend (Baker and Wurgler, 2004a, 2004b) and life-cycle theory (Fama and French, 2002).

- **Dividend Smoothing**

Lintner (1956) reports that the managers give importance to the stability of dividends. They do not like to cut or omit dividends. Instead, companies generally set a target payout ratio. They consider current earnings and previous year’s dividend as important determinants of dividends. However as shown by Miller and Modigliani (1961), in a perfect world and under stringent assumptions, dividend decisions are considered irrelevant. If these stringent assumptions are relaxed then it has been found that dividend policy is relevant due to the tax-induced clientele effects (Litzenberger and Ramaswamy, 1979; Miller and Scholes, 1982). Also, Solomon (1963), Ross (1977), Bhattacharya (1979) and Miller and Rock (1985) explore that there is an informational content of dividends since asymmetric information exists. Starr and Ho (1969) have applied the concept of nonzero-sum differential games to determine the dividend payout ratio to maximize the shareholder’s utility function.

  - **Free Cash flow and agency cost**

  According to Jensen (1986), agency cost of free -cash flow model predicts that companies with higher free cash flows do not invest in projects with lower NPV but pay higher dividend. It also assumes that such firms take a higher amount of debt which involves payment of fixed interest charges. The obligation on part of the company to make timely payments of principal and interest will ensure that the company does not invest in less profitable investment opportunities and thus help in reducing agency cost. The catering theory in Baker and Wurgler (2004a) suggests that dividends are declared by firms depending on dividend premium associated with the stock. The life cycle theory predicts that dividends depend on the proportion of retained earnings to total assets (Fama and French, 2002; Grullon et al., 2002; DeAngelo et al., 2006.

- **Dividend as a Signal Mechanism**

The signaling theory emphasizes the role of dividends in conveying private information to investors about the prospects of the firm (Bhattacharya, 1979; Miller & Rock, 1985). The higher the level of information asymmetry faced by a firm, the higher is the firm's payout ratio because dividend policy can be used to reduce information asymmetry and signal profitability and quality.

Miller and Modigliani (1961) were the first authors to propose that “dividend changes may deliver managers inside information on the predictions of the firm performance to outsiders”. According to Bhattacharya (1979) and, John and Williams (1985) the major signaling costs of central dividends to function as consistent signals arise because dividends also have a tax drawback related to capital gains.

Edwards (1987) and Ambarish, John, and Williams (1987) develop a model in which firms can concurrently signal with dividends and investments, where they are subjected to a different structure of dissipative costs. Dissipative costs are those costs which create an equilibrium between firms who can afford to signal via dividends as they have good investment projects and firms for which it is too expensive, provided that the investment has a low rate of return.

Ofer and Thakor (1987) developed a model, where firms signal overlooked firm value through dividends and share repurchases. The cost of signaling is the cost linked with raising new capital seemingly for financing future investments. Bar-Yosef and Huffman (1986) show, “the size of the declared dividend is an increasing function of expected cash flows”. In addition, they show that the higher the level of expected cash flows, the lower the peripheral effects of cash flows on dividends. In a similar vein, Kumar (1988) shows that dividends can only be a signal of firm’s future prospects due to this firms tend to smoothen their dividends. To summarize, there is a massive body of theoretical literature which points to the role of dividends as signaling devices. Still, this literature also points out that it is important to analyze dividend policy changes along with insider control, possible restrictions on the trading of insider stakes and insider trading activity.

- **Information Asymmetry and Dividend Policy**

Information asymmetry between corporate insiders and outside shareholders reveal in widely held firms to signal their prospects to the financial markets, mainly, through dividend policy. For instance, Watts (1973), Black (1976), Miller and Rock (1985), Ambarish, John, & Williams (1987), Noe and Rebello (1996), LaPorta, Lopez-de-Silanes, Shleifer, &Vishny (2000), Aivazian, Booth, & Cleary (2003), Asem and Alam (2015) confirm that dividend policy conveys relevant information about the firm. Bhattacharya (1979) and Miller and Rock (1985) argue that information asymmetries between firms and outside shareholders may persuade a signaling role of dividends. Their study shows that dividend payments communicate private information in a revealing manner. The most important element in the study is that companies have to pay funds regularly. Jensen and Meckling, 1976 claims, the information asymmetry between directors (external shareholders) and agents (managers) can also generate agency costs. The presence of information asymmetry may also despicable that managers need to signal their ability to create higher earnings in future with the help of high dividend payouts (Bhattacharya, 1979, John and Williams 1985, and Miller and Rock, 1985). From investors view point, companies with greater information asymmetry, expectation of dividend payments should be more prominent. Li and Zhao (2008) claimed, “information asymmetry is inversely related to dividend payments, which is unpredictable with the signalling hypothesis”. Miller and Rock (1985) proposes, Signal theory emphasize the importance of the dividend in providing isolated information to investors about the company's future prospects. The higher the level of information asymmetry that a company faces, the higher the dividend payment of the company due to the reduction in information asymmetry.

Empirical Studies on the Factors of Dividend Policy

Dividend policy remains the most important research topic since the 50s of the last centuries and one of the most challenging topics in contemporary financial economics in both developed and emerging markets. Following are the factors which were studied in previous studies are discussed below and represented in Table 1.

- **Firm’s Size**

Size of the firm remains one of the important determinants that affect dividend policy of the firms. Numerous studies have done on this relationship but no consensus has been attained (Table 1). Eddy and Seifert, 1988 claimed, “the bigger firms are associated with lower level of information asymmetry”. In Indian context, Reddy (2003) found the positive relationship between firm’s size and payout policies of the firms. Hence, this determinant of dividend policy infers that the bigger firms’ pay less dividend due signaling power of dividends. However, several other studies find a negative relationship between dividend payments and firm’s size. They propose that small firms are reluctant to reduce dividend payment due to fear of reduction in share price (Yoon and Starks, 1995).

- **Financial Leverage**

Baker et.al (2001) studied the influence of capital structure on dividend policy through the survey of directors and financial managers and found a negative relationship between them. Numerous studies support a negative relationship between the level of leverage and dividend policy (Crutchley and Hansen, 1989; Al-Twaijry, 2007; Papadopoulos and Charalambidis, 2007). Agrawal and Jayaraman, (1994), as cited in Faccio et al., (2001) and Gugler and Yurtoglu, (2003), manager reluctant to pay dividend payment due to under pressure from external creditors to maintain the minimum liquidity requirement, to meet the obligation to pay fixed interest and commitment to creditors. Other studies have explained, the role of negative conventions that place margins on corporate dividend payments at the expense of creditors (Day and Taylor, 1996; Smith and Warner, 1979). Therefore, managers seek to move closer to the capital market to restore creditors' confidence and management planning to access credit markets. (see Table 1).

Jensen and Meckling, 1986 find, debt is used for reducing the agency's cost of free cash flows within the company. Jensen, 1986 highlight, creditors and debtors exercise greater control and oversight over management by improving organizational efficiency and eliminating projects that destroy value. Indeed, debt may be auxiliary to dividends in the asymmetry of information about immersion and agency problems in companies.

- **Growth Opportunities**

Partington (1983) notes that the company pays less dividends when it has broad growth prospects and investment opportunities. The growth opportunities available reduce the company's cash resources that could be used to pay dividends. According to Baker and Kapoor, 2015, the life cycle dividend theory claims that slow-growing companies pay high dividends in their maturity phase due to fewer investment opportunities. While high growth companies tend to preserve most of the undistributed profits that reduce access to external financing (Alli et al., 1993).

However, Mitton (2004) shows the negative relationship between growth opportunities and dividend payments prevails only in countries where there is strong legal protection for shareholders. La Porta et al. (2000a.) explain, if shareholders are not protected and feel insecure, they prefer to receive dividends regardless of the company's growth prospects.

- **Profitability**

Profitability plays an important role in determining the level of corporate payout policy. But the question arises whether the dividend policy depends on the company's current or future profits. Adaoglu (2000) finds a positive relationship between the company's dividend policy and its current profitability in developing economies. Companies tend to increase dividends with an increase in current profits. For example, studies on the Indian market reveal the importance of current profitability in deciding dividend policy are done by Mishra and Narender (1996) and Bhat and Pandey (1994). The same findings in the context of developed markets like the United States (Pruitt and Gitman, 1991). The expected level of future earnings is also cited as a key factor driving dividend policy (Baker and Jabbouri, 2016; Bhat and Pandey, 1994).

- **Liquidity**

Liquidity is also an important factor influencing the company's dividend policy. Without cash, a company cannot pay dividends to its shareholders. Many previous studies have found that the company's dividend policy depends largely on the company's liquidity rather than current earnings (Anil and Kapoor, 2008). Using a sample of American companies, Deshmukh's (2003) study establishes the association between liquidity and dividend policy. He found a positive association between these two. Similarly, using the sample of Japanese companies, Kato et al. (2002) show, changes in dividend policy are mainly due to changes in corporate liquidity.

- **Free Cash Flow**

Jensen (1986), who proposed the free cash flow hypothesis says, agency problems between control and minority shareholders increase as the level of free cash flow increases. To achieve their goals, managers spend excess money on projects with a negative present value that reduces shareholder wealth. From the sample of Eastern Asian and Western European societies, Faccio et al. (2001) show, dividend payments are significantly hampered by the susceptibility of a company's minority shareholders due to the expropriation by the controlling shareholders. Several previous studies have shown, like Gomes (2000) shows paying high dividends can be used to reduce agency costs and mitigate information asymmetry issues by reducing the unrestricted funds that managers could use for their personal goals.

- **Past Dividends**

According to famous Lintner study (1956), past dividends significantly influence the dividend policy. He noted that companies are reluctant to increase the target payment rate and trying to maintain a stable dividend payout rate. Numerous studies like Baker et al. (2002) and McCluskey et al. (2007) have tested the “Linter model” and approved the discovery of Linter's results. They conclude that past payments affect the current dividend payment. But in the case of the developing market, the current dividend payment is independent of its historical dividend model. Since the current dividend is primarily based on current profitability (Glen et al., 1995). Contrast of the previous aspect, Wang et al. (2002) and Adalglu (2000) oppose the Linter findings, the study finds that companies do not follow a stable dividend policy. These companies focus on last year's profitability to determine current dividends regardless of the variability of previous payments.

- **Taxation**

Fiscal policy is apparently a determining factor for payment policy in developed countries (Short et al. 2002). Under current Indian law, Individual shareholders pay no dividend income tax, while they are subject to capital gains tax. Instead, companies have to pay taxes on distributed income. This increases the effective corporate tax rates for companies that pay dividends. There is double taxation effect in India, one in the hands of the company through corporate tax and another in the hands of investors in the form of dividend of the income tax paid by Indian companies. In such a case, an Indian stakeholder would prefer less dividends to be paid by the companies and support retain profits.

Table 1: Factors of Dividend Policy

Factors of Dividend Policy	Prior Literature of Previous Studies	Impact on Dividend Payout Decision
Firms' Size	Moh'd et al., 1995; Baker et al., 2007; Jensen and Meckling, 1976; Bhattacharya, 1979; Rozeff, 1982; Mitton, 2004; Saxena, 1999	Positive
Profitability	Baker and Powell, 1999,2000a, b; Fama, 1974; Fama and Babiak, 1968; Baker and Jabbouri, 2016; Bhat and Pandey, 1994; Farrelly et al. 1986; Nissim and Ziv, 2001	Positive
Leverage	Baker et. al 2001; Crutchley & Hansen,1989; Agrawal & Jayara man, 1994; Faccio et al. 2001; Guglar & Yurtoglu, 2003; Myers &Majluf, 1984; Deshmukh, 2005	Negative
Liquidity	Jensen, 1986; Allen & Rachim, 1996; Sawicki, 2008; Faccio et al., 2001	Positive
Free Cash Flows	Jensen, 1986; Allen & Rachim, 1996; Sawicki, 2008; Faccio et al., 2001	Positive
Past dividends	Lintner, 1956; Allen,1992; Farralley et.al, 1986; Baker, 2002	Positive
Taxation	Short et al. 2002; Jayesh Kumar, 2003; Bhattacharya, 1989; Reddy and Rath, 2005	Negative
Growth Opportunities	Faccio et al., 2001; Smith and Watts, 1992; Mitton, 2004; La Porta et al.,2000b	Negative

Source: Researcher's Compilation.

Conclusion

Many questions linked to dividend policy have puzzled researchers for many years now. The increase in the number of publications especially since 2005 onwards confirms this trend. Using the tools of bibliometric and network analysis, this study has analyzed a total of 768 articles published in the past 47 years obtained from the Scopus database. The main conclusions resulting from this bibliometric study on dividend policy are as follows: The increase in the number of publications since 2005 indicates the growing interest of researchers in this field. The affiliation statistics show that the highest number of publications is from the US followed by the UK. However, the top contributing organizations are mainly from the US. Although there is a significant contribution in this field from.

The results of citation analysis have aided us to recognize prominent studies and researchers in an unbiased way. There is also a need for more collaboration between authors from different countries/universities to have a better understanding of the determinants of dividend policies around the globe. As discussed above, joint publications can lead to more scientific work and increase the readership of a document in this area. It has also helped us to identify certain factors/keywords that need to be examined especially in respect of emerging markets. To summarize the results obtained from this study, a comprehensive account of studies on dividend policy is provided, which can be useful for researchers when commencing new research in this important field of corporate finance.

References

1. The dividend payout decision means likelihood of dividend payment or omission. The payout decision is about how much dividend is paid out of profits.