Dividends and Politics

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An issue that has captured much attention is the set of conditions that need to be in place in order for a country’s corporate economy to be dominated by publicly quoted companies with widely dispersed shares.

One thesis is that a country’s politics (its position on the ideological spectrum) helps to dictate ownership structure.

This paper carries out an empirical test of the extent to which politics is a determinant of corporate governance.

The focus is on the determinants of dividend policy in publicly quoted U.K. companies between 1949 and 2002.
Dividends and Corporate Governance

- Dividends are a potentially integral element of corporate governance.
- A fixed policy of making sizeable and regular cash distributions to shareholders constrain executive discretion since companies must generate profits to distribute cash.
- A commitment to paying dividends means companies must face capital market scrutiny more often.
- Dividends perform a “signalling” function, so disappointing the market can activate alternate corporate governance mechanisms designed to address poor performance or financial distress.
Why the United Kingdom?

- Britain’s political system is well-suited for testing the impact that politics potentially has on corporate governance
- The “Westminster model” gives the party in control substantial leeway to implement policies it prefers
- Among governing parties there were significant swings from left to right over time, with 1951, 1979 and 1997 being leading examples
Roe’s Social Democracy Thesis

- Roe says democracies favour employees over investors, thus creating the potential for an alliance between senior executives and employees.
- Executives want to manage big firms but will seek to avoid changes likely to put their human capital at risk.
- This agenda tallies with the objectives of incumbent employees.
- Hence, under appropriate political conditions an alliance can readily develop that will leave shareholders out in the cold.
Roe’s characterization of managerial preferences implies corporate executives will want to retain profits. Managers will be keen to do so to avoid unwanted scrutiny by capital markets and to protect against a “rainy day.” Employees will agree with management. Workers will tend to think of dividends as funds “lost” to the company that could have been distributed to staff and will want profits to be retained so as to provide a cushion against potential redundancy.
Linking Dividends and Politics

• Left-wing government should correlate with low dividend payouts
• Consider Churchill’s 1951 condemnation of a Labour proposal to introduce compulsory regulation of dividends:
  “To win the extreme section of the trade union leaders to this policy, (the then Chancellor of the Exchequer) proposed that dividends should…be frozen. Observe that this was not done on the merits, but because much of the driving power of the Socialist movement is derived from the jealousy and envy of others who think they are more fortunate than themselves”
• Moves to the right on the political front should, in contrast, be associated with the adoption of more generous dividend policies
Lintner and Dividends

• The essential elements of Lintner’s “partial adjustment model” of dividends are:
  – Managers have target dividend/profits payout ratios
  – Managers believe shareholders prefer pay-outs to remain constant or rise slowly
  – Managers therefore will move only partly toward their target payout ratio each year

• Tests have found his model constitutes a very good predictor of dividend behaviour
Adding Politics to the Lintner Model

- To test the impact of politics and dividends, we augment the Lintner partial adjustment model with independent variables based upon political criteria.
- Our direct test of politics is run by using two indices giving annual scores to the U.K. on the basis of the party platform of the governing party, with one focusing on general political orientation and the other on market regulation and wealth redistribution issues.
- We augment our model by incorporating secondary political variables based on the proposition that politics – albeit at one step’s remove – can influence dividends.
Tax

• In the U.K. changes to corporate tax often have been accompanied by political declarations of intent to dictate dividend policy

• To measure tax’s impact, we relied on a methodology developed by Poterba and refined by La Porta, López-de-Silanes, Shleifer and Vishny to calculate tax preference ratios for pension funds and for top marginal rate taxpayers

• A score of less than 1 represents a tax bias in favour of retained earnings and capital gains, and a figure of greater than 1 signals a tax bias in favour of dividends
Shareholder Dividend Tax Preference

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- **Individual**
- **Pensions**

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Other Secondary Political Variables

- We tested for the impact of dividend controls, which were in place during much of the 1960s and 1970s.
- The power of organized labour can be a product of politics and might be expected to influence dividend payouts, so we tested its impact by way of “union density” and labour costs.
- We tested whether major amendments made to U.K. company law correlated with changes to dividend policy.
- Corporate law qualifies as “political” because labour leaders can oppose reforms designed to protect outside investors.
Dividends Data

• The dependent variable in our model is the annual change in aggregate gross dividends paid by listed U.K. companies.

• Our sources were a databank of accounts of listed companies compiled by the U.K.’s Department of Trade and Industry and economists at the University of Cambridge, and Datastream.

• To ensure our results would not be corrupted by the intricacies of UK tax we:
  – Re-calculated profits by assuming that companies had not paid any dividends (“zero distribution profits”) and
  – Measured what companies paid out (“gross” dividends) rather than what shareholders actually received (“net” dividends).
Results (1)

- Lintner’s original partial adjustment model explains well the dividend policies adopted by listed U.K. companies.
- There was no meaningful statistical correlation between the ideology of the party in power and dividends.
- Dividend controls and company law were not correlated with dividends.
- The outcome was the same with the tax treatment of pension funds and with union density.
- The results with pension funds are striking because they emerged as dominant investors during the period under study.
Results (2)

• With the tax treatment of top marginal tax rate taxpayers, there was a correlation in the predicted direction.
• But the effect was weak: it disappeared when politics was measured by the market regulation/wealth redistribution index rather than the more broadly-based index.
• There also was a statistically significant correlation between labour costs and dividends but the correlation was the opposite of what theory would predict: dividends rose in tandem with labour costs.
• There is no obvious political explanation for the result.
Conclusion

- The theory that social democracy is a determinant of corporate governance has a plausible ring to it.
- But our results contradict the proposition that politics shape corporate governance.
- Listed U.K. companies set dividend policy by adjusting over time towards a target based upon corporate earnings.
- Politics did not disrupt the pattern, meaning in this context politics was not a determinant of corporate governance.