

Dividend payments: some recent trends

Introduction

Controls on dividend payments by companies were lifted at the end of July 1979 after nearly seven years of continuous operation. This article examines some of the legal, fiscal and economic factors bearing on corporate decisions on the size of dividends, and investigates the path of dividends and dividend payout ratios over the period 1961–79.

Legal considerations

Dividends may, in the normal course, be paid only out of profits. The relevant legal provisions, together with the stipulation that a company may not buy its own shares, imply that, if prices are stable, the 'real' value of a company's capital cannot normally be reduced unless net trading losses are incurred.[1] Inflation has, however, destroyed the simple certainty of this rule because, under historic cost accounting, profits include the excess of replacement cost over historic cost depreciation and stock appreciation. The consequence is that, in an inflationary environment, it is possible for companies to distribute to their shareholders 'real' capital as measured on a replacement cost basis.

Dividend controls

Some form of official restraint of dividends has been in operation for much of the post-war period. The early controls rested on moral suasion, but from the mid-1960s dividend restraint has been statutory; the lifting of controls in the 1979 Budget marked the end of a statutory phase which had been continuously in force since 1972.

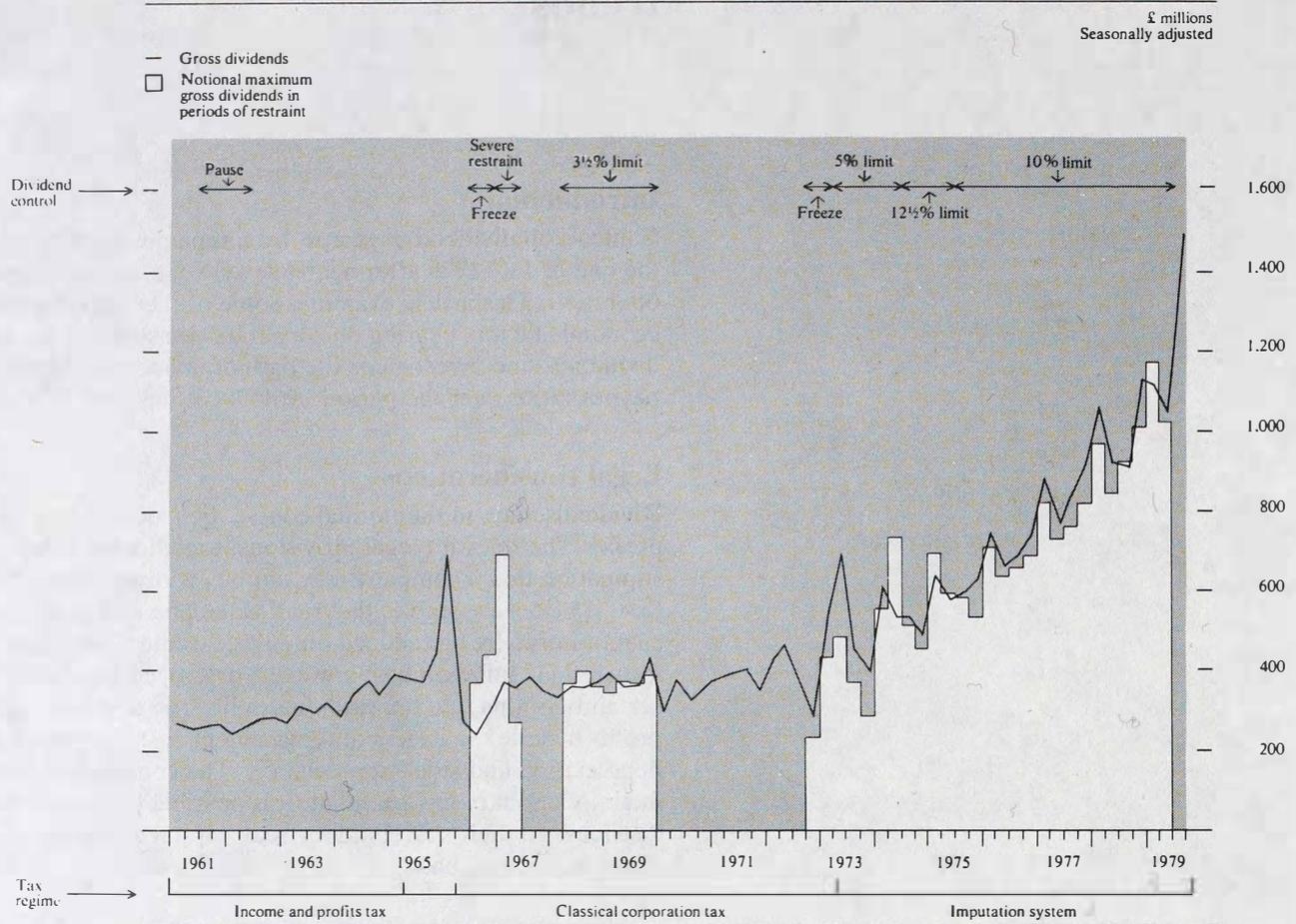
The phases of dividend control since 1961 are depicted in Chart A, which also shows the path of gross ordinary dividends paid by all industrial and commercial companies in the same period. The unshaded areas indicate the notional maxima imposed by dividend controls in the periods in which they were operative. These limits have been derived by adding the permitted percentage increase to actual dividends paid (after seasonal adjustment) in the corresponding quarter of the previous year. The limits take no account of relaxations or exemptions (except in so far as they increase the base from which the limit is calculated) and should be regarded therefore as illustrative approximations only.

It is clear from the chart that the limits imposed in the 1960s were rarely exceeded; there were, however, more overruns in the phase after 1972, largely reflecting the range of exemptions and relaxations that were available and exploited.[2]

[1] For this purpose each year's profit and loss account is treated in isolation; thus there is no obligation to make up past losses before paying dividends from the current year's profits. This aspect of the law would be changed under the provisions of the Companies Bill at present before Parliament.

[2] The principal relaxations permitted were in respect of new issues, takeovers, recovery situations, and, from July 1978, dividend cover. Exemptions were granted to investment trusts, close companies, wholly-owned subsidiaries, newly-quoted companies, UK companies resident abroad for taxation and exchange control purposes, and other UK companies having 90% of their assets and 90% of their earnings located abroad.

Chart A
Industrial and commercial companies



Taxation

Chart A reveals two sharp discontinuities in the dividends series, in the first quarter of 1966 and the second quarter of 1973, which reflect changes in the tax system affecting the distribution and retention of profits. Between 1958 and 1965, companies' total profits were subject to both income and profits tax, and dividends received by shareholders were deemed already to have borne income tax at the standard rate. Corporation tax was introduced in the 1965 Finance Act but under transitional arrangements the previous tax treatment of dividends was retained for the financial year 1965/66. From the second quarter of 1966 to the first quarter of 1973, the full 'classical' corporation tax system was in operation: companies paid corporation tax on their total profits, and that element of profits distributed was further taxed (at source) as shareholders' income. Thus dividends were effectively taxed twice. Finally, in 1973, the present 'imputation' system was introduced; companies are assessed to corporation tax on their total profits, and make an advance payment of their corporation tax liability—advance corporation tax (ACT)—equivalent to the basic rate of income tax on the gross equivalent of dividend payments. A shareholder receives the dividend together with a tax credit which satisfies his liability to tax at the basic rate on the gross amount of the dividend plus the tax credit. In effect, therefore, the post-1973 system is very similar to that prevailing in 1958-66.

Anticipation of a switch to the classical system in 1966 was a major influence on the high level of dividend payments in the first quarter of that year, because it was known that dividends

would thereafter be taxed twice. Conversely, there was an incentive to delay dividend payments until the introduction of the imputation system in 1973; this was reinforced by the concurrent easing of dividend restraint.[1]

A further fiscal influence on the choice between dividends and retentions is the difference between rates of tax applied to income and capital gains. Before the introduction of capital gains tax in the 1965 Finance Act, a rational standard-rate tax payer would, on tax considerations alone, have been indifferent between retentions and distributions, because profits (in 1958–65) bore the same rate of tax whether or not they were distributed, while capital gains on shares, including those resulting from retained earnings, were not usually subject to a tax.[2] Between 1966 and 1973, the same tax payer would have preferred retentions to dividends because the tax rate on capital gains was below that on income, so reinforcing the discrimination in the classical corporation tax system in favour of retentions. Finally, the combination since 1973 of a capital gains tax and the imputation system means that, while profits ultimately bear the same rate of corporation tax whether distributed or not, there is a tax disadvantage to retentions for the basic-rate tax payer, because they may also give rise to capital gains, and thus in many circumstances to capital gains tax.[3]

There are important qualifications to these observations. Shareholders subject to income tax at higher rates (including the investment income surcharge) would be more inclined to favour retentions, although an individual's preference would depend both on the tax régime currently in force and on his particular marginal rate of income tax. More significant is the position of gross funds (pension funds, including those administered by life assurance companies), which are exempt from all taxes.[4] Under the classical system, they would generally have been indifferent between retentions and dividends. But under the present imputation system, the funds may reclaim the relevant ACT, so that the effective tax rate borne on profits earned by companies in which they hold shares is, from the point of view of the funds, reduced by distributing rather than retaining profits; thus, although pension funds are exempt from capital gains tax they have a clear preference for dividends.[5]

In sum, the overall effect of the tax system was largely neutral as between retentions and dividends in 1958–65; favoured retentions in 1966–73; and favoured dividends from 1973 onwards. The qualifications mentioned in the preceding paragraph do, however, modify these conclusions.

Some economic considerations

There is a considerable economic literature on the determination of dividend policy, and this section sketches briefly some of the competing hypotheses. An important

[1] The change in the tax system in 1973 was accompanied by transitional provisions, but these did not substantially affect the incentive to delay dividend payments described in the text.

[2] A tax on short-term capital gains was introduced in 1962, which may have led some shareholders to favour dividends.

[3] This assumes that ACT can be offset in full against mainstream corporation tax. If this is not the case, shareholders subject to income tax at the basic rate will prefer retentions, despite a possible liability to capital gains tax.

[4] They became a significant force in the equity market in the 1970s, and are currently estimated to hold as much as one quarter of UK equities.

[5] The arguments of this and the preceding paragraph are based on the assumption that £1 of net retentions adds £1 to a company's stock market valuation. This is not necessarily true. The increase in market valuation is in fact dependent upon the attitude of the marginal shareholder to capital gains relative to dividends.

starting point is the contention put forward by Miller and Modigliani[1] that the dividend decision is immaterial to the market valuation of a company ('dividend irrelevance') because retained earnings (dividends forgone) will be applied to profitable projects (projects having positive net present values) which will in turn generate higher earnings in the future; and that the present value of those higher earnings will be reflected in the share price to such an extent that the capital appreciation in share value will be exactly equivalent to the cash dividend forgone. This theorem rests, however, on a number of simplifying assumptions—in particular, perfect capital markets, tax neutrality and the absence of bankruptcy. The remainder of this section describes the implications of relaxing these assumptions.

As well as the tax aspects, described above, transactions costs are a market imperfection. Capital gains can be realised only by incurring transactions costs (in the stock exchange), which bear disproportionately on small deals, so that retentions are subject to a non-fiscal disadvantage compared with dividends, especially for the small shareholder.

The separation of ownership and control in the modern company is a further complicating factor: it means that shareholders and managers may not share the same aims. Managers, for example, might prefer to retain funds for investment simply to increase the size of their companies, while shareholders might perceive more profitable opportunities elsewhere. Equally, however, the interests of shareholders in a particular company might not be homogeneous, so that their preferences for dividends or retentions might differ (perhaps for tax reasons).

The most important aspect of the manager-shareholder dichotomy concerns uncertainty and information. As regards uncertainty, it is arguable that dividends have an intrinsic value for shareholders because they are certain. But prospective future dividends arising from retentions are uncertain, with the implication that retentions may not be fully reflected in the current share price. The uncertainty argument may, however, be less plausible than at first appears because retentions will probably be used to finance investment projects yielding a positive expected net present value: thus, after allowance for uncertainty, the investment is expected to be profitable. A company could, however, finance a given investment project either from retentions or by simultaneously paying a dividend and making a rights issue. The uncertainty attached to the investment project is common to the two alternatives:[2] the investment would be in the shareholders' interest whichever way it is financed, provided that it has a positive expected net present value. If, however, profits are retained, shareholders are deprived of the freedom to redeploy their investments except by selling shares, which, as noted above, might prove costly for small amounts.

Finally, the information content of dividends needs to be considered. Herein, it is sometimes alleged, lies the strongest criticism of the dividend irrelevance hypothesis. Essentially, management is better informed than shareholders about a

[1] M. H. Miller and F. Modigliani, 'Dividend policy, growth, and the valuation of shares', *Journal of Business of the University of Chicago*, vol. 34 no.4, October 1961, pages 411–33.

[2] Transactions costs would, of course, be higher in the dividend/rights issue case. Furthermore, there would be equity dilution if the new shares were not all taken up by existing shareholders. This would depress the share price if the new shareholders demanded a higher expected return than existing shareholders.

company's prospects, and the payment of dividends provides an important channel by which information is conveyed to shareholders. But this is an imperfect system of communication, and is susceptible to misconstruction. For example, a reduced dividend in one year, perhaps because the company is retaining funds to invest in a profitable project, might be misinterpreted as signalling a deterioration in prospects; the share price would then fall rather than, as theory predicts, rise to reflect the increased net worth of the company consequent upon acceptance of the new investment project. To avoid this possibility, the phenomenon, mentioned above, of a company simultaneously paying a dividend and making a rights issue is not uncommon, despite the extra costs entailed. A further reason why dividends may not provide reliable signals is that, because of their wish to avoid reducing dividends, managements seek to maintain a stable path over time, irrespective of short-term movements in profits. This has led a number of researchers to suggest that companies have target dividend payout ratios, towards which only partial adjustment is made in each period. Various different measures of the denominator of the ratio have been suggested, and some have been tested successfully.

Despite the imperfections of dividends as a signal, there is a good deal of evidence that they are seen in that light. It might appear that this signalling function contradicts the dividend irrelevance view, because it implies that shareholders value dividends more highly than an equivalent amount of retained earnings. But advocates of the Miller-Modigliani theorem would respond that, because the underlying value of a firm to its shareholders should not be influenced by dividend payments (except for tax reasons), a particular dividend policy should be followed if it mutually satisfies shareholders and management, for profitable investments can always be undertaken by means of new capital issues or fresh borrowing.

Recent experience of dividend payout ratios

There is no unique definition of the dividend payout ratio: the one adopted here is the ratio of dividends, gross of personal income tax, to post-tax earnings attributable to the equity interest. The reciprocal of this ratio shows the number of times the gross dividend is covered by post-tax equity earnings.

In the calculation of dividend payout ratios, it would be appropriate for the numerator to capture the effective cost to the company of paying a dividend. This would suggest that dividends should be measured gross in 1966-72, and net in the earlier and later periods. But there are two arguments against such a treatment. First, it is common practice to show dividends gross throughout in order to avoid discontinuities in the series. Second, a large number of companies at present have insufficient current taxable income against which to offset ACT, so that the effective cost to them of making distributions is equivalent to the gross dividend (although ACT credits can be carried forward without time limit). Accordingly, the ratios described below relate to gross dividends throughout, and the tax deduction from profits in the denominator has been adjusted where appropriate.

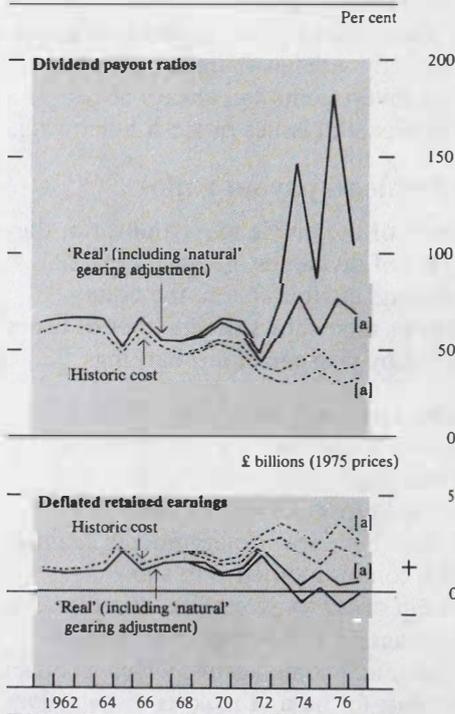
If one looks at the absolute differences between the numerator and denominator of the payout ratio, the result is invariant to the tax treatment of dividends. Charts B, C, and D, therefore, also show these differences, representing retained profits, deflated to 1975 prices.

Three measures of post-tax equity earnings have been calculated:

- conventional historic cost profits;
- 'real' equity profits, calculated as historic cost profits, *less* stock appreciation and additional depreciation needed to provide for replacement costs, *plus* a 'natural' gearing adjustment (i.e. the decline in the real value of net monetary liabilities);
- 'real' equity profits calculated in accordance with ED24,[1] which is the basis of the new accounting standard on current cost accounting.

Two sets of data have been used. The first is the *Business Monitor* (BM)[2] sample of large listed companies in manufacturing, distribution and services. This is based on company accounts, from which the stock market is likely to calculate payout ratios. Unfortunately, the data are currently available only up to 1977. For more recent figures, payout ratios for industrial and commercial companies in the UK national accounts have been calculated. However, because there are insufficient data on net monetary liabilities for this more comprehensive set of companies, their 'real' equity profits can only be approximated, and the ED24 measure has not been attempted.[3]

Chart B
Business Monitor sample:
manufacturing, distribution and services



[a] Excluding deferred tax.

The Business Monitor sample

Chart B shows the first two measures of payout ratios and the corresponding real values of retained earnings. Divergences within the several series from 1969 reflect alternative treatments of transfers to deferred taxation, which are part of total taxation charges in the BM accounts; the series have been calculated both with and without deduction of the deferred tax charge from earnings. On the historic cost basis, it is clear, whether or not deferred tax is deducted, that after a period of relative stability in the 1960s there was a declining trend in the 1970s. This may owe something to dividend controls after 1972, although such an inference should be treated with caution because there was also rapid inflation in the period, and this would be reflected in the denominator (historic cost profits). There is little indication that dividend controls depressed the payout ratio in the 1960s. On the other hand, the change in the tax regime in 1973 does not seem to have led to a higher ratio.

The 'real' payout ratio presents a different picture. If deferred tax is included in the tax bill, the ratio, having followed its historic cost counterpart closely until 1972, thereafter rose very rapidly; although the ratio subsequently fell back, gross dividends exceeded post-tax equity earnings in each of the years 1974, 1976 and 1977. If deferred tax is not counted as a charge, a more subdued series emerges, with a gentler upward trend in the 1970s. Neither series suggests that dividend controls were particularly restrictive (but, of course, the controls were not explicitly related to payout ratios, and it is in any case probable that company managements were more concerned with historic cost ratios). The results might imply that, even when accounting for deferred tax as a current year charge against revenue, companies did not treat it as such in

[1] ED24: *Current Cost Accounting* (published by the Accounting Standards Committee, April 1979).

[2] Department of Industry, *Business Monitor: MA3, Company Finance* (HM Stationery Office).

[3] The numerator of the payout ratio should ideally comprise dividend accruals, and these have been used in the BM calculations. Because of lack of data, however, the ratios for industrial and commercial companies are based on payments, rather than accruals.

their estimate of distributable profits.[1] An alternative explanation is that companies have been misled into over-distribution through insufficient attention to the decline in their 'real' profits; also, as noted above, companies often have other reasons for preferring a stable dividend path.

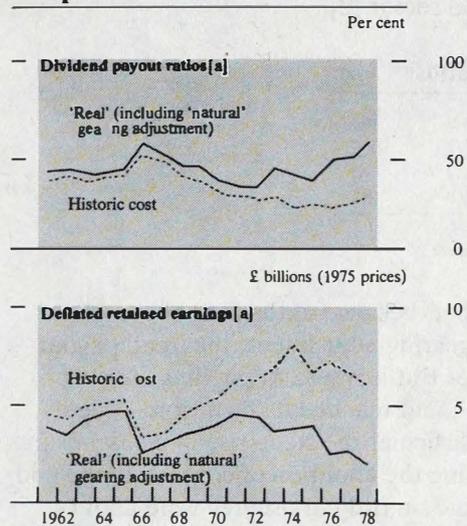
These observations based on gross dividend payout ratios apply also to the respective series for deflated retained earnings. The various changes in the tax treatment of dividends do not appear, therefore, to affect the analysis substantially.

Industrial and commercial companies

The historic cost series for industrial and commercial companies (ICCs) (Chart C) reveals a more prolonged downward trend than the BM sample. (The problem with deferred tax does not arise because such accruals do not form part of the tax series in the national accounts.) The 'real' payout ratio is similar to its BM counterpart; an upward trend is evident after 1972, and its highest level, 60%, was reached in 1978. Again, neither the effects of dividend controls nor of changes in the tax régime are easy to discern.

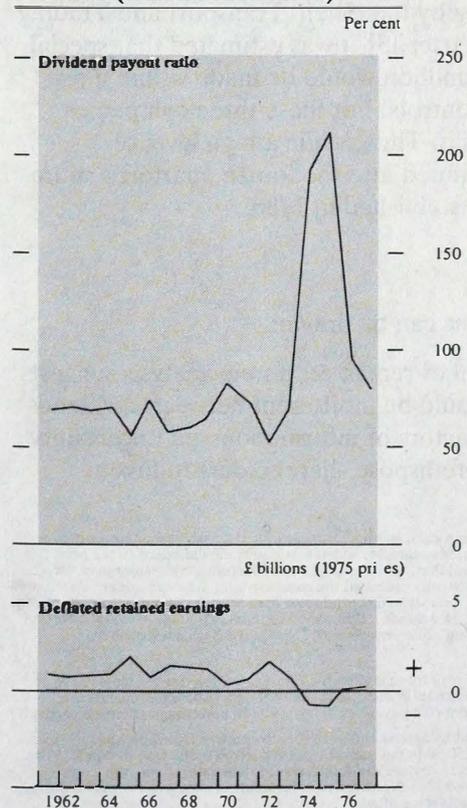
It is noticeable that the BM ratios have consistently exceeded their ICCs counterparts on both measurement bases. This is probably explained in part by statistical discrepancies such as result from the use of physical asset lives to calculate depreciation in the national accounts, in contrast to the (shorter) accounting lives underlying BM estimates. A more substantial explanation of the discrepancy in levels is that the BM sample is confined to large listed companies, on which the pressure to pay dividends is presumably highest (for the reasons set out above). The ICCs estimates include unlisted companies, which are not subject to stock market pressures on the payment of dividends (although they may not be exempt from other such pressures).

Chart C
Industrial and commercial companies



[a] Gross dividends do not include profits remitted abroad; correspondingly, post-tax equity earnings exclude profits due abroad.

Chart D
Business Monitor sample: manufacturing, distribution and services (ED 24 measures)



ED24 dividend payout ratio

Chart D shows, for the BM sample, the ratio of gross dividends to ED24 equity profits (excluding deferred taxation). The ED24 gearing adjustment is much smaller than the 'natural' gearing adjustment used for the 'real' payout ratio, and it is therefore to be expected that on an ED24 basis the payout ratio will rise more sharply in a period of high inflation. There was, indeed, a marked upward shift in the ratio in the 1970s; it exceeded 100% in 1974 and 1975, and fell back thereafter. [2] Even if these two years are excluded as being special cases, the ratio exceeded 80% in three other years in the 1970s (although, paradoxically, it was historically low in 1972). It may be surmised that dividends would probably have been lower in some years if an accounting standard based on ED24 had been in force.

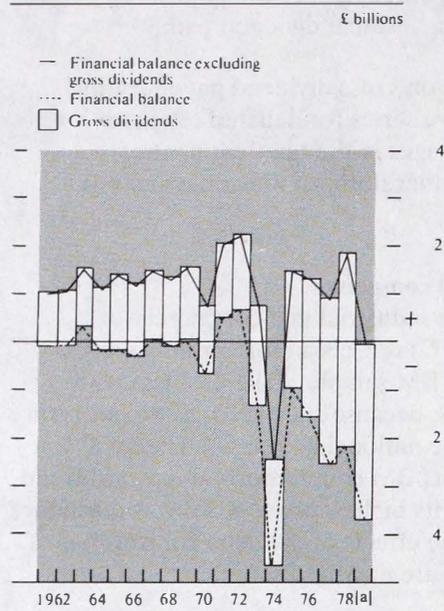
A cash flow measure

All the measures shown above incorporate some element of accrued income, not matched by corresponding cash flows. Cash availability in a given year may also be a potent determinant of dividends so that payout ratios with a cash flow

[1] This attitude to deferred taxation—that it need only be provided if there is a reasonable probability that it will actually become payable—is now adopted in 'Accounting for deferred taxation', *Statement of standard accounting practice no 15*, (The Institute of Chartered Accountants in England and Wales, 1978).

[2] Inclusion of deferred tax would make the ratios very much worse in the 1970s: post-tax ED24 profits were a usually negative on this basis in 1974–75.

Chart E
Industrial and commercial companies



measure in the denominator might be a more appropriate indicator. An impression of the cash flow implications of ICCs dividend behaviour is given in Chart E, which shows their financial deficit (net acquisition of financial assets) before and after deducting gross dividend payments. For the reasons emphasised earlier it should not be inferred from this that dividend payments are the residual item in companies' income allocation decisions. Nevertheless, without gross dividend payments a recorded financial deficit would have been converted into a surplus in eleven of the years shown; and in 1974 the very large recorded deficit would have been nearly halved.[1]

Current position

More up-to-date figures are available only for the whole industrial and commercial sector.[2]

Gross dividend payout ratios

Percentages	1977	1978	1979[a]
Historic cost	26.4	29.0	29.2
'Real' [b]	45.0	50.0	66.1

[a] First three quarters.

[b] Including a 'natural' gearing adjustment.

It must be emphasised that, because of the lack of complete data for calculating the gearing adjustment, the 'real' payout ratio is only approximate. But it is safe to say that the ratio rose very sharply in 1979, and reached its highest recorded level. This reflected in particular the steep rise in dividends in the third quarter, following the abolition of controls at the end of July. Net dividends paid on ordinary shares were about £1 billion, compared with £ $\frac{2}{3}$ billion in each of the previous two quarters. Much of this increase, however, is attributable to a few large companies which had specifically set aside dividend reserves during the period of controls. Unilever Ltd and the British Petroleum Co. Ltd, in particular, made large extra dividend payments in the third quarter, and there was further unwinding of the backlog by the 'Shell' Transport and Trading Co. Ltd in the fourth quarter.[3] It was estimated that special dividends totalling £400 million would be made within a few weeks of the easing of controls, but these three companies accounted for most of that. Thus, while a high level of dividends will have continued into the fourth quarter, a more normal pattern may be established in 1980.

Summary

The following conclusions can be drawn:

- Although a good deal of recent economic analysis suggests that shareholders should be indifferent between dividends and retentions, the factors of information and uncertainty probably generally predispose shareholders to favour dividends.

- [1] There is no unique validity in this particular method of measuring the cash flow consequences of dividends. Professor G. H. Lawson, for example, added new equity capital raised to the pre-dividend financial balance, and found that, for a sample of manufacturing companies over the period 1954-76, dividends had persistently exceeded the resulting total. The consequent deficits were financed with short-term bank finance and medium and long-term debt issues, thus effectively substituting debt for equity. See G. H. Lawson, 'Company Profitability and the UK Stock Market — an exercise in cash flow accounting', *Research Report*, (Centre for Business Research, Manchester Business School, 1980).
- [2] The figures are not fully consistent with those underlying Chart C because tax payments have of necessity been substituted for tax accruals in order to show 1979 data (which has the effect in 1977 and 1978 of reducing the replacement cost payout ratio by 5½ and 9½ percentage points respectively).
- [3] Both Unilever and 'Shell' are bound by agreements with their respective Dutch partners to pay dividends in specified proportions (50/50 in the case of Unilever, 40/60 in the case of 'Shell'). The Treasury permitted both companies to declare dividends in accordance with these agreements during the period of dividend controls, but stipulated that payments in excess of the prevailing ceiling could not be paid until controls were lifted.

- The current tax régime also provides a fiscal reason for preferring dividends, except in respect of companies that have no tax liability against which to offset ACT, and also, perhaps, for higher rate taxpayers.
- Except in the very short term, dividend payout behaviour does not seem to have been affected by changes in the tax régime. In particular, there is no suggestion that the ratio was low in the period of the classical system. But there are too many other factors affecting payout behaviour to be certain that this is a fair inference.
- Judged by the performance of 'real' payout ratios, dividend controls do not seem to have had a powerful impact. Indeed they may occasionally have had a perverse effect because some companies may have been encouraged to treat the limit as a norm so as to avoid any adverse reaction by the stock market.
- Although the historic cost payout ratio may be the usual benchmark used by company management and shareholders, the 'real' payout ratio deserves more prominence.
- The 'real' payout ratio, incorporating a 'natural' gearing adjustment, shows a rather moderate upward trend after 1972 (excluding deferred tax), although for special reasons there was a sharp jump in 1979. A more relevant indicator may be the ED24 payout ratio, which has been disturbingly high in a number of recent years and now seems likely to receive increasing attention.