

WHY INVESTORS WANT DIVIDENDS

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Abstract

The finance literature pays a lot of attention to the question why companies pay dividends. Contrary to this there is very little attention for the motives of the parties that receive dividends. There is particularly little attention for the question of why private investors want to receive dividends. In the United States dividends are taxed more highly than capital gains. For this reason a number of studies have investigated why the private investors still want to receive dividends.

An even more interesting situation exists in the Netherlands. Under the current tax system, that is operational since January 1, 2001, private investors are entirely indifferent between receiving dividends and capital gains (see Meussen (2000) for a detailed description of the Income Tax Act 2001). This allows us to study the preference of investors for dividends under a tax-neutral system. This new system has replaced a system where capital gains were not taxed and dividends were taxed. Since the change in the system is relatively new, we can also study the effect of the tax change on the attitude of investors toward dividend payments. First the tax situation from January 1, 2001 has to be explained. In this tax system, income from profession and income from capital is put in different "boxes". Income from profession is put in box I. The income in box I is taxed at a progressive tax rate. Income from capital is put in box III. The tax system assumes that capital will yield a fixed return of 4%. This is regardless of the actual return, which can be much higher, but also be much lower (or even negative). This return is then taxed at a flat rate of 30%. This means that in fact every investor pays 1.2% of his or her capital in taxes each year. All investors have a tax exemption of approximately 35,000 guilders. This amount is doubled for couples (who have a tax exemption of 70,000 together). A single private investor with a capital in the form of bonds, stocks and bank accounts of a total of 50,000 guilders is taxed as follows:

Capital: 50,000 guilders

Tax exemption: 35,000 guilders -/-

Taxable amount: 15,000 guilders

Fixed return: 4% of 15,000 is 600 guilders

Taxes over income from capital 30% of 600 is 180 guilders.

This new tax system no longer discriminates between dividends and capital gains.

Under the old tax system (before January 1, 2001), private persons who were subject to Dutch income taxes did not pay taxes over capital gains at all¹. On the other hand they did have to pay taxes over dividend income. This worked in the following way. A Dutch private person first determined his income from profession (including income from social benefits and such). The next step was to determine the income from capital, in the form of dividends and interest. Single persons both had a dividend and an interest exemption. Both were equal to 1,000 guilders². If the dividend income was lower than 1,000 guilders, the person in question did not

have to pay taxes over the dividends. If the total amount of dividends exceeded 1,000 guilders, the private person only had to pay income taxes over the surplus. For example, a person who received 1,500 guilders of dividends, had to pay taxes over 500 guilders. The exemptions were doubled for couples. As the taxable amount was added to the income from profession, the private person actually had to pay the marginal tax rate over the dividend income.

According to the Dutch tax system, private investors would be expected to be indifferent between capital gains and dividends. However, in practice we see that a large number of persons still prefer to receive dividends. This question will be further investigated in this study. A rational argument in favour of dividend payments consists of transaction costs. An investor who wants to receive a regular income from his security holdings has a choice between buying dividend paying stocks and cashing in the dividends, and buying non-dividend paying stocks and regularly selling a part of his portfolio. For a small private investor the transaction costs of cashing in the dividends may be significantly smaller than the transaction costs associated with selling a part of the stocks (see e.g. Allen and Michaely, 1995).

Shefrin and Statman (1984) develop a theory of dividends based on the idea that, even if the amount of cash received is the same, it can still make a difference for the investor whether the cash comes in the form of dividends or capital gains. Their model is based on a behavioral theory. In this theory investors want dividends because of self control. This argument comes down to investors wanting to restrict themselves from consuming too much in the present. They don't want to dip into capital and, therefore, they only allow themselves to consume current income such as dividends. The effect described by Shefrin and Statman (1984) is especially strong for elderly (retired) investors, as they have less income from profession. For this reason they rely more heavily on income from their securities holdings. Shefrin and Statman (1984) refer to this as the behavioural life cycle³.

An issue that is closely related to that of cash dividends is the question why some companies "pay" stock dividends. As every standard textbook in Finance teaches us, stock dividends are nothing more than a small stock split. DeBondt and Thaler (1995) refer to stock dividends as one of the big anomalies in finance. Under specific conditions, stock dividends are tax exempt in the Netherlands. For this reason, a large number of Dutch companies "pay" their dividends in the form of stock dividends or, alternatively, they give their shareholders a choice between cash and stock dividends.

Another interesting theory to test has become known as the "bird-in-the-hand", the idea that investors prefer certain dividends now to possible dividends later (Gordon, 1962). While this model fails if it is posited in a complete and perfect market with investors who behave according to very restrictive notions of 'rational' behaviour, it seems to accord rather better with casual observations. Fewings (1979) has subsequently extended this theory in the direction of showing that stocks that do not pay dividends are riskier and hence even perfectly 'rational' investors could prefer dividends.

Other theories that can be tested include agency theory (Jensen 1986 and Easterbrook, 1984); signalling (Bhattacharya, 1979 and Brennan and Thakor, 1990); and, social effects of dividends (Frankfurter and Lane, 1994).

For this study we will use the panel of the CentER for Economic Research at Tilburg University in the Netherlands. This panel consists of about 5,000 Dutch households that are continuously interviewed on a number of issues that deal with financial matters. We will be able to submit our own questions to this panel.

This panel has great advantages over the more usual survey/questionnaire research. Although households can choose not to answer a few of the questionnaires each year, the response rate is guaranteed to be quite high. The data from previous questions over several years is available to us, and includes a large quantity of basic information that allows us to have a better financial and demographic picture of the respondents than that in any other published area of finance research. We can also test for non-response bias more effectively than is ever possible with ordinary surveys. We will pretest our questions on a small sample of the panel first.

Results are available from this panel much faster than ordinary surveys, and CentER will provide us with any coded data in machine readable form quickly. The respondents receive the questions and answer them via computer terminals in their own homes. Accordingly, we can have the data quickly and write a paper suitable for discussion at the 2002 AFA Conference, even though we have not yet submitted our questions.

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1 There is an exception for private persons who hold more (directly or indirectly) of 5% of a firm's stock. Such a holding is called a "substantial interest". Private persons who hold such a substantial interest have to pay a tax over both their dividend and their capital gain income.

2 There are also some additional dividend exemptions, e.g. for dividends that are received on employee savings accounts. See Ho, Robinson and Veld (1999, page 102-103) for a complete description.

3 Shefrin and Statman (1984) argue that their theory is supported by the outcomes of a study from Lease, Lewellen and Schlarbaum (1976) who find that elderly persons have a stronger preference for dividend paying stocks than younger persons.