Does Dividend Policy Have a Political Dimension? The British Case

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An issue that has captured considerable attention in corporate governance circles over the past few years 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 line of enquiry generated by debates on the configuration of systems of ownership and control concerns the impact of politics. Various observers, most prominently law professor Mark Roe, argue that it is impossible to get the full story on corporate governance systems without taking politics into account, in the sense that a country's position on the ideological spectrum helps to dictate how companies are governed (see Roe, 2001, Roe, 2003, and Gourevitch and Shinn, 2005).

Thus far, there have been few empirical tests of the proposition that politics affects corporate governance. To remedy this omission, we have conducted a study focusing on the determinants of dividend policy in publicly quoted British companies between 1949 and 2002. The study, the results of which are reported in detail in the working paper, "Dividends and Politics" (Bank, Cheffins and Goergen, 2006) finds that political variables generally do not correlate in the predicted direction with dividend pay-outs. This implies politics does not shape corporate governance in the manner Roe and others have hypothesized.

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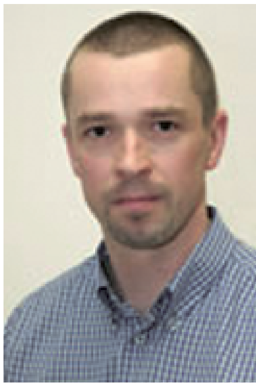
Politics as a Potential Determinant of Corporate Governance

Why might politics be expected to matter with corporate governance? Roe argues that left-wing countries favor employees over investors and correspondingly use regulation to increase the leverage workers possess. Corporate executives, in this milieu, will tend to cater to employee preferences and give shareholders short shrift, thus ensuring that a U.S.-style stock market economy will not evolve. To elaborate, senior executives want to run big firms for reasons of prestige and power but will tend to avoid changes that might put the survival of their companies at risk since they have a massive amount of human capital invested in the firms they run. As Roe points out, this agenda tallies with the objectives of incumbent employees since for staff "a steady as she goes" ethos will foster job security and being associated with a large company can create numerous promotion opportunities. Correspondingly, under appropriate political conditions there is a foundation for an alliance between managers and employees that could leave shareholders out in the cold. A stock market-driven system of corporate governance akin to that existing in the United States, characterized by companies with widely held shares, correspondingly is unlikely to evolve in a left-wing country.

Roe's conjectures can be readily applied to dividend policy. His characterization of managerial preferences implies that corporate executives should prefer to retain rather than distribute profits since corporate growth can be fostered without unwelcome scrutiny via capital markets. Also, executives apprehensive of a potential downturn in their company's fortunes will tend to be biased against dividends since retained profits can help to provide a company with the financial wherewithal to cope with adversity in the event of a "rainy day".

Employees will tend to share management's skepticism towards dividends. With profits companies generate, workers may assume that cash paid out as dividends could have been distributed to staff in the form of more generous wages and benefits.



Employees might also support a conservative dividend policy on the grounds that retained earnings will provide their employers with a financial "cushion" that will allow employment levels to be maintained in the face of unanticipated financial reversals.

Corporate finance theory implies shareholders should be indifferent towards any managerial bias against dividends, as exemplified by Miller and Modigliani's memorable claim that dividends are a "mere detail" (Modigliani and Miller, 1958). Nevertheless, dividends have generally been popular with shareholders, who have welcomed the cash as means to finance their lifestyles. More generally dividends are a potentially integral element of corporate governance. For instance, when companies make regular and continuous dividend payments, this can curb the potentially counterproductive accumulation of undistributed funds (referred to as "free cash flow" in the finance literature) by managers and can activate beneficial capital market discipline by forcing companies to rely on external sources to obtain needed funds. Also, unexpected changes to dividend policy constitute potentially valuable signals under asymmetric information and dividend cuts in particular can activate alternative corporate governance mechanisms that address poor performance or financial distress. This all implies that, to the extent politics constitutes a determinant of corporate governance, political variables will influence the dividend policies companies adopt.

What sort of impact might politics be expected to have? Again, according to Roe, in left-wing countries employees are favored over shareholders and risk-averse empire-building managers will be inclined the same way. Since both managers and workers will be skeptical of dividends, if politics "matters" to corporate governance, left-wing governments should correlate with low dividend payouts. Moves to the right on the political front should, in turn, be associated with the adoption of more generous dividend policies.

Why the United Kingdom?

In "Dividends and Politics" we test the impact of politics on dividend policy by using aggregate annual data on dividends and earnings for the United Kingdom between 1949 and 2002. One reason the U.K. was a suitable choice was the availability of detailed aggregate annual financial data covering most publicly quoted companies as far back as 1949. Another was that Britain's political system is well-suited for testing the impact that politics potentially has on corporate governance. Unlike Continental European political systems that often yield consensus-oriented coalition governments, Britain's "Westminster Model", characterized by the fusion of the executive and the legislature and by majority governments elected under a "first past the post" electoral system, gives the party in control substantial leeway to implement policies it prefers.

Neither of Britain's major political parties (the Conservatives and Labour) dominated exclusively between 1949 and 2002, meaning that there was considerable potential for significant shifts to the left and right and back over time. Given this, and given that there was no doubt at any moment in time which party held political power, if there is a link between politics and corporate governance, the effects should be particularly pronounced for Britain. Indeed, studying the U.K. in isolation arguably constitutes a more robust test for politics' impact on corporate governance than a cross-country study involving countries where coalition-oriented government was the norm.

Modeling Dividends and Politics

Even if politics has an impact on dividends, corporate fundamentals will continue to play an important role. As a result, we rely on Lintner's "partial adjustment" model of dividends (Lintner, 1956) in formulating a model to test for a link between politics and dividends. His work constitutes the foundation for a well accepted consensus in the finance literature that managers set dividend policy with targets based on profitability in mind but only move partially towards these over time. Managers engage in this sort of "dividend smoothing" because they anticipate cutting existing dividends will be unpopular with shareholders, which means in turn they will only increase payouts if current earnings projections imply a change is likely to be sustainable over time.

Our paper supplements Lintner's partial adjustment model in various ways to test the impact of politics on dividend policy. Following Fama and Babiak (1968), we incorporated a lagged earnings variable, with the logic being that managers take into account earnings fluctuations occurring in prior years as well as the current year in setting dividend policy. Our next step was to introduce a direct test of politics, using a dataset that provides annual political rankings for the U.K. (and other OECD countries) from the end of World War II onwards based on the position taken on 26 different social and economic issues by the governing party in its party platform and on the placement of the party in office based on views adopted on 10 different market regulation and wealth redistribution issues.

Even if the ideology of political parties in power is not a determinant of dividend policy, politics and dividends might still be related at one step removed. As a result, we augment our basic political model with "secondary" variables that have a strong political aspect. Tax is one feature added, since in the U.K. changes to corporate tax often have been accompanied by political declarations of intent to dictate dividend policy. In recognition of the fact that institutional shareholders largely displaced individual investors as owners of corporate equity in the U.K. between 1949 and 2002 and were taxed much differently than individuals, our paper draws upon methodology developed by Poterba and Summers (1985), and adapted by La Porta, López-de-Silanes, Shleifer and Vishny (2000), to construct for pension funds and for top marginal rate taxpayers a tax preference ratio based on factors such as income tax rates and the tax treatment of capital gains. Generally, between 1949 and 2002 there was for individuals a strong tax bias in favor of retained earnings and for pension funds, dividends.

Dividend controls, which were in place in the U.K. throughout much of the late 1960s and the 1970s, constitute a second variable added to the basic political model. Winston Churchill's denunciation, as Conservative leader of the opposition, of a 1951 proposal by the Labour government to introduce compulsory regulation of dividends illustrates that such controls could be politically controversial:

"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."

Therefore, if dividend controls cause cash distributions by companies to decline, this implies politics affects dividends.

The power of organized labor is an additional secondary political factor built into our model. The labor relations climate set by government can be expected to affect the prosperity of unions. If unions, in turn, are strong, this could have an impact on dividends since organized labor can potentially extract "rents" available when companies generate above-normal profits and thereby divert wealth from shareholders to employees. The ebb and flow of union bargaining power thus plausibly might be expected to have an impact on dividend pay-outs. "Dividends and Politics" uses two proxies for labor power, these being annual fluctuations in "union density" (the proportion of union members to the total working population eligible to join a union) and annual changes to labor costs in U.K. manufacturing companies, with the presumption being correlations between increases in union density and/or labor costs with falling dividend pay-outs, and vice versa, would imply that politics influences dividend policy.

The basic political model is also supplemented by a corporate law variable. La Porta, López-de-Silanes, Shleifer and Vishny, in a 2000 study covering 46 countries,[1] found companies from countries with strong shareholder protection paid higher dividends than companies from countries where investors were poorly protected, which implies shareholder-friendly laws enable minority shareholders to disgorge dividend payments from corporate insiders. Corporate law is also an appropriate addition to the model because there is a potential political dimension (e.g. labor leaders might object to the enactment of laws designed to improve the protection of minority shareholders, fearing that protecting jobs and securing favorable treatment for workers will be difficult if management feels compelled to focus on the interests of profit-oriented investors). To take corporate law into account, the paper identifies years when major amendments were made to U.K. company legislation to find out if these coincided with significant changes to dividend policy.

Data on Dividends and Earnings

The dependent variable in our political model is the annual change in aggregate gross dividends paid by U.K. public companies, measured by reference to the total for a given year minus the total for the previous year. Two sources, a Cambridge/DTI Databank of

[1] La Porta, López-de-Silanes, Shleifer and Vishny (2000).

Company Accounts and Datastream, were used to assimilate aggregate data for 1949 to 2002 and to collect data on profits, which is a pivotal element of the Lintner partial adjustment model. Dividends and profits were adjusted to ensure that complications arising from the U.K.'s system of corporate tax did not corrupt the findings.

Results

"Dividends and Politics" finds the data fits well with the Lintner model in its original apolitical form, indicating the partial adjustment model explains well the dividend pattern over time. Hence, U.K. public companies set dividend policy annually by moving part of the way toward a target payout ratio based on earnings trends. Politics did little to disrupt this pattern. While if politics "mattered" to corporate governance in the way that has been hypothesized dividend pay-outs should have been higher when the U.K. had a right-wing government and lower when the government was on the left-wing of the political spectrum, no meaningful statistical correlation was found between the ideology of the party in power and dividend policies of British public companies. We ran as a robustness check a similar political test for the United States focusing on the parties controlling the Presidency and Congress and found much the same outcome.

As for the variables designed to test the impact of politics at one step removed, the results generally confirm politics was not a determinant of dividend policy. There was, for instance, no statistically significant correlation between dividend pay-outs on the one hand and dividend controls or company law on the other. The outcome was the same with the tax treatment of pension funds and with union density.

The paper does find a weak correlation in the predicted direction between dividend policy and the tax treatment of top marginal tax rate taxpayers, in the sense dividends tended to rise when tax laws became biased in favor of distributed as opposed to retained profits. The obvious way to interpret the result is to say that companies set dividends with the tax treatment of the top marginal tax rate taxpayer in mind. This interpretation does not tally, however, with historical patterns. Over time the correlation should have weakened since the percentage of shares owned by individuals was declining steadily and companies logically should have been worrying less and less about their tax status. Instead, the correlation remained much the same throughout the entire period under study.

The other statistically significant correlation involves labor costs. Again, however, the results do not provide strong support for the proposition that politics constituted a determinant of dividends. If politics was a determinant of dividends, labor costs should rise under left-wing governments, which in turn should depress dividends. In fact, the converse was found, namely that dividends actually rose in tandem with labor costs and vice versa. There is no obvious political explanation for this pattern, which implies that there is not a political story to be told here.

Conclusion

The theory that politics is a key determinant of corporate governance has a plausible ring to it. Certainly, in countries suffering from political repression and related civil strife, the economic and institutional pre-conditions for the development of large, privately-owned enterprises may well remain unsatisfied. Even in rich, stable democracies, politics stands out as a potential determinant of corporate governance since social democratic policies might exacerbate agency costs by fostering an identity of interest between corporate insiders and rank-and-file employees.

Our results indicate that in the particular context of dividend policy in the U.K. politics did not shape corporate governance. The only robust statistical finding is that British public companies set dividend policy in accordance with a model well accepted in the economic literature, namely by adjusting over time towards a target based upon corporate earnings. Politics, it appears, failed to dislodge the pattern in a readily measurable way, even though dividend controls and tax rules biased against dividends were in place at various points during the period studied.

Bearing these results in mind, one might wonder why managers of U.K. companies "kept their eye on the ball" and continued to pay dividends by reference to targets based on earnings, particularly given the politically oriented constraints on dividend policy. It is possible the threat of a takeover bid could have played a role, since companies that adopted a dividend policy that displeased shareholders should have traded at a discount and thus would have been vulnerable to an unwelcome tender offer. To test this conjecture, we compiled data on the number of mergers carried out in the U.K. annually from 1949 to 2002 and ran their regressions again to see if there was a correlation between takeover activity and dividend pay-outs. Contrary to what would be expected, the coefficient was negative. There is no obvious explanation for this result, but the fact that we had to rely on data based on all mergers, rather than just hostile takeovers, might have played a role.

While it is unclear why U.K. public companies continued to set dividend policy by reference to earnings, the paper's results nevertheless do show that in this particular context politics was not a determinant of corporate governance. Further research involving different proxies for corporate governance and different countries will be required to establish whether this finding reflects a more general pattern. However, since the conditions in the U.K. were highly congenial to a finding that politics influenced dividend policy, politics only seems likely to be found to be a determinant of corporate governance under extreme circumstances.

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