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Is corporate payout taxation a long run phenomenon? Evidence from international data

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ABSTRACT

This paper examines whether dividend and capital gains taxation influences corporate payout policy using the country level data of 21 countries in panel versions of time series models. We find that dividend relative to capital gains tax penalty is cointegrated with corporate payouts (dividends and share repurchases) i.e. corporate payout taxation may be a long run phenomenon. Further, the cointegrating vector estimates are largely consistent with the traditional view of dividend taxation whereby the tax penalty discourages dividends, while the estimates give limited support to the premise that firms substitute dividends for share repurchases in response to an increase in dividend tax penalty. Long run causality also operates between the tax penalty and payouts in the error correction models. Additionally, dividend tax appears to be more influential than capital gains tax on dividend payout decisions. Lastly, taxation affects dividends more significantly in countries with high investor protection.

1. Introduction

Taxation is one of the perennial themes in corporate finance literature. A number of questions have been raised about how taxation affects a firm's decision-making. For example, Becker, Jacob, and Jacob (2013) investigated whether corporate payout has any effect on a firm's investment choice.

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Alzahrani and Lasfer (2012) asked a novel question of whether investor protection has tax implications on dividends. Chief among these questions is whether taxation of dividends relative to capital gains has any impact on corporate payout policy. To address this question, two competing views have been proposed.

The seminal work by Poterba and Summers (1984), and later by Poterba (2004), among many other contributions, expressed the view (the traditional view) that a dividend tax cut should induce an increase in dividend distributions. An underlying assumption of the traditional view is that a firm's investment is sourced from new equity, which implies that returns on investment are taxed at both the firm and shareholder levels, triggering double taxation. Therefore, dividend taxation ought to have an inverse relationship to dividend distribution. Some recent examples of empirical work include Alstadsæter and Fjærli (2009), Korkeamaki, Liljeblom, and Pasternack (2010), and Pattenden and Twite (2008). The evidence from these authors supports the negative relationship between tax and dividend distribution.

An alternative view (the new view) considers retained earnings as the marginal source of investment. As the use of retained earnings operates as a tax shield, neutralizing double taxation, the new view posits that taxation would have no relationship to dividend distribution *unless* dividend tax reductions are temporary. This dividend taxation irrelevance was developed by King (1977), Auerbach (1979), and Bradford (1981). Auerbach and Hassett (2002) offer some evidence consistent with the irrelevance proposition.

Further, corporate finance researchers are faced with another debate; that is, "Do firms then use share repurchases as a substitute for dividends if dividend tax affects shareholders' tax preferences (the so-called substitution hypothesis)?" Several authors responded by providing empirical findings that taxation has a bearing on a firm's payout choice between dividends and share repurchases. Sarig (2004), Rau and Vermaelen (2002) and Oswald and Young (2004) found a positive relationship between share repurchases and tax for the USA and the UK, while Brown and Efthim (2005) and Lee, Liu, Roll, and Subrahmanyam (2006) focused on Asian countries. In addition, Lee and Rui (2007) recently offered a further finding that share repurchases may not be perfect substitutes of dividends but can be both complements and substitutes. However, Lee and Suh (2011) provided findings from international data that firms use share repurchases to distribute excess cash, which implies that a tax advantage may not be the sole cause of share repurchases.

Despite the continued efforts from the contributions cited above, the empirical findings to date are at best mixed. In response, Jacob and Jacob (2013) pointed to the limited information of single country or single event studies and offered evidence from international firm level panel data. For a comprehensive analysis, Jacob and Jacob (2013) compiled an international firm level dataset that consists of 6035 firms across 25 countries for the period of 1990 to 2008. The use of an international panel dataset is commendable for the advantage of capturing rich information from international tax events and affording a high degree of freedom (i.e. a large number of observations given the same number of parameters as single country or single event studies). These authors found that one year lagged dividends taxation relative to capital gains is closely related to a firm's propensity to pay dividends and repurchase shares in the following year. They also ascertained that the tax effect is smaller than that reported previously for single country or single event studies.

1.1. *Taxation as a long run phenomenon*

In this paper, given the findings from Jacob and Jacob (2013), we argue that taxation may also have long run effects on dividends. In other words, we ask "Is dividend taxation a long run phenomenon? Or is it only a short run development as suggested by Jacob and Jacob (2013) in which one year lagged taxation exerts statistically significant impacts on dividends?"

The literature has a strong theoretical and empirical foundation upon which we build our argument for the long run relationship between taxation and corporate payout. Modern approaches to taxation theory often embrace the life cycle hypothesis (see Ando and Modigliani, 1963) and rational expectations permanent income hypothesis about the effects of taxation on consumption. According to the rational expectations permanent income hypothesis (see Hall, 1978; Bernanke, 1985; Campbell, 1987), temporary tax changes have much less effect on consumption than Keynesians had thought because