Dividend Policy and Share Repurchases: Signaling, Agency, and Tax Effects

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ABSTRACT

Dividend policy—the decision of how much of earnings to distribute to shareholders versus retain for reinvestment—presents one of corporate finance's enduring puzzles. Miller and Modigliani (1961) demonstrated that in perfect markets, dividend policy is irrelevant to firm value: investors who prefer income can create 'homemade dividends' by selling shares, while those who prefer capital gains can reinvest dividends, so the form of return is irrelevant to total return. Yet firms invest substantial managerial attention in dividend decisions, investors appear to react significantly to dividend changes, and dividends create tax disadvantages in many jurisdictions relative to share repurchases. This paper reviews the dividend irrelevance theorem and its assumptions, the signaling theory of dividends (Bhattacharya, 1979; Miller and Rock, 1985), the agency theory of dividends (Jensen, 1986), tax clientele effects, and the shift from dividends to share repurchases as the dominant form of cash distribution over the past three decades.

Keywords: Dividend Policy; Share Repurchases; Signaling Theory; Agency Costs; Tax Clientele; Miller Modigliani; Dividend Puzzle; Payout Policy.

1. INTRODUCTION

Miller and Modigliani's (1961) dividend irrelevance theorem—established in the Journal of Business (34(4): 411–433)—showed that in a world of perfect capital markets, rational investors, and no taxes, a firm's choice between paying dividends and retaining earnings does not affect firm value or shareholder wealth. The intuition is straightforward: the total return (dividend plus capital gain) is determined by the firm's investment opportunities and earnings power, not by how returns are packaged. A firm that pays a higher dividend must issue new shares to fund the same investment program, diluting existing shareholders' capital gain exactly equal to the dividend received—leaving shareholders' total wealth unchanged.

The irrelevance theorem's assumptions—perfect markets, no taxes, no information asymmetry—identify the channels through which dividend policy can matter. Taxes create a preference for capital gains over dividends in jurisdictions where dividends are taxed at higher rates than capital gains. Information asymmetry creates a signaling role for dividends: changes in dividend policy convey private information about management's expectations of future earnings. Agency costs create a monitoring role for dividends: paying out cash reduces the free cash flow available for managerial empire-building. These three channels—taxes, signaling, and agency—motivate the major theories of dividend policy.

2. SIGNALING THEORY

Bhattacharya's (1979) signaling model proposes that dividends serve as costly signals of future earnings: firms with strong earnings prospects commit to paying dividends (an observable action), while firms with weak prospects cannot profitably mimic the dividend payment because the cost of sourcing cash externally (after revealing that dividends exceed internal earnings capacity) exceeds the benefit. Miller and Rock (1985) in the Review of Economic Studies formalize this argument: dividends reveal current earnings, which predict future earnings, creating an informational rationale for dividend payment. The empirical prediction is that dividend increases should be followed by earnings increases—a prediction that has received mixed support. Benartzi, Michaely, and Thaler (1997) in the Journal of Finance find evidence that dividend increases signal recent earnings improvements but do not reliably predict future earnings growth, challenging the pure signaling story.

3. AGENCY COSTS AND THE FREE CASH FLOW HYPOTHESIS

Table 1. Dividend policy channels, predictions, and empirical evidence.

Channel	Dividend Policy Prediction	Evidence
Tax clientele	High-tax investors prefer low-dividend stocks; low-tax prefer high-dividend	Elton & Gruber (1970): ex-dividend price drop < dividend → tax clientele
Signaling	Dividend increases signal management's confidence in earnings outlook	Significant price reaction to dividend changes; future earnings prediction mixed
Agency (FCF)	Dividends reduce free cash flow and managerial discretion to overinvest	Jensen (1986): dividend-paying firms in low-growth industries show less waste
Catering	Firms pay dividends when investors demand them (Shiller dividend premium)	Baker & Wurgler (2004 JF): firms initiate dividends when dividend premium is high

4. THE RISE OF SHARE REPURCHASES

The most dramatic development in U.S. corporate payout policy over the past three decades has been the shift from dividends to share repurchases as the primary form of cash distribution. U.S. aggregate share repurchases first exceeded aggregate dividends in 1997, and by 2022 the S&P 500's total repurchases of approximately $920 billion exceeded total dividends of $510 billion. Fama and French (2001) document this 'disappearing dividends' phenomenon: the fraction of U.S. firms paying dividends fell from 67% in 1978 to 21% in 1999, driven partly by the changing composition of public firms (more young, high-growth firms) and partly by a genuine preference shift toward repurchases. Share repurchases offer advantages over dividends in flexibility (can be discontinued without the negative signal associated with dividend cuts), tax efficiency (capital gains taxation typically lower than dividend taxation), and EPS accretion (reducing share count improves earnings per share).

5. CONCLUSION

The dividend puzzle—why firms pay dividends at a tax disadvantage when share repurchases are available as a more tax-efficient substitute—reflects the genuine complexity of corporate payout policy, where signaling, agency, tax clientele, and catering forces interact with managerial preferences and institutional constraints. The trend toward share repurchases resolves some of the tax paradox but introduces new questions about whether repurchase programs serve shareholder interests or managerial objectives (EPS management, stock option accretion). The COVID-19 pandemic's forced dividend cuts provided a natural experiment in dividend signaling effects: firms that cut dividends suffered negative stock price reactions consistent with negative signaling, while firms maintaining dividends through the pandemic showed relative outperformance. Future research should examine how increasing concentration of institutional ownership changes the equilibrium of signaling versus tax clientele in determining optimal payout policy.

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