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To Pay or Not to Pay Dividends: Discussions

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DISCUSSION

G. M. CONSTANTINIDES*: The paper provides a rigorous discussion of the welfare aspects of dividends at a high level of generality. As Professor Hakansson states in his paper, at the technical level the analysis extends the results in Hakansson, Kunkel and Ohlson (1981) by incorporating personal taxes; Proposition V, however, is a new result.

The first set of conclusions is that informative dividends are a matter of irrelevance only under a set of strong assumptions which describe a pathological case (Proposition II). If there are also deadweight costs associated with dividends, dividends lead to a Pareto inferior allocation (Proposition III). The immediate corollary is that informative dividends almost invariably have welfare implications, and we are led to a discussion of the welfare implications of dividends. It is hard to argue against this set of conclusions. Even if one were to disagree with the specific assumptions of the model, one would probably reach a similar conclusion in a wide variety of models that *informative dividends do have welfare implications*.

In the second set of conclusions, Hakansson provides sufficient conditions which guarantee that dividend declarations are Pareto-improving (Proposition IV and necessary conditions for dividends to yield a Pareto improvement Proposition VI). The *key* assumption for (Proposition IV) is that endowments are efficient in the absence of dividend declarations. The proof then proceeds on the following lines: those consumers who refuse to trade after the dividend declaration do not become worse off. Those consumers who choose to trade after the dividend declaration become better off. Thus, as long as our set of sufficient conditions implies trading by some investors after the dividend declaration, a Pareto improvement does occur.

The final set of conclusions is that a policy of informative dividends can bring a market that is less than fully allocationally efficient in the absence of dividends to the equivalent of full allocational efficiency (Proposition V).

My specific comments below should be interpreted not as a criticism of the paper but as a call for further research in this important area of finance.

1. *Are investors rational and are equilibrium prices informative?*

A casual reading of the paper may give the impression that investors are irrational because they learn nothing from the equilibrium prices although they

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are asymmetrically informed. In a rational expectations model asymmetrically informed investors must learn something from the equilibrium prices, unless the noise is infinite. Hakansson's model is consistent with rational expectations under appropriate interpretation. The π_{is} 's which Hakansson calls the prior beliefs are properly interpreted as the posterior beliefs which occur at equilibrium with partially revealing prices, as, for example, in the rational expectations models of Hellwig (1980) and Diamond and Verrecchia (1981). Likewise the posterior beliefs, after the announcement of a dividend scheme or a dividend, should be properly interpreted as the posterior beliefs which occur at equilibrium after the announcement of a dividend scheme or a dividend.

2. *Why are dividends informative?*

If I replace the words "dividend announcements" with the words "earnings announcements" or "signals" in the propositions, does anything change? I think not. To my knowledge nobody has provided a satisfactory answer why dividends are better signals than some other type of announcement. Let us then turn to a simpler question: why are dividends informative (although not necessarily the only announcement which is potentially informative)? This question is addressed in two papers by Bhattacharya (1979, 1980). In the first paper dividends have deadweight costs and lead to a signalling equilibrium wherein management conveys information to the shareholders. In the second paper dividends lead to a signalling equilibrium, even though there are no deadweight costs. Also in Miller and Rock (1982) dividends are shown to be informative. In their model the dividend announcement is the result, not of the management's desire to convey information per se, but of the management's effort to resolve the potential conflict of interest between the exiting and the staying shareholders. Their dividend announcement provides the missing piece of the sources/uses constraint, which the market needs to judge the firm's *current* earnings. That earnings figure then serves as the basis for estimating future earnings.

3. *Do the conclusions remain valid in a multiperiod context?*

The key assumption in Proposition IV is that endowments are efficient in the absence of dividend declarations. Since it appears unlikely that endowments just happen to be efficient, I provide a multiperiod scenario which bypasses this difficulty:

- Consumers start out with some endowments which, in general, are not allocationally efficient. They also start out with heterogeneous beliefs and assign some positive probability to the event that a dividend scheme will be introduced.
- Markets open and the consumers trade. After trading stops, the consumers' allocations may be interpreted as what Hakansson calls "allocationally efficient endowments."
- Now a dividend scheme is introduced. In other words, consumers are informed that a dividend will soon be declared but the amount of the dividend, which may even be zero, has not been declared yet.

In Hakansson's single-period model, Proposition IV states that, at this point, a

Pareto improvement occurs. It would be interesting to examine whether the various propositions remain valid in the proposed multiperiod scenario.

4. *Does the announcement that a dividend scheme will not be installed lead to an allocation which is necessarily inferior to the announcement that a dividend scheme will indeed be installed?*

As I stated above, my interpretation of Hakansson's "efficient endowments" is that announcements occur at two stages. In the first stage the firm announces that a dividend scheme will be installed and, in the second stage, the firm announces the actual amount of the dividend. I conjecture that even the announcement that a dividend scheme will *not* be installed carries information and may lead to a Pareto improvement. It is of interest then to compare the welfare implications of the announcement of different dividend schemes. This issue is briefly discussed by Hakansson in his concluding remarks.

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DISCUSSION

L. H. SUMMERS*: Litzenberger and Ramaswamy, henceforth (LR) in their paper respond to one of the major criticisms of earlier work on dividend yields and stock market returns. This is the argument that observed ex-post dividend yields contain information which was not available to market participants at the beginning of the month, over which monthly returns are computed. This argument explains the observed positive relationship between dividend yield and stock market return as due to the information effect of the dividend yield, when the yield is high, or average positive information has been conveyed during the month, when it is low, negative information has been received.

This potential explanation for the observed relation between yields and returns is convincingly refuted by LR. First they note that a number of previous studies have found evidence of yield effects using methodologies which do not suffer from this difficulty. Second, they report results obtained using a yield variable which is estimated conditional only on available information. These results are quite

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