

## Why do corporations issue dividends?

Standard corporate finance theories suggest that companies should never issue dividends. Nonetheless, they do. Are managers deluded, even after half a century of modern finance explaining the pointlessness of the practice? Are they responding to deluded investors who, contrary to the theories' most fundamental assumption, act irrationally even over extended periods of time? Are the theories wrong on their own terms? Or are the simplified models on which they are based missing some critical aspect of our markets?

### I. Debt/Equity doesn't matter.

The standard theory is associated with Modigliani and Miller's seminal articles from the 1950s. MM argued that the value of a firm should be based on its economic profits or surplus -- its ability to produce and sell a product or service for more than it is required to pay to its various inputs. How it divides that surplus will, of course, affect which firm participants get more or less of it, but it should not affect the total value of the surplus or the firm that creates it.

In particular, they contend, the total value of the firm's stocks plus bonds should be unaffected by whether it finances itself mainly by debt or mainly by equity. They offer a mathematical proof of the proposition in a highly simplified model assuming "perfect" markets at equilibrium -- i.e., completely rational investors with complete knowledge (including of the future), no transaction costs, employees and other suppliers (except for capital) paid a market price that is also the marginal cost of their production, and so on. But the proposition need not be based on such counterfactual assumptions.

A more heuristic justification for this claim runs something like this.

First, it is fairly easy to see that their basic point -- that the value of the company is not affected by how it divides its profits between bondholders and stockholders -- should apply if the same investor holds all the stocks and bonds of the corporation. As the sole shareholder and sole bondholder, the investor will receive both interest and dividends, and thus is indifferent as to whether surplus is paid out in the one form or the other.

To be sure, interest is an expense, reducing profits in standard accounting, whereas dividends are seen as a distribution of profits -- so if the company pays more interest, its accounting profits will be lower. But the sole investor should be able to see the reality behind this accounting convention: the important number is not "profits" but Earnings Before Interest and Taxes -- which tells us how much is available to pay interest, dividends or taxes.

And, indeed, investors seeking to buy companies (rather than individual shares of stock) generally are far more interested in EBIT than in profits. Profits are a function of whether the company is financed by debt or equity, and that is easily changed; EBIT is more dependent on whether the company is able to sell its product for more than it pays its employees and other suppliers.

This sole investor is a reasonable metaphor for the finance markets as a whole -- or any diversified portfolio investor in it. The stock and bond markets are not separate. Most large institutional investors

– that is, most investment capital – invest in both and move back and forth between them in response to relative small changes in the returns they expect to earn in one rather than the other.

From a passive investor's perspective, after all, the difference between stocks and bonds are differences of degree not kind: each offers basically the same deal. In each case, the investor will give up cash now (usually to another investor, but the first investor – to the company), in return for a promise of periodic payments from the company over time. In each case, should the individual investor wish to get its money back, it will ordinarily look to the secondary market. That is, it will sell the security to another investor. From the company's perspective the two types of security are similarly similar: in each case, the company receives cash (in an IPO) in return for issuing a transferable claim to future payments.

To be sure, stocks and bonds aren't identical. First, bonds have an expiration date on which the company promises to pay back the principal amount; shares last indefinitely. But this difference is less than it may seem. Successful companies never pay back bonds – they simply refinance them, that is, replace the old bonds with new ones. So, in substance, the loan remains outstanding indefinitely, just like stock, and investors expect to be repaid by other investors, not the company. Conversely, if the company is sold – usually because it has been highly successful, or less successful than expected – both shareholders and bondholders may find their "indefinite" claims on the company's future income stream abruptly ended, converted into a final payment.

Second, bonds have a contractual claim on future company income ("interest"), whereas shares have only an expectation that the company board will declare dividends when company income warrants it. If companies in fact were the profit-maximizers of finance theory, or product markets reflected the perfect competition of simple economic models, this distinction would be critical: no company would ever declare dividends. In a fully competitive consumer market, paying dividends would raise its costs above its competitors and lead to its collapse. Even if it were able to earn disequilibrium rents, profit-maximizing managers would never pay them to shares, which are, after all, a sunk cost, or give them to shareholders, which are purely fungible past providers of a fully fungible commodity (cash). The rents would surely go to some corporate participant able to claim some more unique contribution or with a tighter hand on the reins of internal power – executives or directors, perhaps.

However, in the world as we actually know it, companies treat dividends as almost as obligatory as interest. Contracts, of course, can be broken, renegotiated or, in bankruptcy court abrogated; when companies can't pay interest, they don't. More importantly, even when they can, they only do so if it is in their current interest: when market interest rates drop, companies usually find a way to eliminate old, higher interest, obligations. Conversely, companies tend to treat dividends – which, in the eyes of the law, are simply gifts – as sacred obligations. Even though dividends are, legally and formally, paid out of profits, like taxes, as if they were not costs of production, companies relentlessly lobby for lower taxes to improve "competitiveness." When times are bad, they cut employment and investment, even at the cost of the institution's future, rather than cut dividends. That is, they act as if dividends are less "what's left over" than the first obligation, just as they treat taxes as an unnecessary burden rather than either the "price of civilization" paid out of their surplus.

Moreover, from the issuer's perspective, the difference between stock and bonds can be quite important. Interest is a contractual obligation: if the company doesn't pay it, the creditors can seize its assets or force it into bankruptcy reorganization. Dividends, in contrast, are not: shareholders have no right of action if they do not receive the dividend they expect. Conversely, shares have political rights that bonds do not: shares, but not bonds, vote for the board of directors. So stock may be politically dangerous – if shareholders become unhappy with management's operation of the firm, they may vote out the board of directors. Moreover, directors owe a fiduciary duty to shares, but not to bonds.

But for a sole investor, these legal distinctions are largely irrelevant.

The sole shareholder can replace directors at will and therefore controls the board. There is no political danger. Moreover, it has no need to enforce fiduciary duties, since it can simply direct the directors to act according its will or replace them if they do not. And it need not worry about its director appointees violating their fiduciary duties to, for example, exercise independent judgment – only the sole shareholder has standing to enforce them. Fiduciary duties are irrelevant.

Additionally, the sole investor can decide, via its control of the board, when and whether to issue dividends according to its understanding of its best interest. Perhaps less obviously, the exact same thing is true of interest: the contractual obligation is irrelevant. If it decides that it would prefer to pay more or less interest, it can renegotiate the terms of the bonds or refinance them. The negotiation shouldn't be unduly difficult, given that the investor controls the board and is therefore negotiating (as bondholder) with itself (as shareholder/director).

Finally, dollars are dollars. From the perspective of this investor, it doesn't matter if the dollars that come out of the firm are labeled dividends or interest – they are just as spendable, and just as out of the firm (and out of reach of other firm creditors), in either event. In short, the investor has the complete ability to trade interest for dividends and vice versa and, at least in the first instance, should be largely indifferent between them.

So far, however, I've ignored taxes, as MM did in the first version of their theory. Taxes are a good reason not to be indifferent between interest and dividends. Corporations pay income tax on their income, which is defined as accounting profits: after interest but before dividends. In other words, interest reduces the firm's taxable income and therefore its taxes. Dividends do not. A tax-avoiding investor, then, should always prefer to be paid in interest rather than dividends: it means that the corporation is sharing less of its profits with the US. Less for the citizenry in general means more for corporate participants. Changing the label doesn't change much (as shown above). But it does reduce the US government's share of the company.

Indeed, in the old days, when closely-held corporations were subject to the corporate income tax, business owners often attempted to have their corporations earn no profits, even if they were earning large surpluses. The tax applies to profits, not surplus. Rather than sharing profits with the government, investors preferred to pay themselves surplus in forms that reduce profits, such as interest. Thus, recharacterizing surplus as (deductible) expenses rather than (taxable) profits was a core part of small business corporate practice. Similarly, small business owners often sought to recharacterize their

capital contributions to the firm as loans rather than equity in order to obtain the seniority advantages of debt in insolvency.

MM's innovation was to point out that this intuitive and well-understood scenario largely applies even when the company has many shareholders and many bondholders and they are not a single person. They make their point by modeling an unrealistically simple market.

If every investor had the same knowledge and expectations, and trading were simple and cost-free, and traders were seeking investments with the best available risk return ratios, then the prices of stocks and bonds at equilibrium would have to adjust to make investors indifferent between holding stocks and bonds. If one offered a better deal, all investors would instantly switch to it, driving the price up until it no longer offered a better deal. In the real world, of course, people will disagree and trading will never be this quick or easy, but we can still view the equilibrium that MM describe as a first approximation of the state towards which the market tends.

(We will need to consider later whether this description of an equilibrium point is a close enough approximation to be useful. In effect, equilibrium theories like MM are like describing a pendulum by considering its resting point, or the positions of the planets in the solar system as, on average, being in the sun. Describing the system by its stable point obscures something vital: pendulums are interesting and useful when they are not at equilibrium but swinging; the solar system will reach this equilibrium only at its death. Nonetheless, equilibrium theory does capture the important fact that pendulums don't swing in one direction forever and planets don't stray too far from the sun. Of course, we also have to justify using the metaphor of a pendulum or planetary system in the first place. Not everything has an equilibrium point around which it fluctuates.)

In a competitive finance market, the value of a security (stock or bond) is the present discounted value of its future income stream. The total value of a company's stocks and bonds, thus, should be the PDV of the company's future income stream dedicated to both stocks and bonds, i.e., EBIT. Changing that allocation between interest, dividends and retained earnings (i.e., future dividends) does not increase EBIT. It just changes which security gets it. This is just as true when the securities are in many hands as when they are in one.

In the real world, of course, investors will disagree (MM have simplified their model by assuming this away). It is possible that bondholders will be more pessimistic than shareholders. In that case, bondholders might charge the company more than shareholders (on a risk adjusted basis, of course). The company, then, could in fact increase its total market value by selling more securities to the optimists and fewer to the pessimists. But it is hard to see why this would happen on a systematic basis: nothing stops optimists from moving to the more pessimistic market and bidding up the prices. In other words, not only can companies exploit these kinds of price differences, but investors can too. But if investors and companies all want to enter the lower priced market, demand will increase and so will prices. The effect will be to drive prices back towards equilibrium, in which stocks and bonds sell for the risk-adjusted PDV of the future income streams, and MM are right.

Real world implication of MM, number one, then: if you can identify places where markets are not at equilibrium – that is, that bonds or stocks are not priced the same on a risk adjusted basis – you can profit, and your profits will also tend to drive the market back towards equilibrium. Paradoxically, MM explain that dividends and interest are the same – but also show why it might be quite profitable to hunt for instances when they are priced as if they were different. So companies and investors alike responded to MM by increasing their attempts to profit from mispricing, to sell high priced securities and buy low priced ones.

MM, thus, start by showing that companies should view stocks and bonds as largely interchangeable – the same at equilibrium and substitutes for each other if prices are wrong. They are just ways of acquiring money, and company treasurers should jump on any opportunity to buy or rent money at a discount price.

Second, they show that the historical concerns about reaching an ideal balance between debt and equity were misplaced. The only issue is whether stocks or bonds are mispriced; if they are priced correctly, it doesn't matter.

To show this, they again assume away mispricing or information asymmetries. Assuming that the market gets things right, they contend that companies cannot increase the total value of their securities by balancing stocks and bonds. The intuition here follows directly from the story of the single investor: Changing the ratio of stocks and bonds changes the allocation of risk between the two classes of securities. But it is a zero sum game. Whatever risk the stock sheds, the bonds absorb, and vice versa. So leveraging or deleveraging doesn't change the total value of the company. The company's underlying business doesn't change. EBIT is the same; the corporation's value as a whole is the same.

One way to see that this must be correct is to view it from the perspective of the investor. The profits of a highly leveraged company will be far more volatile: if the company has to pay high interest costs, profits will drop more in bad times and rise more in good times than if it has no interest. Risk is bad, so you might think that this would make the stock price drop.

But this is exactly the type of volatility that is easy to eliminate in a diversified portfolio. Most simply, an investor could buy the company's stock and bonds in exact proportion. Now, it has an investment that acts just like the company, unlevered: the investor's return will be based on EBIT not profits. That means that a fully rational investor will be willing to pay full price for the stock – there is no reason to charge for risk that it can eliminate at no cost. At equilibrium, prices will not include a risk premium for the stock. Now, in the real world, we are never at equilibrium, and investors are likely to be confused or misinformed. So there will be profit to be made by hunting for the disequilibria and trading against them. If the market mistakenly believes that leverage increases the value of the stock, companies should seize the chance – it's a \$100 bill in Times Square – and give the market what it wants. MM don't disagree. They simply point out that this process drives the market back towards the equilibrium they described.

Conversely, if the company delevers, this will make its profit quite stable. But this should not increase the value of the stock to those who want stable stock – they could, instead, buy highly levered stock plus

bonds. Nor does it decrease the value of the stock to those who want leverage: they can borrow money to buy the stock, and recreate something quite similar to the stock of a leveraged company.

Once again, the real world is more complicated. In particular, we can see that there seems to be excess demand for company level leverage. MM makes it easier to understand this. Apparently, there are investors that cannot borrow to buy stock (some are legally banned from doing so, like mutual funds; some are barred by their bosses; some want more leverage than is permitted in a margin account and do not have access to other credit). These investors will be willing to pay extra for company-level leverage precisely because they cannot lever up “at home.” Ordinarily, MM assume that if some particular investor cares, they will not affect the price: other investors who are indifferent will sell to them. After all, those who want less leverage can get it from highly levered stock (plus bonds) or less levered stock, and so will be happy to sell the highly levered stock the moment its price rises above comparable less-levered securities. But if the demand from investors seeking more leverage than they can make is large relative to the dollar-size of investors who are indifferent, we could end up with only risk seeking investors buying highly levered stock – and overpaying for it. This would, in turn, encourage companies to lever up: they can sell bonds for more than stock. This increases supply, decreasing price, and tending to return the market to MM’s equilibrium.

## II. No dividends.

If you are convinced that the debt equity ratio doesn’t matter at equilibrium (modeled by MM’s simplified assumptions of free information and no transaction costs), it follows almost automatically that dividend policy is irrelevant.

First, MM point out that any new investment can be financed by new debt, new equity or retained earnings. The choice among them should be based on which is cheapest. And, of course, at equilibrium the prices must be the same or investors and issuers will jump to the cheaper.

So, at equilibrium, the company should be indifferent between having retained earnings or paying them out. This, of course, gives us one key reason why companies might NOT be indifferent: they might expect that markets will not be at equilibrium, so that they’ll find new issuance far more expensive than using retained earnings. This might happen, for example, if the finance markets are irrational or cyclical. For example, the best time to invest is often when everyone else is scared to – but if everyone is scared, the markets are likely to refuse to provide new investment funds except at a high price. Or it might happen due to information problems. For example, the company might be certain that it has a good investment opportunity, but unable to explain it to the markets because it needs to preserve trade secrets or unable to convince outsiders because they are more pessimistic than the insiders. Of course, if finance markets and companies disagree, one of them is wrong; we need to think about whether one is more likely to err than the other.

Second, investors should be indifferent between dividends and not. If the company pays a dividend, the investor must either spend it or reinvest it. If it reinvests, it should reinvest in the company that offers the best expected return. But if the company does not offer a dividend, the investor confronts

exactly the same choice: it must either hold or sell the stock. If it sells, it must either spend or reinvest the proceeds. If it reinvests, it should reinvest in the company that offers the best expected returns.

We express this point by saying that an investor can create “homemade dividends” by selling stock – and thus has no reason to pay extra for stock of a company that does this for it. Conversely, if a stock pays a dividend, an investor always has the option of using the dividend to buy more stock – so it has no reason to pay extra for a company that does this for it. In short, investors can, virtually cost free, create whatever dividend policy they want. It would be irrational to pay extra to have managers do this for them.

Once again, there may be some investors who cannot do this. Small investors may have trouble selling small amounts of stock on a regular basis to create a homemade dividend. But it is hard to see how such investors could affect the market price. Most stock is held by institutions that are quite large enough to make the transaction costs of selling stock to create income vanishingly small and most small investors hold mutual funds that are happy to accept standing orders to sell small quantities of the fund every month at essentially no cost. If the investors who need an official dividend drove the price of a given stock up, these investors who are indifferent should happily sell it to them until the price drops back down. MM’s equilibrium seems to describe the real world reasonably closely.

However, taxes matter. A company that chooses to pay its investors by dividends will owe corporate income taxes. One that chooses to leverage up and pay interest instead will owe less. So self-interested, profit-maximizing investors should prefer levered companies and to receive their return as interest rather than dividends.

Next, MM point out that stock buybacks are basically the same thing as dividends. In both cases, money leaves the firm and goes to the shareholders. For a single shareholder, they are obviously functionally identical. But even when the company has many shareholders, MM show that at equilibrium the two are equivalent.

Imagine a firm worth \$100 with 100 shares, each selling for \$1. It decides to pay a 10 cent per share dividend. After the dividend, the firm will be worth \$90 with 100 shares each selling for \$.90, and each shareholder will have 10 cents in cash. (Of course, in the real world, markets move up and down for other reasons, so the price movement won’t be this neat, but on average this has to be right -- any other result would be a perpetual motion machine and impossible.)

Now imagine that, instead, it decides to buy back 10 shares at \$1. After this, it will have 90 shares worth \$90, and some former shareholders will have \$10 in cash. Now, if it wishes, it can declare a stock dividend or split: that is, that every 9 old shares will be converted into 10 new shares. This is a completely meaningless transaction; every shareholder will have exactly the same entitlement to vote and dividend as before. However, after the split, the firm will have 100 shares and, since it is still worth \$90, each one should drop in price to 90 cents. In the aggregate this is identical to the dividend. The firm has passed \$10 out to its shareholders.

But, you say, the shareholders have been treated differently: in the dividend everyone got 10 cents per share, whereas here only some shareholders were bought out. MM point out that at equilibrium, the two are the same. Start with the dividend. Investors who received the dividend have 1 share worth \$.90 and 10 cents. Some investors reinvested, so they used it to buy additional shares. A ten cent dividend buys  $1/9^{\text{th}}$  of a share for every share they received. So they end up with 1 and  $1/9$  shares at \$.90 per share, for a total of \$1 worth of shares. Now look at the buyback. If you didn't sell, you end up with  $1 \frac{1}{9}$  shares for every share you originally had – at \$.90 per share for a total of \$1 per share. Exactly the same. If you did sell, you receive \$1 for each share you had. But you can buy a new share for \$.90 – leaving you with one share and ten cents. Exactly the same.

Now, in the real world, this is too simple. But not by much. Institutional investors – which hold most shares – make these kinds of readjustments all the time, so the transaction costs are minimal. Prices will bounce around a bit, so some shareholders will pay more or less than the equilibrium price, but those should balance out.

Note, however, that if the buyback price is too high, the effect is to take from the continuing shareholders and give to the selling ones, and vice versa if the buyback price is too low. If the buyback is in the open market (as is customary), these errors should be small and random, unless the market is irrational or wrong for some reason. Still, buybacks are not as obviously pro rata as dividends; shareholders that believe strongly in equality and mistrust market prices (and do not believe in their own ability to profit from wrong prices) may prefer dividends.

MM, thus, have established that dividends and buybacks are quite similar. Once again, however, taxes matter. When a company pays dividends, the shareholders (if they are taxpayers), owe income taxes on dividends received, even if they immediately reinvest in the company. If it does a stock buyback, in contrast, shareholders who do not sell owe no taxes. Even those who do sell owe only capital gains taxes, on the part of their sale price that is a gain, rather than taxes on the entire amount of the dividend. So tax-avoiding investors should always prefer a buyback to a dividend.

One last point. At equilibrium, investors should be indifferent between a dividend and the company reinvesting its earnings.

First, they can always sell stock if they need cash now, or reinvest a dividend if they don't. So the dividend does not change the shareholder's liquidity or short term returns. This assumes a public market and does not apply to closely held firms where it may be hard or impossible to sell stock routinely.

Second, if the company does not pay a dividend, the money doesn't go away: it stays in the company for reinvestment or a future dividend or to pay down debt. As we have seen above, whether the company pays a dividend or not, it needs to make decisions about future investments and how to finance them. And we've already established that at equilibrium, equity, debt and retained earnings are priced the same, so this decision doesn't matter for the company; in the real world, the company will do best by pursuing whichever of these interchangeable routes is cheapest.

At equilibrium or in MM's simple model, this means that if the dividend isn't paid now, it will be larger later: the company will reinvest the money and produce more. Stock market investors, as we've seen, should be indifferent between profits now and profits later; those who want profits now can always sell their stock to those who prefer profits later. In the real world, people will disagree about the future and prices may reflect this disagreement, so some shareholders will win more or lose more than expected. But this is a zero sum game: those who win more than expected are exactly balanced by those who lose. On balance, MM's equilibrium should be right. Investors as a group should be indifferent between dividends now and dividends later.

Taxes, again, matter. Dividend now means taxes for all taxpaying recipients. Dividends later means no taxes now for those who want to continue their investment in the company, and probably fewer taxes for those who wish to exit. Those who like to get something for nothing will prefer dividends later.

So we come to this conclusion: The theory suggests that companies should leverage up as much as possible so that they avoid taxes by paying pay interest rather than dividends. And to save their investors some taxes, they should distribute surplus to shareholders by stock buybacks rather than dividends, and they should always reinvest rather than distribute surplus at all. Why then do we see dividends at all?

### III. Possible explanations for the divergence between the world and MM

One point to notice is that we have fewer dividends than when MM was published. Companies are more leveraged, pay less income tax, retain more of their accounting profits, have lower dividends and are more likely to do stock buybacks. So one answer might be – businesses and markets are simply very slow and inefficient at assimilating this information. Sixty years hasn't been enough, but any day now. Still, this explanation isn't terribly satisfying: why are they so slow? If they can't figure out this well-established point, why do we imagine that they can figure out tough stuff, like how to convince people to come to work in the morning or how to allocate capital effectively?

Others have sought to emphasize information asymmetries. A dividend, it is said, shows something about the company. It is proof that the company isn't a complete fraud, that it is actually making some profits, or at least has enough cash on hand to make the dividend. This argument is strikingly weak. Ponzi schemes always pay dividends – that's how they convince the mark that they are real. Why do we imagine that investors are so dumb that they can't see that companies can play that game as well? A company that is prepared to release fraudulent financials is probably also prepared to borrow or sell equity to pay dividends.

Or, perhaps a dividend, like a peacock's feathers, is simply a form of conspicuous consumption, showing that the company is doing well. In particular, a dividend seems to be a clear indication that the company has monopoly power or otherwise is not in a competitive, efficient CONSUMER market. In competitive consumer markets, prices drop to marginal cost, and the firm earns no surplus (more correctly, the entire surplus it produces goes to consumers in the form of lower prices). If it issues a dividend, either it will be forced to raise prices above its competitors, or it will be forced to cut some essential cost, such as advertising or R&D or quality. In either case, it will be forced out of business. So a dividend is a clear

indication of market failure on the consumer side, which is good news for investors. As Warren Buffett says, investors should stick to companies with a “franchise” – pricing power. But once again, the story doesn’t quite work. Why can’t investors see the franchise? Didn’t investors know that Apple had pricing power before it issued a dividend?

Or perhaps a dividend is a sign that the company has nothing to do with its retained earnings. This is known as the life-cycle theory of dividends. It presumes that there is some reason why the company does not simply invest its retained earnings in the market (perhaps for fear of being regulated as an investment company). I find this more persuasive. But note that this theory means that a dividend is BAD news – a sign that the company no longer expects to grow. And it doesn’t explain why self-interested managers wouldn’t simply hold onto the cash inside the company and look for more opportunities to invest, or waste it.

Power based explanations are better. Shareholders have relatively little power in the firm. But if investors in the aggregate decide that the firm is not being operated in their interest, presumably they will drive its stock price down. This has no direct effect on the company. But it does have indirect ones. First, the shares will be less available as currency to buy other companies or give out to executives as a replacement for cash salaries. I’m not sure how important this is, since the company largely can compensate by giving out more shares.

Second, if the price gets low enough, a Wall Street financial entrepreneur (private equity firm or hedge fund) may decide to try to buy enough of them to control the board of directors. Using that control, it could force managers to reverse course and operate the company in Wall Street’s image. Managers may prefer to avoid this problem by doing what Wall Street wants before being forced to do so. At one time, this explanation seemed central to me. Today I’m less sure. First, this is basically a story about hostile takeovers, and the poison pill and related developments have made hostile takeover extremely difficult. Buying a control block of shares is quite risky if you can’t be sure to get control. So I suspect that managers have quite a bit of autonomy before they are forced to follow the market player’s bidding. Second, the claim that managers will do what the market wants before they are forced to is strange. Why? Why not hold out as long as possible, instead of preemptively caving?

Relatedly, perhaps dividends are a public loyalty ritual, meant to assure shareholders that managers and directors love and obey them. It is hard to see how this could work, however, unless MM are wrong and dividends actually are in shareholder interests. Why would shareholders feel better seeing manager act out a ritual that hurts them?

Another set of explanations focuses on a key weakness in MM’s model. MM assume that risk is basically volatility and that equilibrium models capture a meaningful average, describing what investors can expect if they are diversified enough. But much risk doesn’t seem to work this way. Even leaving aside large unquantifiable risks, often the market seems to act more like a herd than a pendulum or roulette wheel: there is no meaningful average around which it reverberates, and small causes can have large effects that permanently change the future course. If investors perceive this type of risk, they may be far less self-confident than MM’s model presumes. In particular, MM treat future profits as knowable

and (therefore) saleable right now to more patient investors. If, instead, investors consider future profits to be unquantifiable, they may have a strong preference for current dividends over future ones, much as nineteenth century bondholders wanted to see sinking funds. This story seems to be wrong. It requires that investors be consistently irrational, not just fearful: dividends, as MM explain, don't actually reduce their risk (just as sinking funds, which have been long since abandoned, didn't either). Modern corporations and investment portfolios both have indefinite lifespans; they will always be investing and divesting. So there is no special meaning to a particular dividend payment – a pension fund simply has to reinvest it, which it would have to do anyway.

So perhaps MM are wrong at a deeper level. Perhaps the answer is in anthropology rather than politics or economics. Companies issue dividends because managers and directors think they ought to – not because they must or because it is in their interest. Dividends are part of the ritual that maintains the corporate world, another way to convince employees that investors – not the people actually doing the work – are the job creators, the rightful owners, the appropriate beneficiaries of the corporate surplus. Or perhaps they issue dividends because managers and directors reject the self-interested profit maximizing model of the economists and, instead, see themselves as loyal retainers to the invisible stock market King.

If these stories are right, shareholders may – as a group – be setting aside their own individual interests in favor of class solidarity. It is never in the interests of an individual profit-maximizer to pay taxes just because collective survival depends on it, just as it is never in the interest of a particular company to pay dividends just because the stock market would collapse if no one did. Maximizing, economic, stories cannot explain these kinds of other-directed behavior; they should, instead, predict collapse. But people manage to overcome prisoner's dilemma situations all the time; corporations themselves are best understood as one way to do that. The stock market is not "people"; anonymous markets should have the hardest time of all overcoming the prisoner's dilemma. But corporate managers and directors are a small and tightly connected group: perhaps they have developed the social structures to commit each other to dividends that are essential for the continued existence of their collective ability to profit from the work of others.

For many years, employees accepted jobs on the understanding that the commitment was mutual and they would be employed for as long as they wished, barring crisis on the company's side or misbehavior on their own. Similarly, they accepted lower pay now in return for pension promises later. These agreements were not legally enforceable, but people acted as if they were: consciously or not, they were doing business on a handshake and it worked pretty well. Handshakes have the advantage, after all, of being cheap and easy to create and enforce – no complicated lawsuits are necessary between men of honor.

But at some point, managers realized that handshake deals are easy to exploit. The dishonorable can simply refuse to honor the deal (and because of their willingness to renege, they can pay extra for the right to do so: a company is worth more to a person who doesn't feel bound by implicit contracts than to one who does). Employees who've locked themselves in to a specific job will have no choice if the company reneges on its side of the deal. If it threatens to fire them, or manufactures a crisis, or violates

its pension promises – they have little alternative but to accept whatever the company offers them. A generation of managers was able to exploit a generation of employees by backing out of unenforceable promises.

But younger people, unlike Charlie Brown, do eventually learn to be suspicious of Lucy's promises. After seeing enough older people lose their jobs and pensions, most younger people figured out that they shouldn't rely on that type of corporate promise. Not everyone can, but those who could began to think about future employability rather than committing to a particular company, refused to bargain current income for future benefits, and the like. This makes the world a poorer place: like any market for lemons, trades that would make both parties better off are impossible. Some people and some companies would prefer the old deal; they are out of luck. (People who preferred flexibility, of course, could find that in the old world as easily as the new one, so it is no answer to say that flexibility and self-reliance are better than stodgy bureaucracy, careerism and mutual commitment.)

The question is why dividends haven't followed the same path. Shareholders can be exploited just as easily as middle-aged employees. They too invested with an expectation – in the shareholder case, of dividends – that is not legally enforceable. They too have essentially no remedy if managers decide to renege, to simply decide not to pay the dividends but instead to, for example, pay themselves higher bonuses or spend it elsewhere in the corporation. Going forward, shareholders can protect themselves just like employees, by refusing to rely on promises. Employees can demand pay up front; shareholders can decide to become bondholders instead. The net result will be a social loss – once trust is lost, investors and companies that would prefer the handshake deal of dividends will find it hard to make a deal. But that social loss is irrelevant to the predators, who have in front of them a defenseless herd of public shareholders ripe for picking.

The individualist models of corporate finance give a clear answer: prisoners who count on the solidarity of others lose. Even a few predators in the game should lead, ineluctably, to the end of dividends and the collapse of the stock market, just as it has destroyed life-time employment and the company-based unfunded pension. We can see the tendencies in this direction. But something, not picked up by the economic models, is acting as a countervailing force. Surely it is not altruistic, other-regarding, directors and managers, who mercilessly exploit those they actually work with in order to freely give their ill-gotten gains to an anonymous stock market. It must, instead, be something more powerful. A religion of mammon, not greed? The ties of a common education? The power of ideology? Do dividends work only because it doesn't occur even to the most self-interested to question their righteousness? Was Marx completely wrong – is it the superstructure that maintains the economy and not the other way around?