Dividend Pay-Out Policy and Functioning of the Stock Market

ARUN KUMAR*

Various financial institutions like commercial banks and insurance companies have been nationalized for meeting the needs of our developing economy. Scant attention however, has been paid to the stock market which is still a major source of financial resources.

The investors in the stock market pay high premium for those firms who have a higher dividend payout in general. Otherwise, for a given risk class, any reduction in the dividend payout should be balanced by equivalent price appreciation in the stock market. The reduction in return due to decrease in dividend payout should have been counter-balanced by the increase in capital gains.

In a typically capitalistic economy, the role of financial institutions can be described as that of intermediaries. They generate their funds from diverse sources and direct these funds to those users who need them most. The financial institutions differ from each other in their clientele for generation of funds. These institutions also have broad guidelines for investing the funds. Examples include commercial banks, insurance corporations etc. With nationalisation, these institutions can invest their funds only in those sectors as are prescribed by the Government. These institutions however, have retained their original clientele profile for generating their funds.

The government agencies, by directing the flow of funds to only some sectors as opposed to others, encourage growth and development of those select sectors. At times, this is done even at the expense of other sectors. This is rational as the favoured sectors rank high in priorities as compared to other sectors in our developing economy.

The stock markets, behave in a slightly different manner. The investors themselves invest in different enterprises by buying their stocks. For a given risk class, the investors prefer more profitable and efficient organisations to others with a low profit record. Various business enterprises compete for the funds of investors and this competition encourages operational efficiency. These firms, thus grow, and develop due to the increased patronage of the stock holders.

Our developing economy needs selective growth and development in certain sectors. These sectors are not identical to those sectors that would grow and develop if market forces are left free. (Otherwise, the financial institutions would not have been nationalised. Banks and the like would have invested in those sectors only in which they are investing now thus rendering nationalisation redundant).

The important question that needs to be answered now is that, do we need the resources generated by the stock market to augment the resources generated by nationalised financial institutions for development of the priority sectors of our developing economy ? Our economy needs more production (in all the industries) and, therefore, the dividend policy should be liked with the units of production. We also strongly believe that stock markets should actively participate in the developmental process of our economy.

Let us assume that there are some performance indices, which are desirable for our developing economy. Units of production will then be one such index. Figure 1 depicts the relationship between production and earnings for three hypothetical cases.

FIG-1
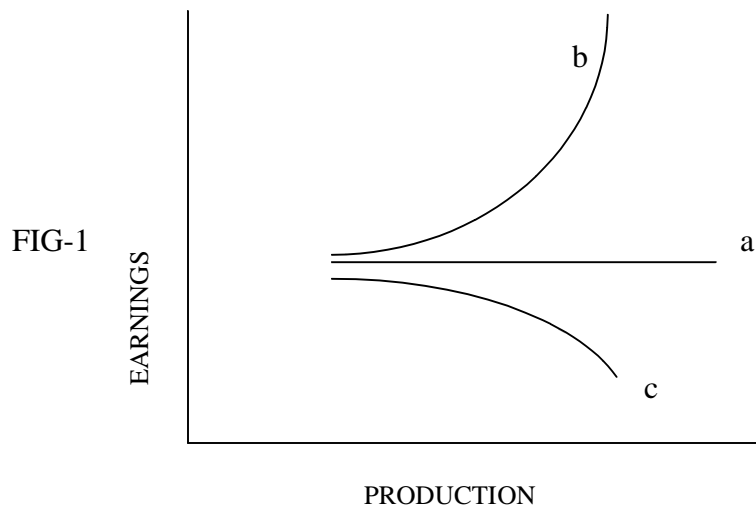
RELATIONSHIP BETWEEN EARNINGS AND PRODUCTION

The firms belonging to curve 'b' show increase in earnings with the increase in production. These firms are operating on the downward sloping part of their average cost curve and not operating at an optimal point due to inertia and other factors. By linking dividend payout ratio with units of production, these firms will get an incentive to raise their production because then they will be able to payout higher dividends and thus attract more investors.

This argument comes in sharp focus in the limited case where the firm is operating on the horizontal part of their average cost curve. This is shown by curve 'a'. Without linking dividend payments with production, the firms will have no incentive to raise their production.

However for the case 'c' where the firms are operating on the increasing average cost curve position, the linking of dividends with production may not be a prudent policy. (These are some industries where maximum production is governed by technical constraints. For these industries, there cannot be over-utilisation of capacity and production, and therefore cannot exceed beyond the minimum average cost point. Our subsequent discussion excludes these industries). To explain this, let us assume that a firm has raised its production (even at the expense of earnings) to be able to give increased dividend payments. This will, however, reduce its proportion of retained earnings normally required for continual operations and development. Therefore, it will have to go to capital markets for attracting fresh capital.

The price of the stock of this hypothetical firm would be under two conflicting pressures.

(i)   Reduction in earnings due to increased production.
(ii) Increased patronage by the investors due to higher dividend payments.

If the market preference over current dividends more than compensates the impact of reduction in earnings, then the firm can raise additional capital for its continual operations and growth without diluting the worth of its existing stockholders. This will amount to transfer of part of the worth of existing stockholders to new stockholders. The firm distributes the earnings as dividends to stockholders and raise this amount from other (or at best, the same) shareholders at no additional cost.

Market imperfections may allow this in the short run. However, in the long run, this process will cost money to the firm and would therefore result in dilution of the worth of the existing owners.

We recommend that for the firms belonging to category 'c', the government should provide incentives, credits and other concessional measures totalling to such an amount that it will twist the curve 'c' to coincide with 'a'. Thus the firms would be motivated to increase production for availing themselves of the incentives provided by the government.

The controls can be exercised at two levels.

1.   At the level of industries by segregating the priority industries.
2.   At the level of firms within an industry by prescribing desirable indices and linking them with dividend payments.

At the level of industries, these controls will help direct the flow of funds of priority industries. Thus the resources of stock market will augment the resources of nationalised financial institutions to meet the needs of our developing economy. By prescribing desirable indices within an industry, the stock market will still retain the desirable features of competitive market forces.

Performance Indices: Production per unit of capital employed and production per unit of labour employed can be used as measures for determining the maximum allowable dividend payment. Thus, a company operating at low capacity will have lesser production per unit of capital employed. Only when it can increase its capacity utilisation and thereby production per unit of capital utilisation and thereby production per unit of capital employed, can it raise its dividend payment.

By linking the allowable dividend ratio to production per unit of labour employed, this scheme will help resolve the employment problem also to a certain extent.

It may be possible to evolve optimal capital-labour ratios for some key industries and dividends policies may include this factor. We have implicity assumed in our analysis that it is expedient for firms in our economy to operate on the rising portion of their average cost curve beyond the optimal point. The slope of average cost curve beyond the minimum point will vary from industry to industry. By linking the capital-labour ratio with the dividends, we can ensure that the firms do not operate beyond a certain point on the rising average cost curve.