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Dividends and taxes: The moderating role of agency conflicts

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ABSTRACT

We find that potential conflicts between majority and minority shareholders strongly influence how dividends respond to taxes. When the controlling shareholder has a smaller stake, the incentives to extract private benefits are stronger – a shareholder conflict that can be mitigated by dividend payout. We study a large and clean regulatory shock in Norway that increases the dividend tax rate for all individuals from 0% to 28%. We find that dividends drop less the higher the potential shareholder conflict, suggesting that dividend policy trades off tax and agency considerations. The average payout ratio falls by 30 percentage points when the conflict potential is low, but by only 18 points when it is high. These lower dividends cannot be explained by higher salaries to shareholders or diverse liquidity needs. We also observe a strong increase in indirect ownership of high-conflict firms through tax-exempt holding companies and suggest policy implications for intercorporate dividend taxation.

1. Introduction

The effect of taxes on dividends continues to be an open question. While some claim that taxes have a first-order negative effect on dividends (Poterba, 2004; Chetty and Saez, 2005, 2006, 2010), others argue the effect is only minor (Hubbard and Michaely, 1997; Brav et al., 2008; Yagan, 2015). We hypothesize that these conflicting results arise because dividends are also determined by corporate governance, which moderates the effect of taxes. Specifically, lower dividends do not just reduce taxes, but might also increase agency costs by making the free cash flow problem more acute (Rozeff, 1982; Jensen, 1986). Therefore, when dividend taxes are increased, firms with serious agency problems might be reluctant to cut dividends despite the potential tax savings.

We study the causal effect of taxes on dividends by exploiting a regulatory shock in Norway in 2006 that increased the dividend tax rate for individuals from 0% to 28%. Because the tax shock is large, any change in dividend policy around the time of the shock is likely to be driven by taxes. Because the shock is unusually clean, with a flat tax rate both before and after, we avoid complications due to multiple tax brackets. Because dividends and capital gains are taxed identically and share repurchases are negligible, we can limit ourselves to just cash dividends.

Our main contribution is to show that the impact of taxes on dividends depends strongly on the severity of agency costs. One common source of agency costs is the conflict of interest between managers and shareholders (e.g., Jensen and Meckling, 1976; Jensen and Murphy, 1990). We consider instead the less analyzed conflict between majority and minority shareholders in firms where a controlling shareholder owns more than half the equity. The two conflicts have been called the vertical and the horizontal agency problem, respectively (Roe, 1994). This horizontal agency problem is particularly important for dividend policy because the

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controlling stake gives majority shareholders sufficient power both to single-handedly make the dividend decision and to extract private benefits at the expense of minority shareholders.¹ The controlling stake also gives the owner strong incentives to monitor management and mitigate the vertical agency conflict.

The controlling shareholder captures the entirety of any private benefits, but suffers the cost only in proportion to her stake. Hence, the smaller her stake (i.e., the closer to 50% rather than 100%), the greater her incentives to extract private benefits – and thus the greater the importance of using dividends to mitigate the agency conflict (Gomes, 2000). We therefore use the size of the controlling stake as an inverse measure of the potential shareholder conflict.²

The tax shock we observe increases the cost of paying dividends and should therefore cause all firms to pay less. However, the controlling shareholder must trade off the positive effect of reduced taxes against the negative effect of higher shareholder conflicts, which is larger the smaller the controlling stake. Thus, because dividends are used to address agency costs, we hypothesize that firms reduce dividends less after the tax shock the smaller the controlling shareholder's stake.

We find that the tax shock has a large effect on dividends, reducing the average payout ratio (dividends to earnings) from 43% to 18%. Consistent with our hypothesis, the drop is smaller the higher the potential shareholder conflict. For instance, the average payout ratio falls by 30 percentage points when the majority stake is high (90–99%, low conflict), but falls by only 18 percentage points when the stake is low (50–60%, high conflict). Similarly, multiple-owner firms, which trade off both tax and agency effects, cut dividends less than do single-owner firms, which have no shareholder conflicts and therefore face only tax effects. Moreover, dividends and the largest equity stake are unrelated in firms without a controlling shareholder, where nobody can single-handedly set the dividends. Taken together, these results suggest that, because controlling shareholders trade off the effect of dividends on taxes against the effect of dividends on shareholder conflicts, the relationship between dividends and taxes depends on the severity of agency costs.

We consider and reject four alternative explanations. First, we avoid several tax-related complications because, unusually, the tax rate is flat and identical for dividends and capital gains. This fact rules out problems that often plague dividend studies – tax-based dividend clienteles (Elton and Gruber, 1970; Desai and Jin, 2011), tax arbitrage between dividends and capital gains around tax shocks (Sørensen, 2005), and firms' using tax-disadvantaged dividends to signal intrinsic value (Bernheim, 1991; Bernheim and Wantz, 1995). Most tax reforms examined in the literature change the relative taxation of dividends and capital gains, such as the 1986 and 2003 reforms in the United States (Hubbard and Michaely, 1997; Chetty and Saez, 2005). We study a tax reform designed to affect dividends and capital gains equally regardless of payout type. Thus, the dividend response cannot be due to tax-induced shifts between dividends and repurchases.³

Second, controlling shareholders might pay themselves larger salaries to offset the lower dividends after the tax decrease. If this were the case, what looks like a tradeoff between tax effects and agency effects of dividends is just a tax-driven switch between two payout forms (Jacob and Michaely, 2017). We find no such evidence. Third, although unequal liquidity preferences among shareholders seem to matter for the tax sensitivity of dividends as in Jacob and Michaely (2017), we find that such coordination concerns do not replace agency concerns. Finally, we find that neither conflicts between shareholders and managers nor shareholder wealth influences the observed relationship between dividends, taxes, and agency costs.

Our hypothesis implies that firms with severe shareholder conflicts, which are reluctant to reduce dividends despite the tax shock, will look for ways to mitigate the increased tax burden. While the tax reform raised the tax on dividends paid to individuals from 0% to 28%, dividends paid to firms remained tax-free. This difference creates incentives to own shares indirectly through holding companies rather than directly. Indirect ownership ensures that free cash flow can be taken away from the majority shareholder's control without triggering immediate tax payments.⁴ We hypothesize that higher dividend taxation for individuals increases the use of indirect ownership, particularly in firms where potential shareholder conflicts are high.

¹ Johnson et al. (2000) and Bertrand et al. (2002) provide evidence that controlling shareholders extract private benefits. Common mechanisms are tunneling, nepotism, and social visibility.

² This measure also reflects a common agency measure used in the literature, which is the wedge between voting rights and cash flow rights (Faccio et al., 2001). In particular, our measure reflects the ratio between control rights, which are constant across the sample, and cash flow rights, which vary. However, our measure is not driven by dual-class shares, which are rare in Norway. For instance, Che and Langli (2015) find that only 3.8% of the firm-year observations involve firms with dual-class shares in Norwegian private firms from 2001 to 2011. Up until 1994, foreigners as a group could not own more than one third of a firm's voting shares. The firms adapted to this regime by widespread use of non-voting shares targeted to foreigners. When EU regulation outlawed the discrimination of foreign investors in 1995, however, the use of dual-class shares dropped very strongly and remained low. There are no legal restrictions or corporate governance codes on the use of dual-class shares in private firms in our sample period.

³ We find repurchase activity in only 1.4% of the firm years, varying between 0.9% and 2.0% over the years. Excluding these cases has no effect on any result. Repurchases might be unusually low not just because of tax neutrality, but also because shareholders who sell might lose control. Moreover, sellers must negotiate with the firm at every repurchase because there is no liquid market and no obvious market price for the private firm's shares.

⁴ Norwegian holding companies have no special tax status. Just as for any corporate owner, dividend income is tax-free. However, a holding company cannot permanently shield its personal owners from taxes on cash needed for consumption, because the holding company must pay this cash to the person as taxable dividends. Nevertheless, the holding company can be used to temporarily store the cash paid from the operating company at zero tax costs. Because the average holding company has only 1.2 operating companies (see Table 3), most holding companies cannot be used to reallocate capital across operating companies. Moreover, because holding companies have no operating activity and very few owners (2.5 on average after the tax reform), agency problems in the holding company are negligible. Finally, establishing a holding company is not costless. There are registration costs, reporting costs, and equity requirements.

We find strong support for this prediction. The number of holding companies quadruples after the tax shock, and the ratio of holding companies to all companies grows from 2% to 12%. Difference-in-difference tests across four Nordic countries confirm that this growth in indirect ownership is unique to Norway. We also find that firms with higher conflict potential are more likely to be indirectly owned, and that controlling for self-selection does not alter our main result: Firms with higher conflict potential cut dividends less when the tax cost of dividends increases.

The properties of our data set increase the ability to identify the relationship between dividends, taxes, and agency costs. The data cover the population of active firms over 13 years. We use proprietary microdata from publicly audited accounting statements, personal tax returns and salary receipts data of more than one million individuals, the ownership and leadership structure of every firm in the economy, and data on all family relationships between owners, directors, and CEOs. The detailed ownership and family data allow us to identify majority shareholders by ultimate ownership and to analyze a clearly identified agency conflict.⁵

Our evidence extends the dividend literature in four ways. First, we find that although taxes have a first-order effect on dividends, the effect varies strongly with potential agency conflicts. This result implies that considering the role of agency costs, which most of the literature on dividends and taxes does not do, is critical to understanding how taxes affect dividend policy.

Second, we show how dividends are used to decrease agency costs. We use the tax shock and the extremely stable ownership structure as our identification strategy. Because the firm's largest equity stake is identical from 1 year to the next in 93% of the firm years, we consider ownership concentration exogenous to the tax shock. Unlike Chetty and Saez (2005) and Hanlon and Hoopes (2014), we choose an empirical setting where the important conflict is between majority and minority shareholders rather than between shareholders and managers. Unlike Jacob and Michaely (2017), who study dividends as a tax-based tool for splitting a given payout into dividend income and labor income, we study dividends as a tool for reducing the free cash flow problem. While Jacob and Michaely study small, entrepreneurial firms that might or might not be majority-controlled, we study the population of majority-controlled firms. We account for the number of owners, which is the coordination measure used by Jacob and Michaely, showing that our results are influenced neither by switching between labor income and dividends nor by agency conflicts between managers and controlling shareholders.

Our findings are consistent with, but distinct from, those of Berzins et al. (2018), who study the effect of agency conflicts on dividend policy. They find that controlling shareholders mitigate agency conflicts by choosing a more minority-friendly dividend policy the more serious the agency conflict. Such firms also receive higher investment from minority shareholders in the future, suggesting that majority shareholders benefit from building trust by signaling a commitment to not exploit minority shareholders (Leland and Pyle, 1977; Gomes, 2000). In contrast, we study the causal effect of taxes on dividend policy. We exploit a large shift between two tax regimes to identify the tax effect, showing that it depends critically on the severity of the agency conflict. We also document that controlling shareholders of firms with high conflict potential more often choose indirect ownership after the tax shock. Thus, we analyze two main determinants of payout policy – tax costs and agency costs – and show how shareholders approach the tradeoff between the two.

La Porta et al. (2000) also study how dividends relate to agency costs and find that firms pay higher dividends in countries with stronger shareholder protection. They interpret their results as supporting the “outcome” theory that strong legal regimes force firms to pay dividends. Our results instead support the “substitute” theory that majority shareholders voluntarily choose high dividends to mitigate conflicts with minority shareholders. One possible reason for this difference is that while La Porta et al. study the relationship between dividends and agency conflicts across different countries, we study different firms within one country, where it might be easier for investors to spot firms with minority-friendly payout policy. Moreover, the role of dividends as a mitigator of agency conflicts might be more important in our sample of predominantly private firms, which are less transparent than public firms are. Also, the illiquidity of private firms' shares increases the importance of dividends rather than capital gains as a source of cash. Finally, the higher cost of trading the private firm's shares increases the importance of carefully considering potential shareholder conflicts before an investment is made. Regardless, our results suggest that the potential for agency conflicts has important effects on dividends even when minority investors are well protected by the law. While legal protection may be sufficient, it may not be necessary, as dividend policy can reduce agency conflicts by building trust. Thus, reducing agency costs by market mechanisms and voluntary action rather than by institutions and mandatory law is an important perspective on how dividend decisions are made. This perspective seems particularly relevant when investors are well protected by the law, as in common-law countries like the United Kingdom and the United States.

Our third contribution arises because almost every sample firm is private. Thus, we expand the very limited literature on dividends in private firms, which is the dominating firm type globally (Kobe, 2012). Our findings support the insight that agency concerns matter for dividends in such firms (see studies of private firms in the United Kingdom (Michaely and Roberts, 2012), Sweden (Jacob and Michaely, 2017), and Norway (Berzins et al., 2018). We also identify a strong empirical link between dividends, taxes, and the predominant agency conflict in private firms, which is the one between majority and minority shareholders (Nagar et al., 2011).

Finally, our findings suggest that indirect ownership might bring more benefits than what the literature has claimed (Faccio et al., 2001; Morck and Yeung, 2005). A system of taxing intercorporate dividends as used in the United States might limit pyramiding, but might also increase the cost of taking cash outside the reach of expropriating shareholders. In contrast, a system of tax-free

⁵ Because majority shareholders have strong incentives and power to monitor managers, agency conflicts between shareholders and managers are small. Because our results are also robust to whether the CEO belongs to the controlling family, the closeness between the controlling shareholder and management seems unimportant.

intercorporate dividends used in Norway and many other countries enables shareholders to organize their ownership in ways that reduce the cost of trading off tax effects and agency effects.

In the next section we describe the regulatory setting, and in [Section 3](#) we present the data and the sampling procedure. In [Section 4](#) we explore the dynamics of dividend payouts around the tax reform, while in [Section 5](#) we examine how indirect ownership influences the tradeoff between tax effects and agency effects. We summarize and conclude in [Section 6](#).

2. Regulation

The Norwegian tax reform we examine increased the tax cost of paying dividends to individuals and aligned the tax rates on dividends, capital gains, interest, and labor income.⁶ The reformed tax system resembles the one used in most countries, where only individuals pay dividend tax.⁷

The tax reform announced on March 26, 2004 and implemented on January 1, 2006 introduced a 28% personal tax on dividends and capital gains in excess of a threshold amount based on riskless returns set by the Ministry of Finance. Under the previous tax regime, dividends were tax-exempt for any shareholder, while capital gains were almost always applied to a zero base and hence were tax-exempt as well. Firms paid no taxes on dividends and capital gains either before or after the reform. During the transition in 2005, personally held shares could be transferred to a holding company without triggering a capital gains tax. There were no confounding events around these tax reform dates.⁸

Three properties of the Norwegian tax system should be noted. First, the system is neutral regarding dividends and share repurchases both before and after the tax reform.⁹ Thus, whether the earnings are used to pay dividends or to buy back shares is immaterial for the shareholder's tax bill. Second, capital income taxes cannot be avoided altogether by not paying dividends. Although retaining the earnings rather than paying them out means no taxes are paid now, the resulting capital gains are taxable when the shares are sold later. Because only 1.7% of the majority stakes leave our sample on average per year, however, the holding period is long. This means the present value of the capital gains tax is also low, and that the tax saved by not paying a unit of dividends is close to the dividend tax rate. Finally, the 28% tax rate applies to interest, dividends, and capital gains alike, making it a general capital income tax rather than just a dividend tax. Given the dividend focus of our paper, however, we use the term “dividend tax” rather than “capital income tax.”¹⁰

The dividends are proposed by the board, and the shareholder meeting sets the dividends by majority vote. Dividends are paid to all shareholders in proportion to their percentage equity stake, and the dividends can be paid out of the previous year's earnings and any retained earnings from earlier years. The dividend decision is typically made 2 months after the fiscal year's end, and the payment happens 2 weeks afterwards.

3. Data

The data set covers the period 2000–2012.¹¹ We include several years on both sides of the tax reform in order to capture permanent shifts in dividend policy rather than just one-off temporary effects. Our dating system uses the accounting year rather than the payout year, which is the year after. According to this logic, the last year before the tax reform is 2004 (payout in 2005), while the first year after is 2005 (payout in 2006).

We apply several filters to build the sample of economically active firms from the population of all limited-liability firms:

⁶ The main purpose of the tax reform was to reduce the difference in tax rates on labor income and capital income. The reform decreased the top marginal tax on labor income from 64.7% to 54.3%, while the sum of taxes paid by the firm and the investor on dividends and capital gains increased from 28% to 48.2%. The system of tax-free intercorporate dividends and capital gains was maintained to ensure that the tax on capital income would not exceed the tax on labor income. Source: www.regjeringen.no/nb/dep/fin/.

⁷ The major exception is the United States, where intercorporate dividends are taxed, albeit at a discounted rate. Because institutions pay no dividend tax in that regime, institutions might have a role similar to that of holding companies in our sample. However, [Grinstein and Michaely \(2005\)](#) do not find that higher institutional ownership is associated with higher payout. One possible reason is that institutions rarely own controlling stakes.

⁸ As detailed in [Section 3](#), we exclude the transition years 2004 and 2005 when the reform was announced, but not yet implemented. Including these two years does not change our results.

⁹ Both payout forms generate the same tax payment. The tax rate is 0% before and 28% after for individuals, while it is 0% both before and after for firms.

¹⁰ Most firms in our sample are controlled by families. Because the same family might control the firm for several generations, one could ask if the inheritance tax matters for the dividend decision. The answer seems to be no. First, the inheritance tax applies to the total inherited wealth rather than its separate components. Thus, it is irrelevant whether the inherited wealth consists of earnings paid out from the firm (dividends) or as earnings retained (share value). Second, there is no relationship between the tax systems for dividends and for inherited wealth. For instance, the inheritance tax for parents and children in 2008 was 0% for inherited wealth up to NOK 0.25 million, 8% for the next NOK 0.3 million, and 20% thereafter. The tax rates were higher for more distant family members. In contrast, dividends were taxed at a flat 28% regardless of amount and family relationship. Third, whoever inherited paid tax only on the capital gains between the date of the inheritance and the date of the sale of the asset.

¹¹ Accounting, ownership, and board data are from Experian (www.experian.com). Tax returns data and data on family relationships are from Skattedirektoratet (www.skatteetaten.no), which is a state agency. All data items were received electronically and stored by the Centre for Corporate Governance Research (www.bi.edu/ccgr).

1. As is usually done in the literature, we exclude financial firms in order to avoid the impact of peculiar accounting rules, capital requirements, and ceilings on ownership concentration.
2. We require positive sales, assets, and employment to avoid inactive firms. The firm must be active at least 1 year before and 1 year after the tax reform.
3. We exclude business groups and subsidiaries unless controlled by a holding company.¹² Dividends in business groups can be distorted by special tax rules for cash transfers between group members.
4. We exclude holding companies except as owners of operating companies.
5. We ignore the smallest 5% of firms by assets, sales, and employment.

These filters produce a sample of all active non-financial public and private firms. We add an ownership filter to construct the sample of firms with potential conflicts of interest between majority and minority shareholders. Firms in this sample must have a controlling shareholder, which means more than half the equity is owned by a family or by a firm whose ultimate owners cannot be identified.¹³ The ownership filter, which uses ultimate equity stakes, produces a sample of majority-controlled firms representing around 70% of aggregate sales, assets, and earnings in the Norwegian economy. All firms except for three are private.

We keep majority control constant across the sample firms while exploiting the variation in ownership concentration. This variation reflects how cash-flow rights are split between majority and minority shareholders. The majority shareholder can determine the total payout single-handedly, but the proportion of it she receives depends on the size of the majority stake. The potential conflict between shareholders and management is low, because the average controlling shareholder owns 72% of the equity. This stake provides the power to hire and fire managers as well as strong incentives to monitor them. Moreover, the controlling shareholder is a family in 94% of the cases, is on the board in 90% of the cases, and holds the CEO position in 74% of the cases.

We reduce complexity and increase power by excluding firms without a controlling shareholder because both shareholder conflicts and shareholder–manager conflicts can be important for payout in such firms. A larger stake might increase the former conflict (Demsetz and Lehn, 1985), but might decrease the latter (Shleifer and Vishny, 1986), making the net agency effect of dividends ambiguous. Moreover, complex owner coalitions might be needed to establish control (Laeven and Levine, 2008), and the ownership of managers vs. of outsiders might become important (Eckbo and Verma, 1994). Therefore, not surprisingly, we find that, unlike in majority-controlled firms, dividends and the largest equity stake are unrelated in firms with no controlling shareholder.

The time period we study overlaps with the global financial crisis. However, the effect of the crisis on the Norwegian economy was limited because of high oil prices. There was a dip of -1.0% in GDP in the last quarter of 2008 and a dip of -0.8% in the first quarter of 2009. Payout ratios remained quite stable throughout the financial crisis. Moreover, as shown in Table A.5 in the Online Appendix, our results are robust to excluding the crisis years and to controlling for year fixed effects when the crisis years are included.

Finally, we measure indirect ownership as holding company ownership. A holding company must have the relevant industry code or a ratio of sales to assets below 5%, reflecting minor economic activity beyond owning financial assets. This filter ensures that holding companies mainly manage their owners' investments in operating companies. Holding companies enter our sample only as owning entities and never as owned entities.

4. The agency-related shift in dividend policy after the tax increase

An important question in agency-related dividend policy is whether shareholders use dividends to reduce or increase agency conflicts. There are two mutually exclusive theories (La Porta et al., 2000; Cheffins, 2006). Dividends are used to reduce agency conflicts, according to the substitute theory, which reflects minority-friendly behavior. A larger conflict potential, as reflected in the ownership structure, is associated with higher payout. The opposite behavior is assumed in the outcome theory, where majority shareholders opportunistically exploit minority shareholders by paying lower dividends the larger the potential conflict. We specify the agency-related hypotheses under only the substitute theory, because the outcome theory always predicts the opposite.

4.1. The baseline model

We test two hypotheses in this section. The first prediction is:

Hypothesis 1. Dividends will decrease in dividend-paying firms after the tax increase (H1).

¹² Pyramiding is rare in Norway, because 79% of the holding companies have just one owner after the tax reform, while 8% have two owners. The pre-reform proportions were 43% and 17%, respectively. Building control through more than one level of pyramiding occurs in 0.52% of the operating companies after the tax reform and 0.18% before.

¹³ We define a family as a group related by blood or marriage up to the fourth degree of kinship (<https://www.mec.no.gov/WebDocs/PDF/Misc/RelationshipChart.pdf>). We cannot identify the ultimate owners of financial institutions nor can we identify foreign personal investors and foreign corporate investors. Our definition of family ownership ignores possible conflicts within the family, which might increase with the number of owning family members. Unreported regressions show, however, that the main results stay unchanged when we account for the number of owners in the controlling family. Moreover, we find that dividends become more sensitive to the tax shock as the number of owning family members increases. This result seems inconsistent with the idea that a stronger need for coordination across shareholders makes dividends less sensitive to tax shocks (Jacob and Michaely, 2017).

We test H1 by comparing the average firm's payout ratio and payout propensity before and after. We define the pre-reform period as 2000–2003, which is before the tax reform was announced. Our post-reform period is 2006–2012. We exclude the immediate pre- and post-reform years 2004 and 2005 in order to avoid the temporary effect created by firms paying high dividends after the reform is announced, but before it is implemented.¹⁴

Our second prediction is:

Hypothesis 2. The fall in dividends after the tax reform will be smaller the more dividends can reduce shareholder conflicts (H2).

Hence, we expect payout to fall, but that firms with higher conflict potential will be more willing to continue paying. As in [Chetty and Saez \(2005\)](#), we classify firms into groups with different intensity of the agency problem based on the ownership structure just before the tax reform was announced. H2 implies that among firms with a controlling owner, dividends will decrease less in multiple-owner firms than in single-owner firms, because the latter have no shareholder conflicts. Also, the decrease will be smaller in multiple-owner firms where the controlling stake is low (closer to 50%) rather than high (closer to 100%). We first test H2 with univariate models for the paired difference in payout before vs. after the tax reform.

The ownership structure of our sample firms is very stable. Because all sample firms except three are private, their shares rarely trade. Indeed, ownership concentration is identical from 1 year to the next in 93% of the firm years.¹⁵ This property makes us consider ownership concentration exogenous to the tax shock. Therefore, we classify a firm's conflict potential using its average ownership concentration in 2000–2003, which is before the tax increase was announced. In contrast, we use contemporaneous values for free cash flow, an additional measure of conflict potential, because it is much less stable than ownership.

[Fig. 1](#) shows how dividend policy develops over the sample period. Consistent with hypothesis H1, the average payout ratio drops sharply after the tax reform in all firms as a whole, in low-concentration firms with a majority shareholder, and in high-concentration firms with a majority shareholder. Consistent with H2, the average dividend drop is smallest in low-concentration firms, which have the highest potential shareholder conflict.

Panels A and B of [Table 1](#) report univariate tests of H1 and H2 by comparing the drop in the payout ratio (Panel A) and the proportion of dividend payers (Panel B) from before to after the tax reform in all firms (H1) and in majority-held firms with different conflict potential (H2).

Considering first any firm regardless of its ownership structure (All firms), the mean payout ratio in Panel A declines from 43% before the tax reform to 18% after. The proportion of dividend payers in Panel B declines from 41% to 23%. Consistent with H1, this shift in payout policy is strongly significant both statistically and economically, supporting the argument that taxes have a first-order effect on dividends ([Poterba, 2004](#); [Chetty and Saez, 2005, 2006, 2010](#)). Also, the large tax effect on dividends in our sample of mostly private firms supports the idea that dividend smoothing is not a major concern in such firms ([Michaely and Roberts, 2012](#)).

A similar shift happens in firms with a controlling owner, which is the relevant sample for H2. Both the payout ratio and the payout propensity decrease significantly less in multiple-owner firms (potential shareholder conflict) than in single-owner firms (no shareholder conflict). For instance, Panel A shows that average payout decreases by 30 percentage points in single-owner firms and by 27 in multiple-owner firms. This difference has a *p*-value below 0.1%.

We further decompose the sample of multiple-owner firms with a controlling owner into low-concentration firms (large conflict potential) and high-concentration firms (small conflict potential). Both payout measures fall much less in low-concentration firms. For instance, Panel A shows that the average payout ratio decreases by 30 percentage points in high-concentration firms and by just 18 percentage points in low-concentration firms. The difference is highly significant statistically.

The average payout ratio before the tax reform in Panel A is smaller when ownership concentration is low rather than high (0.382 vs. 0.463). This relationship is not inconsistent with the idea that dividends are used to mitigate shareholder conflicts. First, the dividend tax was zero and payout was high pre-reform. Because cash could be transferred between firms and owners at zero tax costs, payout would resemble the firm's residual cash. The high overall payout was likely sufficient to reduce most agency concerns, and cross-sectional differences were more likely to reflect other payout determinants. After the tax reform, however, paying is costly, most firms decrease payout, but some decrease it less than others, possibly because lower dividends increase agency costs. Second, the payout difference in [Table 1](#) is univariate, ignoring the possibility that dividends might depend on more than just shareholder conflicts. When moving from the univariate tests in [Table 1](#) to the multivariate tests in [Table 2](#) and subsequent tables, the estimates are consistent with our hypotheses. This is also the case when we use propensity score matching, with the pre-reform payout ratio as a matching variable in [Table A.9](#). Finally, we study how the dividend response to taxes depends on potential agency costs. Therefore, the hypotheses are not about the level of payout either before or after the tax shock, but are instead about the change from before to after.

The results in Panels A and B of [Table 1](#) are consistent with the tradeoff logic of H2 that dividends react less to higher dividend taxes the more serious the potential shareholder conflict. However, this effect might also depend on other dividend determinants than taxes and shareholder conflicts, and shareholder conflicts might not just be due to ownership concentration. Therefore, Panel C shows characteristics of the ownership structure, free cash flow, and other possible dividend determinants in majority-controlled firms. The figures show that 36% of the firms have multiple owners, that 12% of these multiple-owner firms have a majority shareholder owning between 50% and 60% (low-concentration firm), and that 18% have a majority shareholder owning between 90% and 99% (high-

¹⁴ The year refers to the accounting year the dividends are based on. For instance, the 2006 dividends are based on accounting data from year-end 2006 and are paid in the spring of 2007. No relationship changes significantly if we include 2004 and/or 2005 or if we include only three years before and three years after the tax reform in order to reduce the impact of possibly confounding events.

¹⁵ Tests using the ownership structure in the first sample year produce very similar results.

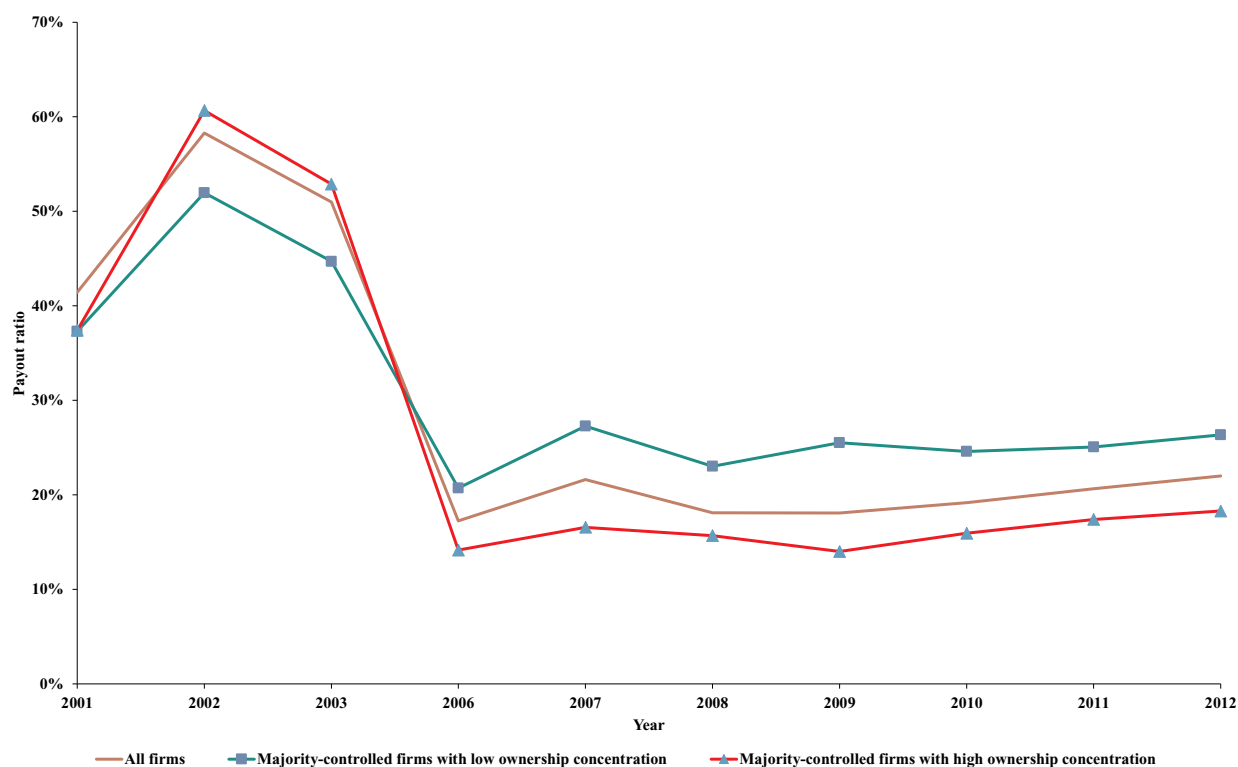


Fig. 1. Dividend policy over time. This figure shows the average ratio of dividends to earnings per year for our sample firms. The sample is the population of limited-liability Norwegian firms that are active, not among the 5% smallest firms, not a financial, not part of a business group, and not a holding company. “Majority-controlled firms with low ownership concentration” is the subsample of firms where the largest shareholder’s stake is between 50% and 60%. “Majority-controlled firms with high ownership concentration” is the subsample of firms where the largest shareholder’s stake is between 90% and 99%. “All firms” is the firms with a majority shareholder. A majority shareholder owns more than 50% of the firm’s equity and is either a family (95% of the cases), a domestic institutional investor (0.8%), a foreign entity (0.3%), or unknown (3.9%).

concentration firm). The average low-concentration firm has 3.54 owners, a Herfindahl index for minority-shareholder concentration of 0.73, a person as a majority shareholder in 94.7% of the cases, and an institution in 0.9%. Compared to the average high-concentration firm, the average low-concentration firm is about 11% larger and 1.5 years younger.

We use a multivariate model in the second test of H2, examining the effect on dividends of taxes, potential agency conflicts, the interaction between the two, and control variables. Our baseline model is:

$$D_{it} = \alpha + \beta_1 \text{After tax reform} + \beta_2 \text{Ownership}_{it} + \beta_3 \text{Ownership}_{it} \cdot \text{After tax reform} + \beta_4 \text{Free cash flow}_{it} + \beta_5 \text{Free cash flow}_{it} \cdot \text{After tax reform} + \beta_6 \text{Number of owners}_{it} + \beta_7 \text{Number of owners}_{it} \cdot \text{After tax reform} + \beta_8 \text{Size}_{it} + \beta_9 \text{Age}_{it} + \beta_{10} \text{Growth}_{it} + \beta_{11} \text{Risk}_{it} + \varepsilon_{it} \quad (1)$$

The dependent variable is the payout ratio D , which we calculate as cash dividends to operating earnings. We measure the agency conflict in three ways. The first is to let *Ownership* be the dummy variable *Single-owner firm*, which captures the dividend effect of not being subject to any shareholder conflict whatsoever. Our second and most important agency measure is to let *Ownership* be *High-concentration firm*, which is 0 if the majority shareholder’s ultimate equity stake is 50–60% (high conflict potential) and 1 if the stake is 90–99% (low conflict potential). The third agency measure is *Free cash flow*, where a higher value reflects higher conflict potential. We measure free cash flow as cash flow from operations over assets, recognizing that we cannot validly observe the theoretical construct, which is liquidity available for management discretion after all value-creating projects have been financed (Jensen, 1986).

We control for financial constraints, growth opportunities, and risk (DeAngelo et al., 2009). We expect that payout will increase with the firm’s *size* and *age* (Denis and Osobov, 2008), which Hadlock and Pierce (2010) interpret as indicators of lower financial constraints. Fama and French (2001) show that dividends relate significantly to size, which we measure by the log of revenues in million NOK. We measure age by the log of the number of years since the firm was founded as of 2005. *Growth* is measured by sales to assets, using the logic that a higher ratio reflects lower slack, higher investment needs, and hence lower dividends.¹⁶ *Risk* is measured

¹⁶ This growth measure uses the logic that higher sales per unit of assets reflect higher capacity use, lower slack, higher investment needs, and hence lower dividend capacity. We prefer this forward-looking measure to measures using past growth, which might overlap with *Free cash flow*. Unreported results show, however, that no significant relationship changes if we replace the forward-looking by the backward-looking growth measure.

Table 1
Summary statistics.

This table compares payout characteristics before (2000–2003) and after (2006–2012) the dividend tax reform in Panels A and B, while Panel C reports sample size and mean value of select explanatory variables used in our regressions. Panel A shows the mean payout ratio (cash dividends divided by operating earnings), and Panel B shows the payout propensity (fraction of firms with positive dividends) before and after the tax reform across six different samples. “All firms” is every limited-liability Norwegian firm that is active, not among the 5% smallest, not a financial, not a holding company, and not part of a business group. “Firms with a controlling owner” have > 50% ownership by a family, a domestic institutional investor, or a foreign entity. “Single-owner firms” have only one shareholder, while “Multiple-owner firms” have at least two. “Low-concentration firms” are firms where the largest shareholder’s stake is between 50% and 60%. “High-concentration firms” are firms where the largest shareholder’s stake is between 90% and 99%. “Largest owner’s stake” is the largest ultimate equity stake in the firm, “Number of owners” is the number of ultimate individual shareholders in the firm, “Herfindahl index, minority” is the Herfindahl index using only the minority shareholders’ ownership stakes, “Free cash flow” is cash flow from operations divided by assets, “Size” is sales in million 2005 NOK, “Age” is the number of years since the firm was founded as of 2005, “Growth” is sales over assets, and “Risk” is the standard deviation of sales growth over the last three (minimum) to seven (maximum) years. The payout ratio is winsorized at the 0% and 95% values, while “Free cash flow”, “Size”, “Growth”, and “Risk” are winsorized at the 0.5% and 99.5% values. The *p*-values are shown in parentheses.

Panel A: The mean payout ratio					
Sample	After tax reform	Before tax reform	Difference		
All firms	0.176	0.426	-0.251	(0.000)	
Firms with a controlling owner	0.163	0.455	-0.292	(0.000)	
Single-owner firms	0.155	0.459	-0.304	(0.000)	Single- vs. Multiple-owner firms:
Multiple-owner firms	0.177	0.447	-0.270	(0.000)	-0.034
High-concentration firms	0.164	0.463	-0.299	(0.000)	High- vs. Low-concentration firms:
Low-concentration firms	0.200	0.382	-0.182	(0.000)	-0.117
					(0.000)

Panel B: The proportion of dividend payers					
Sample	After tax reform	Before tax reform	Difference		
All firms	0.230	0.408	-0.178	(0.000)	
Firms with a controlling owner	0.230	0.438	-0.208	(0.000)	
Single-owner firms	0.218	0.438	-0.220	(0.000)	Single- vs. Multiple-owner firms:
Multiple-owner firms	0.250	0.437	-0.187	(0.000)	-0.032
High-concentration firms	0.241	0.433	-0.191	(0.000)	High- vs. Low-concentration firms:
Low-concentration firms	0.275	0.393	-0.118	(0.000)	-0.073
					(0.000)

Panel C: Characteristics of firms with a controlling owner												
Sample	Number of firms	Number of years	Number of firm	Largest owner's stake	Number of owners	Herfindahl index, minority	Firms with person as majority	Firms with institution as majority	Free cash flow	Age	Growth	Risk
Firms with a controlling owner	39,484	321,574	91.0	1.976	0.848	94.3%	0.7%	0.127	21.825	15.848	2.436	0.306
Single-owner firms	25,229	206,377	100.0	1.570	n.a	93.4%	0.8%	0.127	23.029	15.767	2.490	0.299
Multiple-owner firms	14,255	115,197	74.8	2.703	0.840	95.9%	0.7%	0.129	19.668	15.994	2.338	0.320
High-concentration firms	2,568	22,276	94.5	2.410	0.887	95.4%	0.7%	0.115	22.755	18.624	2.289	0.301
Low-concentration firms	1,679	12,808	54.0	3.535	0.726	94.7%	0.9%	0.117	25.284	16.154	2.506	0.303

Table 2

The sensitivity of dividends to taxes and agency conflicts.

This table shows regressions results for models (1) and (2) in the main text, using the payout ratio (cash dividends divided by operating earnings) as the dependent variable in panels A and B, and a dummy variable for positive dividends in Panel C. “All firms” is the population of limited-liability Norwegian firms that are active, not among the 5% smallest firms, not a financial, not part of a business group, and not a holding company. “All firms with a controlling owner” are those among all firms that have > 50% ownership by a family, a domestic institutional investor, or a foreign entity. “Multi-owner firms with a controlling owner” are those among all firms with a controlling owner that have more than one shareholder. “After tax reform” is 0 if the observation is from 2000 to 2003 and 1 if the observation is from 2006 to 2012. “Single-owner firm” is 1 if the firm has just one shareholder and 0 otherwise. “High-concentration firm” is 1 if the largest ultimate equity stake is between 90% and 99% and 0 if it is between 50% and 60%. “Free cash flow” is cash flow from operations divided by assets, “Number of owners” is the number of ultimate individual shareholders, “Size” is the log of sales in million 2005 NOK, “Age” is the log of the firm’s age in years as of 2005, “Growth” is sales over assets, “Risk” is the standard deviation of sales growth over the last three (minimum) to seven (maximum) years. The payout ratio is winsorized at the 0% and 95% values, while “Free cash flow”, “Size”, “Growth”, and “Risk” are winsorized at the 0.5% and 99.5% values. Panel A (C) uses the payout ratio (payout propensity) from years before and after the tax reform as the dependent variable, reporting results from pooled regressions with standard errors clustered at the firm level. Panel B uses the difference between the average payout ratio after and before the tax reform as the dependent variable. We report the *p*-values in parentheses.

Panel A: The payout ratio			
Independent variable	All firms	All firms with a controlling owner	Multiple-owner firms with a controlling owner
After tax reform	-0.339	-0.320	-0.274
Single-owner firm		(0.000)	(0.000)
Single-owner firm * After tax reform		0.033	(0.000)
High-concentration firm		-0.046	(0.000)
High-concentration firm * After tax reform			
Free cash flow	0.387	0.384	0.038
Free cash flow * After tax reform	-0.030	-0.021	-0.079
Number of owners	-0.014	-0.004	0.424
Number of owners * After tax reform	0.014	0.003	-0.042
Size	0.039	0.040	-0.013
Age	-0.002	0.004	0.012
Growth	-0.017	0.004	0.041
Risk	-0.164	-0.016	0.018
Industry effects	Yes	-0.172	-0.019
Adjusted R ²	0.130	Yes	Yes
n	474,154	332,931	35,451

Panel B: The change in the payout ratio			
Independent variable	All firms	All firms with a controlling owner	Multiple-owner firms with a controlling owner
Single-owner firm			
High-concentration firm		-0.038	(0.000)
Change in free cash flow	0.163	0.160	(0.000)
Number of owners	0.002	0.003	(0.149)
			-0.062
			0.205
			0.010

(continued on next page)

Table 2 (continued)

Panel B: The change in the payout ratio			
Independent variable	All firms	All firms with a controlling owner	Multiple-owner firms with a controlling owner
Change in size	0.084	0.002	0.002
Age	-0.088	-0.118	-0.130
Change in growth	-0.012	-0.004	-0.002
Change in risk	-0.089	-0.158	-0.084
Industry effects	Yes	Yes	Yes
Adjusted R ²	0.069	0.044	0.062
n	67,889	33,493	3,803

Panel C: The payout propensity			
	All firms	All firms with a controlling owner	Multiple-owner firms with a controlling owner
After tax reform	-0.258	-0.229	-0.201
Single-owner firm		0.022	
Single-owner firm * After tax reform		-0.039	
High-concentration firm			
High-concentration firm * After tax reform			
Free cash flow	0.333	0.325	0.005
Free cash flow * After tax reform	0.063	0.080	-0.040
Number of owners	-0.011	0.001	0.363
Number of owners * After tax reform	0.011	0.002	0.064
Size	0.056	0.058	-0.008
Age	0.004	0.007	0.008
Growth	-0.019	-0.017	0.024
Risk	-0.157	-0.157	0.066
Industry effects	Yes	Yes	Yes
Adjusted R ²	0.116	0.122	0.115
n	480,360	337,470	35,938

by the volatility of sales growth over the last three (minimum) to seven (maximum) years. Dividends have been shown to be inversely associated with risk (Grullon et al., 2002). Finally, we include the *Number of owners* and its interaction with the after-tax-reform dummy to account for possible coordination problems among shareholders with unequal dividend preferences that might reduce the elasticity of dividends to taxes (Jacob and Michaely, 2017).

We first estimate (1) on the population of all firms regardless of ownership structure. In this version of (1) we do not include the ownership variable, predicting $\beta_1 < 0$, $\beta_4 > 0$, $\beta_5 < 0$, and $\beta_7 > 0$. We predict $\beta_5 < 0$ because the tax cost of paying out free cash flow is higher after the tax increase. Similarly, we expect $\beta_7 > 0$ because the need to coordinate more owners might make it harder to reduce dividends after the tax increase. For the control variables, we predict $\beta_8 > 0$, $\beta_9 > 0$, $\beta_{10} < 0$, and $\beta_{11} < 0$. Because we have several observations for each firm, we cluster standard errors at the firm level.¹⁷ We use industry dummies and year fixed effects in all specifications.¹⁸ Moreover, we account for unobserved cross-sectional heterogeneity by considering the change in payout within each firm as described in model (2) below. Because all our hypotheses and regressions are about the change in dividends rather than the level, persistent dividend determinants will not matter.

When using the subsample of firms with a controlling shareholder, we measure *Ownership* in (1) by the dummy variable *Single-owner firm*, which we also interact with *After tax reform*. We expect a negative coefficient for the interaction term, because single-owner firms have no shareholder conflict and can cut dividends when the dividend tax increases without producing higher agency costs. Narrowing the sample further to multiple-owner firms with a controlling shareholder and either high or low ownership concentration, we measure *Ownership* as *High-concentration firm* (the majority shareholder's equity stake is 90–99% as opposed to 50–60%), which we also interact with *After tax reform*. We expect a negative coefficient for the interaction term, because high-concentration firms have lower potential agency conflicts and hence find it less costly to reduce dividends to save taxes for their shareholders.

Table 2 shows the results. Panel A presents the estimates of model (1). The strongly negative coefficient for the post-reform dummy in all three samples shows that the large decrease in payout we found in Table 1 persists even when we account for the heterogeneity of firm characteristics. These results support H1.

As in Table 1, we use the sample of firms with a controlling owner to test H2. Single-owner firms (no shareholder conflict) experience a larger decrease than do multiple-owner firms, the interaction term being -0.0463 . Multiple-owner firms with high ownership concentration (low shareholder conflict) reduce their payout more than do low-concentration firms (high shareholder conflict), because the interaction term is -0.0792 . Controlling for firm characteristics, the expected decrease in payout ratio is 8 percentage points smaller in firms with large conflict potential. This difference is economically large, considering that the average decrease is 25 percentage points and that the post-reform average payout ratio is 18%. Higher free cash flow is associated with higher dividends in every sample, although the association in majority-held firms is weaker after the tax shock.

As expected from the coordination argument, having a larger number of shareholders reduces the tax elasticity of dividends. Finally, the control variables relate to dividends as predicted: Larger, older firms with fewer growth opportunities and lower risk pay higher dividends.¹⁹

As an alternative to (1), we estimate a model where the dependent variable is the average payout ratio after (2006–2012) minus before (2000–2003) the tax reform:

$$\begin{aligned} \Delta D_i = & \alpha + \beta_1 \text{Ownership}_i + \beta_2 \Delta \text{Free cash flow}_i + \beta_3 \text{Number of owners}_i \\ & + \beta_4 \Delta \text{Size}_i + \beta_5 \text{Age}_i + \beta_6 \Delta \text{Growth}_i + \beta_7 \Delta \text{Risk}_i + \varepsilon_i, \end{aligned} \quad (2)$$

where Δ denotes difference. This model uses less information than (1) does, but reduces the possible problem caused by auto-correlated independent variables (Bertrand et al., 2004). *Ownership* is measured as the average for 2000–2003, and *Age* is measured in 2005.

Panel B presents the estimates of (2). We once more find that single-owner firms reduce their dividends more after the tax increase than multiple-owner firms do, and that high-concentration firms with multiple owners reduce payout more than low-concentration firms do. Increased free cash flow is associated with higher dividends after the tax reform. Having more owners reduces the decrease in payout, although the result is rather weak. Increased size and decreased risk are associated with higher dividends.

Panel C uses payer status rather than payout ratio as the dependent variable. Consistent with the results using payout ratios in Panel B, we find that the likelihood of paying dividends decreases after the tax reform, and that the decrease is more pronounced for single-owner and high-concentration firms.

4.2. Robustness of the baseline results

We will now investigate the robustness of the findings in Table 2, which are consistent with H1 and H2. One concern about the

¹⁷ No result changes if we use standard errors double-clustered at the firm level in order to account for possibly dependent observations in the cross-section.

¹⁸ All firms are classified according to their NAIC industry code at the five-digit level. We use these codes to assign a firm into one of 18 broad industrial sectors.

¹⁹ Institutional investors pay no taxes on dividends and capital gains. Therefore, their dividend decision does not reflect the tradeoff between tax effects and agency effects. Consistent with this fact, we find in unreported regressions that firms controlled by institutions barely change their payout after the tax reform. The coefficients on the main agency variables remain unchanged and are in line with our predictions.

classic payout measure we use (dividends to earnings) is that controlling owners may inflate it by manipulating reported earnings downwards to mislead minority owners (La Porta et al., 2000). We address this problem in three ways. First, such manipulation is not possible for the positive dividends dummy used in Panel C of Table 2, which produces the same results as in Panels A and B. Second, we measure payout in Table A.1 of the Online Appendix as dividends to sales and as dividends to assets. Both measures might be harder to manipulate than dividends to earnings (La Porta et al., 2000). The results are consistent with those in Table 2.

Third, the change in payout after the tax reform might come from firms that stop paying dividends altogether (omissions) or from reductions in still positive dividends (decreases). Along the lines of Chetty and Saez (2005), we therefore examine dividend changes at the extensive margin by considering the proportion of firms with dividend omissions. We also consider the intensive margin by analyzing firms with dividend decreases, which we define as firms that pay dividends both before and after the reform, but that reduce dividends by at least 20% after the reform. Table A.2 shows that firms with higher potential for agency conflicts change dividends less both at the extensive margin (Panel A) and at the intensive margin (Panel B), with the former effect being larger than the latter. Thus, dividend changes around the tax reform are more likely to come from omissions than from decreases, particularly when shareholder conflicts are moderate. This finding is in line with our main results.²⁰

A major rationale of the tax reform was to reduce the gap between the taxation of capital income (dividends and capital gains) and labor income by increasing the tax on capital income for individuals (Sørensen, 2005). Therefore, one might suspect that the reduced dividend income we have observed has been compensated for by increased labor income, making total payout insensitive to the tax increase. Such compensation might be more likely in firms controlled by a family, which constitute 94% of the majority-held firms in our sample. If this compensating labor income does not materialize, we expect total payout to decrease and cash holdings to increase.

Panel A of Table A.3 shows the labor income paid to the firm's shareholders. We normalize labor income by the sum of the firm's earnings and labor income to shareholders. These gross earnings reflect resources that can be paid to the owners, whether as dividend income or labor income. The figures show that the labor income either stays constant or decreases after the dividend tax increase, and that the effect is unrelated to potential shareholder conflicts. For instance, the average ratio of labor income to gross earnings is unchanged at 64% for all firms with a controlling shareholder, and the change is not significantly different in low- and high-concentration firms. Hence, it seems increased labor income is not used to offset reduced dividend income.

Panel B shows the average dividends paid from the firm to its shareholders per unit of gross earnings. The results are in line with those in Table 1: Dividends decrease after the tax reform, and the decrease is smaller the higher the potential agency conflict.

The findings in Panels A and B show that firms reduce total payout to shareholders per unit of gross earnings after the dividend tax increase. This evidence suggests the firm might have increased its cash holdings. This intuition is confirmed by Panel C, which shows the average, annual change in cash holdings per unit of gross earnings. The figures show that while the cash holdings decrease slightly before the tax reform, they increase afterwards. Finally, in Panel D we replace the dividends to earnings ratio of the baseline model by salary to gross earnings and by dividends to gross earnings, respectively. The estimates show that, unlike dividends, labor income to shareholders is insensitive to the tax reform. Thus, our main results are not due to substitution between dividend income and labor income.

We have so far ignored potential agency conflicts between owners and managers, arguing that this problem is generally small in our sample, where the dominating agency conflict is between majority and minority shareholders. However, the controlling family might have concerns about potential conflicts with a CEO who is not recruited from the family (Anderson and Reeb, 2003). Accordingly, family-controlled firms without a family CEO might pay higher dividends not to reduce shareholder conflicts, but to reduce shareholder–manager conflicts. In Table A.4 we estimate (1) in family-controlled firms that do vs. do not have a family CEO. The estimates show that the sensitivity of dividends to taxes, ownership concentration, and free cash flow is very similar in the two samples. Thus, concerns for shareholder–manager conflicts do not dominate concerns for shareholder conflicts when majority shareholders make the dividend decision.

The baseline regression in Table 2 shows that the tax elasticity of dividends is smaller the more difficult the shareholder coordination problem as measured by a larger number of shareholders. However, the estimates for the agency variables suggest that this coordination story is not an alternative explanation of the inverse relationship between dividends and ownership concentration. In Panel A of Table A.5 we analyze the coordination story further by estimating the baseline model in four samples where the number of shareholders in the firm is the same within each sample. The results show that no main relationship from Table 2 changes.

In Panel B we account for the size of the controlling family. We do this to capture both regular coordination concerns as discussed above and conflicts that might be more common in groups with strong emotional ties and a long history. We find that firms with more owners in the controlling family decrease their payout more rather than less after the tax reform. This result is inconsistent with the coordination story, which predicts that having more shareholders makes coordination more difficult and dividends less sensitive to tax shocks. In contrast, the finding supports the agency story: Having more members in the controlling group might make it harder to agree on private benefits, which in turn makes it less necessary to maintain payout for agency reasons.

Dividends might depend on the owners' wealth, particularly in private firms, where illiquid shares make it costly for shareholders to produce home-made dividends (Miller and Modigliani, 1961). Thus, low shareholder wealth might make dividends important for financing private consumption. In Panel A of Table A.6, we control for variables that reflect the shareholder's wealth. The estimates show that dividends drop less the lower the minority shareholders' wealth, strengthening the argument that the minority shareholders' financial position matters when the majority shareholder makes the dividend decision. This is also the message in Panel B,

²⁰ Unreported findings on dividend initiations and increases are consistent with our main result: Single-owner firms and high-concentration firms are significantly less likely to initiate or increase dividends after the tax reform.

which shows that a more fragmented structure of minority shareholdings (measured by a lower Herfindahl index of minority stakes) is associated with higher dividends after the tax reform. This finding suggests that weaker minority shareholders are paid higher dividends as protection against expropriation. Importantly, the coefficients on our main variables in both panels are virtually unchanged from those in the baseline case. Hence, neither shareholder wealth nor the composition of the minority stakes is an alternative explanation of our agency story.

Independent variables that are serially correlated might lead to inconsistent standard errors (Bertrand et al., 2004). To reduce this possibility, we estimate model (1) in Panel A of Table A.7 by collapsing the annual values for each variable into one average value pre-reform and one average value post-reform. Moreover, we estimate (1) with annual dummies instead of the before/after tax reform dummy in Panel B. The results are consistent with what we found in Table 1. Finally, in Panel C we run regressions separately before and after the tax reform. The results show that firms with higher conflict potential pay significantly more after the tax reform.

Our next robustness test uses a version of (1) that interacts every control variable with the post-reform dummy variable. We do this to account for potential shifts in how control variables influence payout around the time of the tax reform. The findings as shown in Table A.8 are consistent with those in Table 2.

Finally, there could be a worry that pre-reform payout might affect post-reform payout in ways we have not accounted for. For instance, Table 1 shows that high-concentration firms have higher average payout pre-reform than do low-concentration firms. Further, even though we control for several firm characteristics in the regressions, the possibility remains that high-concentration firms differ too much from low-concentration firms for any comparison to be meaningful. To address these issues, we use propensity score matching on firm size, industry, and pre-reform payout ratios.²¹ The results are presented in Table A.9, where the estimates are close to those in Table 2.²² This result alleviates the concern that the relationships we have found might be affected by different pre-reform payout policies or by firms that are not really comparable, at least on observable dimensions.

Altogether, we find no evidence that the relationship between dividends, taxes, and shareholder conflicts depends on the way we measure payout, shifts from reduced dividends to increased salary, conflicts between owners and managers, coordination problems between owners in general and family owners in particular, shareholder wealth, the concentration of minority shareholders' stakes, serially correlated variables, shifts in control variables around the tax reform, or incomparable firms.

5. Trading off tax effects and agency effects under indirect ownership

In this section we explore whether the choice of organizational form is used to more easily trade off tax effects against agency effects in dividend policy. We can study this mechanism because the tax reform introduced taxes on personal dividends, but not on intercorporate dividends. This reformed tax system might create incentives to own shares through corporate entities, which we call holding companies. The holding company has no special tax status and no economic activity. It does not allow shareholders to avoid taxes permanently, because dividends paid out for consumption trigger personal taxes. However, the cash paid from the operating company to reduce its free cash flow problem can be stored at zero tax costs in the holding company until the owner needs the cash.

We test two hypotheses by analyzing whether the tax increase for individuals, but not for firms, makes shareholders switch from direct to indirect ownership to maintain payout, particularly when potential shareholder conflicts are large. Such a mechanism would support the main result from Section 4 by suggesting that shareholders ensure free cash flow can be paid at minimum tax costs when the agency benefit is substantial.

Hypothesis 3. The tax increase for individuals makes shareholders switch from direct to indirect ownership (H3).

Hypothesis 4. The larger the potential shareholder conflict, the stronger the tendency for shareholders to switch from direct to indirect ownership, and the less sensitive the dividend to the tax shock (H4).

We classify a firm as indirectly owned if at least one of its shareholders is a holding company. If not, the firm is directly owned. We test H3 by analyzing whether indirect ownership is more common after the tax reform than before and whether this is a unique Norwegian phenomenon. We use *t*-tests for the difference before vs. after in the proportion of holding companies and in the proportion of companies with a holding company owner.

Consistent with H3, Table 3 documents a strong increase in the use of indirect ownership around the time of the tax reform. Unlike for operating companies, the number of holding companies grows sharply from 725 in 2000 to 5869 in 2012 (column 4). As expected, the large jump happens around the time of the tax reform, the growth being 371% from 2004 to 2005. Also, while 6.3% of the operating companies have a holding company owner in 2004, the fraction almost triples to 18.6% in 2005 and grows every year thereafter to 31.8% in 2012 (column 6).

Table 3 also shows that holding companies are increasingly set up by just one investor to own shares in just one operating company. For instance, the average number of owners per holding company decreases from 3.1 in 2004 to 2.2 in 2005 (column 7), while the average number of operating companies per holding company falls from 1.44 to 1.18 (column 8).

To explore whether this large growth in indirect ownership depends on more than increased dividend taxes for individuals, we use a difference-in-difference test to compare the prevalence of holding companies in Norway with the prevalence of holding companies in the neighboring countries Denmark, Finland, and Sweden before and after the Norwegian tax reform. Because the other Nordic

²¹ We thank an anonymous referee for this suggestion.

²² We use nearest neighbor matching. Caliper matching produces very similar results.

Table 3

Operating companies and holding companies.

This table presents aggregate statistics for the prevalence of operating companies and holding companies, and for how these companies are owned. An operating company is sampled from the population of limited-liability Norwegian companies that are active, not among the 5% smallest firms, not financials, not part of a business group, but is a firm where > 50% of the equity is owned by a family, a domestic institutional investor, or a foreign entity. A holding company has some ownership stake in an operating company and either has a sales-to-assets ratio under 5% or uses the Statistics Norway sector code for a holding company. A holding company may have a parent, but the parent cannot be a subsidiary. Ownership is based on ultimate cash flow rights. Except for column 1, we exclude single-owner operating companies. Columns 1–4 show the number of companies. The bottom three rows show statistics from the pooled samples in the two subperiods. “All (.)” refers to the sample of all private limited-liability companies and not just those with a controlling shareholder. In the last row we report the *p*-values (in parentheses) for the differences between the two subperiod averages.

Year	1	2	3	4	5	6	7	8	9	10
	Operating companies	Operating companies with multiple owners	Owners in operating companies	Holding companies	Owners per operating company	Fraction operating companies with holding company	Owners per holding company	Operating companies per holding company	Holding companies per operating company	Fraction single-owner operating companies with holding company
2000	45,985	22,611	56,961	725	2.92	4.9%	3.68	1.54	1.03	3.4%
2001	47,727	23,470	58,023	796	2.87	5.5%	3.36	1.58	1.03	3.6%
2002	48,209	23,733	58,472	853	2.86	5.5%	3.30	1.52	1.04	3.5%
2003	49,911	24,431	60,430	904	2.84	5.7%	3.27	1.52	1.03	3.5%
2004	49,911	24,462	60,444	1,047	2.82	6.3%	3.11	1.44	1.05	3.7%
2005	49,407	22,577	55,820	4,471	2.82	18.6%	2.21	1.18	1.29	14.1%
2006	50,063	22,162	53,792	5,404	2.81	22.5%	1.82	1.19	1.31	14.9%
2007	49,821	20,772	52,136	5,687	2.89	25.5%	1.83	1.18	1.28	14.1%
2008	50,187	20,298	51,316	5,887	2.95	27.4%	1.90	1.19	1.28	14.1%
2009	50,121	19,710	49,802	5,965	2.94	28.6%	1.89	1.19	1.28	14.4%
2010	50,417	19,247	48,886	5,957	2.93	29.4%	1.89	1.19	1.27	14.7%
2011	49,151	18,306	46,331	5,851	2.92	30.5%	1.88	1.20	1.27	14.7%
2012	49,280	17,450	52,341	5,869	3.92	31.8%	2.64	1.20	1.28	14.3%
All (2000–2004)	92,036	60,704	224,265	2,757	3.85	5.7%	4.48	1.54	1.09	4.3%
All (2005–2012)	112,092	66,695	278,438	18,407	4.04	24.9%	2.55	1.22	1.31	15.7%
(<i>p</i> -value, difference)					(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)

countries did not change tax-based incentives for indirect ownership in this period, and because their regulatory environments are similar in general, these countries constitute a natural control group.

Fig. 2 and Panel A of Table 4 document that the upwards shift in the number of Norwegian holding companies after the Norwegian tax reform has no equivalent elsewhere. This impression is supported by the estimates in Panel B. The expected ratio of holding companies to all companies increases by about 10 percentage points more in Norway than in any other country around the time of the tax reform. Thus, a tax reform that allows for paying tax-free dividends to firms but not to individuals produces a large, new layer of tax-free intermediaries between operating firms and their ultimate, taxable owners. This evidence is consistent with H3.

We can use this new layer of indirect ownership to better understand how firms with different agency costs respond differently to the tax shock. Indirect ownership allows for tax-free payout of free cash flow that would otherwise be at the majority shareholder's discretion inside the firm. The higher tax on dividends paid by individuals might therefore produce a positive link between conflict potential and indirect ownership. Given H2, firms with indirect ownership will also decrease their dividends less after the tax shock. H4 predicts that a move from direct to indirect ownership is more likely in firms with a higher potential for agency conflicts, and that the dividends of indirectly owned firms will respond less negatively to the tax shock.

We examine H4 by first extending the univariate tests used for H1, looking separately at firms with and without indirect ownership. We expect that indirectly owned firms decrease payout less after the tax shock, and that the decrease is smaller the larger the conflict potential.

As predicted, Table 5 shows that payout does indeed decrease less with indirect ownership except in single-owner firms, where shareholder conflicts cannot exist. In the sample of indirectly owned firms, which have the lower tax costs of dividends after the reform, low-concentration firms (high conflict potential) reduce their payout by fewer percentage points than do high-concentration firms (low conflict potential), the numbers being 16 and 25 percentage points, respectively. Among the directly owned firms, the numbers are 19 and 31 percentage points, respectively. Both differences in payout response are economically large and statistically significant at the 1% level. These results are also consistent with the findings for H2 in Section 4.

The second test of H4 accounts for the possibility that if firms with higher conflict potential plan to pay higher dividends, they might self-select into indirect ownership to reduce taxes. This means the tax cost will differ across our sample firms according to conflict severity, which could affect identification. To address this possibility, we estimate an endogenous switching model consisting of a selection equation and a dividend equation (Maddala, 1983; Song, 2004; Li and Prabhala, 2007). We add instruments that have an exogenous effect on whether a firm is indirectly owned. The selection equation is:

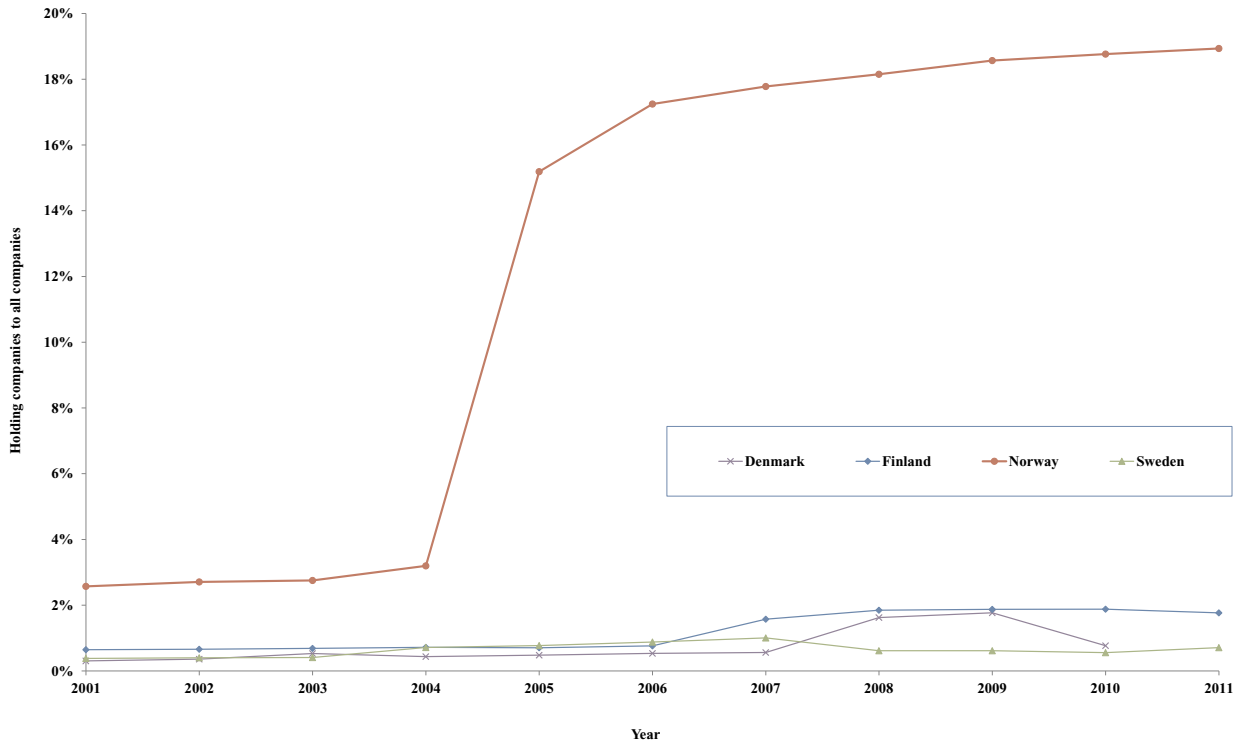


Fig. 2. Holding companies in Denmark, Finland, Norway, and Sweden. This figure shows the ratio of holding companies to all companies in four Nordic countries. The sample is based on the sector code for holding companies. Data sources: Statistics Denmark, Statistics Finland, Statistics Norway, and Statistics Sweden.

$$\begin{aligned}
 IO_{it} = & \alpha + \beta_1 \text{After tax reform}_{it} + \beta_2 \text{Number of investments}_{it} + \beta_3 \text{Large equity base}_{it} \\
 & + \beta_4 \text{Ownership}_{it} + \beta_5 \text{Free cash flow}_{it} + \beta_6 \text{Number of owners}_i \\
 & + \beta_7 \text{Size}_{it} + \beta_8 \text{Age}_{it} + \beta_9 \text{Growth}_{it} + \beta_{10} \text{Risk}_{it} + \eta_{it}
 \end{aligned} \tag{3}$$

$IO_{it} = 1$ if the firm has indirect owners and 0 otherwise. Firms will presumably be indirectly owned if the benefit of this organizational form exceeds the cost. We use *Number of investments* and *Large equity base* as instruments for indirect ownership. *Number of investments* is the largest number of firms any of the firm's shareholders invest in. *Large equity base* equals 1 if the largest shareholder's investment in the firm exceeds the regulatory minimum share capital for holding companies, which is NOK 100,000. Given the fixed cost of setting up a holding company, indirect ownership is worthwhile for non-tax reasons only if the holding company can be used to manage multiple investments or large investments (the relevance condition).²³ The number of investments the shareholder makes or whether the investment in question is above a fixed threshold are unlikely to directly influence the payout ratio (the exclusion restriction). Finally, we add the control variables from (1).

The dividend equation of the switching model is identical to the dividend equation in (1), and we estimate the equation separately for the two organizational forms. Because firms can self-select into one of the groups, the two error terms of (1) (one for each organizational form) are assumed to be possibly correlated with the error term of (3). We make the standard assumption that the three error terms have a trivariate normal distribution.

This switching model, which consists of (1) and (3), allows us to measure the change in payout after the tax reform in (1) while controlling for self-selection into indirect ownership in (3). Moreover, (3) estimates characteristics of firms that are more likely to be indirectly owned.

We also estimate a switching model using the dividend change equation in (2) and the following selection equation:

$$\begin{aligned}
 IO_i = & \alpha + \beta_1 \text{Earlier indirect ownership} + \beta_2 \text{Number of investments}_i + \beta_3 \text{Large equity base}_i \\
 & + \beta_4 \text{Ownership}_i + \beta_5 \text{Free cash flow}_i + \beta_6 \text{Number of owners}_i \\
 & + \beta_7 \text{Size}_i + \beta_8 \text{Age}_i + \beta_9 \text{Growth}_i + \beta_{10} \text{Risk}_i + \eta_i
 \end{aligned} \tag{4}$$

²³ Setting up a holding company involves several fixed costs. Out-of-pocket setup costs are registration and auditing fees totaling NOK 6000 (about US\$700), while the annual auditing fee is around NOK 15,000 (about US\$1750). These costs are tax deductible at a 28% tax rate. Because the average dividend received by a holding company in our sample is NOK 0.5 million, the average tax saving of indirect ownership exceeds the cost by a wide margin. Source: www.smbinfo.no.

Table 4

Indirect ownership in four Nordic countries.

This table compares the use of indirect ownership through holding companies in Denmark, Finland, Norway, and Sweden. Panel A shows the ratio of holding companies to all companies year by year in each country, while Panel B uses a difference-in-difference approach to compare the use of holding companies in Norway with their use in the other three countries one by one, and with their use in the other countries as a group. The reported coefficient in Panel B is the effect on the ratio of holding companies to all companies when the observation is from Norway rather than from the other countries and from after the Norwegian tax reform (2006–2010) rather than before (2001–2005). The sample is based on the sector code for holding companies. Data sources: Statistics Denmark, Statistics Finland, Statistics Norway, and Statistics Sweden.

Panel A: The ratio of holding companies to all companies				
Year	Denmark	Finland	Norway	Sweden
2000			1.1%	0.4%
2001	0.3%	0.6%	1.3%	0.4%
2002	0.4%	0.7%	2.6%	0.4%
2003	0.5%	0.7%	2.0%	0.4%
2004	0.4%	0.7%	2.0%	0.7%
2005	0.5%	0.7%	2.3%	0.8%
2006	0.5%	0.8%	11.4%	0.9%
2007	0.6%	1.6%	11.9%	1.0%
2008	0.5%	1.8%	12.6%	0.6%
2009	1.8%	1.9%	13.0%	0.6%
2010	0.8%	1.9%	13.5%	0.6%
2011		1.8%	13.6%	0.7%
Average	0.6%	1.2%	7.3%	0.6%

Panel B: Difference-in-difference estimates		
	Coefficient	(p-value)
Norway vs. Denmark	10.175	(0.000)
Norway vs. Finland	9.869	(0.000)
Norway vs. Sweden	10.577	(0.000)
Norway vs. Denmark, Finland, and Sweden	10.200	(0.000)

Earlier indirect ownership is 1 if the firm had indirect ownership before the tax reform, which suggests the firm is more likely to also be indirectly owned after the reform. However, holding companies are unlikely to be set up in order to avoid dividend taxes before the reform.

We use (2) as our dividend equation, estimating it separately for the two organizational forms. We allow the two error terms in (2) to be possibly correlated with the error term of (4), and we assume the three error terms have a trivariate normal distribution.

The findings from the two switching models are reported in Table 6. Panel A uses (1) as the dividend equation and (3) as the selection equation, while Panel B uses (2) as the dividend equation and (4) as the selection equation.

The estimated coefficients for the selection Eq. (3) in Panel A show that majority-held firms are more often owned indirectly after the tax reform when their owners have several investments and when the firm has multiple owners, less concentrated ownership, a larger size, a lower age, and lower growth. Firms with higher potential agency problems are therefore more likely to be indirectly owned after the tax reform. The estimates of the dividend Eq. (1) support the notion that multiple-owner firms decrease their payout less than single-owner firms do, and that multiple-owner firms with a low ownership concentration decrease dividends less than their high-concentration counterparts do. Finally, the results in Panel B based on dividend changes in Eqs. (2) and (4) are in line with the results in Panel A, which are based on dividend levels.

The findings in Table 6 are consistent with H4 and support the findings in Table 2: The self-selection into indirect ownership does not affect our main result on the tradeoff between tax effects and agency effects: Firms with higher potential agency problems do decrease their payout less even when we account for their self-selection into being indirectly owned.

These results also support the notion that the lack of an intercorporate dividend tax produces higher payout. The average firm with a controlling owner would have had a predicted payout decrease of 42% with direct ownership and of 37% with indirect ownership. In the subsample of firms with multiple owners, the numbers are 32% and 20%, respectively. These estimates suggest that a system of taxing intercorporate dividends, as used in the United States, has the disadvantage of increasing the cost of using dividends to take cash outside the reach of insiders.

Overall, in this section we have shown that indirect ownership is more common after the tax reform made dividend income taxable for individuals, but not for firms. The more important result from our tradeoff perspective on taxes and agency costs is that the tendency to own indirectly in order to protect dividends increases with the potential shareholder conflict. This evidence supports the idea that dividends are used to reduce shareholder conflicts, and that indirect ownership is a tool for ensuring that the beneficial dividends carry minimum tax costs.

Table 5
 Dividends, potential shareholder conflicts, and indirect ownership.
 This table shows how the average payout ratio before and after the tax reform depends on whether the firm has potential agency problems and whether it has indirect ownership through holding companies. We measure the payout ratio as cash dividends to operating earnings. The *p*-values are reported in parentheses. “Indirect ownership” means that at least one owner is a holding company. “Direct ownership” is when no owner is a holding company. “Before tax reform” is 2000–2003, and “After tax reform” is 2006–2012. We measure potential agency problems by ownership concentration as reflected in the largest ultimate equity stake. “All firms” is the population of limited-liability Norwegian firms that are active, not among the 5% smallest firms, not a financial, not part of a business group, and not a holding company. “Firms with a controlling owner” have > 50% ownership by a family, a domestic institutional investor, or a foreign entity. “Single-owner firms” have only one shareholder, while “Multiple-owner firms” have at least two. “Low-concentration firms” are firms where the largest shareholder’s stake is between 50% and 60%. “High-concentration firms” are firms where the largest shareholder’s stake is between 90% and 99%.

Sample	Indirect ownership			Direct ownership				
	After tax reform	Before tax reform	Difference	(<i>p</i> -value)	After tax reform	Before tax reform	Difference	(<i>p</i> -value)
All firms	0.234	0.511	-0.277	(0.000)	0.148	0.441	-0.293	(0.000)
Firms with a controlling owner	0.242	0.532	-0.289	(0.000)	0.147	0.441	-0.294	(0.000)
Single-owner firms	0.225	0.567	-0.341	(0.000)	0.144	0.443	-0.299	(0.000)
Multiple-owner firms	0.264	0.490	-0.227	(0.000)	0.155	0.438	-0.283	(0.000)
High-concentration firms	0.235	0.484	-0.249	(0.000)	0.147	0.460	-0.313	(0.000)
Low-concentration firms	0.304	0.461	-0.157	(0.000)	0.165	0.357	-0.192	(0.000)

Panel B: The change in the payout ratio

Independent\dependent variable	All firms with a controlling owner			Multiple-owner firms with a controlling owner		
	Indirect ownership	Change in payout ratio for firms with indirect ownership	Difference with direct ownership	Indirect ownership	Change in payout ratio for firms with indirect ownership	Difference with direct ownership
The selection equation						
Earlier indirect ownership	2.035	(0.000)		1.975	(0.000)	
Number of investments	0.059	(0.000)		0.028	(0.068)	
Large equity base	0.433	(0.000)		0.440	(0.000)	

(continued on next page)

Table 6

The relationship between dividends, taxes, agency costs, and indirect ownership.

This table shows the estimates of two switching models, where operating companies may self-select into being owned by holding companies. Panel A uses (1) of the main text as the dividend equation and (3) as the selection equation, while Panel B uses (2) as the dividend equation and (4) as the selection equation. Every variable relates to an operating company, which is sampled from the population of limited-liability Norwegian firms that are active, not among the 5% smallest firms, not financials, not part of a business group, not a holding company, and that have more than 50% ownership by a family, a domestic institutional investor, or a foreign entity. The dependent variable in the selection equation is the dummy variable "Indirect ownership", which is 1 if at least one owner is a holding company and 0 otherwise. The dependent variable in the dividend equation is the payout ratio (cash dividends to operating earnings) in Panel A and the average payout ratio after the tax reform less the average payout ratio before the tax reform in Panel B. "After tax reform" is 1 in 2006–2012 and 0 otherwise. "Number of investments" is the largest number of investments by any of the firm's shareholders in 2005. "Large equity base" equals 1 if the largest shareholder's investment in the firm exceeds the regulatory minimum share capital for holding companies and 0 otherwise. A "Single-owner firm" has only one shareholder, while a "Multiple-owner firm" has at least two. "High-concentration firm" is 1 if the largest ultimate equity stake is between 90% and 99% and 0 if it is between 50% and 60%. An owner is a family unit, a domestic institutional investor, or a foreign entity. "Free cash flow" is cash flow from operations divided by assets, "Number of owners" is the number of ultimate shareholders, "Size" is the log of sales in million 2005 NOK, "Age" is the log of the company's age in 2005, "Growth" is sales over assets, and "Risk" is the standard deviation of sales growth over the last three (minimum) to seven (maximum) years. "Holding company" has some ownership stake in an operating company and either has a sales-to-assets ratio under 5% or uses the Statistics Norway sector code for a holding company. In Panel B, variables denoted "before tax reform" are averages for 2000–2003, while variables denoted "change" are differences between averages for 2006–2012 and 2000–2003. "Earlier indirect ownership" is a dummy variable that is 1 if the operating company had a holding company among its owners before the tax reform and 0 otherwise. The payout ratio is winsorized at the 0% and 95% values, while "Free cash flow", "Risk", "Growth", and "Size" are winsorized at the 0.5% and 99.5% tails. All regressions include industry dummies. The *p*-values are in parentheses.

Independent/dependent variable	All firms with a controlling owner				Multiple-owner firms with a controlling owner			
	Indirect ownership	Payout ratio for firms with indirect ownership	Payout ratio for firms with direct ownership	Indirect ownership	Payout ratio for firms with indirect ownership	Payout ratio for firms with ownership	Indirect ownership	Payout ratio for firms with ownership
The selection equation								
After tax reform	1.189 (0.000)			1.088 (0.000)				
Number of investments	0.215 (0.000)			0.141 (0.000)				
Large equity base	0.006 (0.600)			0.058 (0.393)				
Single-owner firm	-0.209 (0.000)							
High-concentration firm				-0.102 (0.031)				
Free cash flow	0.451 (0.000)			0.305 (0.004)				
Number of owners	0.010 (0.000)			0.022 (0.038)				
Size	0.519 (0.000)			0.467 (0.000)				
Age	0.042 (0.000)			-0.067 (0.067)				
Growth	-0.146 (0.000)			-0.160 (0.000)				
Risk	0.303 (0.000)			0.266 (0.001)				
The dividend equation								
After tax reform	-0.030 (0.000)	-0.308 (0.000)	-0.041 (0.036)					
Single-owner firm	-0.088 (0.000)	0.047 (0.000)						
Single-owner firm * After tax reform	-0.047 (0.003)	-0.057 (0.000)						
High-concentration firm								
High-concentration firm * After tax reform	0.195 (0.000)	0.503 (0.000)						
Free cash flow	0.289 (0.000)	-0.096 (0.000)						
Free cash flow * After tax reform	0.001 (0.687)	0.006 (0.000)						
Number of owners	0.003 (0.293)	-0.003 (0.105)						
Number of owners * After tax reform	0.036 (0.000)	0.098 (0.000)						
Size	0.010 (0.002)	0.011 (0.000)						
Age								

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Table 6 (continued)

Panel A: The payout ratio		Multiple-owner firms with a controlling owner			
Independent\dependent variable	All firms with a controlling owner		Multiple-owner firms with a controlling owner		Payout ratio for firms with direct ownership
	Indirect ownership	Payout ratio for firms with indirect ownership	Indirect ownership	Payout ratio for firms with indirect ownership	
Growth	-0.001	(0.872)	-0.031	(0.000)	-0.034
Risk	-0.098	(0.000)	-0.134	(0.000)	-0.153
n	3,32,931	48,860	2,84,071	34,541	28,677

Panel B: The change in the payout ratio		Multiple-owner firms with a controlling owner			
Independent\dependent variable	All firms with a controlling owner		Multiple-owner firms with a controlling owner		Change in payout ratio for firms with direct ownership
	Indirect ownership	Change in payout ratio for firms with indirect ownership	Indirect ownership	Change in payout ratio for firms with indirect ownership	
The selection equation					
Earlier indirect ownership	2.035	(0.000)	1.975	(0.000)	
Number of investments	0.059	(0.000)	0.028	(0.068)	
Large equity base	0.433	(0.000)	0.440	(0.000)	
Single-owner firm	-0.200	(0.000)	-0.164	(0.009)	
High-concentration firm					
Free cash flow before tax reform	0.146	(0.011)	0.023	(0.889)	
Number of owners before tax reform	0.018	(0.034)	0.027	(0.151)	
Size before tax reform	0.104	(0.000)	0.017	(0.000)	
Age	-0.016	(0.412)	-0.012	(0.817)	
Growth before tax reform	-0.039	(0.000)	-0.073	(0.000)	
Risk before tax reform	-0.100	(0.005)	-0.051	(0.609)	
The dividend equation					
Single-owner firm					
High-concentration firm					
Change in free cash flow	-0.044	(0.004)	-0.070	(0.000)	-0.157
Number of owners before tax reform	0.179	(0.001)	0.185	(0.000)	0.160
Change in size	0.009	(0.138)	0.005	(0.126)	0.009
Age	0.001	(0.000)	0.005	(0.000)	0.005
Change in growth	-0.106	(0.000)	-0.101	(0.000)	-0.114
Change in risk	-0.014	(0.024)	-0.001	(0.839)	-0.001
n	33,493	5680	27,453	3803	2889

6. Summary and conclusion

The existing literature reports both first-order effects and minor effects of taxes on dividends. Exploiting a large and clean regulatory shock to dividend taxation, we find that the tax effect is first-order. Our major result is that the causal effect of taxes on dividends is strongly moderated by the relationship between agency costs and dividends. In particular, we show that dividends depend on the tradeoff between an important cost of dividend payments (higher taxes, which depend on whether ownership is direct or indirect) and an important benefit (lower shareholder conflicts, which depend on the controlling shareholder's equity stake). For instance, the average dividend drop is largest, at 31 percentage points, when the tax cost of dividends is high (direct ownership) and the agency benefit is low (high controlling stake). The dividend drop is smallest, at 16 percentage points, when the tax cost is low (indirect ownership) and the agency benefit is high (low controlling stake). These results cannot be explained by tax-motivated switching between labor income and dividends, by coordination between shareholders' liquidity preferences, by shareholder wealth or the minority shareholder structure, or by the relationship between the firm's managers and shareholders.

This evidence suggests that both tax concerns and agency concerns are important determinants of dividend policy, that the costly effect of dividends on taxes is actively traded off against the beneficial effect of dividends on agency conflicts, and that investors organize their ownership in ways that allow them to capture the beneficial effect of dividends on agency conflicts at the lowest possible tax cost.

These results shed new light on how the effect of taxes on dividends interacts with the main agency problem for most firms in any economy, which is the conflict of interest between majority and minority shareholders. Our evidence also suggests that indirect ownership might have more positive effects than what the literature has claimed. While a system of taxing intercorporate dividends makes it costlier to reduce agency costs by paying out free cash flow, the system of tax-free intercorporate dividends we analyze avoids this problem.

We conclude that to understand the role of taxes in dividend policy one must understand how shareholders trade off costly tax effects against beneficial agency effects, and how shareholders choose organizational form to alleviate this tradeoff.

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Appendix A. Supplementary data

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