SHOULD STATE-OWNED ENTERPRISES PAY DIVIDENDS?

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Abstract: *The dividend puzzle for private corporations has a long-lasting history. Six theories provide to certain extent explanations of this puzzle. However, the dividend puzzle has not yet been discussed as an economic problem for state-owned enterprises (SOEs). The article addresses this issue.*

All well-known six theoretical concepts of the dividend puzzle are presented and their strengths and weaknesses are analysed. After that, the specific features of SOEs are brought out and the dividend puzzle for them is formulated. After presenting the experience of the dividend policy of SOEs, a confrontation with the theories is made. It is proved that only the theory of dividend payment preference is relevant to SOEs.

Keywords: *Dividend puzzle, state-owned enterprises, dividend policy, Bulgaria*

JEL: *G35 G38 H32 H62*

1. Introduction

The question: Should state-owned enterprises pay dividends? initially was raised by Black (1976). In the beginning of an article entitled *The Dividend Puzzle* he asked two questions: `What should the individual investor do about dividends in his portfolio?` and `Why do investors pay attention to dividends?`. After a short analysis and discussion, Black's answers like this: 'We don't know' and we still don't know what are the economic rationales for dividend payouts (Tanushev, 2016). For that reason, the dividend policy is considered as one of the 'thorniest puzzles' (Allen, Bernardo and Welch, 2000) and an `enigma` (Al-Malkawi, Rafferty and Pillai, 2010). The `dividend controversy` ranks in the ten most important unresolved financial issues (Brealey and Myers, 2002).

The Dividend Puzzle is traditionally discussed for private corporations located in different countries around the world. Very rarely it is analyzed in the context of state-owned enterprises (SOEs). The purpose of this article is to present the results of a study on the relevance of the leading theoretical constructs that explain the dividend puzzle to the experience of SOEs in certain countries and especially in Bulgaria.

The article is conventionally divided into four parts. In the first part, a literature review of the main studies of the dividend puzzle is made and the theories that serve to explain it are presented. The second part is devoted to the peculiarities of dividend policy in SOEs. The third

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part presents the experience of the dividend policy in Bulgarian SOEs. In the last part, the main conclusions of the study are summed up.

2. Literature review

The wide application of SOEs since 1950s is not adequately reflected in research on their governance (Aharoni, 1982). Attempts to delineate the nature of the dividend have been the subject of economic research for more than a century, yet theoretical models have been unable to fully explain it (Wood, 1994). In its origin, the dividend predates the share and, in its evolution, takes different forms:

- Return on Investments. The dividend arose in the 17th century due to the need to attract capital for sea expeditions. Shipowners share the profits from trading with investors depending on the part of their investment for the commercial trips (Leeson, 2009).
- *Liquidation share*. Due to the creation of corporations for a limited time and their subsequent liquidation, the dividend is used as a liquidation share for shareholders. Practices in the Netherlands and the UK begin to limit dividend payouts to net profit and companies are given the opportunity to doing business longer.
- *Monopoly rights*. In the nineteenth century, large-scale railway infrastructure projects began in rapidly industrialising countries and monopoly rights were offered to attract investment. The first cases of unfair practices date from this period - dividends are declared before the calculation of profits and are paid out of accumulated capital or the proceeds of subsequent issues.
- *Response to tax pressure*. In the 1930s, laws were enacted in the United States to tax retained earnings. In response, many corporations increased dividends or introduced special dividends. The modern form of dividend policy emerged.
- *Reduction of information asymmetry*. To solve the principal-agent problem, managers pay high dividends to mitigate the principal's control over them. The dividend begins to perform a signaling function and provide information about the financial condition and future earnings of the company.

The ‘dividend puzzle’ derived from the Modigliani–Miller theorems of 1959 and 1961 (Modigliani and Miller, 1959; Miller and Modigliani, 1961). An excellent interpretation of their work and formulation of the dividend puzzle is found in La Porta et al. 2000: “...in a frictionless world, when the investment policy of a firm is held constant, its dividend payout policy has no consequences for shareholder wealth. Higher dividend payouts lead to lower retained earnings and capital gains, and vice versa, leaving total wealth of the shareholders unchanged.”

However, in a real world, dividends paid by companies are not always proportional to their earnings - some companies pay out high dividends even when their earnings are low, while others pay out low dividends even when their earnings are high (Lintner, 1956). This is seen as a puzzle because it contradicts the traditional financial theory that companies should pay out dividends in proportion to their profits.

There are several possible explanations for the dividend puzzle, which are known as theories. The most prominent of them is presented in the following part.

Dividend irrelevance theory. At a certain point in economic history, capital markets are seen as perfect, investor behavior as rational, and company information as accessible to all stakeholders. According to the theorem of Fr. Modigliani and M. Miller, the dividend does not affect the value of the shares due to the assumption of a perfect capital market and a tax-free dividend (Miller and Modigliani, 1961). The theorem refers to situations in which the dividend is managed by factors of the internal environment, e.g., managers. In order to increase the market value of the company, profits are not distributed but used for investment purposes. This decision of managers is reflected in the behaviour of investors to hold or sell their shares.

Theory of clientelism. According to this theory, the rational behaviour of market participants influences the dividend decision. The change of ownership of the shares before the date of dividend declaration depends upon the tax characteristics of investors (Elton and Gruber, 1970). Changes in tax laws shape the relationship between dividend policy and investor behaviour depending on the tax liabilities of each investor group (Berk and DeMarzo, 2013). Investors with high tax liabilities may prefer companies to use share buybacks in order to avoid payment of high taxes. Other option is more radical. It refers to avoiding the payment of dividends, which would reduce the cost of capital and in the future would lead to an increase in the share prices of the company.

Agency theory. Agency theory deals with agency problems arise from the conflicts of interest between managers and shareholders because the incentives for managers are likely to differ from those of shareholders. Jensen and Meckling (1976), Easterbrook (1984) and Berezinets, Ilina and Alekseeva (2017) observe that an increase in dividends mitigates agency problems and leads to higher company value because managers have less free cash flows to invest in negative net present value projects. This forces managers to raise funds from the capital markets, which have better means of controlling managerial opportunism.

Dividend payouts can solve the vertical agency problem - between shareholders and managers, but can ignore the horizontal agency conflicts of interest between minority shareholders and controlling shareholders who can exert considerable influence on management's decision making (Shleifer and Vishny, 1997).

Last but not least, the dividend rejects the neoclassical view that managers are a homogeneous group given their opinion on dividend policy (Sarwar et al., 2019). According to this view, the ultimate owner of SOEs, the citizens, assume that an enterprise functions normally if it pays high and permanently-paid dividend (Kowerski, 2015).

Signaling theory. Market imperfections and related information asymmetry can be reduced by paying a dividend. Executive managers payout a dividend to signaling of shareholders, investors, staff and other stakeholders company's financial condition and its future plans

(Bhattacharya, 1979; Miller and Rock, 1995). The fundament of this theory are managers who have complete information about the company, take into account the expectations of shareholders and balance the taxation. In adopting this theory, other profit-sharing options such as share buybacks are eliminated due to lack of information signal.

Life cycle theory. Startups have greater financing needs that require them to reinvest their profits as internal sources of finance are cheaper than external ones. In contrast, companies in a mature stage already have stable earnings and can pay dividends (Grullon et al. 2003; DeAngelo et al. 2006).

This theory is closed to the theory for signal function of dividend, the difference being in providing information about the presence or absence of growth. The maturity effect is to some extent related to the "principal-agent" theory, as the agency problem manifests itself at the maturity stage and it is at this stage that it is recommended to solve the problem through the dividend policy (Kowerski, 2015).

Theory of the dividend payment preference (A bird in the hand is better than two in the bush). This theory follows J. Williams (1938) thought that the value of a share is determined only by the money that it brings. Gordon's (1961, 1962) argues that shareholders prefer a policy of high dividends to their investment in the future development of the company. They wish to receive a dividend today and not take risks to receive a capital gain from future investments. A number of studies demonstrate that this model fails if it is posited in a complete and perfect market with investors who behave according to notions of rational behavior (Miller and Modigliani, 1961; Bhattacharya, 1979). Nonetheless, the original reasoning of Gordon (1961) is still frequently cited.

All theories developed to explain the dividend puzzle refer to practices of private corporations. The dividend puzzle becomes even more complicated if the peculiarities of SOEs are taken into account.

By definition, a state-owned enterprise is created not only to maximize the profits of its shareholders, but also to fulfill social goals related to welfare, incl. reduction of unemployment, national security, provision of social services, development of technical and social infrastructure, uniform development of regions and others (Keremidchiev - Nedelchev 2020). Then why should SOEs pay dividends that are determined by bureaucrats and go to the state budget to finance unclear what programs, instead of remaining in SOEs and serving to support projects related to the social goals they fulfill?

In this way, two effects can be achieved. First, the influence of bureaucrats on the financial decisions of SOEs will be reduced, and secondly, the redistribution that takes place through the state budget, which simultaneously receives dividends and finances SOEs in various forms, will be reduced.

Another feature of SOEs that reflects on solving the dividend puzzle stems from the ownership of real property in SOEs. As a rule, the ultimate owner of state property is the sovereign. If so, then why are the dividends of SOEs not distributed among all citizens. In reality, however, citizens are mediated and extremely distant owners. They do not make a single important decision about the state enterprise, neither on its establishment, nor on the appointment of directors in it, nor on the distribution of its financial results, nor on its privatization or closure. All these functions have been handed over to government bureaucrats and Parliament. These institutions can, and most often do, have different priorities than the sovereign. Therefore, decisions on SOEs, incl. for the payment of dividends by them are driven by other motivations that arise from pursuing fiscal, political, populist and other objectives. In this case, the solution to the dividend puzzle for SOEs should answer the following questions: why should state enterprises pay dividends, to whom and under what conditions? Obviously, the dividend puzzle in SOEs is very different from that in private enterprises, and its solution derives from clarifying the nature of state ownership.

3. Dividend Policy in State-Owned Enterprises

In order to confront the theory with the practice, in the next two parts, the experience of the dividend policy of different countries is analyzed.

Dividend Policy in SOEs is aimed at achieving one or more of the following objectives:

- Guaranteeing adequate return on capital for the state as owner (Czech Republic and Hungary);
- Encouragement SOEs to follow higher rates of return and to invest in financially viable projects (Lithuania);
- Improving credit ratings and dividend levels that are consistent with private sector practices (Australia);
- Raising competition in the economy, increasing the transparency of liabilities of SOEs and reducing the risk of large-scale SOEs (China);
- Reducing equity and to achieve a higher rate of return on invested capital (Norway and Sweden) (World Bank, 2014).

The government, as the owner, has the ultimate right to impose the rate, terms and other conditions for the payment of dividends by SOEs. It is debatable whether the term `dividend policy` refers to this activity or rather it should be a `payment policy of dividend` (World Bank, 2009).

Under special conditions, such as economic shocks, the state may request an additional dividend. These cases became common after the global financial crisis in 2007-2008 and the turmoil connected to COVID-19. The Irish government imposes special dividends on the Electricity Supply Board and Bord Gáis Energy - both leading energy suppliers, of €585 million and €350 million respectively to implement the state policy for dealing with the effects of the crisis (Palcic and Reeves, 2017). A similar measure was taken by the Bulgarian government in connection with the need for fresh financial resources in the Covid-19 lockdown. It imposed 100 dividend payout rate of SOEs for the financial year 2021 (Table 2).

In most countries, the dividend is paid to the Ministry of Finance, regardless of which ministry acts as principal (Kuijs, Mako and Zhang, 2005). In some cases, special government funds have been set up to accumulate dividends and be used for structural reforms in the economy, to finance government agencies, projects and programmes. For example, in France a part of the dividends by SOEs is paid to a state pension fund, in the Czech Republic – to a special state-owned fund (National Property Fund of the Czech Republic – NPF), and in Austria – to the fund Österreichische Beteiligungs AG.

The privatisation proceeds are similar to dividends, as both revenues are in the portfolio of a competent authority for the budgeting process. Privatized entities pay a `*special dividend*` in the form of the sale proceeds from their assets at the request of the state-principal (World Bank, 2009).

The experiences of different countries are very diverse, but can still be represented by the policies undertaken for large non-financial state-owned enterprises (Palcic and Reeves, 2017). The main sources of information about the dividend payout are published financial statements, which are certified by an external auditor. Dividend policy has three forms of application: general guidelines defining the factors that must be taken into account when setting the dividend level; a specific percentage of net income; level of dividend required to maintain an optimal capital structure (OECD, 2018).

One of the main factor in formulating the dividend policy is the adopted ownership structure. In a decentralized ownership structure, the current needs and imbalances of state budget are partially compensated by dividend payouts. The centralized ownership structure is characterized by a high degree of predictability of financial results and risk mitigation, which makes it easier to implement dividend policy. An additional factor for the dividend policy are social and fiscal goals of SOEs.

The dividend decisions of SOEs differ in who makes the decision for them, what criteria are used to justify them and on what legal basis they are made (Table 1).

Table 1. Dividend decisions of SOEs

Country	Dividend decision is taken by		Criteria for dividend payout			Dividend payout is in accordance with		
	the board	**competent authority**	**Fiscal needs**	**financial state of SOE**	**life cycle of SOE**	**legal act**	**the statute of SOE**	**consultations between competent authority and board**
Bulgaria		√	√			√		
Canada	√			√				√
Czech Republic		√	√					√
Denmark	√				√			√
Estonia		√		√				√
Finland	√				√			√
Hungary		√	√					√
Ireland		√	√					√
Israel		√	√			√		
Italy		√	√	√				√
Latvia		√	√			√		
Lithuania	√			√			√	
Netherlands	√			√				√
Norway	√				√			√
Poland		√		√		√		
Slovenia		√	√			√		
Sweden	√				√	√		√
Switzerland		√		√		√		
In total	**8**	**11**	**8**	**7**	**4**	**7**	**1**	**11**

Source: adapted from Böwer, U. (2017) and Richmond et al. (2019).

In 11 of the 19 countries whose experience is summarized in Table 1 the dividend decision is taken by a competent authority that acts as the owner of the SOE. Such a practice exists in Czech Republic, Estonia, Hungary, Italy, Lavia, Poland, etc. In other countries such as Canada, Denmark, Finland, Sweden dividend decision is taken by board of SOE (Table 1).

Three criteria are most commonly used when making dividend payout decisions in SOEs:

- Fiscal needs. The state may request the payment of an *ad hoc* dividend for special purposes. This type of dividend policy has a smoothing effect on the state budget and some authors consider it to be the first form of dividend policy for SOEs (Gugler, 2003). The fiscal needs are the main factors for taking dividend decisions, which is common in most countries, e.g., Czech Republic, Hungary, Ireland, Slovenia, France, Germany, New Zealand, South Korea (Böwer, 2017; Richmond et al., 2019; World Bank, 2005).
- Financial state of the SOE. A dividend is paid each year depending on the company's financial state and the achievement of certain financial metrics. This is the case in

Canada, Lithuania, Poland, Switzerland, etc (Böwer, 2017; Richmond et al., 2019; Ter-Minassian, 2017).
- The life cycle of a SOE is a criterion that is taken into account mainly in the Nordic States - Denmark, Finland, Norway and Sweden (Böwer, 2017; Richmond et al., 2019).

In a dominant number of countries - 11 dividend payout is done after consultations between the competent authority and board. In seven countries such as Israel, Poland, Slovenia, etc. dividend payout is defined in a special legal act. Only in Lithuania dividend payout is set in the statute of SOE (Table 1).

4. Dividend Policy in Bulgarian SOES

In Eastern European countries, the role of SOEs is not well understood or consistently reported (International Monetary Fund, 2019). The amount of information generated plays a crucial role in the attitude towards SOEs, and in most cases the data from governments rarely exceed some basic indicators. For these countries, the degree of development of dividend policy in SOEs is considered as benchmark of the level of economic transition to a market economy (World Bank, 2005). These are the reasons to recommend to government of these countries to articulate explicitly the dividend policy of SOEs in order to reduce the undertaking of unjustified risks and avoid macroeconomic imbalances (World Bank, 2014).

In Bulgaria, the state owns or controls 259 enterprises in 2019. Out of them 211 enterprises are with 100% state ownership, and the remaining 48 companies have more than 50% state participation (Keremidchiev and Nedelchev, 2021). Most often the minority owner in them are the municipalities, as is the case with some hospitals and water and sewerage companies.

The legislation considers SOEs as legal entities functioning in the interest of citizens to achieve maximum value for society through the efficient allocation of resources. There are three rationales for the existence of SOEs:

- to eliminate market failures;
- to provide goods or services of strategic importance or those related to national security or development;
- to manage strategic ownership for the state.

The elaboration of dividend policy in Bulgarian SOEs are obligations of the government. The decisions of the Council of Ministers are in line with the preparation of the state budget and aims to provide conditions for the implementation of the revenue part of the state budget. Such an approach to the distribution of profits after the end of the financial year, mainly due to fiscal needs possess problems to the SOE strategic planning (Böwer, 2017). To avoid this problem one can recommend implementation of a structured dividend policy through broad guidelines or pre-defined payout (Böwer et al., 2016). It would enable investment and innovation activities in SOEs.

Traditionally, the Council of Ministers annually adopts three types of decisions related to dividend policy. The first one concerns what share of net profit to be paid as a dividend. At the beginning of the study period in 2016, dividends were defined as 60% of net profit. Thereafter, until 2021, this percentage was 50% with a few exceptions where the take of profits as dividends was 80 or even 100% (Table 2). In 2021, due to the need for fresh financial resources in the aftermath of the COVID-19 crisis, a 100% clawback of SOE profits in the form of dividends has been set, with exceptions made at a lower rate for a few specific enterprises.

Another governmental decision concerns SOEs being excluded from dividend payouts. In 2016, only state-owned hospitals were excluded from paying dividends. In the following year, water and sewerage companies joined this category. These groups of companies along with mental health centres are permanently excluded from paying dividends. The exclusion of these enterprises has a certain impact on the state budget given their profits: BGN 15 million of SOEs in the healthcare sector in 2018 and BGN 9 million for the water supply and sewerage sector in 2018. In some years, individual enterprises most often State Consolidation Company EAD, "National Industrial Zones Company" EAD, "Bulgarian Development" Bank AD are also excluded from paying dividends.

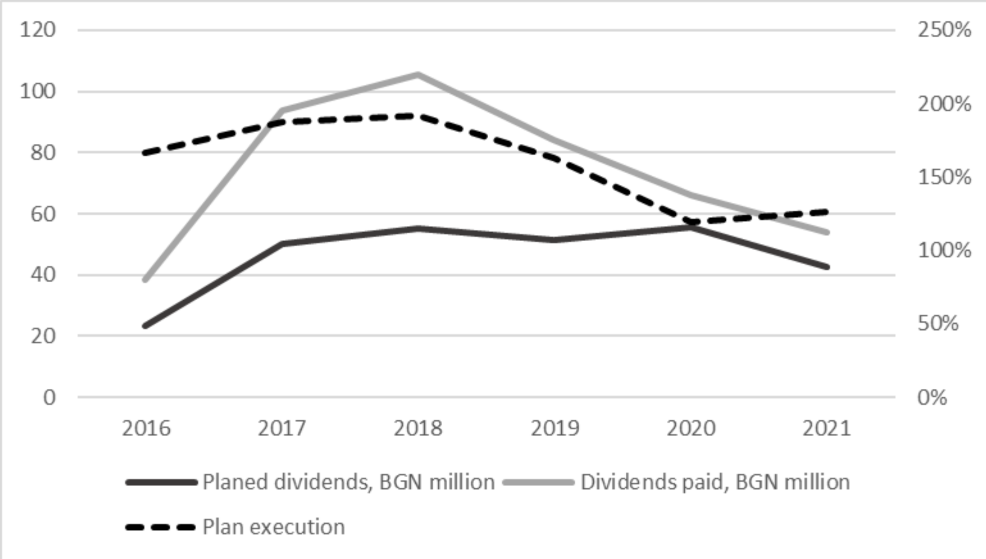
Table 2. Exemption of dividend payouts

Financial year	**Exempted SOEs**	**Regular dividend rate**	**Notes**
2014	Hospitals	60	
2015	Hospitals and companies in the water supply and sanitation sector	50	
2016	Hospitals and companies in the water supply and sanitation sector	50	
2017	Hospitals and companies in the water supply and sanitation sector	50	
2018	Hospitals and companies in the water supply and sanitation sector and State Consolidation Company EAD	50	Special dividend rate for "Bulgarian Development Bank" AD – 80%
2019	Hospitals and companies in the water supply and sanitation sector, State Consolidation Company EAD, "National Industrial Zones Company" EAD, "Bulgarian Development Bank" AD	50	Special dividend rate for State Enterprise "Air Traffic Control" - 100%
2020	Hospitals and companies in the water supply and sanitation sector, State Consolidation Company EAD, "National Industrial Zones Company" EAD, "Bulgarian Development Bank" AD	50	State Consolidation Company EAD, "National Industrial Zones Company" EAD, with the annulled decision as of August 2021.
2021	Hospitals, mental health centres and companies in the water supply and sanitation sector	100	Special dividend rate for: • 5 SOEs – 50% • "Information Service" AD - 70%

Source: Collected by the author from decisions of the Council of Ministers, 2015-2022.

None of the decisions of the Council of Ministers on the determination of dividends from SOEs present arguments. In the public domain, the explanation is that companies in the water supply and sanitation sector are exempted from paying dividends due to their obligation to co-finance the implementation of European Cohesion Fund projects in the water sector.

Figure 1. Dividend payouts of SOEs



Note: Planned and paid dividends are in per cent of the central government budget.

Source: Prepared by the author based on data from the state budget execution reports of Ministry of Finance.

The explanation for the exclusion of hospital care facilities is that they are extremely dependent on a limited number of funding sources and taking into account their specificity (Table 2). This rationale is flawed because it is not the number of funding sources that is important, but the volume of that funding. According to the National Statistical Institute (NSI), current expenditure on hospitals from various sources has increased by 93% - from BGN 2.106 million in 2011 to BGN 4.071 million in 2020 (NSI, 2023). With regard to the number of funding sources, after the country's accession to the EU in 2007, hospitals have the opportunity to finance special projects from European structural funds.

Dividends from SOEs are important for the central state budget as their share of non-tax revenues varies between 16 and 52% in 2016-2021. For this period, the absolute amount of dividends paid by SOEs ranges between BGN 39 million in 2020 and BGN 106 million in 2018 (Figure 1).

A specific feature of SOE dividend planning is that they are understated throughout the period. Actual amounts of dividends paid are on average nearly 60% more than planned for the period.

6. Conclusion

The dividend puzzle is an economic concept that reflects problems of private enterprises. This article confronts this concept to theories and practices of SOEs. Five of the six theories analysed are not relevant to the SOE dividend puzzle.

The dividend irrelevance theory is not relevant because the state doesn`t pay taxes over the dividends. Dividends are determined entirely by the principal and behaviour of investors to hold or sell their shares is not taken into account.

The clientelism theoryis not applicable due to the fact that the state is the sole or dominant owner of SOEs and the tax characteristics of investors are not taken into account.

The agency theory is nor relevant as the dividends are determined entirely by the principal and unrestricted financial resources are lacking or very limited.

The signalling theory also does not help solving the dividend puzzle of SOEs as managers do not influence dividend decisions. Signals are received at the principal through the reporting information, controllers, auditors and other control bodies. Dividends are determined entirely by the principal. Unrestricted financial resources are lacking or very limited.

Only the theory of dividend payment preference is relevant and provides a partial explanation of the dividend puzzle in SOEs as dividends are determined mainly for fiscal reasons and financing of SOEs future projects is done mainly in other ways, but not through dividends.

Through the sovereign fund system, it finances the creation of a state-owned enterprise and then decides what portion of the dividend to seize from its profits, regardless of what social goals the enterprise pursues. This puts the fiscal before the social goals of the enterprise. On the other hand, the severe winterization of the residual profit limits the future investments of the enterprise and makes it dependent on new state injections. This is the vicious circle of the dividend puzzle in SOEs that has not yet been solved and deserves to be discussed in future research.

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