

Disciplined Managers, Rewarded Firms: Agency Costs and Dividend Taxation

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Abstract We examine the stock market reaction to the approval of dividend taxation in Brazil and its relationship with firms' payout policies. We document that firms increase dividend payments before the implementation of taxation, consistent with an intertemporal shifting mechanism. The approval of dividend taxation generates a positive and statistically significant stock market reaction. We show that this effect is heterogeneous across firms and is significantly stronger among those with higher payout policies. Using a two-sample instrumental variables approach, we provide evidence of a causal effect of payout on stock market reactions. Our results are consistent with an agency-based interpretation: higher payouts reduce free cash flow and mitigate agency costs, leading to more favorable market reactions. Overall, our findings highlight that the effects of dividend taxation depend not only on tax rates but also on firms' ability to adjust payout decisions intertemporally, with important implications for corporate governance and firm value.

Keywords: Dividend, tax reform, agency theory, payout.

JEL codes: G14, G18, G32, G35

1. Introduction

Dividend taxation plays a central role in corporate finance by shaping firms' payout policies and, ultimately, firm value. Several studies show that taxes are an important determinant of how firms distribute cash to shareholders, with evidence indicating that reductions in dividend taxation lead to significant increases in firms' payout (Jacob & Michaely, 2017, p. 3176). These findings suggest that firms respond strongly and rapidly to changes in tax incentives, adjusting their payout policies

to maximize after-tax shareholder value. In other words, companies adjust their payout policies to meet shareholders' preferences regarding profit distributions. When dividend taxes are low, investors would prefer to receive dividends. However, payout policies may also depend on the timing of tax changes and firms' ability to adjust distributions intertemporally. Buchanan et al. (2017), for example, show evidence that firms increase their dividends when they expect a tax increase.

In this paper, we analyze the approval of dividend taxation in Brazil in October 2025, which represents a structural shift in a setting where firms have historically distributed earnings through both cash dividends and interest on equity, each with distinct tax treatments (Boulton et al., 2012). While interest on equity was already taxed, the reform also introduced a tax on cash dividends, effective starting in 2026, creating strong incentives for firms to adjust their payout behavior prior to its implementation. In contrast to prior studies that focus on tax cuts (Brown et al., 2007; Jacob & Michaely, 2017), we examine a setting in which dividend taxation increases, but is anticipated in advance. This feature allows us to identify not only the level effect of taxation, but also its intertemporal dimension.

Our first key result is that anticipated tax increases can lead to higher payouts before they are implemented. We document a significant increase in dividend payments in 2025, consistent with firms accelerating distributions to avoid the higher tax burden that would apply in 2026. This finding is not inconsistent with the existing literature; rather, it reflects an intertemporal response to taxation. While tax cuts increase payouts by making distributions more attractive in the present, anticipated tax increases induce firms to shift payouts forward. Therefore, both tax cuts and expected tax increases can lead to higher payouts, albeit through distinct mechanisms—contemporaneous incentives in the former and intertemporal shifting in the latter. This result

highlights that the effect of dividend taxation on payout is not monotonic in the tax rate but depends critically on expectations about future taxation.

While taxation provides first-order incentives for payout decisions, its effects are shaped by agency problems within the firm (Jacob & Michaely, 2017). In the absence of frictions, dividend taxation would have a large impact on payout policy. However, conflicts between managers and shareholders, as well as among shareholders, can attenuate this response, generating a “muting effect” (Jacob & Michaely, 2017, p. 3176) in the relationship between taxes and dividends. That is, when firms lack strong governance mechanisms to protect shareholders from managerial discretion, the potential positive stock market returns resulting from tax decreases may not be as robust as they should be. These frictions arise because managers may prefer to retain earnings to pursue private benefits or inefficient investments. As a result, the observed response of dividends to taxation depends on the extent of agency conflicts and ownership structure.

The role of payout policy as a governance mechanism is central to our analysis. According to the free cash flow theory (Jensen, 1986), managers have incentives to retain excess cash and invest in projects with negative net present value, particularly when firms generate substantial internal resources and lucrative projects are scarce. Distributing cash to shareholders reduces the resources under managerial discretion and increases external monitoring, thereby mitigating agency costs. In this framework, dividends are not merely a transfer of resources from firms to shareholders but also a mechanism that disciplines managerial behavior. Consequently, tax-induced changes in payout—especially those driven by intertemporal shifting—can have important implications for firm value by altering the amount of free cash flow available within the firm. We argue that an increase in dividend taxation can raise the expected dividend payoff, leading to a strong positive stock market reaction, especially for firms with strong governance incentives.

In addition to agency considerations, payout policy is shaped by firm characteristics and life-cycle dynamics. Firms with higher profitability, lower growth opportunities, and a greater accumulation of retained earnings are more likely to distribute cash to shareholders, reflecting their transition to a more mature stage of the corporate life cycle (Deangelo et al., 2006). Moreover, the evolution of payout mechanisms suggests that firms actively adjust not only the level but also the form of distributions, as stock repurchases increasingly substitute for dividends in response to changing economic and institutional conditions (Skinner, 2008). These factors imply that the response to dividend taxation is likely to be heterogeneous across firms, depending on their payout policies, governance structures, investment opportunities, and other internal characteristics.

Building on these insights, we develop a simple mechanism linking dividend taxation, intertemporal payout decisions, and stock market reactions. The anticipation of dividend taxation induces firms to distribute cash earlier, leading to a temporary increase in payouts and a corresponding reduction in free cash flow. This reduction mitigates agency problems by limiting managerial discretion and reducing the likelihood of inefficient investment. As a result, firms that engage more aggressively in pre-tax distributions experience a greater improvement in expected future cash flows, which is reflected in stock prices. From this perspective, the valuation effects of dividend taxation depend not only on the tax burden itself, but also on how firms adjust their payout policies in response to the reform.

Our primary hypothesis is that firms with higher payout policies tend to have more favorable stock market reactions to the approval of dividend taxation, as they are generally perceived to have better governance. We test this hypothesis using an event study centered on the Brazilian Chamber of Deputies' approval of the reform. Our empirical results provide strong support for this prediction. First, we document a positive and statistically significant market reaction to the

approval of dividend taxation, consistent with the view that investors perceive the reform as value-enhancing in the short run. Second, we show that this reaction is significantly stronger for firms with higher pre-event payout ratios, indicating that the benefits of tax-induced distributions are concentrated among firms that are more likely to reduce free cash flow. Third, additional analyses suggest that these effects are more pronounced in settings where agency problems are likely to be more severe, reinforcing the importance of governance in explaining market responses to taxation.

This paper contributes to the literature in several ways. First, we provide new evidence on the effects of dividend taxation in an emerging market, complementing prior studies that focus primarily on tax reductions in developed economies. Second, we highlight the importance of intertemporal shifting as a key mechanism through which taxation affects payout policy, showing that anticipated tax increases can lead to higher payouts prior to implementation. Third, we connect taxation to corporate governance by demonstrating that tax-induced changes in payout can mitigate agency costs and affect firm value. Overall, our findings suggest that the consequences of dividend taxation extend beyond mechanical changes in payout, influencing both managerial behavior and market valuation.

2. Methods

2.1. Data, sample, and variables

The data used in our study were collected from Capital IQ. Our initial sample comprises publicly traded firms from Brazil from 2007 to 2025, except financial firms (SIC codes 6000-6999), utilities (SIC codes 4900-4999), nonprofit and government (SIC codes 8000), Executive, Legislative & Government (SIC codes 9100-9199) and nonclassifiable establishments (SIC codes equal to or greater than 9900). We also excluded companies with zero or negative equity. We have an initial

sample size of 2,773 firm-years; however, this may be smaller in some analyses due to missing data.

Our main dependent variable is Cumulative Abnormal Returns (CARs), which we describe in the following section.

2.2. Empirical strategy

2.2.1. *Event study*

The first step in our empirical strategy is to conduct an event study to analyze the stock market's reaction to the Chamber of Deputies' approval of dividend taxation. This approval marks the initial stage of the legislative process for a federal bill in Brazil, followed by a vote in the Federal Senate. Once both houses approve the bill, it is signed by the President of the Republic.

Some might argue that the Chamber of Deputies' approval of dividend taxation should not be unexpected, as a change of this magnitude would typically entail extensive discussion beforehand. In this case, the stock markets would likely have already priced in the information regarding dividend taxation. However, the debate over dividend taxation in Brazil has long been marked by significant political uncertainty. The reform of the income tax system had long been on the government's agenda. However, until late 2024, market expectations were mainly focused on the implementation of the Value-Added Tax (VAT) and the regulation of consumption tax reform. The government's sudden shift in priority toward dividend taxation—intended to meet budgetary targets for 2025—was an unexpected development. This unanticipated change is essential to our identification strategy, as it ensures that the Cumulative Abnormal Returns (CAR) calculated around the event date accurately reflect the marginal impact of the new tax burden, rather than a delayed response to previously leaked information.

Our event date, $t = 0$, is October 30, 2025, the day on which the Chamber of Deputies approved dividend taxation. Our event window spans four trading days before and after the event. We use the 180 business days before the event day as our estimation window, which is the period to estimate the so-called normal return by running the market model (MacKinlay, 1997; McWilliams & Siegel, 1997), as Eq. (1) shows:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}, \quad (1)$$

where R_{it} is the rate of return on the share price of firm i on day t , R_{mt} is the rate of return on a market portfolio, α_i is the intercept, β_i is the systematic risk of stock i , and ε_{it} is the error term. We use the MSCI All Country World Index (MSCI ACWI) as our market portfolio because it is more diversified than the local Ibovespa index. This helps avoid potential biases due to the excessive concentration of the Ibovespa in certain stocks.

Using the estimates of normal returns derived from Eq. (1), $\hat{\alpha}_i$ and $\hat{\beta}_i$, we calculate the daily abnormal returns (AR) for each firm i using the following Eq. (2):

$$AR_{i\tau} = R_{i\tau} - \hat{\alpha}_i - \hat{\beta}_i R_{m\tau}, \quad (2)$$

where the subscript τ denotes the event window specific date, with $\tau = -4, \dots, +4$.

After the calculation of each firm's AR, abnormal returns are aggregated according to the following Eq. (3), resulting in the so-called Cumulative Abnormal Return (CAR):

$$CAR_i = \sum_{\tau=-4}^{+4} AR_{i\tau} \quad (3)$$

The variable CAR is then used as our main variable of interest in the subsequent analysis of its relationship with the firm's payout policy.

2.2.2. Two-model identification strategy

We study the causal effect of payout policies on stock market reactions, measured by cumulative abnormal returns (CAR), using a two-sample instrumental variables (TSIV) approach (Angrist & Krueger, 1992). This design is appropriate in our setting because payout is not observed jointly with CAR in the same sample. In our first sample, we have a panel data from 2007 to 2024 from which we estimate the effect of payout determinants. In turn, the second sample is a cross-sectional dataset that includes firms' CARs calculated from the event study.

In the first stage, we estimate the relationship between *payout* and a set of instrumental variables, as Eq. (4) shows:

$$payout_{i,t} = \mathbf{Z}'_{i,t-1}\pi + \mathbf{D}'_t\lambda + \alpha_i + u_{i,t}, \quad (4)$$

where $\mathbf{Z}'_{i,t-1}$ is a vector of lagged instrumental variables that finance literature indicates as drivers of payout (e.g., Deangelo et al., 2006; Denis & Osobov, 2008; Fama & French, 2001; Skinner, 2008) and \mathbf{D}'_t is a vector of time fixed effects (i.e., year dummies). The coefficient vector π captures the effect of the instruments on *payout* and λ the effects of year dummies. The *payout* determinants are *Retained Earnings*, *Cash holding*, *Gross Cash Flow*, *Tobin's Q*, *Book leverage*, *Capex*, and *Size*. The first six determinants are divided by total assets, while the variable *Size* represents the natural logarithm of revenues. All variables, except *Size*, are winsorized at the 1st and 99th percentiles to mitigate the influence of potential outliers.

Our main interest is to gauge the causal effect of payout on CAR in 2025. Conceptually, the structural equation can be written as Eq. (5) shows:

$$CAR_i = \beta \widehat{payout}_i + \varepsilon_i, \quad (5)$$

where $\widehat{payout}_i = \mathbf{Z}'_i \hat{\pi}$ denotes the predicted *payout* based on the first-stage estimates. Because *payout* is not observed in the second sample, we estimate instead the reduced-form relationship between the instruments and CAR, as Eq. (6) shows:

$$CAR_i = \mathbf{Z}'_i \gamma + \varepsilon_i, \quad (6)$$

Under standard IV assumptions, the reduced-form and first-stage coefficients are linked by:

$$\gamma = \beta \pi \quad (7)$$

Our identification strategy requires that the instruments be relevant and satisfy the exclusion restriction. The relevance condition requires that the instruments be correlated with *payouts*, a requirement supported by the finance literature and confirmed by the statistical significance of several instruments in the first stage. The exclusion restriction requires that the instruments affect stock market reactions (i.e., *CAR*) only through their impact on *payout* policies. First, from a chronological perspective, it is unlikely that the determinants of 2024 *payouts* are related to the dividend taxation event in October 2025. The 2024 dividend was already paid by the event date. Second, although one may argue that dividend taxation was somewhat expected before the event date and was already priced, it was still surrounded by significant political uncertainty, as we mentioned in the previous section. As the event study shows, the *CAR* was positive and statistically significant on the event date, indicating that the Brazilian tax dividend can be considered exogenous. Therefore, in our setting, any impact on *CAR* is expected to occur only through changes in *payout* decisions.

3. Results

We begin by examining the historical behavior of payout ratios in our sample. Table 1 reports the evolution of payout from 2007 to 2025. The 2025 numbers are still preliminary, since only slightly more than half of the companies have published their financial results as of this version of the manuscript. The average payout across the full sample is 41.5%, but the time-series variation is substantial, with notable increases in recent years. In particular, payout rises sharply in 2022 (62.6%) and 2023 (51.4%), peaks in 2024 (76.9%), and remains elevated in 2025 (66.7%). In the first analysis, the decrease in the mean payout in 2025 does not confirm our expectation. However, since the mean is higher than the median values in all years, we can conclude that the mean is driven by some outliers paying high payouts. The median payout, in turn, increases in 2025 to 38.8%, more than doubling relative to its long-run average (14.2%).

Table 1
Payout history

Year	Mean	Standard deviation	Median	N
2007	42.3%	102.5%	23.7%	113
2008	27.6%	57.2%	14.0%	119
2009	45.4%	102.9%	14.4%	126
2010	28.9%	43.4%	18.9%	132
2011	49.9%	135.0%	22.1%	133
2012	28.9%	58.1%	11.4%	143
2013	44.1%	107.1%	19.4%	147
2014	36.3%	91.7%	20.1%	147
2015	62.8%	165.8%	15.1%	147
2016	28.7%	100.1%	0.0%	149
2017	29.0%	52.5%	4.0%	159
2018	35.0%	75.5%	17.3%	161
2019	28.5%	49.9%	14.3%	162
2020	22.4%	61.9%	4.8%	166
2021	25.8%	35.0%	14.7%	167
2022	62.6%	162.2%	10.7%	169
2023	51.4%	140.2%	8.5%	171
2024	76.9%	182.7%	15.8%	169
2025	66.7%	133.1%	38.8%	93
Total	41.5%	108.6%	14.2%	2773

This pattern we see in the median payouts provides preliminary evidence consistent with the intertemporal shifting mechanism discussed in the introduction. As firms anticipate the introduction of dividend taxation in 2026, they accelerate distributions in the preceding year (2025). This behavior aligns with the notion that firms adjust payout timing in response to expected tax changes, rather than only to contemporaneous tax rates. In this sense, our descriptive evidence complements prior findings (e.g., Buchanan et al., 2017) that payout responds to tax incentives, but highlights that such responses can occur through timing adjustments when tax increases are anticipated.

Figure 1 and Table 2 present the results of the event study analyzing the stock market reaction to the approval of dividend taxation. The event in question is the Chamber of Deputies' approval of dividend taxation, which occurred on October 30, 2025. Table 2 reports the daily abnormal returns (AR) and cumulative abnormal returns (CAR) over the event window. Our event study results show a positive and statistically significant market reaction just after the event date. Before the event, the average AR and CAR are not statistically different from zero, suggesting the stock market had not yet priced in the dividend tax approval. On the event day ($t = 0$), the average abnormal return is 1.21% ($p < 0.001$), and the cumulative abnormal return reaches 2.09% ($p < 0.001$). The positive reaction persists in subsequent days, with CAR increasing to 3.96% by day +4 ($p < 0.001$). These results are visually reinforced in Figure 1, which shows a clear upward trajectory in CAR around the event window.

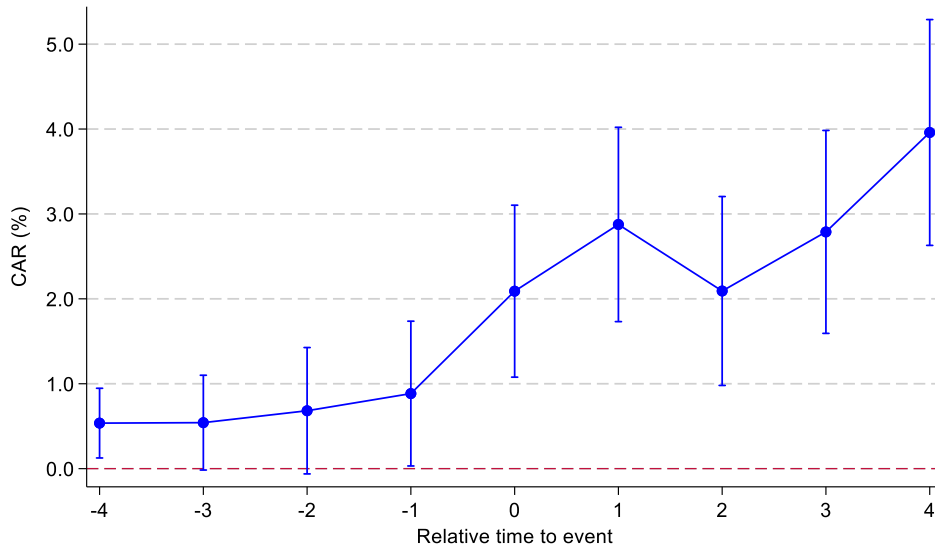


Figure 1: Cumulative Abnormal Returns (CAR)

The positive market reaction to an increase in dividend taxation is consistent with the mechanism proposed in the introduction section. The anticipation of taxation induces firms to distribute cash earlier, reducing free cash flow and, consequently, agency costs. According to the free cash flow theory (Jensen, 1986), lower internal cash availability limits managers' ability to invest in negative net present value projects, improving expected firm performance. Therefore, the market interprets the reform as value-enhancing in the short run, particularly through its governance implications.

Table 2
Average abnormal returns (AR) and cumulative abnormal returns (CAR)

Event day	AR	CAR
-4	0.54% *	0.54% *
-3	0.01%	0.54%
-2	0.14%	0.68%
-1	0.20%	0.88% *
0	1.21% ***	2.09% ***
1	0.79% ***	2.88% ***
2	-0.78% ***	2.09% ***
3	0.70% ***	2.79% ***
4	1.17% ***	3.96% ***

Note: *** p < 0.001, ** p < 0.01, * p < 0.05.

To further investigate heterogeneity in market reactions, Table 3 compares firm characteristics between groups with positive and negative CARs. Firms with positive CARs exhibit significantly higher payout ratios (median 17.0%) than firms with negative CARs (9.0%), with the difference statistically significant at the 1% level. This result provides preliminary support for our main hypothesis that firms with higher payout policies experience more favorable market reactions. It is consistent with the idea that higher payout firms are more likely to engage in pre-tax distributions, leading to a greater reduction in free cash flow and stronger mitigation of agency problems.

Table 3
Median values of variables grouped by positive and negative cumulative abnormal returns (CAR)

Variables	Positive CAR		Negative CAR		Wilcoxon test p-value
	N	Median	N	Median	
<i>CAR</i>	145	4.4%	52	-2.9%	0.000
<i>Payout</i>	2027	17.0%	701	9.0%	0.000
<i>Retained earnings</i>	2028	8.1%	702	5.8%	0.006
<i>Cash holding</i>	2028	12.6%	702	11.3%	0.027
<i>Gross cash flow</i>	2028	7.6%	702	6.7%	0.001
<i>Tobin's Q</i>	2028	0.94	702	0.82	0.000
<i>Book leverage</i>	2028	46.5%	702	41.1%	0.000
<i>Capex</i>	2028	3.2%	702	2.9%	0.365
<i>Size</i>	2022	22.44	695	21.62	0.000

In addition, firms with positive CARs present higher retained earnings, cash holdings, and gross cash flow. These characteristics are indicative of more mature firms with greater internal resources, consistent with the life-cycle theory of dividends (Deangelo et al., 2006). Such firms are more likely to distribute cash and, therefore, to benefit from the intertemporal shifting mechanism. The higher leverage and size among positive CAR firms are also suggestive that more mature firms benefit from higher stock returns. Interestingly, firms with higher leverage also exhibit more positive CARs, which may reflect the disciplining role of debt as a substitute for payout in reducing agency costs. In contrast, capital expenditures (Capex) do not differ

significantly across groups, suggesting that investment intensity is not a primary driver of cross-sectional variation in market reactions in this setting. Finally, Tobin's Q is higher among firms with positive CARs. This result is somewhat counterintuitive, as we expect firms with higher growth opportunities to experience negative returns following an event that induces dividend payments.

While our identification strategy assumes that the determinants of payout are solely related to CAR through a firm's payout, we also examine the direct relationship between CAR and the firm's payout determinants. We do this by running quantile regressions of CAR against the firm payout and its determinants. Table 4 presents the results of these regressions examining the relationship between firm characteristics and CAR across different points of the CAR distribution. Overall, the results indicate that the effect of firm fundamentals on market reactions is heterogeneous across quantiles.

Table 4
Quantile regression

Independent variables	Dependent variable: Cumulative Abnormal Return (CAR)		
	[1] Quantile: 0.25	[2] Quantile: 0.5	[3] Quantile: 0.75
<i>Payout (t-1)</i>	0.001 (0.004)	0.003 (0.004)	0.000 (0.006)
<i>Retained earnings (t-1)</i>	0.033 (0.021)	0.022 (0.018)	0.046 (0.029)
<i>Cash holding (t-1)</i>	0.064** (0.028)	0.064** (0.025)	0.075* (0.040)
<i>Gross cash flow (t-1)</i>	-0.091** (0.039)	-0.049 (0.034)	-0.035 (0.055)
<i>Tobin's Q (t-1)</i>	-0.003 (0.016)	-0.014 (0.014)	-0.013 (0.022)
<i>Book leverage (t-1)</i>	0.007 (0.030)	0.028 (0.026)	-0.018 (0.042)
<i>Capex (t-1)</i>	-0.030 (0.147)	-0.112 (0.129)	0.382* (0.205)
<i>Size (t-1)</i>	0.001 (0.004)	0.001 (0.004)	0.000 (0.006)
<i>Constant</i>	0.002 (0.124)	0.001 (0.109)	0.058 (0.173)
Observations	161	161	161
Pseudo R ²	0.283	0.245	0.317
Industry fixed effects	Yes	Yes	Yes

Note: Robust standard errors in parentheses. *** p < 0.01, ** p < 0.05, * p < 0.1. t-1 represents one-year lag.

Cash holdings is the only variable that is consistent across the quantiles. It has a positive and statistically significant effect on CAR across all quantiles, with coefficients of 0.064 ($p < 0.05$) at the 25th and 50th percentiles and 0.075 ($p < 0.10$) at the 75th percentile. This finding suggests that firms with greater liquidity experience stronger positive reactions, consistent with the idea that such firms have more flexibility to engage in pre-tax distributions, thereby reducing free cash flow and agency costs.

Gross cash flow has a negative and significant effect at the lower quantile (-0.091 , $p < 0.05$), indicating that firms with higher operating cash flows may experience weaker reactions when CARs are relatively low. One possible interpretation is that, in firms with abundant internal resources, agency problems are more severe, and the disciplining effect of anticipated payouts may be less pronounced.

Importantly, the coefficient on *payout* is not statistically significant across quantiles. This lack of significance in the direct specification contrasts with the strong univariate evidence in Table 3 and suggests potential endogeneity in the payout-CAR relationship. This motivates the use of the instrumental variables strategy in the next subsection.

Table 5 reports the results from the two-sample instrumental variables (TSIV) approach (Angrist & Krueger, 1992), which addresses potential endogeneity between payout and market reactions. In the first stage (column 1), several variables commonly identified in the literature as determinants of payout are statistically significant. Retained earnings, gross cash flow, leverage, Capex, and firm size all exhibit significant relationships with payout, confirming the instruments' relevance. These results are consistent with the life-cycle and firm characteristics literature (DeAngelo et al., 2006; Skinner, 2008), supporting the validity of the first-stage specification.

Table 5
Two-sample instrumental variables

Independent variables	First stage	Second stage			
	[1] FE Payout	[2] OLS CAR	[3] LPM Positive CAR	[4] Logit Positive CAR	[5] Probit Positive CAR
<i>Payout (t-1)</i>		0.035 (0.027)	0.295* (0.148)	1.584** (0.775)	0.928** (0.468)
<i>Retained earnings (t-1)</i>	0.167** (0.078)				
<i>Cash holding (t-1)</i>	0.225 (0.193)				
<i>Gross cash flow (t-1)</i>	0.838*** (0.288)				
<i>Tobin's Q (t-1)</i>	-0.021 (0.047)				
<i>Book leverage (t-1)</i>	-0.281** (0.112)				
<i>Capex (t-1)</i>	-1.235* (0.665)				
<i>Size (t-1)</i>	0.069*** (0.026)				
<i>Constant</i>		0.015 (0.022)	0.520*** (0.134)	-0.103 (0.643)	-0.035 (0.397)
Observations	2435	162	162	162	162
R2 / Pseudo R ²	0.043	0.008	0.025	0.022	0.022
Firm fixed effects	Yes	No	No	No	No
Year fixed effects	Yes	No	No	No	No

Notes: The first stage is run with fixed effects (FE). The second stage is run under four specifications: In column 2, the dependent variable is CAR, estimated by ordinary least squares (OLS). In columns 3, 4, and 5, the dependent variable is a dummy variable that equals 1 if the CAR is positive and 0 otherwise, and the models are estimated using Linear Probability Model (LPM), logit, and probit, respectively. Robust standard errors in parentheses in column 1. Standard errors clustered at the industry level (two-digit SIC code) in parentheses in columns 2 through 5. * p<0.10, ** p<0.05, ***p<0.01

In the second stage, we find strong evidence that payout has a positive and statistically significant effect on market reactions. In the OLS specification (column 2), we do not find statistical significance when the dependent variable is the metric measure of CAR. However, when the dependent variable is the dummy *Positive CAR*, payout is positive and significant (0.295, p < 0.10) in the Linear Probability Model (LPM), Logit (1.584, p < 0.05), and Probit (0.928, p < 0.05).

These results provide robust support for our main hypothesis. Firms with higher predicted payout policies are more likely to experience positive stock market reactions to the approval of dividend taxation. This finding is consistent with the agency-based mechanism proposed in the introduction: higher payout firms reduce free cash flow more aggressively in response to anticipated taxation, leading to stronger governance improvements and higher firm value.

Taken together, the results provide a coherent picture that aligns with our theoretical framework. First, we document evidence of intertemporal shifting, with elevated payout levels prior to the implementation of dividend taxation (Table 1). Second, we show that the market reaction to the tax reform is positive and significant (Table 2 and Figure 1), consistent with short-term value gains from reduced agency costs. Third, we demonstrate that this reaction is heterogeneous and stronger among firms with higher payout policies (Table 3). Finally, using an instrumental variables approach, we establish a causal link between payout and market reactions (Table 5). Overall, these findings support the view that dividend taxation affects not only payout levels but also firm value through its interaction with agency problems and intertemporal payout decisions.

4. Conclusion

This paper examines the stock market reaction to the approval of dividend taxation in Brazil and its relationship with firms' payout policies. Leveraging a setting in which taxation was introduced with a lag, we provide evidence on how expected tax changes affect payout timing and firm value. We document three main findings. First, firms increase dividend payments prior to the implementation of taxation, consistent with an intertemporal shifting mechanism. This result shows that firms respond not only to current tax rates but also to expected future changes. Second, the approval of dividend taxation generates a positive and statistically significant stock market reaction, suggesting that investors perceive short-term benefits from the reform. Third, this reaction is stronger among firms with higher payout policies, indicating that the valuation effects of taxation are closely linked to firms' propensity to distribute cash.

Taken together, our results suggest that the effects of dividend taxation on firms extend beyond mechanical changes in payout levels. By inducing firms to adjust the timing of distributions, taxation can influence the allocation of free cash flow within firms, with important implications for corporate governance and firm value. In particular, anticipated tax increases may generate short-term governance benefits by prompting firms to decrease cash, thereby limiting managerial discretion.

This paper contributes to the literature in several ways. First, we provide new evidence on the effects of dividend taxation in an emerging market, complementing prior studies that focus primarily on tax reductions in developed economies. Second, we highlight the importance of intertemporal shifting as a key mechanism through which taxation affects payout policy. Third, we show that taxation can indirectly affect firm value through its interaction with agency problems, reinforcing the role of payout policy as a governance tool.

Our findings also have important policy implications. While dividend taxation is often evaluated based on its impact on tax revenues and long-term investment incentives, our results suggest that its short-term effects may include improvements in corporate governance and market valuation. However, these benefits may not persist in the long run, as higher taxation could discourage future payouts and increase retained earnings, potentially exacerbating agency problems over time.

Future research could explore the long-term consequences of dividend taxation on investment efficiency, payout composition, and firm value. In addition, further work could investigate how the interaction between taxation and corporate governance varies across institutional environments and ownership structures.

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