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Tax incentives and the demand for life insurance: evidence from Italy

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Abstract

The theoretical literature suggests that taxation can have a large impact on household portfolio selection and allocation. In this paper we analyze the tax treatment of life insurance, considering the cancellation of tax incentives in Italian life insurance contracts for investors with high marginal tax rates and the introduction of incentives for those with low rates. Using repeated cross-sectional data from 1989 to 1998, we find that the tax reforms had no effect on the decision to invest in life insurance or the amount invested. The likely explanations are the lack of information and lack of commitment to long-term investment.

Keywords: Tax incentives; Portfolio choice

JEL classification: D91; H20

1. Introduction

The theoretical literature suggests that taxation has a potentially large impact on household portfolio selection and allocation. The theory has two central insights: that what matters for investors is the after-tax return on each asset, and that the differing fiscal treatment of the various assets creates wedges in the structure of

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those returns. In this paper we bring fresh evidence to this literature by studying the portfolio effect of changes in the tax treatment of life insurance, using repeated cross-sectional data. The change that we consider is the cancellation of tax incentives in Italian life insurance contracts for investors with high marginal tax rates and the introduction of incentives for those with low marginal tax rates. Our sample, a decade of microeconomic data on household assets, income and demographic variables, provides a truly unique setting for spotlighting the effect of taxes on household portfolio selection and allocation.

A study of this kind raises crucial identification issues. Theory predicts that portfolio choice is affected by household resources and by after-tax interest yields. However, as the after-tax yield on some assets depends on the taxpayer's marginal income tax rate, which is inherently correlated with the level of income, it is difficult to disentangle genuine variation in after-tax interest rates, for given income, from genuine variations in income, for given after-tax interest yields. For some assets this is actually impossible, because at any point in time all investors face the same rate of return.

Despite the identification problems, some empirical studies do document the existence of a link between marginal tax rates and portfolio choice. In general, applied work in this area has estimated the tax rate elasticity of participation in tax-sheltered assets and their portfolio shares controlling for household income, wealth and other demographic variables. The most recent study is Poterba and Samwick (1999), who build on the seminal contributions of Feldstein (1976) and King and Leape (1998). Poterba and Samwick impute marginal tax rates in the Survey of Consumer Finances and estimate probit models for eight broad asset categories. Their results support the view that taxes affect asset selection. Controlling for income and wealth, they find that the probability of individuals' investing in tax-deferred accounts, equity and bonds is a positive function of the marginal tax rate. To the best of our knowledge, outside the United States the evidence on the role of taxes in shaping household portfolios is limited to the Netherlands (Alessie et al., 1997), Sweden (Agell and Edlin, 1991) and the United Kingdom (Banks and Tanner, 2001). Poterba (2001) reviews these empirical studies and concludes that investors take the tax treatment into account when selecting their asset menu. In all countries the evidence of a link between taxes and portfolio shares is weaker than for asset selection.

Identifying the tax effects on portfolio choice is hard in the Italian case as well. Pre-interest income on bank deposits, government bonds, corporate bonds and mutual funds is subject to a flat rate withholding tax in settlement of the tax liability, so the after-tax yields on these assets are identical for all investors. The return on stocks, on the other hand, depends on the marginal tax rate and therefore does display cross-sectional variability. In order to identify the effect of taxes on portfolio choice, however, one needs not only cross-sectional variability in returns but also genuine variation in after-tax yields that is not perfectly correlated with the general income tax rate.