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# Investor home bias and sentiment about the country benefiting from the tax revenue

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ABSTRACT

This paper provides a novel tax behavior explanation for investor home bias. Specifically, we show that investors are reluctant to hold foreign equity with a tax levied by a foreign tax collector. Starting point is the observation that willingness to pay taxes depends on the attributes of the tax collecting country. This relationship indicates a form of country-specific tax behavior: taxpayers respond to country attributes as they indicate cooperative and trustworthy behavior of tax authorities, the government or other taxpayers. We conduct a laboratory investment experiment to explore the effect of sentiment towards different tax collectors, specifically of the view on home country taxation relative to foreign country taxation. The results suggest that investors prefer domestic equity and invest in riskier portfolios in case of a foreign tax rather than a domestic tax on foreign dividend income.

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## 1. Introduction

Are self-interested taxpayers indifferent between an obligatory income tax paid to the treasury of their home country and an equivalent tax paid to any other collector? Indifference is consistent with an ideal separation of tax collection and benefits received from public spending.[1] There is miniscule marginal benefit for oneself in the level of paid taxes: The collected tax revenue is pooled and distributed at the discretion of the government. There is no claim on the proceeds based on individual tax paid. Hence, "one's own outcome is unaffected by one's own contribution" (Slemrod, 2003) and tax is a "one-sided sacrifice with no quid pro quo" (Schmölders, 2006). Therefore, standard theory presumes taxpayers to free-ride – ignoring the effect on other citizens and the government.

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[1] Musgrave and Musgrave (1984) thoroughly discuss this point. According to the "ability-to-pay" principle the tax problem is viewed by itself, independent of expenditure determination. A certain level of expenditure is taken as given and each taxpayers must contribute to financing in line with his ability to pay, most of time measured by income. Actual tax policy is largely determined independently of the expenditure side. The contrasting approach is the benefit principle: each taxpayer contributes in line with the benefits which he receives from public services. Musgrave and Musgrave classify the latter approach as of interest mainly as a theoretical concept with practical applications only found in specific instances, for example in the case of fees or tolls.

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Despite the preceding reasoning, individual willingness to pay taxes depends on the characteristics of the tax-collecting government (McCaffery & Slemrod, 2006; Slemrod, 2007). Observed tax behavior suggests a form of conditional cooperation: Individuals are willing to pay taxes honestly as long as others do the same and the government uses the tax revenue in the best interest of the citizens. Along this line trust in the tax authorities has an important role for tax compliance (Kirchler, Hoelzl, & Wahl, 2008). Just as indifference, conditional cooperation in a trustful relationship can represent self-interested behavior: It reflects a cooperative strategy in a repeated game to ensure future cooperation of others.

Whereas previous research on sentiment about the tax-collecting government focuses on tax compliance – the decision to report taxes honestly vs. tax underreporting – this paper studies a choice between different beneficiaries of the tax revenue of an obligatory tax. To our knowledge, we are the first to contribute an analysis of a decision in which the tax payment itself is obligatory and exogenous but there is a choice on tax revenue recipients. This approach permits us to draw novel conclusions on the consequences of tax behavior. Namely, we provide a tax behavior explanation for the puzzle of equity home bias – the observation that investors prefer to hold domestic equity (Lewis, 1999). Previous tax-based explanations of home bias focus on the avoidance of securities of tax-disfavored countries (Chan, Covrig, & Ng, 2005; Desai & Dharmapala, 2011; Mishra & Ratti, 2013), while we study equivalent tax burdens but variation of tax collectors.

The investigated decision context is an allocation of portfolio investments to either domestic or foreign securities. Experimentally, we implement a variation of governments that collect taxes on foreign dividend income. In practice, many countries impose a withholding tax on income from financial assets paid to nonresidents. In case of double taxation (foreign withholding and domestic income tax), tax credits or exemptions often apply. In the case of a full credit or exemption, the tax burden between domestic and foreign equity is identical and taxes on foreign financial income are exclusively paid to a foreign tax collector.

Building on insights of tax compliance research on the role of trust in tax authorities and the government and conditional cooperation we hypothesize that investors are concerned about the country benefiting from a tax. Based on this sentiment they potentially prefer taxes paid to the local treasury to taxes paid to foreign treasuries. Exploiting the experimental variation allows us to test whether investors invest more in domestic securities in case of a foreign tax on foreign dividend income than in case of a domestic tax on foreign dividend income. Based on the experimental variation one can distinguish the effect of sentiment about tax collector countries from other explanations of favoring domestic or foreign securities. Further, we examine whether investors invest in riskier portfolios in case of a domestic tax on foreign dividend income. The idea is that sentiment about the country collecting a tax potentially affects the perceived familiarity of an investment opportunity. This will change investors' risk preferences with a negative correlation between familiarity and perceived investment risk (Benartzi, 2001; Weber, Siebenmorgen, & Weber, 2005).

Experimentally, we find evidence supporting the concept that investors account for the country benefiting from a tax, which affects international portfolio choices involving taxes. Subjects are willing to support the fiscal authorities of their home country. Moreover, the country benefiting from a tax affects the observed choices of portfolio risks. In line with a multiple attribute choice, risk and return consideration as well as tax collector countries influence the portfolio decision.

The paper proceeds as follows. The next section discusses related taxation and finance literature. Section 3 investigates the cross-country association between seeing taxpaying as the duty of a good citizen and equity home bias. Section 4 formulates our research hypotheses and describes a lab experiment conducted to test these hypotheses. The last section concludes.

## 2. Country-specific sentiment in investments and taxation

Individual investors do not pick securities purely based on return and risk consideration but consider multiple attributes of investment alternatives (Hofmann, Hoelzl, & Kirchler, 2008). Recent research explores the effect of country-specific sentiment on individual financial investment decisions. Morse and Shive (2011) find that investors from more patriotic countries and within the U.S. from more patriotic states exhibit a higher degree of home bias. The authors discuss the concept that patriotic investment may be source of utility to some investors. Hwang (2011) shows that popularity of a country among Americans positively affects investments in securities from that country and M& A activities. Kumar, Niessen-Ruenzi, and Spalt (2012) highlight that national sentiment is not limited to company headquarters or business activities. Specifically, they show that perceived foreignness of mutual fund managers' names reduces fund inflows. All three studies demonstrate that home country-specific sentiment or patriotic considerations affect investor decisions. However, they all leave aside any tax issues and focus on investments per se.

Another manifestation of patriotic financial investments are the so-called diaspora bonds. These are public debt instruments marketed to raise financing from a country's overseas diaspora. In particular Israel and India issue these bonds with a price premium relative to comparable bonds (Ketkar & Ratha, 2010). This means, people are willing to sacrifice material payoffs to support the treasury of their ancestral home country.

Previous tax literature challenges seeing taxpaying as a one-handed sacrifice independent from the nature of tax collecting country or government. The willingness to pay taxes increases with several attributes of the revenue receiving country, such as approvement of public expenditures (Alm, Jackson, & McKee, 1993), attitudes toward government (Slemrod, 2003), political participation rights (Torgler, 2005), decentralization (Güth, Levati, & Sausgruber, 2005), perceived military threat (Feldman & Slemrod, 2009), institutional quality (Torgler & Schneider, 2009), trust in authorities (van Dijke & Verboon, 2010), and municipal spending efficiency (Barone & Mocetti, 2011). Moreover, specifics and goal framings about the use

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