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Intrinsic and extrinsic effects on behavioral tax biases in risky investment decisions ☆

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ABSTRACT

Individuals often do not take taxes correctly into account, which results in distorted or unexpected investments. We shed further light on the discussion of such behavioral tax perception biases by analyzing intrinsic and extrinsic effects on investment decisions. We study two dimensions: (1) the influence of emotions and perceived risk (individual dimension, intrinsic effects) and (2) the influence of available tax information by varying tax complexity and salience (tax system dimension, extrinsic effects). In our laboratory experiment, we construct the payoff structure such that the subjects are confronted with exactly the same choices in net terms in a situation with or without a capital gains tax. This design allows us to identify pure tax perception biases. We show that both dimensions are able to explain tax perception biases. In particular, we find evidence that perceived risk is lower and consequently willingness to take risk is higher with a capital gains tax (with full loss offset provision) than without taxation. Furthermore, this positive effect on risky investment is higher in a situation with a rather low level of tax information in which tax complexity is high and tax salience is low.

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1. Introduction

In this paper, we focus on three literature strands which are recently discussed: the occurrence of behavioral tax biases (e.g., Blaufus, Bob, Hundsdoerfer, Kiesewetter, & Weimann, 2013; Djanali & Sheehan-Connor, 2012), the influence of salience and complexity effects on decision making (e.g., Ackermann, Fochmann, & Mihm, 2013; Bayer & Ke, 2013), and the influence of emotions on risk-taking (e.g., Lucarelli, Uberti, Brighetti, & Maggi, 2015; Schwager & Rothermund, 2013). In particular, we examine the investments and the willingness to take risk of individuals under taxes. By analyzing the influence of intrinsic and extrinsic effects on tax perception and decisions, we shed further light on the discussion of behavioral tax biases. We study two dimensions to contribute to the literature: (1) the influence of emotions and perceived risk (individual dimension)

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and (2) the influence of tax and after tax information provided by the tax system (tax system dimension). Whereas the first influence depends on the individual (i.e., intrinsic effect), the second influence depends on fiscal aspects characterizing the tax system itself which are exogenously given (i.e., extrinsic effect). For these two dimensions, we address the following research questions. First, how are perceived risk and emotional reactions to taxation related to the occurrence of tax perception biases? Second, how do changes in tax complexity and tax salience, by varying the tax information provided, influence these tax biases?

Because archival data that only measure overall responses would not enable us to identify tax perception effects, we decided to conduct a laboratory experiment. In each independent situation of our simple experiment, subjects must decide on the investment in risky assets with the choice of retaining the non-invested capital. In other words, subjects have two investment alternatives: a risky asset with a positive or a negative capital gain and a risk-free asset with zero return. We use a 2×3 design with two within- and three between-subjects design treatments. In the former, we modify tax rules (no tax and tax treatments). In the latter, we vary the information provided to our subjects to determine the risky asset's net capital gain (low, medium, and high info treatments). We construct the payoff structure such that the subjects are confronted with exactly the same choices in net terms in a situation with or without a capital gains tax. If participants integrate the fiscal effects of taxation correctly into their decisions, they should therefore reveal exactly the same preference for the risky asset in both situations. However, if they do not integrate taxes correctly, the decisions are distorted, and differences between both situations are revealed. This difference in risky investment quantifies the extent to which investment behavior is biased by tax perception and is hereafter referred to as the *Perception Effect*. To examine the influence of intrinsic effects (individual dimension), we measure subjects' affective reactions to tax regulations and subjects' perceived risk in different tax situations and hypothesize that these issues influence investment behavior. To examine the influence of extrinsic effects (tax system dimension), we use our three info treatments. The variation in these treatments has two effects: tax complexity and salience effects. Whereas complexity decreases, salience increases from the low to the high information level.

We find conclusive results that both dimensions are able to explain tax perception biases. In particular, we find evidence that perceived risk is lower and consequently willingness to take risk is higher with a capital gains tax (with full loss offset provision) than without taxation leading to a positive Perception Effect. Furthermore, this positive effect on risky investment is stronger in a situation with a rather low level of tax information in which tax complexity is high and tax salience is low. However, even in the treatment with the highest information level, we find that the Perception Effect does not vanish. Politicians should be therefore aware that governmental interventions could influence risk-taking even more than standard neoclassical theory predicts. Furthermore, future experimental work should consider that investment decisions can be heavily biased. We argue that experimental researchers should ensure that participants receive sufficient tax information to minimize potential tax perception biases. Furthermore, theoretical predictions can be improved if the identified perception biases are considered in investment models.

The remainder of the paper is organized as follows: in Section 2, we present our experimental design and our treatments. Hypotheses are derived in Section 3. Section 4 outlines the sample and the experimental protocol. The results of our study are presented in Section 5. Section 6 summarizes our results and discusses the scientific and political implications of our findings.

2. Experimental design and treatments

2.1. Decision task

In our experiment, subjects decide on a risky investment in 20 independent situations. In each decision situation, every participant receives a fixed endowment e of 100 lab-points (where 1 lab-point corresponds precisely to 20 Euro-cent). Participants' task is to determine which share of this endowment should be invested in risky assets. In particular, each subject is asked to determine the number of risky assets she wants to buy. The amount invested riskily is denoted by q. The remaining amount $(e - q)$ is not invested but is retained by the participant in cash. Individuals act as price takers and the constant asset price equals 1 lab-point. Therefore, each subject is able to buy up to 100 risky assets in each situation.

In every decision situation, all risky assets bought are sold and yield a cash flow (sales price). However, to keep the design of the experiment simple, we abstract from this sales process during the experiment and concentrate on the (gross) capital gain of the risky asset. The (gross) capital gain of the risky asset is the difference between the cash flow of a risky asset and its purchase price. This capital gain is denoted by g and depends on the state of nature i. A total of six states of nature are possible. In three states, the capital gain is positive, and in the other three the capital gain is negative (i.e., a capital loss is suffered). All states of nature occur with the same probability $p = 1/6$. Participants do not know the actual state of nature when they decide on their risky investment. However, the six potential (gross) capital gains are displayed before the decision is made. The risky asset's capital gain in each state of nature is chosen to satisfy the following inequalities:

$$\sum_{i=1}^{6} p \cdot g^i = \frac{1}{6}\sum_{i=1}^{6} g^i > 0, \tag{1}$$

$$g^1 > g^2 > g^3 > 0 > g^4 > g^5 > g^6. \tag{2}$$

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