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Home bias and cross border taxation

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A B S T R A C T

The relationship between cross border taxation and free float home bias is examined. This explicitly recognizes that insider shares are unavailable to foreigners. Other important explanations for home bias – information asymmetry, behavioural and governance issues – are controlled when examining the impact of cross border tax variables. In our sample of countries about sixty percent (eighty percent) withhold taxes on realized capital gains (dividends) of foreign investors and about thirty percent of the mature economies provide imputation of taxes paid on dividend income by domestic corporations. Dividend imputation is a statistically significant impediment to cross border equity flows. A tax credit variable for foreign taxes paid on dividends is constructed and found to be statistically significant in reducing home bias. A relatively high foreign tax rate that cannot be offset by tax credits is found to significantly increase home bias. These results hold for float adjusted home bias and traditional international portfolio home bias.

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1. Introduction

A major literature has focused on why an investor holds far too high a share of his or her wealth in domestic securities compared with the optimal share predicted by the traditional theory of portfolio choice. This literature is comprehensively reviewed in Lewis (1999), Karolyi and Stulz (2003) and Sercu and Vanpee (2007). Within the literature on home bias, international taxes have been widely discussed as a barrier and as a cost of international diversification of investment flows. The link between stock

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returns and taxes and holdings of domestic and foreign stocks has been examined in models by Black (1974), Stulz (1981) and Errunza and Losq (1989), amongst others. Studies' recognizing that taxes are a potentially important influence on cross border portfolio flows are closely related to the literature on optimal taxation. Razin et al. (1997) and Devereux (2008) note that production efficiency across countries is preserved when an investor resident in a country faces the same rate of tax on investment income without regard to the source of that income, since this ensures equality of pre-tax returns to capital across countries.[2]

In practice, taxes on dividends and taxes on realized capital gains are levied on foreign investors in many countries. For example, in our sample of countries listed in Table 1, 49% withhold taxes on realized capital gains of foreign investors. In addition, tax advantages can accrue to an investor depending on the source of income. In our sample of mature economies that have resident investors with foreign income, 52% of the observations are provided imputation of taxes paid on dividend income by domestic corporations. Imputation eliminates the double taxation of income and dividends. Accordingly shareholders receive a higher income stream under dividend imputation tax system. These factors have the potential to significantly influence the extent of foreign investment in equity flows. Cross border taxation in foreign country induces a bias towards source country holding domestic financial assets because it puts additional cost on holding foreign securities from a source country investors' perspective. In mitigation, French and Poterba (1991) note that dividend withholding tax by foreign governments can typically be credited against taxes in the investors' home country.

Sercu and Vanpee (2007) argue that among the potential explanations for equity home bias the most salient seem to be information asymmetries, governance issues and behavioural biases. The other proposed explanations, hedging domestic risk and implicit and explicit costs of foreign investments, "may not explain much of the actual portfolio choices of investors (p. 18)."[3] Cross border taxation belongs to the implicit and explicit costs of foreign investments category and we find in this paper that certain cross border taxation factors do influence free float home bias, that is, home bias after controlling for shares held by insiders. Dahlquist et al. (2003) and others observe that portfolio investors can only hold the float adjusted world market portfolio, i.e. a world portfolio of shares not held by insiders. Controlling for information asymmetries, behavioural bias, insider holdings and other governance factors results in finding influence of cross border taxation on free float home bias.

The paper considers the role of cross border taxation on free float equity home bias and on traditional international portfolio home bias over the years 2001–2009 for 49 countries. Dividend imputation is established as a statistically significant and robust impediment to cross border equity flows. A tax credit variable for foreign taxes paid is constructed and is found to be statistically significant in reducing home bias. A relatively high foreign tax rate that cannot be offset by tax credits is found to significantly increase home bias. These results hold for float adjusted home bias and traditional international portfolio home bias. Results are robust to inclusion of corporate governance variables. Empirical estimation employs Arellano–Bover/Blundell–Bond linear dynamic panel-data methods to control for endogenous variables and for tests of robustness of results.

[2] The literature on the theory of optimal taxation considers a number of issues that complicate the analysis. Gordon and Varian (1989) examine a situation in which a country can influence prices in the international securities market, thus providing an incentive to set taxes to restrict trade in securities and for domestic residents to concentrate portfolios in domestic equity. Gordon and Bovenberg (1986) consider a model when there is asymmetric information between domestic and foreign investors and demonstrate that a small open economy might benefit from subsidizing the importation of capital. Huizinga and Nielsen (1997) show that with an increase in foreign ownership of firms a higher tax rate on source-based investment income may be called for. Baldwin and Krugman (2000) emphasize that bigger countries have larger location-specific rents and greater shelter from tax competition. McGrattan and Prescott (2005) show that a standard growth model can relate tax policy to market valuation and explain movements in U.S. and U.K. stock market valuations relative to GDP.

[3] Cooper and Kaplanis (1994) estimate the levels of costs required to generate the observed home bias in portfolios consistent with different levels of risk aversion. Cooper and Kaplanis (2000) show how capital budgeting rules depend on the level of investor costs to cross border investment, both directly and also indirectly through the portfolio specialization they induce. Sercu and Vanpee (2008) find that equity home bias is related to a mixture of risks and frictions, such as information asymmetries, institutional factors and explicit costs. Moor et al. (2010) reconsider the costs to international equity investments implied by standard portfolio theory and find that estimated costs are mostly driven by risk estimates, not by asset holdings.

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