The effect of taxation on human capital investment: Direct evidence from a panel of individual tax returns

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Abstract

Little is know about the relation between tax structure and human capital investment. To stimulate investment in training by employees, the Dutch tax system allows a deduction of direct training expenditures from taxable income. This paper uses a panel of tax return data to investigate to what extent the resulting cost reduction encourages training investments.

To solve the identification problem, independent and exogenous variation is needed in the rate at which costs and benefits of training are taxed. To address this issue, we exploit variation in changes in marginal tax rates generated by a tax reform that took place in 2001 in combination with a regression discontinuity design.

The results show a positive and significant effect of tax deductability on investment in training. A 10 percent increase in the rate against which training costs can be deducted, increases the probability of training investment by 1 percentage point (50%). This finding is robust to various specification tests.