Marginal Cost of Public Funds: from the theory to the empirical application for the evaluation of the efficiency of the tax-benefit systems

Emanuela Lezzi*,†, Luca Gandullia1, and Francesco Figari2

1University of Genova – Italy
2University of Insubria – Italy

Abstract

The measurement of efficiency of the tax-benefit systems is often limited to proxies as individual work incentive indicators or labour supply elasticities. In our work, we estimate the Marginal Cost of Public Funds (MCF) as an overall indicator of efficiency of tax-benefit systems and reforms. The marginal cost of public funds is the marginal welfare cost for the government of raising revenue by distortionary taxes popularised in the theoretical optimal taxation literature. The novelty of our work is the calculation of the MCF indicator fully based on empirical micro data representative of the population. This indicator combines both changes in labour force participation (extensive elasticities) and hour-of-work labour supply elasticities depending on working (intensive elasticities) with the incentives embodied in the tax benefit system at the intensive (effective marginal tax rates) and extensive margin (participation tax rates). Our results, related to the Italian case, show first the importance of taking into account the heterogeneity of the population with the second earners, usually women (both single or in couple), facing a more inefficient system compared to the first earner. Second, our micro-data based indicator shows the potential bias of MCF indicators based on stylised and hypothetical measures of work incentives, as usually adopted in the theoretical optimal taxation literature, given that the variations due to the assumptions related to elasticities and effective tax rates explain a large part of the indicator itself.

Keywords: Empirics