A New Approach to Evaluating the Welfare Effects of Decentralized Policies

Abstract

We establish a framework to quantify the welfare effects of decentralized policies. Local policies result in benefit-spillovers, mobility of households and firms, and interjurisdictional fiscal externalities that are not internalized by the government enacting the policy. Their magnitudes are measured by a new metric, the "marginal corrective transfer" (MCT), the share of funding the federal government should provide to induce a locality to internalize these interjurisdictional externalities. Formally, the MCT is estimated as the wedge between the marginal value of public funds (MVPF) of the locality enacting the policy and the MVPF of the entire federation. To calculate this wedge, we develop a rigorous framework for distinguishing between the benefits and costs that are internal and those that are external to the enacting locality. The MCT enables comparisons of local policies, allowing the federal government to prioritize policies based on the relative external benefits and costs. Empirically, we show that property tax cuts, K-12 education, and higher education have positive MCT's, implying federal subsidies should be employed while race-to-the-bottom type policies such as wealth tax cuts and bidding-for-firm programs with negative MCTs should be federally taxed. Depending on the taxing instruments utilized at the state level, we show if states rank policies to intervene on, they may diverge substantially from the federal government and from other states.

This paper is joint work with David R. Agrawal (University of Kentucky) and Tidiane Ly (NBER)

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