

**Fiscal Centralization versus Decentralization:
Growth and Welfare Effects of Leviathan, Spillover, and Capital Mobility**

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Abstract

What are the growth and welfare effects of fiscal centralization (FC) versus fiscal decentralization (FD)? To analyze this question, we develop an endogenous-growth model characterized by three parameters, indexing respectively the degree of (i) Leviathan politicians, (ii) spillovers of public goods, and (iii) capital mobility across jurisdictions. While fiscal policy is coordinated between jurisdictions under FC, there is no such coordination under FD. Within this framework, we derive the following results. First, higher capital mobility generates stronger tax competition and drives down equilibrium tax rates if the regime is characterized by FD rather than FC. Secondly, stronger tax competition promotes economic growth but at the same time retards the provision of public goods. Thirdly, FD always dominates FC in economic growth, whereas the welfare domination between FD and FC is non-monotonic. In particular, FD dominates FC in welfare if and only if the degree of capital mobility and hence tax competition falls within an intermediate range, which is decreasing in the degree of spillovers. In light of our findings, we explore the question: In addition to European monetary integration, should there be European fiscal integration?

Keywords: Fiscal decentralization, spillover, tax competition, Leviathan taxation

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