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Economic integration and fiscal devolution

Manuel Leite-Monteiro^{a,*}, Motohiro Sato^b

^a*FCEE, Universidade Católica Portuguesa, Lisbon, Portugal*

^b*Graduate School of Economics, Hitotsubashi University, Tokyo, Japan*

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Abstract

In this paper we investigate how economic integration influences the political decision of integration and separation of jurisdictions. In a model with (imperfect) capital mobility, we consider that, not only the redistributive policy itself, but also the level of policy centralization is decided by a majority vote. We find that the net benefit from integration is not monotonic with the level of world capital market integration and present a case where integration of two regions occurs only for intermediate levels of mobility. This conclusion relies on the comparison of the regional majorities' utility under the various regimes. The benefits from integration arise from the elimination of tax competition across jurisdictions, which allows for more income redistribution, whereas the costs are linked to the diversity of preferences across regions, namely that of the decisive voters. We also show that a federal regime is better than complete centralization in keeping a nation united.

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1. Introduction

Recently, the world political map has changed: economic and political unions have been created (such as the European Union, NAFTA and Germany's reunification) and, simultaneously, former nations have been disintegrated (such as the Soviet Union and Yugoslavia), separtist movements have appeared in some countries (such as in Spain, Belgium and Canada) and further regional autonomy has been demanded (such as in

* Corresponding author.

E-mail addresses: mlm@fcee.ucp.pt (M. Leite-Monteiro), satom@econ.hit-u.ac.jp (M. Sato).

Scotland). The European Union is a notable case by itself, where there has been a tendency to centralize some of the national policies and, at the same time, some member countries have experienced increasing demands for regional autonomy.

When regions choose to integrate into a single nation or to separate from it, they evaluate the costs and benefits of their decision, which helps answering several types of questions. For example, what are the effects of increasing factor mobility on the political decision of integration and break-up of a nation? Does centralization of redistributive policies alleviate the pressure on the welfare state? And, how does the political structure of the integrated nation influence the sustainability of the united nation?

The literature on political integration and separation has extensively discussed the costs and benefits of policy centralization.¹ The costs of integration are mainly associated with heterogeneity of preferences and political risks (Alesina et al., 1997; Alesina and Spolaore, 1997; Alesina and Perotti, 1998; Bolton and Roland, 1996, 1997). Once two regions integrate into a nation, the central government becomes responsible for providing public services and financing its expenses. This national provision has been typically assumed to be uniform across regions and determined by a nation-wide majority voting, in which a national median voter is decisive. This national median voter, however, may differ from its regional counterparts who would represent regional preferences and would have been decisive if the two regions remain sovereign. When regions have different preferences over public services, national provision would not match all regional preferences. Moreover, if income distribution is different between the two regions, centralized policies may involve inter-regional transfers. From a regional majority's standpoint, these should be accounted as costs of integration. In addition, political risk arises from integration if national politics favours either region or income shocks on the national median voter increase uncertainty over the outcomes of national politics.

The benefits from integration are associated with risk sharing of regional economic shocks, internalisation of spillovers of public good provision and scale economies in public good production and delivery. The benefits from risk sharing would be significant when economic shocks are regionally independent and the central government can effectively make inter-regional transfers, providing an insurance device against such shocks. Centralized provision of defence is an example of a non-rival public good involving scale economies, which generates inter-regional spillovers as well. Moreover, there are efficiency gains from free trade within a nation when the domestic market coincides with the political unit or when international trade is restricted by political constraints (Bolton and Roland, 1997).

Therefore, political integration involves a trade off and, if it is decided by majority voting, the preferences of regional majorities are decisive: each majority compares its welfare in the case of separation with that under a united nation. We follow the literature that it is necessary that all regions favour centralization for their integration into a single nation, but one region can unilaterally secede from a nation.

We share the view that economic integration would go hand in hand with political separation/integration, but we focus on the comparative advantage of centralized income

¹ For an extensive survey on the existing works, see Alesina et al. (1995) and Bolton et al. (1996).

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