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**Competing in taxes and investment  
under fiscal equalization**

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**Abstract**

The paper considers a model of a federation with two heterogeneous regions that try to attract the capital by competing in capital income taxes and public investment that enhance the productivity of capital. The regions' choices determine the allocation of capital across the regions and their revenues under a tax sharing scheme. This framework allows for the examination of different approaches to fiscal equalization schemes (Boadway and Flatters, 1982, and Weingast, 2006). We show that tax competition distorts (downwards) public investments and that the equalization grants discourage public investments with a little effect on equilibrium taxes. However, the equalization schemes remain beneficial for the federation and, provided that the degree of asymmetry is small, for each region as well.

**Keywords:** heterogeneous regions, fiscal federalism, fiscal equalization, public investments.

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