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Cross-border shopping in a federal economy

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Abstract

The purpose of this paper is to consider an economy that incorporates cross-border shopping and where the different levels of government are concerned with the well-being of their citizens. We assume a federal economy with a central government and two regions with specific characteristics. Two kinds of externalities, horizontal and vertical, arise and we show the possibilities of internalising them. With the governments of symmetric regions behaving as Nash players, they would optimally set their tax rates and replicate the unitary nation optimum. Finally, we show how the central government as a Stackelberg leader can adjust its fiscal instruments so that the tax externalities are also internalised.

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