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# Regional State Capacity and the Optimal Degree of Fiscal Decentralization\*

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## Abstract

We study the optimal degree of fiscal decentralization in a federation. Regional governments are characterized by their abilities to deliver public goods (administrative capacity) and to raise tax revenues (fiscal capacity). Two regimes are compared on efficiency grounds. Under partial decentralization, regional governments rely on central bailouts to complete local projects in financing needs. Under full decentralization, marginal financing is achieved via local capital taxes. We show that the presence of sufficiently low levels of administrative capacity is a necessary condition for full decentralization dominance. This condition may also be sufficient, depending on the projects' characteristics. Some extensions are presented.

**Keywords:** Fiscal federalism - State capacity - Partial and full fiscal decentralization - Bailouts - Hard budget constraints. **JEL Codes:** H77.

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