The relationship between the openness of the economy and the size of general government has been analyzed by several contributions. In a pioneering study, Cameron (1978) found, on an empirical ground, a positive relationship between trade openness and the level of public expenditures in a sample of eighteen OECD countries. Rodrik (1998) gave further insights to the understanding of the economic process underlying Cameron’s empirical findings, arguing that increasing external economy’s exposure (trade openness) may lead to more demand for public expenditures. The basic argument is that increasing openness may lead to increasing risk. Citizens may therefore demand more redistributive public expenditures to compensate for this risk.

This debate, however, has neglected various issues that may potentially raise interesting results: a) the existing literature has mostly focused on one dimension of openness, namely trade openness. The possible impact of an increase in capital openness has been only partially considered (some exceptions are Bretschger and Hettich, 2002; Swank, 2002; Dreher, 2003; Slemrod, 2004); b) no systematic attempt has been made to investigate the impact of both trade and capital openness on the distribution of public expenditures among government levels (the structure of public budget), rather than on the total size of the public sector (one exception is Garrett and Rodden, 2000); c) as a consequence, no attempt has been made to investigate how the changed distribution of public expenditures across government levels may shape (and be affected by) the levels of local and aggregate inequality within a country.

All these factors could play an important role in the composition of the public sector budget in given times and places. Increasing degrees of capital openness may leave central governments with a reduced ability to raise the necessary tax revenue and through this way affect inequality. On the other hand, many countries are experimenting an increase in fiscal decentralization which involves the assignment of social expenditures. This, in turn, may again affect the levels of local and aggregate inequality (in this direction, see Stegarescu, 2003; Whinston and Janeba, 2005).
The aim of this paper is to contribute to the understanding of the relationship between openness, the government decentralization process and the role of local and aggregate inequality. To this purpose, a theoretical model where local governments interact with central government is proposed. In particular, local governments choose the level of local public expenditures that maximize the utility of their representative resident, while central government maximizes a Social Welfare Function that aggregates local welfare (as in Whinston and Janeba, 2005). The interesting insight of the model is that if one is ready to assume that the central tax revenue is a decreasing function of the degree of capital openness, while local tax revenues are not (as local governments tax less mobile tax basis as opposed to ones taxed by the central governments), a decentralized equilibrium (where local and central governments choose expenditure levels independently) might lead to more decentralization when openness increases. Comparative statics is therefore performed in order to understand the role of local and aggregate inequality in shaping this result and, in turn, the role of capital openness and decentralization in affecting local and aggregate inequality. An empirical test of the most relevant results will also be performed.