

# Tax decentralisation, the *flypaper* effect, and growth

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*The aim of this paper is to determine a theoretical linkage between tax decentralisation and growth. For this purpose, we consider a two-tier framework of local and federal government originally developed to examine how changes in taxes and transfers affect long-term equilibrium values of consumption and capital stock. In this framework we introduce a tax decentralisation indicator, take into account the existence of the flypaper effect and specify a Cobb-Douglas form for the production technology. As a result we are able to determine the level of tax decentralisation that will maximise the long-term equilibrium per capita income. Such level depends on private and public capital productivities, the tax burden rate in the absence of decentralisation and the intensity of the flypaper effect, as we illustrate using reasonable values of these parameters. The results obtained in this paper could be empirically tested in several economies.*

53

*Con este trabajo se pretende establecer una relación teórica entre la descentralización impositiva y el crecimiento económico. Para ello, se considera un escenario con dos niveles de gobierno, local y federal, que originalmente había sido desarrollado para estudiar cómo determinados cambios en impuestos y niveles de transferencias afectaban los valores de equilibrio de largo plazo del nivel de consumo y el stock de capital en una región tipo. En dicho escenario se introduce un indicador de descentralización impositiva, se tiene en cuenta la existencia del efecto flypaper y se considera una tecnología de producción Cobb-Douglas. A partir de ahí, se puede determinar el nivel de descentralización impositiva que maximiza el valor de equilibrio de largo plazo de la renta per cápita en la región tipo. Este nivel depende de las productividades del capital público y privado, de la tasa impositiva en ausencia de descentralización y de la intensidad del*

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*efecto flypaper, como se ilustra partiendo de valores razonables de los parámetros del marco teórico. El resultado obtenido podría ser evaluado empíricamente a partir de datos de distintas economías.*

Keywords: tax decentralisation; the *flypaper effect*; economic growth; general equilibrium analysis

JEL classification: H77; O40; R10

## 1. INTRODUCTION

Studies of the possible effect of fiscal decentralisation processes on economic growth opened up a new line of research in the latter half of the 1990's. This arose out of a much wider tradition concerned with the relationships between fiscal decentralisation and a series of economic and political goals, which was founded on the seminal work of Tiebout (1956), Stigler (1957), Musgrave (1959) and Oates (1972). In addition to economic growth *per se*, these goals included public spending efficiency, horizontal fiscal equity, controlling the government size, macroeconomic stability, fostering appropriate conditions in the markets and for government, and poverty reduction.

The main spur to the development of this new line of research has been the devolution process from central to lower tiers of government, a process that has taken place mainly in transitional and developing economies with the encouragement of various international bodies, particularly the World Bank. The intuition that these processes might not only affect the efficiency of public spending, horizontal fiscal equity and macroeconomic stability, comprising what might be called the traditional effects, but could also influence economic growth has led researchers at this and other international institutions to analyse this possible effect. Previous works focused on the study of the opposite effect, that of economic growth on fiscal decentralisation, found a positive relationship, this is the case of Kee (1977), Pommerehne (1977), Bahl and Nath (1986), Wasylenko (1987) and Panizza (1999).

The emergence or re-emergence of debate on the subject of fiscal decentralisation in numerous developed economies in recent decades has, meanwhile, motivated scholars to take up or continue this line of research. Consequently, the process holds an important place in the study of these economies with research focusing on the possible relationship with economic growth, one of the basic academic concerns.