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Environmental Policy, Firm Dynamics and Wage Inequality in Developing Countries

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Abstract: This paper examines the effects of pollution taxes on wage gap, social welfare and the environment of a developing economy. In the short run, we find that a rise in the pollution tax has an ambiguous effect on the skilled-unskilled wage gap. However, the higher pollution tax can cause urban firms to exit in the long run. Capital is released to the rural sector and benefits the production of rural workers. These predictions are empirically validated. The higher pollution tax can yield a double dividend by not only reducing pollution emissions, but also mitigating skilled-unskilled wage gap in the economy.

JEL classification: O18, Q52, Q56

Keywords: Environmental tax, firm exit, wage inequality, developing economies

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