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Federalism, Policy Choices, and Income Inequality

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ABSTRACT

The paper studies the effects of federalism on primary-income (before taxes and transfers) inequality. Jurisdictions in a federal system determine economic policies according to their preferences. By contrast, in a unitary system, policies are uniformly determined nationally for jurisdictions. A policy results in a trade-off between intended policy outcomes and incomes, and the analysis considers environmental policies to illustrate the trade-off. More stringent environmental policies of a jurisdiction, for instance, provide higher environmental quality for its residents but decrease production and hence the wages. To the extent that the preferences for environmental quality differ across jurisdictions, environmental policies lead to income inequality among jurisdictions. In addition, jurisdictions differ in their productivity for reasons unrelated to policy differences such as the size of land and other natural conditions, resulting in the difference in the wages and income inequality. As policies are uniform in a unitary system, income inequality mainly stems from the difference in natural conditions and hence tends to be lower in a unitary system than in a federal system. The paper also provides an empirical analysis of the effect of federalism on income inequality, and available evidence suggests that federalism increases income inequality.

KEYWORDS federalism; economic policies; incomes; inequality

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