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Optimal Fiscal Policy with Labor Selection*

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Abstract

This paper characterizes long-run and short-run optimal fiscal policy in the labor selection framework. In a calibrated non-Ramsey decentralized equilibrium, labor market volatility is inefficient. Keeping fixed the structural parameters, the Ramsey government achieves efficient labor market volatility; doing so requires labor-income tax volatility that is orders of magnitude larger than the "tax-smoothing" results based on Walrasian labor markets, but a few times smaller than the results based on search and matching markets. We analytically characterize selection-model-consistent wedges and inefficiencies in order to understand optimal tax volatility.

Keywords: labor market frictions, hiring costs, efficiency, optimal taxation, labor wedge, zero intertemporal distortions

JEL Classification: E24, E32, E50, E62, E63, J20

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