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International Finance Discussion Papers: Tax Smoothing in Frictional Labor Markets

By David M Arseneau, Sanjay K Chugh

Bibliogov, United States, 2013. Paperback. Book Condition: New. 246 x 189 mm. Language: English . Brand New Book ***** Print on Demand *****.We re-examine the optimality of tax smoothing from the point of view of frictional labor markets. Our central result is that whether or not this cornerstone optimal fiscal policy prescription carries over to an environment with labor market frictions depends crucially on the cyclical nature of labor force participation. If the participation rate is exogenous at business-cycle frequencies -- as is typically assumed in the literature -- we show it is not optimal to smooth tax rates on labor income in the face of business-cycle shocks. However, if households do optimize at the participation margin, then tax-smoothing is optimal despite the presence of matching frictions. To understand these results, we develop a concept of general-equilibrium efficiency in search-based environments, which builds on existing (partial-equilibrium) search-efficiency conditions. Using this concept, we develop a notion of search-based labor-market wedges that allows us to trace the source of the sharply-contrasting fiscal policy prescriptions to the value of adjusting participation rates. Our results demonstrate that policy prescriptions can be very sensitive to the cyclical nature of labor-force participation in search-based environments.



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Reviews

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