A POLITICAL ECONOMY THEORY OF FISCAL POLICY AND UNEMPLOYMENT

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Abstract
This paper presents a political economy theory of fiscal policy and unemployment. The underlying economy is one in which unemployment can arise but can be mitigated by tax cuts and increases in public production. Such policies are fiscally costly, but can be financed by issuing government debt. Policy decisions are made by a legislature consisting of representatives from different political districts. With the available policies, it is possible for the government to completely eliminate unemployment in the long run. However, with political decision making, the economy always has unemployment. Unemployment is higher when the private sector experiences negative shocks. When these shocks occur, the government employs debt-financed fiscal stimulus plans which involve both tax cuts and public production increases. When the private sector is healthy, the government contracts debt until it reaches a floor level. Unemployment levels are weakly increasing in the economy’s debt level, strictly so when the private sector experiences negative shocks. Conditional on the level of workers employed, the mix of public and private output is distorted. (JEL: E24, E62, H62)