

# Unemployment, Fiscal Competition, and the Composition of Public Expenditure

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## Abstract

This paper investigates the efficiency of equilibrium policies and public expenditure composition under labor market imperfection in fiscal competition model. The sources of the inefficiency for supplying public goods and inputs with capital tax are the employment-stimulus and fund-raising effects of public inputs and fiscal and unemployment-exporting externalities. Our main findings are explained as follows. First, if public expenditure is financed by capital and lump-sum taxes, public goods are efficiently provided while public inputs are overprovided in the first-best sense because jurisdictional governments seek to attract capital for creating employment and tax revenue. However, public inputs are efficiently provided in the second-best sense. After that, we focus on financing by capital tax. If the capital tax is solely available, public goods are undersupplied in the second-best sense as with previous studies. In contrast, public inputs can be either undersupplied and oversupplied in the second-best sense, depending on positive effects of public input on employment and tax revenue through attracting capital.

*Keywords:* Fiscal Competition; Unemployment; Public Inputs; Public Goods.