1 Introduction

In recent years, both the real business cycle and the New Keynesian literature have devoted a great attention towards studying the effectiveness of fiscal policy in a flexible price environment.[1] While real business cycle theorists have concentrated upon the intertemporal substitution effects on labour supply - an increase in public expenditure raises the interest rate and makes current income more attractive than future income - New Keynesians have identified two transmission mechanisms in which the assumption of imperfect competition plays indeed the crucial role. The first mechanism relies on the multiplier effects of a balanced budget expansion generated by monopoly profits on the labour supply and consumption decisions (Dixon (1987), Dixon and Lawler (1996), Heijdra and van der Ploeg (1996)). The second works through the possibility that fiscal policy actually affect the firms' market power (Pagano (1990), Jacobsen and Schultz (1994)) - by changing the desired price-over-marginal-cost ratio, fiscal policy may induce an increase in the firms' desired level of employment at any real wage.

The aim of this paper is to investigate the technological and demand conditions under which this latter transmission mechanism is actually effective. It is a standard tenet of the literature in this field that an increase in public demand is expansionary when it is associated to a reduction in the desired mark-up, at any level of output. Indeed, under decreasing returns, an increase in the demand elasticity, which reduces the desired price-over-cost margin for any level of output, increases the desired amount of employment at any real wage. This amounts to saying that a downward sloping labour demand curve shifts outwards and the equilibrium employment increases[2] (Lindbeck and Snower (1994), Dixon and Rankin (1994)). This effectiveness result has been extended by D'Aspremont *et al.* (1995), who show that fiscal policy can be expansionary also under increasing returns, provided that it reinforces, rather than counteracts, the firms' market power - if the labour demand schedule is positively sloped, it is a decrease in demand elasticity, a widening of the price-cost margin, which is required to induce firms to expand employment at any real wage.

In this paper we develop a microfounded macroeconomic model with monopolistic competition, in which the firms' market power depends on the relative weight of the public and private components of aggregate demand - a situation which arises whenever firms face both a public and a private demand for their products, characterized by different price elasticities. Clearly, in this case a fiscal expansion causes an overall increase (decrease) in the demand elasticity at any level of output if public demand is more (less) elastic than private demand.

This simple framework allows us to extend the range of situations in which fiscal policy has a positive impact on employment and output, as compared with those identified in the existing literature. In particular, we show that there exists a range of technological conditions - from moderately decreasing to moderately increasing returns, including the constant case - in which fiscal policy is expansionary, independently of the sign of its impact effect on demand elasticity. The economic intuition behind this result is in the 'derived' nature of the

[1] For an assessment of the real business cycle approach to this issue, see Plosser (1989); the contributions in the New Keynesian perspective are reviewed in Silvestre (1993, 1995), Dixon and Rankin (1994) and Benassi et al. (1994).

[2] This result holds true when the labour supply is not inelastic.