Abstract

Higher income inequality is empirically associated with a higher probability of sovereign default and higher sovereign spreads. In this paper we analyze how income distribution, the tax system and political constraints that limit the ability of the government to raise resources, interact to affect sovereign borrowing and default decisions. We perform our analysis by introducing in a standard DSGE model with endogenous sovereign default risk, two novel features: income heterogeneity across households and a requirement that the government garners some of the households' support to raise the resources to repay its debt. In this framework sovereign defaults can be the result not only of a government decision but also of insufficient political support. We calibrate the model to the Argentine economy and show that changes in the income distribution or the tax system that distribute the repayment burden more equally, reduce the probability of default. We also show that political constraints can have a stronger impact, the more unequal is the sharing of debt repayment.