

Accepted Manuscript

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PII: S0165-1889(18)30256-2
DOI: <https://doi.org/10.1016/j.jedc.2018.08.008>
Reference: DYNCON 3619

To appear in: *Journal of Economic Dynamics & Control*

Received date: 28 December 2017
Revised date: 17 August 2018
Accepted date: 20 August 2018

Please cite this article as: Kiyoung Jeon, Zeynep Kabukcuoglu, Income Inequality and Sovereign Default, *Journal of Economic Dynamics & Control* (2018), doi: <https://doi.org/10.1016/j.jedc.2018.08.008>

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Income Inequality and Sovereign Default*

Kiyoung Jeon[†] Zeynep Kabukcuoglu[‡]

August 27, 2018

Abstract

In this paper, we study the role of income inequality in government borrowing and default decisions. We consider a standard endogenous sovereign debt default model and extend it to allow for heterogeneous agents. In addition to shocks to the average income level, we consider the effect of shocks to income distribution. Consistent with the data, income dispersion across individuals increases during a recession and decreases during an expansion. The model is calibrated to match a number of stylized facts for Argentina. We show that (i) rising income inequality within a country increases the probability of default significantly; (ii) the effect of output shocks is larger than the effect of inequality shocks; (iii) the joint effect of these two shocks can generate a high default probability consistent with the Argentine data; (iv) the model can match the high volatility of consumption by the poor relative to the rich; and (v) more progressive income taxes lead to lower default risk.

Keywords: Sovereign debt; Default; Income Inequality; Redistribution.

JEL codes: F3, F4, E5, D5

*We are deeply indebted to Daniele Coen-Pirani, Marla Ripoll and Sewon Hur for their guidance. We would also like to thank to James Cassing, Dean Corbae, Vincenzo Quadrini, Burcu Eyigungor, Illemin Kondo, Ayse Kabukcuoglu, Ariel Zetlin-Jones, Paul-Frederik Schlingemann, Josephine E. Olson, and seminar participants in Midwest Macro Meeting in Florida International University, The European Winter Meeting of the Econometric Society in Universidad Carlos III de Madrid, CEA Annual Meeting in Ryerson University, Midwest Macro Meeting in University of Rochester, ECINEQ 2017 Meeting at the City University of New York, University of Pittsburgh, Pittsburgh Economics Medley, Villanova University, University of Central Florida, Cleveland State University, Bank of Korea, Central Bank of the Turkish Republic, Bogazici University, Middle East Technical University, Istanbul Technical University, Istanbul Bilgi University, TOBB Economics and Technology University and Kadir Has University for many helpful comments.

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