Redistributive Politics and Government Debt in a Borrowing-constrained Economy

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Abstract

We develop a two-period, three-class of income model where low-income agents are borrowing constrained because of capital market imperfections, and where redistributive expenditure is financed by tax and government debt. When the degree of capital market imperfection is high, there is an ends-against-the-middle equilibrium where the constrained low-income and the unconstrained high-income agents favor low levels of government debt and redistributive expenditure; these agents form a coalition against the middle. In this equilibrium, the levels of government debt and expenditure are below the efficient levels, and the spread of income distribution results in a lower debt-to-GDP ratio.

Keywords: Government debt; Borrowing constraints; Voting; Structure-induced equilibrium; Income inequality.

JEL Classification: D72, H52, H60.

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