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Political Incentives for Sovereign Default

Marina Azzimonti and Nirvana Mitra. "Political Constraints and Sovereign Default." ***Journal of International Money and Finance*****, October 2023, vol. 137, pp. 1-25.**

In some countries, actors must garner support from a wide swath of the body politic in order to enact policy. In others, national policy can be enacted by smaller and less representative groups, with the extreme of an absolute dictatorship. These differences among political systems can be summarized as the extent to which the country's policymaking is bound by "political constraints." Naturally, these constraints play a significant role in shaping government policy.

In a recent article in the *Journal of International Money and Finance*, Richmond Fed economist Marina Azzimonti and her co-author Nirvana Mitra of the Reserve Bank of India investigated the role that political constraints play in a government's decision to default on its debts. To do so, they developed a political-economy model in which representatives of different groups with veto power bargain over the nation's taxes, public spending, the level of international borrowing, and whether to default on their current obligations. They used this model to set on solid theoretical ground the intuitive negative relationship between a country's degree of political constraints and its probability of default.

The possibility of government default sets their model apart from a standard political-economic model; while many authors assume that governments will always honor their obligations, Azzimonti and Mitra sought instead to investigate the circumstances in which governments may find it optimal to instead default and exit the credit market. Their model allows for the political constraints of the model economy to vary from period to period. In each period, the "minimum winning coalition" — defined as the number of distinct representatives necessary to support a proposed policy — is allowed to change. To enact a policy beneficial to his or her constituents, a policy proposer will cobble together a proposal with as few fellow legislators as is constitutionally necessary, and to attract their support, the spoils of government are disproportionately expended on "pork" to the participating groups. Hence, the larger the current minimum winning coalition, the smaller the degree to which an unrepresentative selection of the country benefits from government decisions.

The theoretical arguments and empirical evidence amassed by Azzimonti and Mitra suggest that several distinct mechanisms exist by which tighter political constraints can reduce the risk of sovereign default.

Azzimonti and Mitra used this model to identify three distinct theoretical channels through which lower political constraints increase the probability of default. First, less constrained governments will tend to overspend, and thereby incur a larger debt burden. Indeed, the smaller a governing coalition, the greater the relative benefit to their constituents from issuing debt: Borrowed resources are distributed as largesse disproportionately to the few groups with governing representatives, but the eventual cost of repaying the loan is borne by the nation as a whole. For smaller coalitions, the personal benefit will outweigh the cost, leading to more spending, which ultimately increases the likelihood a future government will have no choice but to default.

Second, political constraints have a more direct effect on a government's decision to default. When a government defaults, the resources previously pledged to repay debt are released for the government's disposal, at the cost of temporarily exiting the international credit market. If the entire nation's well-being were to be considered, this scenario would likely not be optimal. Again, however, the released resources are not to be spread equally to all citizens, but disproportionately to those represented in the governing coalition. Hence, with a smaller minimum winning coalition, each group in it gets a larger piece of this pie, and so the benefit to a representative from defaulting is more likely to outweigh the negative consequences of the country exiting the credit market.

This ties into the third and final mechanism, a self-fulfilling prophecy of sorts. Rational international lenders are aware that less constrained governments will be more likely to default, so they demand higher prices for their debt to compensate for this risk. Hence, policymakers' behavior under loose constraints makes the debt burden less manageable, even if they are currently behaving responsibly, and thereby may make it more necessary to default in the future.

The theoretical arguments and empirical evidence amassed by Azzimonti and Mitra suggest that several distinct mechanisms exist by which tighter political constraints can reduce the risk of sovereign default. Their work suggests that tighter political constraints can reduce the degree to which a small segment of the country can overspend national resources for its own benefit, and in turn, reduce the likelihood of the significant economic and social trauma induced by a sovereign default. **EF**