Borrowing constraints, equilibrium default, and progressive taxation

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Abstract

In this paper, I investigate the effects of progressive taxation on private borrowing constraints and risk sharing. In particular, I construct an overlapping generations model with idiosyncratic productivity risk and default in equilibrium. The latter implies that loan prices on consumer credit are determined by individual default risk and thus, endogenous borrowing limits arise. As the main result, I find that public redistribution causes a significant crowding-out of private insurance. That is, increasing the progressivity of the income tax code leads to lower borrowing limits, which is especially pronounced for high-skilled households. Moreover, the dispersion in consumption responds barely to government policy, leading to the conclusion that redistribution might be an inefficient tool to dampen individual consumption fluctuations.

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