Debt Maturity without Commitment*

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Abstract

I analyze how lack of commitment affects the maturity structure of sovereign debt. Ex post, the government balances benefits of default induced redistribution and costs due to income losses in the wake of a default. Ex ante, the choice of short-versus long-term debt determines the probability of default and thus, revenue losses on inframarginal debt. The motive to minimize such losses, paired with the objective to smooth consumption, pins down the equilibrium maturity structure. Closed form solutions of the model predict an interior maturity structure with positive gross positions; a shortening of the maturity structure when debt issuance is high; and a shortening of the maturity structure in times of low output. These predictions are consistent with the empirical evidence.

Keywords: Debt; maturity structure; no commitment; default.

JEL Classification Code: E62, F34, H63.

1 Introduction

Sovereign borrowers exert considerable effort to structure their debt maturities optimally. This is difficult to reconcile with predictions of a frictionless benchmark model in which gross financial positions and thus, the maturity structure are indeterminate since only net positions affect agents’ wealth and incentives (as in Modigliani and Miller (1958) and Barro (1974)).

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In this paper, I offer an explanation for borrowers’ scrupulous choice of maturity, arguing that lack of commitment paired with social losses in the wake of a default undermines the neutrality of the maturity structure. Focusing on these two factors appears natural. After all, a large literature concerned with sovereign lending emphasizes the pervasiveness of limited contract enforceability while providing strong evidence for the presence of social losses in the aftermath of defaults.¹

I consider a government issuing real non-contingent debt of various maturities. Successive governments (or selves of the government) decide whether, and to what extent, to honor maturing debt. They also choose the level of taxation and new debt issuance to finance contemporaneous debt repayment as well as exogenous government spending. The government’s desire to redistribute from foreign bondholders to domestic taxpayers creates an incentive to default on the maturing debt which interacts with an opposing incentive to avoid the cost of defaulting.² I model this cost as temporary income losses for taxpayers, serving as stand-in for various types of social losses discussed in the literature. Both bondholders and the government form rational expectations. The price of debt maturities therefore reflects their expected repayment rate, and government policy is subgame perfect.

In equilibrium, the risk-adjusted required returns for short- and long-term funding are identical and the optimal maturity structure is determined on the demand side. Since debt issuance increases the probability of future default it reduces the price of inframarginal units of debt, generating revenue losses that enter negatively in the government’s program. (Positive effects due to less likely debt repayment in the future are balanced by negative effects due to more likely income losses in the wake of a default.) Under conditions explained in the paper, these revenue losses take the form of convex functions of the corresponding maturities. Minimization of total revenue losses therefore requires a balancing or “smoothing” of the maturity structure—in parallel with the smoothing of taxes in Barro’s (1979) model of convex tax collection costs. However, a perfectly balanced maturity structure generally is suboptimal, for two reasons. On the one hand, debt rollover policies by subsequent governments may give rise to an asymmetry in the structure of revenue losses across maturities. In particular, long-term debt issuance may increase the amount of debt to come due in the long run by less than one-to-one, rendering long-term debt issuance relatively less costly than short-term debt issuance. On the other hand, the government may exploit the default induced state contingency of debt returns for insurance purposes.

Closed form solutions of special cases of the model predict an interior maturity structure with positive gross positions, in line with the empirical evidence, but in contrast with

¹See Eaton and Fernandez (1995) for an overview over the cost that the literature has proposed in order to rationalize why sovereign lenders repay. Reinhart and Rogoff (2004) and Sturzenegger and Zettelmeyer (2006, pp. 49–52), among many other authors, provide strong evidence that sovereign defaults are costly.

²The incentive to default might alternatively derive from the government’s desire to transfer funds from the private to the public sector, in order to avoid tax distortions. Focusing on the redistributive motive is attractive for two reasons. On the one hand, conflict between interest groups indeed appears to affect governments’ default decisions, see the discussion later in the text. On the other hand, abstracting from tax distortions allows to disregard a second source of time inconsistency, related to the optimal timing of taxes (Lucas and Stokey, 1983).
predictions from models that stress the role of the maturity structure in completing markets (see below). The solutions also predict a shortening of the maturity structure when debt issuance is high (in line with evidence summarized by Rodrik and Velasco (1999)) and in times of low output (consistent with the evidence reported by Broner, Lorenzoni and Schmukler (2007)).

As mentioned before, revenue losses on inframarginal units of debt play a central role in the model. Closely related to these revenue losses, previous literature often has emphasized debt dilution as a consequence of lack of commitment. In particular, it has been pointed out that debt issuance reduces the value of outstanding debt and that this effect may increase governments’ incentives to issue new debt ex post. In contrast, the revenue losses of interest in the present paper arise with respect to contemporaneously issued debt and are fully internalized by the government seeking funding. Ex-post benefits from diluting outstanding debt therefore contrast with ex-ante costs of issuing new debt maturities, due to the social losses associated with a default.

Importantly, these findings derive from entirely standard premises. For example, the assumption that debt contracts stipulate non-contingent payments and social losses are triggered in the absence of contractually specified gross payments is standard, presumably reflecting the notion that informational constraints prevent sovereign borrowers from entering into more sophisticated financial arrangements. The present paper does not address the question of why such constraints arise (although it does speak on a related issue, see the discussion in Section 5), nor does it rationalize other central tenets in the sovereign debt literature, in particular lack of commitment. Instead, the paper maintains the standard set of assumptions and analyzes the determinants of sovereign debt maturity within their context.


Eaton and Gersovitz (1981) suggest that the threat of financial autarky discourages strategic default. For discussions and applications of this hypothesis as well as analyses

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3 According to Rodrik and Velasco (1999), “the overall debt burden (debt/GDP ratio) is positively correlated with short-term borrowing in the time-series (but not in the cross-section). One interpretation is that countries that go on a borrowing binge are forced to shorten the maturity of their external liabilities in the short run” (p. 21). According to Broner et al. (2007) “emerging economies issue relatively more short-term debt during periods of financial turmoil, and wait for tranquil times to issue longterm debt” (p. 3).

4 Dilution may be present even if outstanding debt is prioritized, see Bizer and DeMarzo (1992) who analyze the case where increased borrowing leads a borrower to take actions that lower the probability of repayment.

5 The model of this paper is silent about the choice of maturity structure in countries whose governments do not suffer from commitment problems. Choices of debt structure in those countries appear to be affected by liquidity concerns. In the UK, for example, the Debt Management Office “argues that cost is not the only factor. There is a virtue in being predictable, and in keeping all sections of the bond market supplied with debt to trade” (*The Economist*, “Losing interest,” June 14th 2008).
of the role played by the available financial instruments, see Bulow and Rogoff (1989b), Grossman and Han (1999), Kletzer and Wright (2000), Alvarez and Jermann (2000), Kehoe and Perri (2002) and Ljungqvist and Sargent (2004, ch. 19), among many others. Cole and Kehoe (1998) and Sandleris (2006) argue that a sovereign default serves as a negative signal, inducing parties outside of the credit relationship to initiate actions that are costly for the government. More direct default costs of the type considered here are present, for example, in the models of Bulow and Rogoff (1989a), Bulow and Rogoff (1989b), Cole and Kehoe (2000), Aguiar and Gopinath (2006) and Arellano (2008).\footnote{See also Tirole (2006, p. 180) where a default might trigger a costly loss of social capital.}

To motivate an optimal maturity structure, many authors suggest that short-term debt renders a country vulnerable to rollover crises, and that long-term debt reduces such vulnerability (Calvo, 1988; Alesina, Prati and Tabellini, 1990; Giavazzi and Pagano, 1990; Rodrik and Velasco, 1999; Cole and Kehoe, 2000). Chamon (2007) proposes a mechanism to eliminate the coordination failure associated with rollover crises. Phelan (2004) draws a distinction between the maturity of debt and the sequencing of debt rollovers which matters for crises. Broner et al. (2007) argue that supply side features induce emerging markets to borrow short-term in spite of the increased risk of a rollover crisis. In their model, lenders are risk averse and heavily exposed to the price risk of long-term emerging-markets debt. Higher quantities of long-term debt therefore drive up term premia and thus, the cost of long-term funding.

Angeletos (2002) argues that a sufficiently rich maturity structure of non-contingent bonds may serve as a substitute for state-contingent debt by completing markets for the government (see also Gale, 1990). Faraglia, Marcet and Scott (2008) document that the quantitative implications of this “complete market approach” are at odds with the data.

Closer in spirit to the present paper, Calvo and Guidotti (1990) and Missale and Blanchard (1994) discuss the role of the maturity structure of nominal debt for the government’s incentive to engineer surprise inflation. Hatchondo and Martinez (2008) analyze how the duration of government debt quantitatively affects debt issuance and default choices. Finally, a large literature in corporate finance analyzes the role of asymmetric information and control rights for the financial structure of firms (for an overview, see Hart, 1995; Tirole, 2006); see Jeanne (2004) for an application in the sovereign debt context.

The remainder of the paper is structured as follows. Section 2 presents the model. The main analysis is contained in Section 3. Section 4 characterizes the maturity structure in several special cases of the model. Section 5 concludes.

## 2 Model

Time is discrete and indexed by \( n = 0, 1, 2, \ldots \). There is a government that levies taxes, \( t_n \), and issues debt of various maturities, \( \{ b_{nm} \} \), at prices \( \{ q_{nm} \} \). Here, the first and second index of a debt maturity or its price denote the issuance and maturity dates, respectively. The debt maturity \( b_{nm} \) promises a return in period \( m \) that is independent of the state.
of nature in that period. Without loss of generality, exogenous government spending is normalized to zero.

2.1 Private Sector

All government debt is held by foreign investors while all taxes are paid by domestic agents. Taxpayers do not save nor borrow. The assumption that the two groups of taxpayers and investors do not “overlap” is unimportant for the central results, but simplifies the analysis. Modeling a mixed rather than concentrated ownership structure of debt would require a theory of how the ownership structure is determined in equilibrium. No such theory is available that would appear plausible in the current context. Assuming that taxpayers do not save also rationalizes why the government issues debt in the first place, in spite of taxes being non-distorting.

Taxpayers have time- and state-additive preferences over consumption and discount the future according to the discount factor \( \delta \in (0, 1) \). Let \( U_n(z_n) \) denote the value function of taxpayers in period \( n \). Here, the vector \( z_n \) collects current and anticipated state-contingent taxpayer incomes, \( \{y^u_i(s^i)\}_{i \geq n} \), as well as current and anticipated state-contingent taxes, \( \{t_i(s^i)\}_{i \geq n} \); the argument \( s^i \) denotes the history of exogenous shocks until period \( i \). The Bellman equation for taxpayers reads

\[
U_n(z_n) = u(y^u_n - t_n) + \delta E[U_{n+1}(z_{n+1}) | s^n]
\]

where the utility function \( u(\cdot) \) is strictly increasing and concave.

Investors are risk neutral and have access to a large international capital market with a riskfree interest rate equal to \( \beta^{-1}, \beta \in (0, 1) \). In equilibrium, newly issued government debt therefore pays an expected return of \( \beta^{-1} \) per period.

2.2 Government

The government maximizes the welfare of taxpayers. Policies are chosen sequentially and political decision makers cannot commit their successors (or future selves). In each period \( n \), the government in power therefore chooses taxes as well as the repayment rate, \( r_n \in [0, 1] \), on the debt maturing in the period, \( b_{xn} \equiv \sum_{l=0}^{n-1} b_{ln} \). While all maturing debt is treated equally, independently of its issuance date (pari passu), a government’s default decision only applies with respect to the contemporaneously maturing debt. This feature

7Mankiw (2000) or Matsen, Sveen and Torvik (2005) analyze fiscal policy in economies with “savers” and “spenders.”

8In equilibrium, the government’s default decision depends on the ownership structure of debt relative to the distribution of tax burdens across the population, see below. Changes in the ownership structure therefore affect the default decision ex post and thus, investment decisions ex ante.

9Tabellini (1991) and Dixit and Londregan (2000) provide theories of the ownership structure of debt. They assume that households can only save in government debt (Tabellini, 1991), or that the return on the only alternative asset is household specific (Dixit and Londregan, 2000). Both assumptions are not applicable in the current context. See also Niepelt (2004).

10If the government maximized a weighted average of taxpayers’ and investors’ welfare and attached a sufficiently large weight to the welfare of investors, interior repayment rates might result, in contrast to what follows. If the government attached a strictly positive weight to the welfare of investors and if investors were risk averse, the wealth of investors would enter the government’s program, in contrast to what follows.
is a direct consequence of the government’s lack of commitment: Being unable to tie the hands of its successors, a government cannot force its successors to pay a certain rate of return, for example zero. (Of course, default on successive maturities may nevertheless occur as an equilibrium phenomenon; see the discussion in Section 5.)

A large literature on sovereign debt discusses the restrictions that lack of commitment imposes on a government’s ability to issue debt. As mentioned in the introduction, this literature suggests that various default costs are responsible for a government’s decision to honor its obligations ex post rather than renege on them. Following that literature, I assume that a government default—defined as a situation where the repayment rate falls short of unity—triggers income losses for taxpayers (cf. Eaton and Gersovitz, 1981; Cole and Kehoe, 2000; Aguiar and Gopinath, 2006; Arellano, 2008). Ex post, the government therefore balances the benefit to taxpayers of a default induced reduction of government spending and the cost to taxpayers of default induced income losses.

I restrict attention to temporary income losses in the wake of a default. In particular, I assume that a default in period $n$ triggers an income loss $L_n \geq 0$; $L_n$ is the realization of an i.i.d. random variable with cumulative distribution function $F(\cdot)$ and associated probability density function $f(\cdot)$. I assume that $f(L) > 0$ for all $L > 0$. The government learns about the realization of $L_n$ at the beginning of the period, before choosing its policy instruments.

The assumption of temporary income losses is motivated by two considerations. First, temporary costs constitute a natural benchmark. Second, and more importantly, they appear plausible. While permanent exclusion from trade or credit markets and other forms of long-term punishment may serve as threat points, such permanent costs are unlikely to be realized in equilibrium if a defaulting sovereign and its lenders can renegotiate.\(^{11}\) Suppose, for example, that the sovereign chooses between either repaying, or not repaying and entering into a bargaining process with lenders. This process takes one period, generating income losses $L_n$, and results in a settlement where lenders secure a strictly positive repayment rate, $\bar{r}_n > 0$. The analysis in this paper is consistent with this interpretation although it abstracts from any safe return component on sovereign debt (as implied by $\bar{r}_n > 0$).

As a consequence of the default induced income losses, the income of taxpayers in period $n$ is given by

$$y_n^u = y_n - 1_{[r_n < 1]} L_n,$$

where $y_n$ denotes the exogenous income component and $1_{[x]}$ denotes the indicator function for event $x$.

### 2.3 Equilibrium

Conditional on an inherited maturity structure and the exogenous income process, an equilibrium as of period $n$ consists of a state-contingent sequence of policies (tax rates, repayment rates, issuance of debt maturities) and debt prices such that

i. the policy sequence maximizes $U_n(z_n)$;

\(^{11}\)Empirically, defaulting countries are not excluded from credit markets indefinitely.
ii. the dynamic government budget constraint is satisfied in all periods,

\[ t_i + \sum_{j>i} q_{ij} b_{ij} = b_{xi} r_i \text{ for all } i \geq n; \]

iii. the intertemporal budget constraint of the government is satisfied; and

iv. investors are willing to buy newly issued debt,

\[ q_{ij} = \beta^{j-i} \mathbb{E}[r_j(s^i)|s^i] \text{ for all } i, j \geq n. \]

Lack of commitment imposes additional equilibrium conditions. A time-consistent equilibrium as of period \( n \) consists of a sequence of policies and debt prices such that

i. policies and prices constitute an equilibrium; and

ii. anticipated policies coincide with the actual policies that successive governments optimally choose to implement.

The objective of the government in period \( n \) to select the “best” time-consistent equilibrium can now be stated as follows:\textsuperscript{12}

\[ \max_{t_n, r_n \in [0,1], \{b_{ni}\}_{i>n}} \mathbb{E} \left[ \sum_{i \geq n} \delta^{i-n} u(y_i - 1_{\{r_i < 1\}} L_i - t_i)|s^n \right] \]

s.t. \( (t_i, r_i \in [0,1], \{b_{ij}\}_{j>i}) \text{ optimal, conditional on } (y_i, L_i, \{b_{ik}\}), \text{ for all } i > n, \)

\[ t_i + \sum_{j>i} \beta^{j-i} \mathbb{E}[r_j(s^i)|s^i] b_{ij} = b_{xi} r_i \text{ for all } i \geq n, \text{ NPG condition.} \]

Outstanding debt as of period \( n \) that was issued before period \( n \) and will mature in period \( i \) is denoted by \( b_{xni} \): \( b_{xni} = \sum_{l=0}^{n-i} b_{li}, \ i \geq n. \) Accordingly, \( b_{xnn} = b_{xn}. \)

Since no debt is outstanding in the initial period, \( b_{x0i} = 0 \) for all \( i \geq 0 \), investors are insulated against the effects of policy ex ante. Due to rational expectations, all debt is priced at its fundamental value and no default-induced redistribution occurs in equilibrium.\textsuperscript{13} In contrast, the ex-ante welfare of taxpayers does depend on policy. First, because the timing of tax collections determines the smoothness of taxpayers’ consumption and thus, utility. Second, because default reduces taxpayers’ income. \textsuperscript{13}

\textsuperscript{12}I abstract from assets other than government debt. This assumption is not restrictive if the discount factor is sufficiently low. Alfaro and Kanczuk (2007) simulate a calibrated model with short term debt and a riskfree asset for savings. They find that an optimizing sovereign does not accumulate assets since doing so (rather than reducing the stock of debt) would unnecessarily undermine credibility.

\textsuperscript{13}Ex post, investors are of course “vulnerable” because they are directly affected by the government’s choice of repayment rate.
3 Analysis

I focus on the case with two maturities, short- and long-term debt. The former matures after one period, the latter after two. Accordingly, the state of the economy in period \( n \) is given by the tuple \( z_n = (y_n, L_n, b_{x,n}, b_{x,n,n+1}) \). (If the horizon is finite, time constitutes an additional state variable. The notation adopted in the following reflects this case.) The government’s budget deficit in period \( n \) is given by

\[
d_n \equiv b_{n,n+1} \beta E[r_{n+1} \mid s^n] + b_{n,n+2} \beta^2 E[r_{n+2} \mid s^n].
\]

3.1 Optimal Debt Repayment

Consider first the government’s choice of repayment rate, \( r_n \). Due to the temporary nature of the default costs, this choice is static in nature. Substituting the government’s budget constraint in the expression for taxpayers’ disposable income in period \( n \), the choice of \( r_n \) maximizes

\[
y_n - 1_{[r_n < 1]} L_n - b_{x,n} r_n + d_n.
\]

Since the marginal cost of reducing \( r_n \) equals zero for \( r_n < 1 \), the optimal repayment rate equals either zero or unity, depending on the realization of \( L_n \). In particular,

\[
r^*_n(z_n) = \begin{cases} 
1 & \text{if } L_n \geq b_{x,n} \\
0 & \text{if } L_n < b_{x,n}
\end{cases}
\]

(1)

and the government defaults whenever maturing debt exceeds the income losses in the wake of a default. This implication of the model is consistent with the notion that governments tend to default when the associated political cost—i.e., income losses of pivotal pressure groups—is low.\(^{14}\) Governments also tend to default when economic activity is depressed (Borensztein, Levy Yegati and Panizza, 2006; Tomz and Wright, 2007). The model is consistent with this fact as well if it is slightly extended to include a direct default cost for the government in addition to the income losses for taxpayers.\(^{15}\)

Corner solutions for the optimal repayment rate follow under more general assumptions about default costs than those invoked here, see the discussion in Appendix A. Interior repayment rates would only arise if income losses in the wake of a default were a convex function of the default rate (implausible, as argued in Appendix A) or the government attached sufficiently strong weight to the welfare of foreign investors (implausible as well).

\(^{14}\) Tomz (2002) documents that domestic audiences opposed Argentina to suspend debt payments in 1999 but supported such action two years later. Kohlscheen (2004) documents that parliamentary democracies rarely resort to rescheduling (despite shorter office terms of their executives), presumably because domestic constituencies opposed to default are more likely to be politically influential in representative democracies. MacDonald (2003) suggests that it is precisely in countries where a default does not generate clearly identifiable winners and losers among politically influential groups where sovereign defaults have been avoided.

\(^{15}\) If default triggers a cost \( K \) to the government in addition to the income losses for taxpayers, the default decision reduces to \( r_n = 1 \) iff \( u(y_n - b_{x,n} + d_n) \geq u(y_n - L_n + d_n) - K \) where the deficit following repayment may differ from the deficit following a default. Concavity of \( u(\cdot) \) implies that low income levels render a default more likely.
Equation (1) pins down debt prices: The price of short-term debt, issued in period $n$, is given by

$$q_{n,n+1} = \beta E[r_{n+1}|s^n] = \beta(1 - F(b_{x,n,n+1} + b_{n,n+1})), \quad (2)$$

while the price of long-term debt satisfies

$$q_{n,n+2} = \beta^2 E[r_{n+2}|s^n] = \beta^2 E[1 - F(b_{n,n+2} + b_{n+1,n+2})|s^n]. \quad (3)$$

The price of each maturity is decreasing in its quantity. This negative dependence arises because higher debt issuance reduces the probability of repayment. For the same reason, higher inherited, outstanding debt reduces the price of short-term debt while higher expected short-term debt issuance by the subsequent government ($b_{n+1,n+2}$) reduces the price of long-term debt.

### 3.2 Optimal Debt Issuance

From (2) and (3), the deficit in period $n$ can be expressed as

$$d_n = b_{n,n+1}\beta(1 - F(b_{x,n,n+1} + b_{n,n+1})) + b_{n,n+2}\beta^2 E[1 - F(b_{n,n+2} + b_{n+1,n+2})|s^n].$$

Let $b^*_{n,n+1}(z_n)$ and $b^*_{n,n+2}(z_n)$ denote the optimal short- and long-term debt issuance of the government in period $n$, respectively, and let $d^*_n$ denote the deficit along the equilibrium path, conditional on $z_n$:

$$d^*_n = b^*_{n,n+1}(z_n)\beta(1 - F(b_{x,n,n+1} + b^*_{n,n+1}(z_n))) + b^*_{n,n+2}(z_n)\beta^2 E[1 - F(b^*_{n,n+2}(z_n) + b^*_{n+1,n+2}(z_{n+1})|s^n].$$

From the perspective of the government in period $n$ that chooses $b_{n,n+1}$ and $b_{n,n+2}$, issuing a particular maturity has two types of effects. On the one hand, it raises revenue, in proportion to the price of the maturity. On the other hand, it affects the revenue raised from inframarginal units of debt, by changing the repayment probability and thus, price of these units. This second effect is a direct consequence of the government’s lack of commitment.

Formally, taking the rollover policy functions of the subsequent government as given, the effect of a marginal increase in $b_{n,n+1}$ and $b_{n,n+2}$ on the deficit is

$$\frac{dd_n}{db_{n,n+1}} = \beta \left(1 - F(b_{x,n+1}) - b_{n,n+1}f(b_{x,n+1}) - b_{n,n+2}\beta E\left[f(b_{x,n+2}) \frac{\partial b^*_{n+1,n+2}(z_{n+1})}{\partial b_{x,n+1}}|s^n\right] \right),$$

$$\frac{dd_n}{db_{n,n+2}} = \beta^2 \left(E[1 - F(b_{x,n+2})|s^n] - b_{n,n+2}E\left[f(b_{x,n+2}) \left(1 + \frac{\partial b^*_{n+1,n+2}(z_{n+1})}{\partial b_{x,n+1,n+2}}\right)|s^n\right] \right).$$
respectively. According to the first equation, short-term debt increases the deficit in proportion to the expected repayment rate, net of the above mentioned revenue effect on inframarginal units. This revenue effect is composed of two parts since short-term debt issuance does not only (directly) depress the price of short-term debt, but also (indirectly) the price of long-term debt if the increase of $b_{n,n+1}$ triggers responses by the subsequent government; I refer to these two parts as $I_{n,ss}$ and $I_{n,sl}$, respectively. According to the second equation, long-term debt issuance has direct and indirect revenue effects on inframarginal units as well, but only on newly-issued long-term debt; I refer to these as $I_{n,ll}$. Revenue effects on inframarginal units along the equilibrium path are denoted by a star, $I_{n,**}$ etc. Note that, conditional on the rollover policy $b_{n+1,n+2}$ ($z_{n+1}$) and the level of outstanding debt, $b_{x,n,n+1}$, the above marginal effects define the levels of short- and long-term debt issuance that attain the maximum of the “debt-Laffer surface.”

Using (1) and substituting the government’s budget constraint in the expression for taxpayers’ disposable income, the value function of the government in period $n$, $G_n(z_n)$, satisfies

$$G_n(z_n) = u(y_n - \min[b_{x,n}, L_n] + d^*_{n}) + \delta E[G_{n+1}(z_{n+1}) | s^n]$$

s.t.

$$b_{x,n+1} = b_{x,n,n+1} + b^*_{n,n+1}(z_n),$$

$$b_{x,n+1,n+2} = b^*_{n,n+2}(z_n).$$

The value function defines the maximal payoff to the government in period $n$ conditional on the state variables $z_n$. This maximal payoff is attained if the government defaults optimally (as reflected by the min[·] operator) and issues the optimal amount of short- and long-term debt (as reflected by the functions $b^*_{n,n+1}(z_n)$ and $b^*_{n,n+2}(z_n)$ implicit in $d^*_{n}$). Debt issuance in turn determines the stock of the two maturities in the subsequent period, as reflected in the two constraints.

I assume in the following that conditions are satisfied that render the above objective function well behaved, implying that the policy functions are smooth. Later, when considering special cases of the model, I verify that this is indeed the case.\textsuperscript{16}

Consider the effect of a marginal increase in the stock of maturing debt, given by

$$\frac{\partial G_n(z_n)}{\partial b_{x,n}} = \begin{cases} 
-u'(y_n - b_{x,n} + d^*_n) & \text{if } L_n \geq b_{x,n} \\
0 & \text{if } L_n < b_{x,n}
\end{cases}$$

(5)

According to (5), changes in the amount of maturing debt do not have an effect on $G_n(z_n)$ if the debt is defaulted upon anyway. In those states where the government does repay, in contrast, higher maturing debt reduces the government’s value in proportion to taxpayers’ marginal utility of consumption. This negative effect arises because debt repayment translates into higher taxes, notwithstanding the fact that a change of $b_{x,n}$ may also lead to adjustments of short- and long-term debt issuance. Such adjustments do

\textsuperscript{16}In general, the objective function is not concave in the amounts of debt issued, due to the option to default. In particular, two features might undermine concavity. First, the fact that higher debt issuance reduces the probability of repayment in the future. Second, if the price function is convex, the fact that higher debt issuance implies increasingly smaller revenue losses on inframarginal units of debt.
not have a first-order effect on \( G_n(z_n) \) and thus, are not reflected in the above condition since debt issuance is chosen optimally from the perspective of period \( n \).

The derivative of the expected continuation value function is given by

\[
\frac{\partial E[G_{n+1}(z_{n+1}) | s^n]}{\partial b_{x,n+1}} = \frac{\partial}{\partial b_{x,n+1}} \left\{ \mathbb{E}[\int_0^{b_{x,n+1}} u(y_{n+1} - L_{n+1} + d^*_{n+1}) dF(L_{n+1}) | s^n] + \mathbb{E}[\int_{b_{x,n+1}}^{\infty} u(y_{n+1} - b_{x,n+1} + d^*_{n+1}) dF(L_{n+1}) | s^n] \right\} \\
= - (1 - F(b_{x,n+1})) \mathbb{E}[u'(y_{n+1} - b_{x,n+1} + d^*_{n+1}) | s^n],
\]

where the last equality uses the independence of \( y_{n+1} \) and \( L_{n+1} \). (The deficit \( d^*_{n+1} \) in the last line is a function of \( b_{x,n+1}, b_{x,n+1,n+2} \) and the realization of \( y_{n+1} \); it does not depend on the realization of \( L_{n+1} \) since \( L_{n+1} \geq b_{x,n+1} \).

Consider next the effect of a marginal increase in the stock of outstanding debt. Differentiating (4) with respect to \( b_{x,n+1} \) yields

\[
\frac{\partial G_n(z_n)}{\partial b_{x,n+1}} = u'(y_n - \min[b_{x,n}, L_n] + d^*_n)\beta \left( I^{*}_{n,ss} + I^{*}_{n,sl} \right) + \delta \frac{\partial E[G_{n+1}(z_{n+1}) | s^n]}{\partial b_{x,n+1}}
\]

\[
= u'(y_n - \min[b_{x,n}, L_n] + d^*_n)\beta \left( I^{*}_{n,ss} + I^{*}_{n,sl} \right) \\
- \delta (1 - F(b_{x,n+1})) \mathbb{E}[u'(y_{n+1} - b_{x,n+1} + d^*_{n+1}) | s^n],
\]

where it is understood that the debt maturing in periods \( n + 1 \) and \( n + 2 \) depends on \( b^*_{n,n+1}(z_n) \) and \( b^*_{n,n+2}(z_n) \), respectively. Again, indirect effects on \( G_n(z_n) \) due to induced adjustments of short- and long-term debt issuance in period \( n \) are not of first order.

According to (6), higher outstanding debt has two effects on \( G_n(z_n) \). On the one hand, it affects contemporaneous felicity by changing the prices of short- and long-term debt issued in period \( n \) and thus, taxes. This is reflected in the \( I^* \) terms in (6). On the other hand, higher outstanding debt reduces taxpayers’ felicity in those states in the subsequent period where the outstanding debt is repaid. This effect is reflected in the second term on the right-hand side of (6).

With these results at hand, I now turn to a characterization of the debt issuance choice. Consider first the choice of short-term debt. From (4), the effect of a marginal increase in \( b_{n+1} \) in equilibrium is given by

\[
u'(y_n - \min[b_{x,n}, L_n] + d^*_n)\beta \left( 1 - F(b_{x,n+1}) + I^{*}_{n,ss} + I^{*}_{n,sl} \right) + \delta \frac{\partial E[G_{n+1}(z_{n+1}) | s^n]}{\partial b_{x,n+1}},
\]

which can be expressed as

\[
u'(y_n - \min[b_{x,n}, L_n] + d^*_n)\beta \left( I^{*}_{n,ss} + I^{*}_{n,sl} \right) \\
(1 - F(b_{x,n+1})) \left( \beta u'(y_n - \min[b_{x,n}, L_n] + d^*_n) - \delta \mathbb{E}[u'(y_{n+1} - b_{x,n+1} + d^*_{n+1}) | s^n] \right).
\]
Condition (7) identifies two distinct effects of short-term debt issuance on the government’s objective. On the one hand, a consumption smoothing effect, represented by the second line of (7) and reflecting the fact that debt issuance allows to smooth taxpayers’ marginal utility of consumption over time. By issuing one unit of short-term debt at price \( \beta (1 - F(b_{x,n+1})) \), taxpayers increase the deficit by the corresponding amount and gain marginal utility. At the same time, however, taxpayers face lower future consumption in those states where the debt is repaid. This negative effect is discounted at taxpayers’ discount factor, \( \delta \).

On the other hand, the expression in the first line of condition (7) represents the revenue effect on inframarginal units of debt, reflecting lack of commitment and the fact that the choice of \( b_{n,n+1} \) triggers responses by the subsequent government. These responses partly run counter to the interests of the government issuing the debt. To see this, consider the term \( I_{n,ss}^\star \) and suppose that the government wishes to raise revenue and issues short-term debt, \( b_{n,n+1} > 0 \). The higher stock of maturing debt in the following period induces the subsequent government to default more often, thereby depressing the issuance price of the debt. From the perspective of the government in period \( n + 1 \), the increased default probability does not have welfare effects since the government in period \( n + 1 \) is indifferent at the margin between repaying the debt or defaulting on it. From the perspective of the government in period \( n \), in contrast, the increased default probability is suboptimal as it reduces the revenue raised through debt issuance without a corresponding gain. The fact that the government in period \( n + 1 \) does not internalize the consequences of its choice of repayment rate on its predecessor’s revenue from debt issuance is at the source of the time inconsistency problem analyzed in this paper.

In the alternative case where the government prematurely redeems outstanding long-term debt (\( b_{n,n+1} < 0 \)), the induced behavioral response in the subsequent period again runs counter to the interests of the government in period \( n \). For debt redemption increases the expected repayment rate in the following period and therefore raises the price at which the government buys back its bonds. Both positive and negative choices of \( b_{n,n+1} \) therefore are associated with a negative expression for \( I_{n,ss}^\star \), indicating that such choices contribute negatively to the government’s objective. In contrast, the sign of the revenue effect on inframarginal long-term debt, \( I_{n,sl}^\star \), is ambiguous and depends on the sign of the induced change of rollover policy in the subsequent period. If increased short-term debt issuance induces the subsequent government to issue more short-term debt as well, then the default probability on long-term debt increases, implying revenue losses on inframarginal units of long-term debt. If the debt issuance induces reduced short-term debt issuance in the following period, however, then such losses may be averted. Appendix B further discusses the revenue effects on inframarginal units of debt, focusing on the role played by social (rather than private) losses in the wake of a default in shaping these effects.

Consider next the choice of long-term debt. From (4), the effect of a marginal increase in \( b_{n,n+2} \) in equilibrium is given by

\[
u'(y_n - \min[b_{x,n}, L_n] + d_n^\star) \beta^2 \left( E[1 - F(b_{x,n+2})|s^n] + I_{n,ll}^\star \right) + \delta \frac{\partial E[G_{n+1}(z_{n+1})|s^n]}{\partial b_{x,n+1,n+2}} ,\]

where
which can be expressed as

\[ u'(y_n - \min\{b_{x,n}, L_n\} + d_{n}^*) \beta^2 I^*_{n,tl} + \\
\delta E[u'(y_{n+1} - \min\{b_{x,n+1}, L_{n+1}\} + d_{n+1}^*) \beta (I_{n+1,ss} + I_{n+1,sl}) | s^n] + \\
E[(1 - F(b_{x,n+2})) (\beta^2 u'(y_n - \min\{b_{x,n}, L_n\} + d_{n}^*) - \delta^2 u'(y_{n+2} - b_{x,n+2} + d_{n+2}^*)) | s^n]. \]

(8)

Parallel to (7), expression (8) contains a consumption-smoothing effect (represented by the expression in the last line) and a revenue effect on inframarginal units. In contrast to (7), the revenue effect in (8) arises with respect to both contemporaneous and subsequent debt issuance. This is a direct consequence of the fact that long-term debt issuance affects subsequent short-term debt issuance, and that the effect of the latter on revenue raised in period \( n \) remains unaccounted for by the government in period \( n+1 \).

In an interior optimum, the marginal effects (7) and (8) both equal zero. Combining the two expressions and using the definition of prices then yields an alternative, instructive representation:

\[ u'(y_n - \min\{b_{x,n}, L_n\} + d_{n}^*) q_{n,n+2} - \delta E[u'(y_{n+1} - \min\{b_{x,n+1}, L_{n+1}\} + d_{n+1}^*) q_{n+1,n+2} | s^n] + \\
u'(y_n - \min\{b_{x,n}, L_n\} + d_{n}^*) \beta^2 I^*_{n,tl} = 0. \]

(9)

Condition (9) displays in the first line the consumption-smoothing effect from long-term debt that is prematurely redeemed after one period. The second line reflects the revenue effect on inframarginal units of long-term debt due to long-term debt issuance. Note that the debt burden is reflected in marginal utility losses across all states in period \( n+1 \), not only across all repayment states (as was the case in the original representation featuring marginal utility in period \( n+2 \)). A comparison of conditions (7) and (9) thus reveals the following differences between short- and long-term debt issuance: Short-term debt smoothes marginal utility between period \( n \) and the repayment states in period \( n+1 \), while long-term debt smoothes marginal utility between period \( n \) and all states in period \( n+1 \). In addition, short- and long-term debt generate different revenue effects on inframarginal units of debt.

To put these results into perspective, it is useful to recall the benchmark case with commitment, distinguishing between an environment with safe debt on the one hand and state-contingent debt on the other. If the government could commit its successors to honor maturing debt at face value, all \( I^* \) terms in the marginal expressions above would be absent; all \( \min\{b_{x,n}, L_n\} \) terms would be replaced by \( b_{x,n} \); and all repayment probabilities would equal unity. In an interior optimum, both (7) and (9) then would reduce to the same condition,

\[ \beta u'(y_n - b_{x,n} + d_{n}^*) - \delta E[u'(y_{n+1} - b_{x,n+1} + d_{n+1}^*) | s^n] = 0, \]

indicating that the government’s portfolio choice would be indeterminate. This result hinges on the fact that, due to the exogenous asset pricing kernel of investors, the price of outstanding debt does not respond to the realization of shocks. If, in contrast, the price of outstanding debt were state contingent because of an endogenous asset pricing
kernel, then the government’s choice of maturity structure would be determinate (see Gale, 1990; Angeletos, 2002).

If the government could commit its successors to honor maturing debt at state-contingent repayment rates, all $I$ terms in the marginal expressions above would again be absent; all $\min[b_{x,n}, L_n]$ terms would be replaced by $b_{x,n}r_n$; and all repayment probabilities would correspond to the respective averages of state-contingent repayment rates chosen ex ante. The optimal maturity structure then would be determinate if the returns to maturities correlated differently with taxpayers’ marginal utility, as in a standard portfolio choice problem. Absent such differences in the correlation structure (for example because of risk neutrality on the part of taxpayers), the choice of maturity structure would again be indeterminate.

In the model of this paper, determinacy of the optimal maturity structure does not rely on any of these features. In fact, the optimal maturity structure is pinned down although the asset pricing kernel is exogenous and even if tax payers are risk neutral (see below).

4 Special Cases

I now turn to a characterization of the optimal maturity structure in several special cases of the model. In all of these cases, the marginal utility of consumption is assumed to be constant within a period such that insurance considerations do not influence the choice of maturity structure. (As will become clear, this assumption can sometimes be relaxed.) The level of disposable income and thus, $b_{x,n}$, $y_n$ and $L_n$ therefore do not affect the government’s rollover decision in period $n$. This simplifies the analysis and allows to derive closed form solutions.

4.1 Front-Loading Consumption

Suppose that $u(c) = c$ for all $n \geq 0$ and $\delta \leq \beta$. The marginal effects from issuing short- and long-term debt, (7) and (8) respectively, then reduce to

$$\beta (I_{n,ss} + I_{n,sl}) + (1 - F(b_{x,n+1}))(\beta - \delta),$$

$$\beta^2 I_{n,ll} + \delta \beta E[I_{n+1,ss} + I_{n+1,sl}|s^n] + E[1 - F(b_{x,n+2})|s^n](\beta^2 - \delta^2).$$

The $I$-terms on the left-hand side of these expressions reflect the revenue losses on inframarginal units of debt; the terms on the right-hand side reflect the consumption-smoothing benefits from a marginal unit of debt.

Depending on the value of the government’s discount factor, $\delta$, the marginal effects (10) and (11) encompass three interesting scenarios. First, the case of $\delta = 0$ where the government exclusively cares about taxpayers’ current consumption. The consumption smoothing motive then reduces to the motive of raising revenue and the government aims at attaining the maximum of the debt-Laffer surface. As a consequence, all terms in the government’s objective function are proportional to taxpayers’ utility in the current period, implying that the assumption of risk neutrality is without loss of generality.
Formally, if $\delta = 0$, the marginal effects (10) and (11) reduce to

$$I_{n,ss} + I_{n,sl} + 1 - F(b_{x,n+1}),$$

$$I_{n,ll} + E[1 - F(b_{x,n+2})|s^n].$$

Second, the case of $\delta = \beta$. In this case, consumption smoothing considerations are absent from the government’s program and the government exclusively aims at minimizing the revenue losses on inframarginal units of debt. Formally, if $\delta = \beta$, the marginal effects (10) and (11) reduce to

$$I_{n,ss} + I_{n,sl},$$

$$I_{n,ll} + E[I_{n+1,ss} + I_{n+1,sl}|s^n].$$

Note that, absent a consumption-smoothing motive, there is no reason for the government to issue debt in the first place. When characterizing the ex-ante optimal maturity structure in the case $\delta = \beta$, I will therefore posit an exogenous revenue requirement in the initial period.\(^{17}\)

Finally, the case of $0 < \delta < \beta$. In this intermediate case, the government’s objective is dynamic and the low discount factor generates a motive for the government to front load consumption. In the quantitative sovereign debt literature, the assumption $0 < \delta < \beta$ is common. Typically, it is adopted because it is considered necessary in order to being able to match high debt quotas in the data (see, for example, Aguiar and Gopinath, 2006; Arellano, 2008).

As noted earlier, the linear utility assumption renders optimal debt issuance in period $n$ independent of $b_{x,n}$, $y_n$, and $L_n$. To see this, suppose the government in period $n$ expects subsequent rollover decisions to be unaffected by these variables. This implies $\partial b_{n+1,n+1}^*(z_{n+1})/\partial b_{x,n+1} = 0$ and thus, $I_{n,sl} = 0$. The marginal effect of short-term debt issuance, (10), therefore reduces to $\beta I_{n,ss} + (1 - F(b_{x,n+1}))(\beta - \delta)$ which is independent of $b_{x,n}$, $y_n$, or $L_n$.

Scaling this marginal effect by the price of short-term debt yields $-b_{n,n+1}H(b_{x,n+1}) + (\beta - \delta)/\beta$ where $H(L) \equiv f(L)/(1 - F(L))$ denotes the hazard function. In what follows, I assume that this hazard function is differentiable and weakly increasing—a rather weak assumption.\(^{18}\) In this case, the marginal effect of short-term debt issuance is strictly decreasing in $b_{n,n+1}$ and the condition

$$b_{n,n+1}H(b_{x,n+1}) = \frac{\beta - \delta}{\beta} \quad (12)$$

\(^{17}\)Alternatively, one could assume that taxpayers’ utility function is strictly concave in the initial period (generating a consumption smoothing motive in the initial period and rationalizing debt issuance) but linear in all subsequent periods. Identical conclusions would follow under this assumption.

\(^{18}\)Examples of distribution functions with increasing hazard functions include uniform, normal, exponential, logistic, extreme value, Laplace, power, Weibull, gamma, chi-squared, chi, or beta distributions (see, e.g., Bagnoli and Bergstrom, 2005).

If $L_n$ is distributed according to an exponential distribution, $F(L) = 1 - \exp(-\lambda L)$, then the hazard function is constant, $H(L) = \lambda$.

If $L_n$ is distributed according to a Weibull distribution, $F(L) = 1 - \exp(-L^\lambda), \lambda > 1$, then the hazard function is strictly increasing, $H(L) = \lambda L^{\lambda - 1}$; moreover, for $1 \leq \lambda \leq 2$, the hazard function is concave, and for all $\lambda > 1$, $H'(L)^2 - H(L)H''(L) > 0$. 

defines a smooth positive function $b_{n,n+1}^*(b_{n-1,n+1}) \geq 0$. Conditional on the amount of outstanding debt, $b_{n-1,n+1}$, equation (12) therefore pins down a unique, positive level of short-term debt issuance.

For later reference, note that the function $b_{n-1,n+1} + b_{n,n+1}^*(b_{n-1,n+1})$ is strictly increasing in $b_{n-1,n+1}$. For if $H(L)$ is constant, the function $b_{n,n+1}^*(b_{n-1,n+1})$ is constant as well; and if $H(L)$ is strictly increasing, then $-1 < \partial b_{n,n+1}^*(b_{n-1,n+1})/\partial b_{x,n,n+1} < 0$. Note also that the same function is convex if the hazard function satisfies a second-order criterion. In particular, $\partial^2 b_{n,n+1}^*(b_{n-1,n+1})/(\partial b_{x,n,n+1})^2 \geq 0$ requires that the following condition is satisfied:

(C) The function $H'(L)^2 - H(L)H''(L)$ is weakly positive, for example because the hazard function is concave.

(The exponential and Weibull distribution functions, among others, satisfy condition (C), see footnote 18.)

Turning to the marginal effect of long-term debt issuance, (11), and maintaining the assumption $H'(L) \geq 0$, we again have $L_{n+1,sl} = 0$. Since $b_{n+1,n+2}^*(b_{n,n+2})$ is deterministic, all expectation operators in (11) can be dropped. Moreover, since the expression in (10) equals zero, the marginal effect simplifies to $\beta^2 L_{n,n} + (1 - F(b_{x,n+2}))(\beta^2 - \delta \beta)$. Scaled by the price of long-term debt, this yields $-b_{n,n+2}H(b_{x,n+2}) \left(1 + \frac{\partial b_{n+1,n+2}^*(b_{n,n+2})}{\partial b_{x,n+1,n+2}}\right) + (\beta^2 - \delta \beta)/\beta^2$. Since $H'(L) \geq 0$ and $\partial b_{n+1,n+2}^*(b_{n,n+2})/\partial b_{x,n+1,n+2} > -1$, the condition

$$b_{n,n+2}H(b_{n,n+2} + b_{n+1,n+2}^*(b_{n,n+2})) \left(1 + \frac{\partial b_{n+1,n+2}^*(b_{n,n+2})}{\partial b_{x,n+1,n+2}}\right) = \frac{\beta - \delta}{\beta} \tag{13}$$

does not decline too quickly as a function of $b_{n,n+2}$. Under condition (C), for example, this is the case and the solution therefore is unique. Note that $b_{n,n+2}^*$ is independent of $b_{x,n}$, $b_{x,n+1}$, $y_n$, or $L_n$.

Summarizing, we have the following Lemma:

**Lemma 1.** Suppose that the utility function is linear, the hazard function weakly increasing and $\delta \leq \beta$. There exists an equilibrium in which the policy functions $b_{n,n+1}^*(z_n)$ and $b_{n,n+2}^*(z_n)$ do not depend on $b_{x,n}$, $y_n$, or $L_n$, for all $n \geq 0$. If the left-hand side of equation (13) is increasing in $b_{n,n+2}$, for example because condition (C) is satisfied, then the maturity structure in this equilibrium is unique.

The equilibrium characterized in the Lemma is the only equilibrium that arises in a finite horizon economy, including the limiting case where the number of periods approaches infinity. This follows from a straightforward backward induction argument. In the subsequent discussion, I focus on this type of equilibrium.

According to the first-order conditions (12) and (13), the government issues short- and long-term debt as long as the marginal cost falls short of the marginal benefit.\footnote{If the hazard function is not weakly increasing, the optimal maturity structure might be concentrated.} The marginal cost, given on the left-hand side of the two conditions, is given by the revenue
losses on inframarginal debt (normalized by the price of the respective maturity). The marginal benefit, given on the right-hand sides, is given by the net utility gain from the revenue and expected repayment of a marginal unit of debt (also normalized by the price of the respective maturity). This gain varies with the value of $\delta/\beta$. If $\delta = 0$, the gain equals unity, the marginal utility of current consumption, and the optimal policy attains the maximum of the debt-Laffer curves. If $\delta = \beta$, the gain equals zero because consumption smoothing considerations are absent from the government’s program. Finally, if $0 < \delta < \beta$, the gain lies between zero and one.

The optimal maturity structure depends on the value of $\delta/\beta$ as well as the shape of the hazard function. There are three constellations to consider. First, the case with a constant hazard function (and an arbitrary value for $\delta$, $0 \leq \delta \leq \beta$). Second, the case of $\delta = \beta$ (and an arbitrary, weakly increasing hazard function). Finally, the case of a strictly increasing hazard function paired with a “small” value for $\delta$, $0 \leq \delta < \beta$. I consider these cases in turn.

If the hazard function is constant, condition (12) implies that $b_{n,n}^*(b_{n-1,n+1})$ is a constant function and thus, that the partial derivative in (13) equals zero. As a consequence, the two conditions determine an interior and fully balanced maturity structure. Intuitively, with a constant hazard function, both the revenue losses on inframarginal debt and the revenue or smoothing gain from a marginal unit of debt only depend on the respective maturity. The optimal amount of each maturity therefore is determined independently of the other. Constancy of the hazard function also implies that the revenue losses on inframarginal debt relative to the marginal revenue gain are a convex function of the amount of debt issued. The optimal policy therefore smooths maturities (or better, the inframarginal losses associated with them), for parallel reasons as those driving Barro’s (1979) tax-smoothing prescription.

Since the quantities of short- and long-term debt issuance coincide within each period and are constant across periods, the default risk is time invariant as well. The market value of long-term debt issuance therefore constitutes a fraction $\beta$ of the market value of short-term debt issuance. In this sense, the maturity structure is tilted towards short-term debt. Moreover, in terms of the market value of stocks rather than flows, the maturity structure equals

$$\frac{(b_{n,n+1} + b_{n-1,n+1})\beta(1 - F(\cdot))}{b_{n,n+2}\beta^2(1 - F(\cdot))} = 2\beta^{-1}.$$

Summarizing, we have the following result:

**Proposition 1.** Suppose that the utility function is linear, the hazard function constant and $0 \leq \delta \leq \beta$. The unique optimal maturity structure is fully balanced in terms of quantities, tilted towards short-term debt in terms of market values, and equal to $2\beta^{-1}$ in terms of market value of the stock of maturities.

Consider next the case where $\delta = \beta$. Conditions (12) and (13) then imply $b_{n,n+1}^* = b_{n,n+2}^* = 0$. Intuitively, absent a consumption-smoothing motive, the government solely aims to avoid losses on inframarginal units of debt. Such losses arise if new debt is issued because debt issuance depresses the price of inframarginal units. They also arise if outstanding debt is prematurely redeemed (that is, if $b_{x,n,n+1} > 0$ and $b_{n,n+1} < 0$) because
debt redemption increases the price of inframarginal units, rendering debt issuance rather than redemption beneficial. As a consequence, the optimal policy abstains from both issuing and redeeming debt.

Suppose the government faces some exogenous revenue requirement in the initial period, \( d_0 > 0 \). The government’s program then runs over just three periods, \( n = 0, 1, 2 \). In particular, in period 0, the government issues short- and/or long-term debt, and in periods 1 and 2, this debt may or may not be repaid at maturity. Since no new debt is issued or prematurely redeemed, \( b_{x,1} = b_{0,1} \) and \( b_{x,2} = b_{0,2} \). Letting \( \mu \) denote the multiplier on the revenue requirement in the initial period, the first-order conditions characterizing debt issuance in period \( n = 0 \) then read

\[
\begin{align*}
    b_{0,1}H(b_{0,1}) &= \mu, \\
    b_{0,2}H(b_{0,2}) &= \mu
\end{align*}
\]

and the optimal maturity structure is fully balanced, for the same smoothing reasons as before. Clearly, this result generalizes to settings with an arbitrary finite number of maturities. In summary:

**Proposition 2.** Suppose that the utility function is linear, the hazard function weakly increasing and \( \delta = \beta \). The unique optimal maturity structure in the initial period is fully balanced in terms of quantities, and tilted towards short-term debt in terms of market values.

Finally, consider the case of a strictly increasing hazard function paired with a “small” value for \( \delta, 0 \leq \delta < \beta \). The optimality condition (12) then implies that \( b^*_n, n+1 (b^*_{n-1, n+1}) \) is strictly decreasing and thus, from (13), that the optimal maturity structure generally is not balanced. (Condition (C) guarantees that the partial derivative in (13) is increasing such that the optimal maturity structure is unique.)

In a stationary equilibrium, \( b^*_n, 1, n+1 = b^*_n, n+2 \equiv b^*_\text{shrt} \) and \( b^*_n, n+1 = b^*_n+1, n+2 \equiv b^*_\text{long} \) and the two conditions read

\[
\begin{align*}
    b^*_\text{shrt}H(b^*_\text{shrt} + b^*_\text{long}) &= 1 - \frac{\delta}{\beta}, \\
    b^*_\text{long}H(b^*_\text{shrt} + b^*_\text{long}) \left( 1 + \frac{\partial b^*_\text{shrt}(b^*_\text{long})}{\partial b_{x,n, n+1, n+2}} \right) &= 1 - \frac{\delta}{\beta}.
\end{align*}
\]

Since the partial derivative lies between -1 and 0, the optimal maturity structure is tilted towards long-term debt, \( b^*_\text{shrt} < b^*_\text{long} \). Intuitively, with an increasing hazard function, higher outstanding debt drives up the revenue losses on inframarginal short-term debt, discouraging short-term debt issuance. This, in turn, reduces the revenue losses on inframarginal long-term debt since long-term debt issuance increases the amount of debt maturing in the long run by less than one-to-one.\(^{20}\) If the partial derivative in the second

\(^{20}\)In spite of this moderating effect on the revenue losses on inframarginal long-term debt, the fundamental conflict of interest between successive governments remains present. Debt issuance by the subsequent government partly runs counter to the interests of the contemporaneous government.
equation is strictly increasing (as is the case, for example, if $L_n$ is distributed according to a Weibull distribution) then the tilt towards long-term debt becomes smaller as the total amount of debt issued increases. *Higher debt quotas then go hand in hand with a shortening* of the optimal maturity structure.

Outside of a stationary equilibrium, closed form solutions can be obtained, for example, if $L_n$ is distributed according to a Weibull distribution with parameter $\lambda = 2$ such that the hazard function equals $H(L) = 2L$ and a unique interior optimum is guaranteed. Equation (12) can then be solved to yield an expression for short-term debt issuance as a function of the stock of outstanding debt,

$$b^*_{n,n+1}(b_{n-1,n+1}) = -\frac{b_{n-1,n+1}}{2} + \sqrt{\frac{b^2_{n-1,n+1} + 2(1 - \frac{\delta}{\beta})}{4}}.$$

Using this relation, the condition characterizing long-term debt issuance, equation (13), reduces to

$$b^*_{n,n+2} = \sqrt{\sqrt{2(1 - \frac{\delta}{\beta})} - (1 - \frac{\delta}{\beta})}.$$

For small values of $b_{n-1,n+1}$, the optimal maturity structure therefore is *tilted towards short-term* debt; for larger values, it is *tilted towards long-term* debt. The maturity structure converges after one period. In the stationary equilibrium, $b^*_{n,n+1}/b^*_{n,n+2} \approx 0.7$, independently of the ratio $\delta/\beta$ and in line with the general finding discussed earlier. Summarizing, we have the following result:

**Proposition 3.** Suppose that the utility function is linear, the hazard function strictly increasing and $0 \leq \delta < \beta$. Condition (C) guarantees that the optimal maturity structure is unique. In a stationary equilibrium, the unique optimal maturity structure is tilted towards long-term debt; moreover, if the function in condition (C) is strictly positive, higher debt quotas go hand in hand with a shortening of the maturity structure. During the transition, the optimal maturity structure may be tilted towards long- or short-term debt.

### 4.2 Smoothing Consumption

I now turn to a setting with cyclical marginal utility of consumption. In particular, I assume that in even periods, $u_e(c) = c$, while in odd periods, $u_o(c) = u_o \cdot c$, with $u_o \geq 1$. This setting offers a useful approximation to an environment with cyclical variation in exogenous output—high output in even periods and low output in odd periods. The approximation is exact to the extent that the effect of output variation on disposable income dominates the effect from fluctuations in debt repayment, debt issuance or income losses in the wake of a default.

Consider a stationary environment with debt issuance $(b^*_{short,e}, b^*_{long,e})$ in even periods and $(b^*_{short,o}, b^*_{long,o})$ in odd periods. In even periods, the (normalized) marginal effects from issuing short- and long-term debt, (7) and (8) respectively, are given by

$$\beta(I_{e,ss} + I_{e,sl}) + (1 - F(b_{x,o}))(\beta - \delta u_o),$$

$$\beta^2 I_{e,ll} + \delta u_o(I_{o,ss} + I_{o,sl}) + (1 - F(b_{x,e}))(\beta^2 - \delta^2).$$
while in odd periods, they are given by

$$\beta (I_{o,ss} + I_{o,sl}) + (1 - F(b_{x,e})) \left( \beta - \frac{\delta}{u_o} \right),$$

$$\beta^2 I_{o,ll} + \frac{\delta \beta}{u_o} (I_{e,ss} + I_{e,sl}) + (1 - F(b_{x,o})(\beta^2 - \delta^2)).$$

Constancy of marginal utility within a period implies as before that $\partial b^\star_{n,n+1}(z_n)/\partial x_n = 0$ and thus, $I_{e,sl} = I_{o,sl} = 0$. Suppose that $\beta - \delta u_o \geq 0$, the hazard function $H(L)$ is weakly increasing, and condition (C) is satisfied. The first-order conditions

$$b^\star_{short,e} H(b^\star_{short,e} + b_{long,o}) = 1 - \frac{\delta u_o}{\beta},$$

$$b^\star_{short,o} H(b^\star_{short,o} + b_{long,e}) = 1 - \frac{\delta}{\beta u_o},$$

then define smooth positive functions, $b^\star_{short,e}(b_{long,o}) \geq 0$ and $b^\star_{short,o}(b_{long,e}) \geq 0$. Moreover, using these first-order conditions to simplify the marginal effects of long-term debt issuance and following steps parallel to those leading to Lemma 1 yields the first-order conditions

$$b^\star_{long,e} H(b^\star_{short,o} + b_{long,e}) \left( 1 + \frac{\partial b^\star_{short,o}(b^\star_{long,e})}{\partial x_n,n+1} \right) = 1 - \frac{\delta u_o}{\beta},$$

$$b^\star_{long,o} H(b^\star_{short,e} + b_{long,o}) \left( 1 + \frac{\partial b^\star_{short,e}(b^\star_{long,o})}{\partial x_n,n+1} \right) = 1 - \frac{\delta}{\beta u_o},$$

which pin down unique, positive long-term debt levels, $b^\star_{long,e} \geq 0$ and $b^\star_{long,o} \geq 0$. Jointly, the four conditions pin down the maturity structure over the two-period cycle.

Consider the case with a constant hazard function (exponentially distributed income losses in the wake of a default). The first-order conditions then imply $b^\star_{short,e} = b^\star_{long,e} \leq b^\star_{short,o} = b^\star_{long,o}$, such that the maturity structure is fully balanced with more debt being issued in periods of high marginal utility. Since $b^\star_{short,e} + b^\star_{long,o} = b^\star_{short,o} + b^\star_{long,e}$, the default risk is constant over time. As a consequence, the revenue raised and the cash flow generated under the equilibrium debt policy are countercyclical—the market value of debt issuance in periods with high marginal utility exceeds the market value of debt issuance in periods with low marginal utility, and the same holds true net of debt repayment. The maturity structure in terms of market values is tilted towards short-term debt (by a factor of $\beta^{-1}$). The relative market value of the stock of maturities equals

$$\frac{(b^\star_{short,e} + b^\star_{long,o})\beta(1 - F(\cdot))}{b^\star_{long,e} \beta^2(1 - F(\cdot))} \geq 2\beta^{-1}$$

in even periods while it is smaller than $2\beta^{-1}$ in odd periods. Measured by market value of the stocks, the maturity structure therefore shortens in periods preceding times of high marginal utility. Summarizing:
Proposition 4. Suppose that marginal utility fluctuates according to a two period cycle, the hazard function is constant and $0 \leq \delta u_o \leq \beta$. The unique optimal maturity structure is fully balanced in terms of quantities and tilted towards short-term debt in terms of market values. Measured by market value of the stocks, the maturity structure shortens in periods preceding times of high marginal utility. Revenue raised and cash flow are countercyclical.

Figure 1 displays an example, illustrating how different debt statistics depend on the ratio of marginal utilities, $u_o$. Solid lines in the figure correspond with periods of low marginal utility, dashed lines with periods of high marginal utility. The top two panels show that the quantities of short- and long-term debt issued within a period coincide while more debt is issued in periods of high marginal utility. The left panel in the second row shows that the debt policy raises more revenue in periods of high marginal utility. For comparison, the right panel in the second row plots the revenue that would be raised if only short-term debt were available. Since the hazard function is constant, having access to one rather than two maturities would lead the government to issue just half the quantity of debt in each period, raising less revenue, and raising revenue less cyclically.

The panels in the third row display the maturity structure in market values, both in terms of flows (on the left-hand side) and stocks (on the right-hand side). Finally, the panel on the left-hand side in the last row of Figure 1 summarizes the effect of debt policy on disposable household incomes (in periods where the government does not default). The cash flows are negative, but less so in periods where resources are scarce. Debt policy therefore helps to smooth consumption. For comparison, the right panel in the last row plots the cash flows that would be generated if only short-term debt were available.

Figure 2 displays an example for a smaller discount factor $\delta$. With this lower discount factor, governments issue more debt, but less cyclically, and they raise similar amounts of revenue in “good” times, but much less revenue in “bad” times. Due to the larger quantities of debt, cash flows in good and bad times are reduced.

With a strictly increasing hazard function, similar effects as those summarized in Proposition 3 come into play. In particular, the strictly negative partial derivatives in the first-order conditions characterizing long-term debt issuance imply that the flow maturity structure is tilted towards long-term debt. But this effect is relatively weaker in times of high marginal utility where higher debt issuance is associated with a shortening of the maturity structure, see Figure 3.

5 Concluding Remarks

This paper highlights the role of revenue losses on inframarginal units of debt. It finds that the optimal maturity structure aims at minimizing these losses, subject to the constraints imposed by subsequent debt rollover policies and the need to smooth taxpayers’ consumption.

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21 The examples are computed under the assumption that $\beta = 0.95$; $\delta = 0.1$ or $0.5$; the parameter of the exponential distribution equals $2/\sqrt{\pi}$; and the parameter of the Weibull distribution equals $2$ (the two distributions therefore have the same mean).
Figure 1: Stationary cyclical debt policies if income losses in the wake of a default are distributed according to an exponential distribution and $\delta = 0.5$. The figure plots debt statistics as functions of the ratio of marginal utilities, $u_o$; solid lines correspond with periods of low marginal utility, dashed lines with periods of high marginal utility.
Figure 2: Stationary cyclical debt policies if income losses in the wake of a default are distributed according to an exponential distribution and $\delta = 0.1$. The figure plots debt statistics as functions of the ratio of marginal utilities, $u_o$; solid lines correspond with periods of low marginal utility, dashed lines with periods of high marginal utility.
Figure 3: Stationary cyclical debt policies if income losses in the wake of a default are distributed according to a Weibull distribution and $\delta = 0.5$. The figure plots debt statistics as functions of the ratio of marginal utilities, $u_o$; solid lines correspond with periods of low marginal utility, dashed lines with periods of high marginal utility.
Closed form solutions of the model are consistent with features of the maturity structure observed in the data. In fact, the basic intuition of revenue losses on inframarginal units may also be able to explain other features that are not directly related to the maturity structure of sovereign debt. For example, revenue losses might serve as the foundation of a theory of “safe” versus state contingent debt. To see this, suppose that governments were able to issue Arrow securities, but the fundamental willingness-to-pay problem took the same form as in the model and income losses in the wake of a default were i.i.d. across states. Governments would then optimally issue “safe” rather than state contingent debt if the hazard function were constant and risk sharing considerations of second order.

These appealing features notwithstanding, some open questions remain. In particular, the assumption of lack of commitment makes it difficult to interpret sovereign defaults on maturing and outstanding debt. One approach to resolving this difficulty consists of simply imposing that a default on maturing debt automatically wipes out all outstanding maturities as well. An alternative approach that seems more consistent with the assumption that governments cannot commit, would be to interpret a “default” on outstanding debt as a debt buyback at low prices. Possible explanations for the low price could derive from a relaxation of the assumption that income losses in the wake of a default are i.i.d. If a low realization of these income losses predicted further low realizations in the future, then the decision not to honor maturing debt would typically go hand in hand with a collapse of the market price of outstanding debt. Alternatively, serial correlation of output as considered in Aguiar and Gopinath (2006) or Arellano (2008) could play a similar role if a government’s decision to default were influenced by the realization of income losses and exogenous output, as is the case in the slightly extended model with direct default costs discussed on page 8.
A Alternative Specifications of Social Losses

Corner solutions for the optimal repayment rate follow under more general assumptions about the losses in the wake of a default. Consider for example the case where income losses are proportional to $L_n$ and the default rate,

$$\text{losses}_n = (1 - r_n)L_n.$$  

The optimal repayment choice then is identical to the one given in the text.

Consider next the situation where income losses are proportional to $L_n$ and the total amount defaulted upon,

$$\text{losses}_n = (1 - r_n)b_{x,n}L_n.$$  

The optimal repayment rate then varies with $L_n$ but does not depend on the amount of maturing debt (because costs and benefits of changes in $r_n$ are proportional to $b_{x,n}$), rendering such a specification unattractive.

Consider next the situation where income losses are a concave function of the amount defaulted upon, for example

$$\text{losses}_n = [(1 - r_n)b_{x,n}]^{1/2}L_n$$

or

$$\text{losses}_n = 1_{[r_n < 1]}L_n + k(1 - r_n)b_{x,n}, \quad 0 < k < 1.$$  

Again, the optimal repayment rate then equals either unity or zero since the total cost from debt repayment and income losses is a concave function of the default rate.

If income losses are a convex function of the amount defaulted upon, for example

$$\text{losses}_n = [(1 - r_n)b_{x,n}]^{2}L_n,$$

then the equilibrium repayment rate is no longer discrete. However, convexity of income losses appears less plausible than the previously discussed specifications, for at least two reasons. First, most notions of income losses are consistent with concave costs: The marginal cost of defaulting on the first 5 percent of debt exceeds the one from defaulting on the following 5 percent. Second, convex income losses would lead governments to always default at least partially, in contrast with the empirical evidence.

B Social Losses and the Incentive to Dilute

In this section, I analyze how the assumption of social losses in the wake of a default shapes the government’s rollover decision. I focus on the case where the government only issues short-term debt. Recall from the text that, in this case,

$$\frac{dd_n}{db_{n,n+1}} = \beta \left( 1 - F(b_{x,n+1}) - \frac{b_{n,n+1}f(b_{x,n+1})}{\tau_{n,ss}} \right)$$
while the marginal effect of short-term debt issuance on the government’s objective is given by

\[
u'(y_n - \min[b_{x,n}, L_n] + d_n^*) \beta \mathcal{I}_{n,ss} + (1 - F(b_{x,n+1})) \left( \beta u'(y_n - \min[b_{x,n}, L_n] + d_n^*) - \delta \mathbb{E}[u'(y_{n+1} - b_{x,n+1} + d_n^*)|s^n] \right).
\]

To understand the role played by social losses in the wake of a default, consider an alternative setup without such losses. Assume as before that the government either fully repays the maturing debt or suffers a cost \(L_n\). In contrast to the main model, however, suppose now that this cost corresponds to a transfer to bondholders rather than a social loss. One can interpret this modified setting as a situation where the realization of \(L_n\) determines the bargaining power of bondholders vis-à-vis the government. According to this interpretation, bondholders can successfully press for full repayment if the realization of \(L_n\) is high. If the realization of \(L_n\) falls short of the maturing debt, however, bondholders must concede and settle for a reduced repayment equal to \(L_n\).

In this modified setup, the repayment rate in period \(n\) is given by

\[
r_n^*(z_n) = \begin{cases} 1 & \text{if } L_n \geq b_{x,n} \\ \frac{L_n}{b_{x,n}} & \text{if } L_n < b_{x,n} \end{cases}
\]

and the expected repayment rate therefore features a new component that accounts for payments in the partial default case:

\[
\mathbb{E}[r_{n+1}|s^n] = 1 - F(b_{x,n+1}) + \frac{1}{b_{x,n+1}} \int_0^{b_{x,n+1}} L_{n+1} dF(L_{n+1}).
\]

Accordingly, the marginal effect of debt issuance in period \(n\) on the deficit in that period changes to

\[
\frac{d}{d b_{n,n+1}} = \beta \left( 1 - F(b_{x,n+1}) - b_{n,n+1} f(b_{x,n+1}) \right) + b_{n,n+1} f(b_{x,n+1}) + \frac{1}{b_{x,n+1}} \int_0^{b_{x,n+1}} L_{n+1} dF(L_{n+1}) \left( 1 - \frac{b_{n,n+1}}{b_{x,n+1}} \right).
\]

The presence of transfers rather than social losses introduces three marginal effects in addition to those present in the main model. First, the increase in \(b_{n,n+1}\) raises more revenue because newly-issued debt is partially repaid in some states, as reflected in the term \(\frac{1}{b_{x,n+1}} \int_0^{b_{x,n+1}} L_{n+1} dF(L_{n+1})\). Second, as reflected in the term \(b_{n,n+1} f(b_{x,n+1})\), an increase in \(b_{n,n+1}\) raises the probability of partial repayment of the newly-issued debt at the critical income loss, \(b_{x,n+1}\). Finally, the increase in \(b_{n,n+1}\) causes revenue losses on newly-issued inframarginal debt, \(-\frac{b_{n,n+1}}{b_{x,n+1}} \int_0^{b_{x,n+1}} L_{n+1} dF(L_{n+1})\), because it reduces the repayment rate in case of partial default.

The second of these additional effects cancels with the loss on inframarginal debt that is already present in the main model. Intuitively, the revenue gain due to more likely,
partial repayment exactly compensates for the revenue loss due to less likely, full repayment. On net, the marginal effect on the deficit therefore amounts to

$$1 - F(b_{x,n+1}) + \frac{1}{b_{x,n+1}} \int_0^{b_{x,n+1}} L_{n+1} d F(L_{n+1}) \left( 1 - \frac{b_{x,n+1}}{b_{x,n+1}} \right).$$

If $0 < b_{x,n,n+1} < b_{x,n+1}$ such that debt is outstanding and the government issues additional debt, then this marginal effect exceeds $1 - F(b_{x,n+1})$ because the *dilution* of outstanding debt increases the revenue raised from newly issued debt. This contrasts with the marginal effect in the main model. There, the devaluation of outstanding debt does not give rise to corresponding revenue gains on newly-issued debt (there is no “redistribution of collateral” from outstanding to newly-issued debt). Absent such benefits from dilution, the net revenue effect of newly issued debt in the main model therefore falls short of $1 - F(b_{x,n+1})$.

The government’s program in period $n$ is unchanged relative to the original setup, except for the modified expression characterizing the deficit. (From the government’s point of view, it is irrelevant whether income losses in period $n+1$ correspond to transfers to bond holders rather than social losses.) The effect of a marginal increase in $b_{n,n+1}$ therefore equals

$$u'(y_n - \min[b_{x,n}, L_n] + d^*_n) \beta \frac{1}{b_{x,n+1}} \int_0^{b_{x,n+1}} L_{n+1} d F(L_{n+1}) \frac{b_{x,n,n+1}}{b_{x,n+1}} +$$

$$(1 - F(b_{x,n+1})) \left( \beta u'(y_n - \min[b_{x,n}, L_n] + d^*_n) - \delta E[u'(y_{n+1} - b_{x,n+1} + d^*_n)|s^n] \right),$$

reflecting the same consumption-smoothing effect as in the main model (in the second line), but a modified revenue effect on inframarginal units of debt (in the first line). Without social losses in the wake of a default as they are present in the original setup, the government therefore has an incentive to dilute outstanding debt.
References


