

2012 (/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&filtertype_1=dateissued&filter_relational_operator_1=contains&filter_1=2012)

Working Paper (/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&filtertype_1=type&filter_relational_operator_1>equals&filter_1=Working Paper)

Financial Markets as a Commitment Device for the Government

Working Paper, EUI MWP, 2012/12



Cite

How does the presence of financial markets shape the government's ability to implement social redistribution? Individuals do not typically constrain consumption to equal their net-of-tax income every period. Instead, access to financial markets allows them to allocate their resources over time. On the other hand, the markets that individual agents trade in are usually incomplete, in the sense that adjustments to contracts are costly. A mortgage, for example, helps to smooth housing consumption. Yet, buying a house constitutes a significant individual commitment. It cannot be changed costlessly at every point in time. In particular a downward adjustment often comes with significant losses. Optimal redistributive policy ought to take agents' involvement in such financial markets into account. I study a two-period endowment economy with heterogeneous income types and private information, where a government without commitment cannot provide any social redistribution. I show how agents' involvement in a financial market can improve the government's ability to commit at least to a partially separating allocation in the second period, enabling it to provide some redistribution across agents. In this world, agents borrow against their promised income and enter long-term individual consumption commitments. However, changing these contracts creates a deadweight loss. This changes the government's ex-post incentives to renege on the promised tax schedule and fully redistribute, because some agents would have to default on their loans. I show that whenever this default cost is positive, the government is able to commit to a schedule that only pools some agents of similar type together. In other words, it serves as a commitment device in the sense that it enables the government to commit not to exploit a limited amount of information. Thus, the presence of financial markets may in fact facilitate redistribution.

Cadmus permanent link: <https://hdl.handle.net/1814/22794> (<https://hdl.handle.net/1814/22794>)

ISSN: 1830-7728

Series/Number: EUI MWP: 2012/12

Keyword(s): [Limited Commitment \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22Limited Commitment%22\)](#) [Commitment Device \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22Commitment Device%22\)](#) [Financial Markets \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22Financial Markets%22\)](#) [Redistribution \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22Redistribution%22\)](#) [E&I \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22E&I%22\)](#) [B21 \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22H21%22\)](#) [B&Z \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22B&Z%22\)](#)

Show full item record (/handle/1814/22794?show=full)

Files associated with this item



([bitstream/handle/1814/22794/MWP_2012_12_Simon.pdf?sequence=1&isAllowed=y](https://bitstream.handle/1814/22794/MWP_2012_12_Simon.pdf?sequence=1&isAllowed=y))

Name:
MWP_2012_12_Simon.pdf

Size:
393.3Kb

Format:
PDF

Description:
2012/12

Collections

- [MWP Working Papers \(/handle/1814/6892\)](#)
- [ECO Working Papers \(/handle/1814/4\)](#)

Connected with:  [. \(https://orcid.org\)](https://orcid.org)  [. \(https://openaire.eu\)](https://openaire.eu)  [. \(https://core.ac.uk/data-providers/993\)](https://core.ac.uk/data-providers/993)  [. \(http://www.sherpa.ac.uk/romeo/index.php\)](http://www.sherpa.ac.uk/romeo/index.php)  [. \(http://repec.org/\)](http://repec.org/)  [. \(https://www.worldcat.org/\)](https://www.worldcat.org/)  [. \(https://scholar.google.com\)](https://scholar.google.com)

Cadmus - EUI Research Repository is a service of the [EUI Library \(https://www.eui.eu/Research/Library\)](https://www.eui.eu/Research/Library).
[Terms and Conditions of Use \(https://www.eui.eu/AboutTheWebsite/Disclaimer.aspx\)](https://www.eui.eu/AboutTheWebsite/Disclaimer.aspx) - [Data Protection \(https://www.eui.eu/AboutTheWebsite/DataProtection.aspx\)](https://www.eui.eu/AboutTheWebsite/DataProtection.aspx) - [Takedown Policy \(https://www.eui.eu/Research/Library/PublishingAndOpenScience/Cadmus-TakedownPolicy\)](#).

Library Open Science Office
© European University Institute
Badia Fiesolana - Via dei Roccettini 9
I-50014 San Domenico di Fiesole (FI) Italy
E-mail: cadmus@eui.eu (<mailto:cadmus@eui.eu>). - Phone: [+39] 055 4685 368 (tel:+39-055-4685368).

About Cadmus

[All about Cadmus \(https://www.eui.eu/Research/Library/PublishingAndOpenScience/Cadmus-About\)](https://www.eui.eu/Research/Library/PublishingAndOpenScience/Cadmus-About)
[Copyright toolbox \(https://www.eui.eu/Research/Library/PublishingAndOpenScience/CopyrightAndOpenAccess\)](https://www.eui.eu/Research/Library/PublishingAndOpenScience/CopyrightAndOpenAccess)
[EUI Open Access \(https://www.eui.eu/Research/Library/PublishingAndOpenScience/OAPublishing\)](https://www.eui.eu/Research/Library/PublishingAndOpenScience/OAPublishing)
[EUI Open Access Policy \(https://www.eui.eu/Documents/Research/Library/PublishingAndOpenScience/EUIPolicyonOpenAccess.pdf\)](https://www.eui.eu/Documents/Research/Library/PublishingAndOpenScience/EUIPolicyonOpenAccess.pdf)
[EUI ORCID Guide \(https://www.eui.eu/ORCID\)](https://www.eui.eu/ORCID)
[Licence agreement \(http://www.eui.eu/Documents/Research/Library/PublishingAndOpenScience/CadmusLicenceAgreement.pdf\)](http://www.eui.eu/Documents/Research/Library/PublishingAndOpenScience/CadmusLicenceAgreement.pdf)

Selected collections

[Open Access Articles \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22info%3Aeu-repo%2Fsemantics%2FopenAccess%22&filtertype_0=type&filter_0=Article&filter_relational_operator_0>equals\)](#)
[Open Access Books \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22info%3Aeu-repo%2Fsemantics%2FopenAccess%22&filtertype_0=type&filter_0=Book&filter_relational_operator_0>equals\)](#)
[Open Access Book Chapters \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22info%3Aeu-repo%2Fsemantics%2FopenAccess%22&filtertype_0=type&filter_0=Contribution+to+book&filter_relational_operator_0>equals\)](#)
[Open Access Theses \(/discover?order=desc&rng=10&sort_by=dc.date.issued_dt&query=%22info%3Aeu-repo%2Fsemantics%2FopenAccess%22&filtertype_0=type&filter_0=Thesis&filter_relational_operator_0=\)](#)
[EUI Theses published as Books \(/discover?scope=%2F&query=%22Published+version+of+EUI+PhD+thesis%22%2B%22Published+version+of+EUI+LLM+thesis%22&submit=&filtertype_0=type&f%0Afilter_0=Book&filter_relational_operator_0=sort_by=dc.date.issued_dt&filtertype_1=subject&filter_relational_operator_1>equals&filter_1=CoFoE&submit_apply_filter=\)](#)

The reuse of metadata from Cadmus, the EUI Research Repository is authorized under the [CC0 1.0 Universal \(CC0 1.0\) Public Domain Dedication](https://creativecommons.org/publicdomain/mark/1.0/) ( (<http://creativecommons.org/publicdomain/mark/1.0/>)).

