Abstract
Europe’s debt crisis resembles historical episodes of outright default on domestic public debt about which little research exists. This paper proposes a theory of domestic sovereign default based on distributional incentives affecting the welfare of risk-averse debt and non-debt holders. A utilitarian government cannot sustain debt if default is costless. If default is costly, debt with default risk is sustainable, and debt falls as the concentration of debt ownership rises. A government favoring bond holders can also sustain debt, with debt rising as ownership becomes more concentrated. These results are robust to adding foreign investors, redistributive taxes, or a second asset. (JEL: E6, E44, F34, H63)

Keywords: public debt, sovereign default, European debt crisis.