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Introduction

> A national bankruptcy is by no means illegal, and whether it is immoral or unwise depends altogether upon circumstances. One can hardly ask of the present generation that it alone suffer for the folly and waste of its predecessors, for otherwise in the end a country could hardly be inhabited because of the mass of its public debts.
>
> Gustav Hugo (1819), *Textbook of Natural Law*

> "It really is irresponsible of the president to try to scare the markets," said Senator Rand Paul, Republican of Kentucky. "If you don't raise your debt ceiling, all you're saying is, 'We're going to be balancing our budget.' So if you put it in those terms, all these scary terms of, 'Oh my goodness, the world's going to end' – if we balance the budget, the world's going to end? Why don't we spend what comes in?"
>
> "If you propose it that way," he said of not raising the debt limit, "The American public will say that sounds like a pretty reasonable idea."
>
> *New York Times*, October 8, 2013

Seeking to cover a large and growing budgetary imbalance, in late 1976 the president of Egypt, Anwar Sadat, turned to the World Bank for loans. As is customary in cases of borrowing from international financial institutions, the World Bank responded by demanding that – in exchange for new lending – the Egyptian government would need to reform several policies that were viewed as detrimental to the budget. Of particular importance was an emphasis on the need to do away with costly food subsidies, especially on bread. Under external pressure to reform cheap food policies, in January 1977 Sadat announced the end of government subsidies on several basic commodities, including flour, rice, and cooking oil. As prices for food skyrocketed by nearly

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50 percent over the next few weeks, the response by a struggling population lacking other channels of government influence was predictable: widespread rioting and unrest in which dozens died and hundreds were injured. Echoing calls by rioters for bread as a mobilizing cry, the "bread riots" of 1977 represented a large-scale outpouring of antiregime protest that was seen as a critical threat to the stability of Sadat's rule. In response, by month's end, the government backpedaled on the economic reforms and reinstated the food subsidies. Yet having failed at the reforms called for by the World Bank, Egypt has subsequently struggled periodically to raise foreign capital, particularly during times of budgetary crisis. This tension between politically popular (and regime-stabilizing) subsidies for the population, and demands for their reform in order to secure international loans, has persisted up to this day: As recently as February 2018, *The Economist* ran an article identifying food subsidies as a constant source of fiscal trouble for Egypt.[1]

Internal demands on government finances are a crucial component of politics. Yet, in the quest to identify additional sources of revenue, states may sometimes run up against external demands for reform in exchange for more money. This dilemma puts incumbent leaders in an exceedingly difficult bind, as fiscal politics is the lifeblood of the state. Without sufficient government revenue, armies go unlevied, granaries are emptied, and bridges fall into disrepair. Regardless of a politician's particular aims for staying in power, these goals will almost certainly require funding to be achieved – and so, before it is anything else, politics is inherently fiscal. This is particularly true in redistributive regimes, where battles over spending and taxation occupy the center of the political spectrum. Whom to tax, and how heavily? Whom to benefit, and how much? If budgets must be balanced between revenue brought in, and spending going out, then every policy choice comes at the expense of some (potentially politically relevant) group, and the delicate balancing act between competing interests will be the source of bitter political struggle.

And yet, as most countries have discovered, the presupposition that fiscal politics occurs under the constraint of a binding budget need not necessarily be true, at least in the short to medium term. If maintaining power requires pleasing multiple groups beyond the normal budgetary capacity of the state, there exists a means of smoothing over this discrepancy: debt. When cash is flush, politics is relatively easy; if you can afford to give everyone what they want, why not do so? By borrowing the difference between what states are capable of coaxing out of taxes, and the spending they wish to pursue in order to please important constituencies, leaders can secure safe tenure in office – until these funds run dry.

[1] www.economist.com/news/middle-east-and-africa/21736552-egyptians-are-addicted-subsidies-make-them-poorer-what-fuel-bread-and

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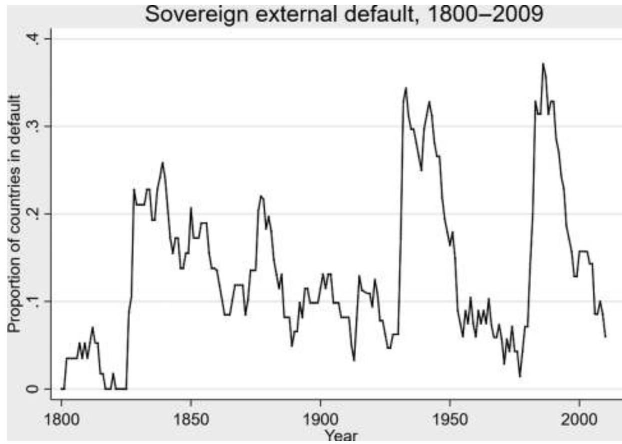

FIGURE 1.1. Proportion of countries in default, 1800–2009.

It is during times of fiscal crisis, when outside borrowing no longer suffices to bridge the gap between what a state spends and what it earns, that politicians are forced to engage in difficult political calculus and identify those groups in society whose support is truly crucial. During these difficult times, some countries manage to successfully engage in structural reforms in order to remain current on their international debt payments. Others, however, ultimately decide that the costs of austerity are politically unpalatable, and thus default on their sovereign debt. What determines the capacity of countries to successfully reform? Conversely, what characterizes the political dynamics of countries that fail to do so, and are forced to default instead?

Figure 1.1, drawn from pathbreaking work on the history of economic crises by Reinhart and Rogoff (2009), shows the yearly proportion of countries that have been in default on debt owed to external creditors, beginning in 1800. As can be seen, default is far from a rare occurrence: there are years when a third of all countries have been in default on their international financial obligations. Additionally, since the 1830s, there has never been a year in which no country was in default. Looking over the entire period, the average proportion of countries in default for the entire sample is just under 15 percent, which suggests that in any given year, we should expect to find one out of every seven countries in the world to be in default. Sovereign default is a historically prevalent, periodically recurrent, and potentially catastrophic form of economic crisis. And yet – despite the right to renege on international debt obligations generally being held by politicians themselves or politically-appointed bureaucrats – our understanding of the political determinants of sovereign default is largely undeveloped. This work fills the gap, deriving a regime-contingent theory linking dynamics of political survival to specific fiscally burdensome policies

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that, during times of budgetary crisis, prove difficult to remove, and thereby increase the likelihood of sovereign default.

1.1 ECONOMIC CRISIS AND POLITICAL REFORM

1.1.1 The Politics of Economic Reform

While there exists little work on the politics of sovereign default in particular,[2] there is a long-standing literature in political science on the politics of economic reform more generally that helps inform my own theorizing. For instance, Gourevitch (1986) usefully linked the material interests of the owners of different factors of production (such as laborers and farmers) to specific policy conflicts that could only be overcome when seismic shifts from economic crisis created opportunities for new political coalitions of support. Relatedly, Simmons's (1997) account of which countries were better able to implement the economic changes necessary to preserve their commitments to the Gold Standard in the interwar years relied in large part on the credibility that such reforms would be feasible to domestic political audiences. To the extent that there existed greater domestic political instability, the implied shortening of time horizons for sitting incumbents was expected to reduce concerns over the long-run costs of reneging on currency obligations. Frieden's (1991, 8) assertion that, during times of fiscal crisis, "policymakers provided more resources to those who exerted more pressure on them, and that economic interest groups exerted pressure on policymakers in direct proportion to what they had to gain or lose from policy and the ease with which they could mobilize" is a close parallel to the broad theoretical approach I employ in this work.

In focusing on the apparent failure of many African countries to successfully reform their economies – despite decades of economic distress – Van de Walle (2001) emphasizes that the reform process has generally taken a back seat to political considerations, such that burdensome but politically influential programs like state employment and agricultural price control have remained stubbornly resistant to change. And while some governments have had success in cutting expenditures for public programs while under the guidance of international institutions like the IMF, work by Nooruddin and Simmons (2006) demonstrates that these effects often vary across regime types, presumably due to differential political pressure from groups under different kinds of institutional settings. While it might seem that authoritarian regimes ought to enjoy advantages in implementing unpopular economic reforms through greater repressive capacity and limited need for popular support, more careful work on the political limits of autocratic rulers has emphasized that there are

[2] While work along such lines remains limited, I am certainly not the first to recognize the need to disaggregate the domestic politics of debt default – over 20 years ago Eichengreen and Lindert (1992, 6) had already noted that "different domestic interest groups may attach very different priority to the maintenance of debt service [and so] understanding either the domestic politics of debt or the course of international negotiations requires disaggregating domestic interest groups."

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still significant constraints on what people in nonelectoral regimes can be asked to bear before turning to protest, particularly in regimes without access to large rents from oil or other natural resources (Haggard 1985). In addition, Pepinsky (2008, 2009) demonstrates that understanding the response of autocratic regimes to economic crisis requires more careful consideration of the precise constellation of societal groups that form the core of its political support.

More recently, Walter (2013, 2016) has developed a useful typology of "vulnerability profiles" for countries facing the need for reforms due to financial crises. This work identifies that, in most cases of macroeconomic disequilibrium that lead to subsequent trouble, countries can usually engage in either "external adjustment" by allowing the currency to depreciate, or "internal adjustment" via austerity measures meant to reduce aggregate demand and thereby affect domestic prices. Walter (2016) emphasizes that countries will generally adjust along the margin which is least politically painful for incumbents; for example, when importers are not a politically-salient constituency, currency devaluation may be more palatable than, say, cutting government expenditures. Alternately, when maintaining a fixed exchange rate is of paramount importance, but domestic expenditure programs to be reformed do not benefit core regime supporters, economic reform via internal adjustment is more likely to occur.

While extremely useful as a guiding typology, I note that, for developing countries facing external debt troubles, neither reform path is likely to be easy. Walter's (2013) focus is primarily on the responses of various developed European countries during the European debt crisis; in such settings, the emphasis on internal versus external margins of adjustment is of central concern. However, as noted by Mosley (2000, 2003) and reaffirmed by Reinhart and Rogoff (2009), concern over sovereign default is much more pronounced among low- to middle-income countries,[3] where the sets of relevant domestic and international pressures during crisis may be somewhat distinct from those faced in the OECD. To begin, much borrowing from foreign lenders by developing countries is denominated in foreign currency – this serves as a means of lessening risks to lenders from currency fluctuation. While this "original sin" of sovereign borrowing by developing countries may have helped reduce risk premia in the short run (Eichengreen, Hausmann, and Panizza 2007), once countries find themselves in financial trouble, this can have the effect of radically increasing the costs associated with the external adjustment path. That is, for countries with foreign-denominated debt, the consequence of currency devaluation is likely to be a dramatic increase in the real cost of debt-servicing, making this adjustment option much less palatable. In addition, my work helps highlight precisely those domestic groups that benefit from

[3] Mosley (2000, 2003) demonstrates that bond traders generally do not fear default risk in developed countries, but do take the threat of default more seriously when investing in developing sovereign debt. Additionally, Reinhart and Rogoff (2009) note that, as a matter of empirical observation, countries above a certain income threshold appear to "graduate" from sovereign debt defaults – for example, while France defaulted on loans to the Crown repeatedly throughout the eighteenth and nineteenth century, after attaining "developed" country income levels, it has yet to do so again.

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government spending programs, and whose support is likely to prove crucial to the continued survival of incumbent rulers. Thus, sovereign debt crises should generally fall into the dreaded "Type II" set of country conditions, which Walter (2016) emphasizes are likely to be characterized by sustained delays in adjustment success, and continued reliance on external financing to make ends meet. When pushed to an extreme, of course, the market tolerance for such delays is not likely to be infinite – it is under these general conditions that I expect sovereign default to be most likely to occur.

1.1.2 Economic Causes and Consequences of Default

While work on the politics of default is limited, there is a well-developed literature on the economic causes and consequences of reneging on international borrowing commitments.[4] This literature takes an anarchic international environment as a starting point: Given the lack of any supranational governing agency, the existence of sovereign debt appears at first as a puzzle. While domestic loans between businesses can ultimately rely on national courts to adjudicate cases in which an agent has defected from its responsibilities, with the exception of the use of force (which is now generally viewed as unacceptable), if a sovereign state chooses to default on repaying its loans, there are no institutional consequences for doing so. Given this lack of a supranational debtors court, rational financial actors should be able to predict that a government with time-inconsistent preferences will eventually find it in its best interests to renege on repayment obligations, and as such, should never make such loans in the first place.

Eaton and Gersovitz's (1981) seminal paper was the first to point to the market itself as an enforcer of international promises. The centerpiece of their argument rested on the assumption that future loans to governments could be conditioned on past behavior, presenting a game in which financial agents punished countries that defected in previous rounds by excluding them from borrowing forever. Given this strategy, it might no longer necessarily be in the best interests of a government to default on its debt, even without an international institution that would hold it accountable. So long as incumbent rulers valued access to future lending, they would internalize the consequences of breaking their word to lenders today, thereby establishing a rational basis for sovereign loans.

However, subsequent work by Bulow and Rogoff (1989) points out that this explanation for sovereign loans replaces one cooperation problem with another: in a world of tens of thousands of individual investors in sovereign bonds, it should be difficult to maintain the exclusion of countries from access to capital markets even in the case of default. Even if lenders who were defaulted upon decided to deny future loans to a defaulting country, that country would

[4] For the definitive summary of recent work in this field, see Tomz and Wright (2013).

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be willing to offer better terms on loans to other investors, who would find it in their best interest to cooperate, thereby undermining the exclusion mechanism which was supposed to make sovereign borrowing rationally possible in the first place. It has been subsequently demonstrated that,[5] especially in the middle to late twentieth century, countries that defaulted on foreign loans were able to return to capital markets at roughly the same rate as those that had remained faithful in repayment,[6] although more recent work by Cruces and Trebesch (2013) recovers a significant linkage between size of the "haircut" associated with debt restructuring and subsequent terms of financial market access.

Rather than relying on market exclusion, Bulow and Rogoff (1989) propose the importance of "issue-linkage" – particularly the connection between sovereign loans and international trade – as the driving force behind sovereign lending. According to their argument, countries do not fear to default because of restricted access to future borrowing. Instead, debtor countries often find that trade with partners from whom they have borrowed is tied, either explicitly or implicitly, to remaining current on interest payments, and that foreign financing for trade may also depend on faithful debt servicing. Subsequent empirical work by Rose (2005) demonstrates a significant reduction in trade levels between lender–debtor country pairs following a default, a finding replicated by Borensztein and Panizza (2009).[7]

A third school of thought resuscitates the original linkage between default and future borrowing originally suggested by Eaton and Gersovitz (1981) by focusing more specifically on reputation-based arguments. Most prominent among these accounts is Tomz's (2007) book tracing the rise of sovereign lending in Europe and its spread to New World nations which emphasizes the importance of a reputational mechanism in affecting market rates of loans to different countries at the time, and especially the interest rate spreads that followed default instances during the nineteenth and early twentieth century. At the center of this account is a recognition of the need to consider bondholder behavior in a world of incomplete information – with perfect understanding of borrowers and their interests, Tomz notes, reputation would have little effect at all. Conversely, in the more realistic world of incomplete information, investors inform their view of the likelihood of being repaid as a function of updating beliefs about a borrower's type, as determined by their record of repayment under good times and bad. Rather than replacing one cooperation

[5] See, for example, studies found in Eichengreen and Lindert (1992) or Sturzenegger and Zettelmeyer (2006).

[6] One of the most egregious examples of this is found in Jorgensen and Sachs's (1988) account of the Latin American debt crisis of the 1930s, in which Argentina was essentially the sole major Latin American country which did not default on its debt obligations at the time. While this did apparently earn Argentina slightly lower interest rates on continued borrowing to repay its existing loans through the end of the 1930s, "having conscientiously retained its creditworthiness by honoring its debt service obligations, [Argentina] did not receive noticeably better treatment in the 1950s in return for its admirable behavior in the previous two decades" (78).

[7] However, see Tomz (2007) for evidence against this account.

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problem among lenders with another among enforcers of issue-linked policies, a reputation-based theory of sovereign lending allows self-interested lenders to best protect their own expected profitability by internalizing the past play of different debtors. Knowing this, governments should place great weight on their international reputation, as the economic consequences of damaging this reputation can include costly risk premia or even complete credit rationing by the private market.

Yet, despite presenting a wealth of evidence to demonstrate the preeminence of a reputational theory of sovereign borrowing over others based on sanctions or the use of force, the data from Figure 1.1 still point to an important puzzle: Given these reputational consequences, why do so many countries still choose to default? As noted by Tomz (2007, 16–17), "many factors could affect how governments balance the costs and benefits of debt repayment. The political strength of incumbents, the willingness of citizens to tolerate austerity, and the power of contending interest groups could all come in to play. So, too, could the time horizons of leaders – their patience for reputational rewards that might not materialize for months or years." Tomz continues by noting that "the exact sources of heterogeneity [in government preferences for default] are interesting in their own right, but are not the focus of this book." Tomz takes the political calculations over default as given, and develops a theory of international reputation to explain why countries might still remain current on international obligations, even in an anarchic environment. Contrarily, this work looks at the other side of the coin: I take the reputational costs of default as given, and develop a theory linking citizen influence over political survival to incentives for leaders to renege on their sovereign debt.

Finally, a current avenue of research is focused on determining what domestic-level factors impact the sustainability of debt, in the hopes of generating predictive models to indicate early warning signs that countries are headed into dangerous waters. For example, Kraay and Nehru's (2006) investigation of developing country debt defaults finds that, while standard economic factors such as the size of the debt burden and economic shocks explain a decent fraction of the variation in default cases, the predictive power of their models is substantially improved by the inclusion of broad measures of institutional quality as well. In a finding that echoes that of Reinhart, Rogoff, and Savastano (2003), the authors point out that while a standard "rule of thumb" for evaluating the sustainability of borrowing is to look at debt to export ratios, in fact the level of debt to exports at which countries have defaulted appears to be contingent upon the underlying institutional structures in the country. It is with these sorts of results in mind that recent summaries of the literature in economics on sovereign debt default have suggested that "there also needs to be more work on the private incentives of policymakers to default or fight a crisis as opposed to the incentives of a social planner … [and] to our knowledge, a systematic analysis of the relationship between sovereign debt, defaults, and

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political career concerns has not been undertaken and is an interesting area for future research" (Panizza, Sturzenegger, and Zettelmeyer 2009, 682, 692).

1.1.3 The Politics of Sovereign Debt Default

In the past several years, a limited literature has developed that looks at default explicitly as a political problem. Tomz's (2002, 2004) work on the political dynamics of default in Argentina's crisis at the turn of the millennium spearheaded empirical investigation of the topic, as did Stasavage's (2003) investigation of the role that domestic political dynamics played in making credible the commitment to honor economic obligations by the English government following the Glorious Revolution. A series of empirical papers by Van Rijckeghem and Weder (2009), Saiegh (2009), and Kohlscheen (2010) have produced a new "stylized fact" of defaults in developing democracies, finding that countries with parliamentary political systems and with coalition governments tend to be less likely to default than presidential systems. This is argued to result from the inclusion in the ruling coalition of holders of a country's sovereign debt, who clearly favor faithful repayment. As these individuals tend to be found within the relatively wealthy minority of citizens, it is argued that they are most likely to have influence over decisions to default in political environments that encourage the representation of small electoral groups – this should be most likely under parliamentary systems, particularly when no single party can secure executive control without a broader coalition of support.[8]

While laudable for their efforts to begin to unpack the politics of default, these empirical findings do not fully explain politicians' priority to represent bondholders over other groups, and ignore the political dynamics of default in autocracies entirely. On the first point: despite arguing that default is prevented when bondholders are included in the ruling coalition, these works do not explain why bondholders (as opposed to some other voter group) would necessarily become an electorally salient coalition member during fiscal crises; this seems particularly problematic given the tiny number of voters likely to be represented by such a party. This is not to argue that wealthy investors lack political influence – they almost certainly do – and yet it is uncommon to view their primary source of power as linked to their electoral strength. Instead, they are likely to influence democratic outcomes through access to vast lobbying resources; yet, if true, it is unclear why these resources could only be deployed in proportional representation systems or under coalition governments.

[8] While not directly studying the decision of a government to default or not, there is closely-related recent work on the preferences for default among the public in democracies by Curtis, Jupille, and Leblang (2014) and Nelson and Steinberg (2018); one of the most consistent findings in this literature is the effect of partisan orientation in driving support for repayment of international loans.

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Additionally, these works ignore the politics of autocratic default entirely. If sovereign default is primarily an economic phenomenon, then perhaps this omission is understandable. Alternately, if the survival dynamics of incumbent politicians are the same across autocracies and democracies, then focus on the particularities of autocratic systems may be redundant.[9] However, casual observation suggests that both these claims are untrue, and in this work I provide evidence demonstrating not only that politics is a critical driver of default outcomes, but that the specific political processes by which citizens link incumbent survival to fiscal politics vary widely across democratic and autocratic regimes.

1.2 MY ARGUMENT IN BRIEF

1.2.1 Closed Autocracy and Urban Bias

Politicians enjoy the perquisites of power, whether they rule in democracies or dictatorships. Yet the specific ways in which citizens may threaten an incumbent's tenure vary across these regime types. In *closed autocracies* that lack multiparty elections, the will of the people is of little importance to the ruling elite, except when the masses can threaten their hold on power. This is most likely, I argue, when citizens can credibly threaten revolt if their basic demands go unmet. While there are a host of factors that may improve the collective action capacity of the masses, it is easier to get more people out to protest when there are more people nearby. This suggests that unrest should be more common in urban areas than in rural ones, given simple facts of demographic density (Bates 1982; Wallace 2014). If a rural farmer needs to walk several miles to reach her nearest neighbor, and if government offices are far away in distant towns, mobilizing rural actors will be particularly difficult. Contrast this with the situation facing an urban worker, who may be able to reach hundreds of potential coconspirators in his apartment building or on the workfloor at his factory. In addition, a walk across town to government offices or central squares is likely to prove much less arduous than a trek from rural hinterlands to the center of political power. With urban consumers often literally at the doorstep of government, autocrats wary of unrest will place much greater weight on the needs of potentially restive city dwellers.

This suggests that we should observe an *urban bias* in autocratic policies – one of the most common forms of such urban bias comes from the quest to provide food cheaply. Following Engel's Law, food comprises a large and important proportion of total expenditure by the poor, particularly the urban

[9] If autocracies are also likely to suffer from credit rationing, as suggested by Beaulieu, Cox, and Saiegh (2012), then the issue of autocratic default may be even worse. Note, however, that Oatley (2010) finds that autocracies appear to have taken on more foreign debt than democracies. See also the discussion of borrowing rates across regimes in Cox (2011).

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