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To cite this article: Kathleen J. Brown, Matthew DiGiuseppe & Patrick E. Shea (2023): Ethnic politics and sovereign credit risk, Review of International Political Economy, DOI: [10.1080/09692290.2023.2225143](https://doi.org/10.1080/09692290.2023.2225143)

To link to this article: <https://doi.org/10.1080/09692290.2023.2225143>



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Ethnic politics and sovereign credit risk

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ABSTRACT

How does domestic politics affect sovereign credit risk? To date, scholars have largely focused on how economic interests along class-cleavages influence sovereign default risk and borrowing costs. Ethnic dynamics are another important political factor that explains governments' creditworthiness, yet are understudied. We investigate how ethnic politics shape governments' credit access and argue that the fiscal incentives generated by ethnic coalitions influence credit risk differently than those created by class cleavages. Because ethnic coalitions are usually smaller than class coalitions, left governments with ethnic support can commit to lower spending and receive more favorable risk assessments. Right governments that rely on ethnic support, however, will have greater spending demands because of their need to satisfy ethnic groups. We test our argument using a new indicator of government ethnic support and four indicators of sovereign credit risk. We find that, in emerging markets, the borrowing costs of right governments increase as they become more dependent on ethnic groups for political support. Our findings suggest that financial markets are attuned to multiple dimensions of domestic politics and demonstrate that ethnic divisions can have strong implications for governments' access to credit.


KEYWORDS

Sovereign debt; ethnic politics; partisanship; emerging markets

Introduction

The COVID-19 pandemic, coupled with higher food and fuel prices, pushed many countries to the brink of debt crisis in 2022. Roughly 25% of countries whose debts are traded in financial markets are in distress, while the International Monetary Fund has warned of a global debt crisis.¹ How governments address their debt problems not only affects future credit access but also a country's economic health and political landscape. International financial actors like bond traders and credit rating agencies assess political and economic risk to determine when and how much governments can borrow, and at what cost. Understanding the determinants of borrowing costs offers key insights into which governments are most vulnerable to debt crises or best positioned to fund economic development.

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 Supplemental data for this article can be accessed online at <https://doi.org/10.1080/09692290.2023.2225143>.
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To study how politics affect credit risk assessments, political economists have focused on two central variables: Political institutions (Archer et al., 2007; Ballard-Rosa et al., 2021; Biglaiser & Staats, 2012) and government economic orientation, usually conceived of along a left-right continuum (Ballard-Rosa et al., 2022; Barta & Johnston, 2018; DiGiuseppe & Shea, 2019; Stasavage, 2007). While there is a general consensus that democratic institutions offer credit advantages, there is comparably less agreement on how credit markets assess economic orientation.² On one hand, some research suggests that left governments imply greater risk (Alesina & Sachs, 1988; Block & Vaaler, 2004; Broz, 2013; Cotoc et al., 2021). Other research, however, argues that left-right orientation is a noisy or unimportant signal (Ballard-Rosa et al., 2021). Left governments are either too heterogeneous or too constrained by international credit markets for their economic orientation to affect creditors' risk assessments (Brooks et al., 2022; Roos, 2019).

To help explain these mixed findings, we propose that another political factor influences a government's credit risk. We argue that the organization of political coalitions along ethnic dimensions either improves or worsens the ability to repay debt, conditional on a government's left-right orientation.

A broad interdisciplinary literature documents how ethnic politics, beyond class politics, influences a wide variety of economic outcomes from corruption to the insufficient provision of public goods (Alesina et al., 1999; Beiser-McGrath et al., 2021; Chandra, 2005; Hopkins, 2009; Mousseau, 2001; Posner, 2005). Given such a strong impact on economic outcomes and government economic policy decisions, it is odd that scholars have yet to examine the link between ethnic politics and sovereign credit risk. We remedy this shortcoming and theorize how ethnic support influences sovereign credit risk and how this influence interacts with governments' left-right economic orientation.

Generally, 'left' governments make stronger, more inflexible commitments to public spending than 'right' governments and thus have more difficulty committing to fiscal consolidation that prioritizes creditors (Barta & Johnston, 2018, 2021; Cotoc et al., 2021). Building on the theory of Huber (2017), we contend that ethnic support offers governments a smaller minimum winning coalition than the broad, class-based coalitions that underpin left-right governments. Thus, left governments that also rely on ethnic support need to make fewer fiscal commitments, generating lower default risk. We expect the opposite among 'right' governments; while they generally prefer lower spending, ethnic political support requires increased fiscal commitments, constraining their ability to repay creditors. Consequently, the default risk among right-leaning governments will increase as they become more dependent on ethnic support.

We introduce a novel measure of ethnic political support built from the V-Party data set (Lührmann et al., 2020) that captures the ruling coalition's support from ethnic groups. Using this new variable, we test our argument on four indicators of sovereign credit terms in 68 emerging market economies. We find that ethnic support correlates with lower bond spreads and higher credit ratings among left governments and higher spreads and lower credit ratings among right governments.

Our study has several implications. First, our findings help explain why economic orientation appears to be a 'weak' predictor of sovereign credit terms (Brooks et al., 2022; Roos, 2019) beyond external pressure that limits a government's 'room to move' (Mosley, 2000). Instead, the role of economic orientation may be conditional on other aspects of domestic politics like ethnic divisions. This is particularly

relevant in emerging markets, where economic orientation and ethnic cleavages coexist, forcing creditors to evaluate multiple dimensions of political competition to assess default risk.

Next, this work demonstrates the importance of considering sources of political support beyond class conflict in the broader study of international political economy (IPE). Class-based conflicts figure prominently in the macroeconomic policies of advanced industrialized states (Barta & Johnston, 2021; Barta & Makszin, 2021) and in prominent cases (i.e. Latin American debt crises) explored in the literature (Campello, 2015; Kaplan & Thomsson, 2017). However, this overlooks other dimensions of political competition in emerging market countries that have economic consequences. Examining the role of ethnic cleavages is particularly important given 1) the increasing participation of ethnically divided societies in international credit markets and 2) the growing importance of ethnic divisions brought about by demographic change. Towards this end, our argument heeds growing calls to incorporate ethnic and racial politics into IPE research (Best et al., 2021; LeBaron et al., 2021).

Credit risk

A government's access to credit is determined by how creditors assess future default risk, inflation, and exchange rate fluctuations that threaten creditors' returns on investment. If creditors doubt a government's ability or willingness to repay debts, they will restrict access and demand compensation for risk in the form of higher interest rates (Eaton & Gersovitz, 1981). Numerous factors play into credit risk and much of the variance is due to global market forces that impact a government's revenues, trading relationships, and reserve holding (Zeit, 2022). A sizeable share of this risk, however, stems from domestic politics. Political economists have focused on variance in political constraints and incentives to prioritize creditors' interests. Much of the literature has emphasized the role of regime type and the so-called 'democratic advantage' (Beaulieu et al., 2012; Dasgupta & Ziblatt, 2021; DiGiuseppe & Shea, 2015). Scholars have also examined related factors like government transparency (Copelovitch et al., 2018), non-institutional variables like the ability of domestic forces to mobilize for or against repayment (Ballard-Rosa, 2020), and a country's history of repayment (Tomz, 2007).

Researchers have also examined how a government's economic orientation influences creditors' assessment of default risk and the outcomes of restructuring (Brooks et al., 2022; DiGiuseppe & Shea, 2019; Vaaler et al., 2006). This stems from a wide body of research concerning the partisan or political business cycle which explains how left-right economic orientation influences a variety of economic policy outcomes, like deficit spending and monetary policy, that ultimately influence default risk.³ Importantly, political support for governments on this left-right dimension cleaves broadly along class lines (Huber, 2017), which has implications for how creditors assess creditworthiness.

Default risk and class-based political support

What is the logic behind the relationship between class support and default risk? Most theoretical arguments focus on differences in government spending

preferences and the implications for inflation and debt repayment. Governments in debt distress can choose to impose the burden of adjustment on their domestic constituency or require that external borrowers take a *haircut* (DiGiuseppe & Shea, 2019). Left-leaning governments, for ideological or political survival reasons, are committed to large and inflexible fiscal transfers (Cotoc et al., 2021) because their supporters, on average, are poorer and rely more on government transfers. If supporters value government spending, governments will not prioritize repayment of sovereign debt obligations in the event of declining public revenues or an external shock (Campello, 2015; DiGiuseppe & Shea, 2019). The supporters of right-leaning governments are assumed to be generally wealthier, less concerned with social programs, and more likely to own assets that would be negatively impacted by sovereign default. As such, creditors can have greater confidence that right governments will repay debt across macroeconomic conditions and prioritize stability.

Creditors may assess higher default risk for left governments because their core spending priorities are politically difficult to cut in the event of a liquidity or solvency crisis. While left ideology may advocate higher spending, public spending or deficits are not always higher on the left than the right, particularly among advanced economies (Bechtel, 2009; Sattler, 2013). Importantly, creditor assessments of default risk are not only based on the level of spending but also the ability and willingness of the government to make cuts. Consistent with the idea of forward-looking creditor bias, Barta and Johnston (2021) find that rating agencies do not necessarily assess governments based on total spending but rather on the ‘fiscal flexibility’ of their commitments. Among two left- and right-leaning governments with similar spending levels, the left government is more likely to have inflexible commitments to generous entitlements (pensions, unemployment, etc.) that will be politically difficult to cut should fiscal consolidation become necessary. Credit rating reports pay close attention to the flexibility of spending plans, directly linking such policies to governments’ default risk (Barta & Makszin, 2021).

Another reason that creditors pay attention to economic orientation is that right governments’ interests align closely with their own. Right-leaning governments represent relatively wealthier constituents and so are more likely to count the domestic creditors of the government among their support base (Stasavage, 2007). For example, those in emerging markets with private pensions will indirectly hold government debt and be more exposed to default (Curtis et al., 2014). Left governments, given a poorer support base, are less likely to have creditors among their supporters. If having government supporters hold debt increases incentives to repay (Chari et al., 2020), right governments have a stronger credible commitment to not default on debt obligations because this would disproportionately harm their supporters (Stasavage, 2007).

Ethnic politics and the economy

The connection between government economic orientation and public debt outcomes follows straightforward logic. However, this story is complicated by the fact that left-right orientation or class-based conflict is not the only cleavage that influences fiscal and monetary policy.

In order to survive elections or revolutions, political entrepreneurs often gather popular support by targeting supporter groups with resources (Golden & Min, 2013). Securing this support requires that leaders credibly commit resources to members of the group while refusing resources to those outside the group. Where ethnicity forms a boundary between in-group and out-group members, ethnic divisions can come to define political competition. Ethnic group members are often easily identifiable by region, language, or phenotype, allowing politicians to efficiently target ‘pork’ to co-ethnics while excluding others (Fearon, 1999).

Much of the literature on ethnic politics focuses on the advantages of ethnic favoritism as a strategy for governments to identify and maintain support. Several studies have demonstrated that where ethnic groups are identifiable and exclusive, governments favor their co-ethnics in return for political support (Burgess et al., 2015; Franck & Rainer, 2012; Hodler & Raschky, 2014). This may be exacerbated when ethnic groups are segregated geographically, making it easier for governments to target supporters through local public goods (Alesina & Zhuravskaya, 2011; Ejdemyr et al., 2018).

In addition to separating in-group and out-group members, leaders have other incentives to court supporters by ethnicity. Notably, Huber (2017) argues that ethnic coalitions can be more efficient than class coalitions because ethnic divisions help leaders get closer to a minimum winning coalition. At the micro-level, ethnic identity often increases trust and strengthens information networks within the group (Fearon & Laitin, 1996; Robinson, 2020), making it easier for politicians to credibly commit to transfers among co-ethnics. Ethnic favoritism can thus be an effective strategy in political competition, and targeted appeals are often highly successful in generating political support within ethnic groups (Carlson, 2015; Kramon, 2018).

The political salience of ethnic cleavages correlates with a variety of economic outcomes that affect a government’s creditworthiness. Ethnic divisions may impact macroeconomic outcomes through increasing conflict and political instability, lowering human capital, inducing market distortions, and altering fertility rates (Annett, 2001; Gören, 2014; Hopkins, 2009). Where ethnicity defines political support, ethnic divisions can alter the government’s distribution of resources. Ethnic diversity has been associated with an under-investment in public goods, as ethnic groups disagree about the amount and type of public goods that the government should supply (Alesina et al., 1999). Beyond diversity, the distribution of power among ethnic groups can also exacerbate common pool problems as groups try to dominate fiscal decisions and capture resources for co-ethnics (Baldwin & Huber, 2010; Beiser-McGrath & Beiser-McGrath, 2020). As maintaining the support of an ethnic group demands a large spending commitment, ethnic divisions can prevent governments from pursuing a fiscal policy that corresponds with creditors’ preferences.

Fiscal commitments across class and ethnic support

Ethnic-based government coalitions are strongly associated with different government spending priorities and macroeconomic outcomes than governments without ethnic support (Alesina et al., 2016; Beiser-McGrath et al., 2021; Ejdemyr et al., 2018). What does this mean for the default risk assessments from creditors and

rating agencies? We argue that risk assessments will reflect ethnic politics in two ways: Fiscal transfers and smaller winning coalitions.

First, when a government's core supporters are from a specific ethnic group, they face strong political incentives to direct resources toward this group. If governments fail to do this, ethnic groups will defect from the party or replace party leadership (Horowitz, 2000). Consequently, just as left governments have incentives to maintain welfare commitments, governments representing ethnic groups are also constrained in their ability to prioritize creditors. Thus, creditors should interpret ethnic support as an inflexible spending commitment in a similar way that left-leaning governments are committed to directing resources along class lines.

An extension of this logic would suggest that ethnic support would additively *increase* default risk by increasing the incentive of governments to prioritize transfers over debt repayment. However, looking at ethnicity alone ignores that default risk is also shaped by class-based support which provides an important baseline comparison. We theorize that ethnic political incentives interact with class-based incentives, and that the effect of ethnic support is conditional on the class-based commitments of the government.

First, we consider if it is possible for governments to hold both class-based *and* ethnic-based support. Traditionally, for the sake of parsimony, many models of political mobilization assume that ethnic and class-based support are perfect substitutes. For example, Huber (2017) argues that politicians, depending on the distribution of class and ethnic groups in society, will choose to mobilize on the dimension that provides the smallest winning coalition (as a proportion of the (s)electorate). Thus, Huber's model predicts that parties will be either ethnic- or class-based. However, as one steps away from a parsimonious model, the data show that ethnic voting is a continuous rather than a binary variable (Huber, 2017, p. 150).⁴ Political competition and the mobilization of supporters occurs along multiple dimensions, even in Africa where many assume ethnic voting dominates elections (Boone et al., 2022; Chandra, 2005; Ichino & Nathan, 2013). Within a single country, some parties may mobilize along class lines while others mobilize along ethnic lines. Additionally, parties may decide to mobilize along both ethnic and class lines either because of the overlap of ethnicity and class or the need to build a broader coalition (Boone et al., 2022; Ichino & Nathan, 2013).

Given that governments have, at least, two dimensions relevant to their fiscal policies, we ask how these dimensions overlap and what relevance this holds for fiscal policy and default risk. While both left-leaning support and ethnic support require a spending commitment, relying on both ethnic and class-based support should offer politicians a smaller minimum winning coalition relative to a party relying entirely on class-based support (Huber, 2017). Securing power with class-based support usually requires a large coalition with both the large middle class and either the lower *or* the higher class. With only income as a means to divide groups, it is more difficult to exclude portions of the electorate from government benefits. As many scholars have noted, ethnicity provides a convenient attribute upon which to exclude certain voters from resources (Chandra, 2005; Horowitz, 2000; Huber, 2017). This ability to exclude, as Huber (2017) notes, permits political entrepreneurs to increase the efficiency of their distribution of public goods and to get closer to 51% of the winning coalition. In contrast, an entirely

class-based approach would theoretically result in an inefficient winning coalition further from the 51% threshold.

Ethnic groups are also generally smaller and more numerous than broad economic classes and offer governments a larger set of potential winning coalitions, the smallest of which is likely to be closer to 51% of the electorate.⁵ With a smaller support coalition, government spending commitments will be lower in ethnically organized groups compared to purely left-leaning, class-based parties. As such, ethnic support reduces the fiscal requirement of remaining in office for left governments.

In sum, we theorize that ethnic support provides incentives for governments to commit to fiscal transfers to reward supporters. At the same time, organizing political support along ethnic lines decreases the number of constituents a leader must satisfy. What are the implications of these seemingly contradictory effects?

Left governments that rely entirely on class-based support will have more difficulty achieving a minimal winning coalition given the difficulty in excluding citizens from the distribution of government benefits based on class and income alone (Huber, 2017). Consequently, they must provide government benefits to more voters than is necessary to remain in power. Left governments supported by ethnic groups, on the other hand, are less constrained in this regard. They can exclude voters on the basis of ethnicity and reduce their minimum winning coalition. This permits the use of more targeted government fiscal spending and limits the appeal of broad-based fiscal commitments. Governments with this smaller support base should face fewer constraints and may have more 'slack' to prioritize creditor interests. Furthermore, reliance on ethnic support may broaden the class diversity among supporters, making it more likely that the non-payment of debt would have consequences for those within the leader's coalition. If politics is driven purely by class conflict, left governments face less pressure to repay debts given their supporters are less likely to be creditors or directly exposed to financial losses due to default. However, if left governments are supported by an ethnic group that includes members across class divides, they are more likely to find creditors among their supporters. This should increase the political costs of default. Thus, we expect that left-ethnic governments will make smaller spending commitments and have a greater ability to weather economic downturns as they can more flexibly sacrifice government spending to prioritize creditors.

The effect of ethnic support should be different for right governments. Absent ethnic support, right governments are less constrained by their class-based supporters in cutting spending. Even if they spend similar amounts to left governments, they likely have more fiscal flexibility that allows them to cut without triggering opposition (Barta & Johnston, 2021), and may be rewarded for fiscal consolidation (Bansak et al., 2021). However, when right governments rely on ethnic support, considerations for class interests are diminished. While class supporters may reward right governments for cutting spending, ethnic supporters may be more critical. Maintaining ethnic support requires making inflexible commitments to fiscal transfers. In other words, markets will increasingly fear that if the right government is forced to choose between continuing debt payments and continuing patronage to an ethnic support base, political realities will favor the latter. Traditionally, class-based supporters on the right favor debt repayment and may even be government creditors themselves, but ethnic support will likely dilute this effect as ethnic

supporters from diverse class backgrounds may be less exposed to the costs of default. We expect that right-ethnic governments will make larger, more inflexible spending commitments that increase default risk.

Lastly, in addition to the relationship between spending commitments and default risk, the political influence of bondholders also presents an alternative mechanism with the same prediction. As we mentioned above, several theories suggest that it is bondholders' access to power that drives default risk (Stasavage, 2007; Tomz, 2007). If ethnic groups have similar income distributions, left governments that also rely on ethnic support are more likely to count wealthier bondholders among their ranks. This would mean left-ethnic governments would face more political pressure to repay debts relative to a strictly class-based left government. Similarly, right-ethnic governments may face less pressure to repay as the concerns of bondholders in their ranks are likely to be countered by the interests of poorer ethnic supporters.

Class and ethnic support in practice

An implicit assumption in our theory is that political support has multiple dimensions and that governments can simultaneously attract ethnic support and profess a class-based economic orientation. Before testing the empirical implications of our theory, we discuss prominent examples that demonstrate how class and ethnic support overlap and shift creditors' assessments of default risk.

Bolivia: movement for socialism, 2006 - 2019

Bolivia offers a clear example of a left-ethnic government under the administration of Evo Morales between 2006 and 2019. In 2005, Morales was elected Bolivia's first indigenous head of state while his staunchly left-wing MAS party won a legislative majority. During the campaign, MAS called for the overthrow of US capitalism, rejected the 'voraciousness of international capital' (Madrid, 2008), and was (unsurprisingly) assessed as a credit risk by international markets and the financial press (Neuman, 2014). Across three terms, the administration delivered traditional leftist economic policy including nationalizing the gas industry, raising taxes on foreign corporations, increasing pensions, and expanding conditional cash transfer programs (Crabtree, 2017).

In addition to economic policy that favored lower classes, the government was characterized by its explicit reliance on ethnic support. Morales is a member of the Aymara ethnic group and helped to build MAS as a coalition of indigenous supporters. The party designed electoral platforms around reducing inequality between white and indigenous Bolivians and won over 70% of the indigenous vote in the 2005 election, compared to only 31.6% of white votes (Madrid, 2008). Once in power, MAS delivered on many of its campaign promises and directed political power and economic resources toward its ethnic base. The 2009 constitution introduced quotas for indigenous legislators and Morales expanded the controversial coca industry which represents a significant share of indigenous employment (BBC, 2017). Income inequality between indigenous and white Bolivians decreased by 25% in the government's first term (Hicks et al., 2018), and land reforms

distributed state-owned land titles primarily to indigenous beneficiaries (Bottazzi & Rist, 2012).

Despite the government's socialist pedigree, economic policy during this period was more market-friendly than creditors had originally anticipated (Neuman, 2014). Bolivia's economic success during the Morales-MAS administration was in part driven by high commodity prices, but creditors noted that gains were also the product of prudent fiscal policy. A portion of rising resource revenues was used for targeted social and infrastructure spending in indigenous stronghold areas (Hicks et al., 2018), but the majority of these funds were channeled into foreign reserves which rose to 50% of GDP by 2012 (Achtenberg & Currents, 2012). Fitch raised Bolivia's credit rating in 2010, citing the unexpectedly low deficit and 'willingness to service its debt, even through periods of heightened unrest' (Ratings, 2010). This strategy allowed the government to reassure creditors while maintaining ethnic support, and in 2012 Bolivia re-entered the international private credit market after a 90-year absence with the issue of a \$500 million bond. Finance Minister Luis Arce described the bond as an opportunity to 'position the country; there are several reasons why Bolivia should be in the international financial markets' (Schipani, 2012). This was a surprising departure in rhetoric for a MAS cabinet member who previously railed against 'savage capitalism' (Schipani, 2009). Credit markets clearly found the shift in tone credible, and in 2014 S&P raised their rating from BB- to BB with the expectation that Morales would win a third term in the 2015 election (Schipani, 2014).

South Africa: national Party, 1948 - 1994

Conversely, a hallmark example of right-ethnic government was South Africa under the National Party (NP). After coming to power in 1948, the NP implemented the apartheid system of racial segregation and white Afrikaner dominance and maintained a parliamentary majority until the first multi-racial elections in 1994. The NP was economically conservative (Durham et al., 2010) and in the 1980s attempted to rededicate itself to the 'panaceas of market mechanisms, privatisation and deregulation rather than state responsibility for service provision' (Smith, 1992, p.353).

The NP government relied exclusively on the political support of the white Afrikaner minority. Only whites could run for or vote in elections, and white voters were rewarded for their political support with an outsized share of government resources. Fiscal policy during apartheid was built around maintaining this ethnic support and led to the development of a broad welfare state for whites in the 1970s and 80s. The government introduced generous family allowances and pensions for white citizens and maintained high public sector employment with white-majority job quotas (Van der Berg, 2014). The policy of segregating the Black population into 'homeland' regions also allowed the government to more precisely target local public goods to white supporters. Healthcare and education spending was over 10 times higher in white-majority areas than in the 'homelands', and in 1993 household income was nearly 10 times higher for whites than for Blacks (Fiske & Ladd, 2006; Simkins et al., 1985).

This commitment to ethnic support weakened the NP government's commitment to fiscal conservatism. While whites were far wealthier than Black and

'colored' South Africans, there remained significant inequality within the white community (Charney, 1984), forcing the NP to appeal to white supporters across class lines. In addition to high welfare spending, the NP introduced traditionally leftist policies like agricultural subsidies and price controls to benefit majority-white farmers (Charney, 1984). While wealthy whites did not benefit directly from government transfers, they did rely on continued funding for the expensive apartheid bureaucracy and security forces that guaranteed their social and economic dominance (Lowenberg, 1997; Smith, 1992). As (Jones & Inggs, 1994, p.17) described, 'There was a deep-rooted liking for state intervention in the National Party and the commitment to the market was never completely convincing.'

By the 1980s the economy was suffering under the weight of anti-apartheid sanctions. However, Lowenberg (1997) argues that capital withdrawal in mid-1980s was also driven by the government's unwillingness to stabilize the economy. As sanctions intensified the NP pushed for more government resources to be used to prop up the coal, steel, and aluminum industries that formed the cornerstone of white employment (Lowenberg, 1997). The government defaulted on foreign bank loans in 1985 (Borensztein & Panizza, 2009) and between 1986 and 1994 the deficit rose from 3.6% to 7.3% and debt to GDP from 29.6% to 43.5% (Koch et al., 2005). Economic historians have argued that this contributed to the collapse of apartheid 'under its own weight' as conservative fiscal policies were undermined by inefficient commitments to the white minority (Mariotti & Fourie, 2014, p.116). After apartheid ended in 1994, the new majority-Black, left-leaning African National Congress government was able to do what the NP government could not, and engaged in ambitious fiscal consolidation (Van der Berg, 2014).

Empirical implications & data

We argue that left-right class-based support affects sovereign risk, and identify two ways that ethnic political support can mitigate class-based political incentives. First, it increases the demand for government transfers, and second, it affects the size and composition of a government's winning coalition. How these factors affect credit risk assessment interacts directly with a government's economic orientation. Specifically, we argue that the effect of ethnic support is conditional on the economic orientation of the government.

Hypothesis 1. The effect of ethnic group support will decrease default risk among left-leaning governments and increase default risk among right-leaning governments.

Measuring ethnic-based political support

Existing ethnic politics measures are not well-suited for our theory. Many studies are interested in the effect of ethnic diversity, fractionalization, or discrimination on political and economic outcomes. These variables are often time invariant (Alesina et al., 2016) or take a bottom-up approach to measure the political status of certain groups (Vogt et al., 2015), and these approaches fail to capture the degree by which politics is influenced by ethnic divisions.

We focus on the political incentives that follow from relying on an ethnic group(s) for political support, and so construct a variable using the V-Party Dataset (Lührmann et al., 2020) that captures a ruling government's reliance on ethnic support directly. V-Party measures the sources of a party's support base as coded by experts in a given country. For each national election, coders are asked: 'To which particular group in society does the core membership and supporters of this party belong?'⁶ Coders can choose among 14 different sources of party support, one of which is 'an ethnic or racial group'. Coder responses are then aggregated using a Bayesian item response theory model and each party is given a score for each support group. Scores range from 0 to 1; a higher value of the ethnic support score indicates that 'ethnic or racial groups' was more frequently coded as the party's core source of political support.

We use this party-election level information to build a continuous indicator of the governing coalition's reliance on ethnic groups with the following equation:

$$EthnicSupport_{it} = \sum_{p=1}^p (S_{pt} * G_{pt}) \quad (1)$$

$EthnicSupport_{it}$ is the aggregate ethnic support score of the governing coalition in each country-month (it) for countries that have a national parliament. For parties in the governing coalition p , we multiply each party's ethnic support score, G_{pt} , by the party's share of seats in the governing coalition of the lower chamber, S_{pt} . These weighted scores are then summed across parties in the coalition to produce an ethnic support score for the government. Importantly, weighting party scores by seat share accounts for institutional differences that may influence how ethnic support affects government decision-making. Large governing coalitions may include multiple parties with high G_{pt} values, but if these are junior coalition partners that received a lower share of seats, their strong ethnic support base may be inconsequential for the government's fiscal policy. V-party scores are updated at each election (as are seat shares) and so the $EthnicSupport_{it}$ value in each country is constant in the periods between elections. We generate values between 1980 and 2019 for each country-month. The final measure is scaled from 0 to 1 where larger values indicate the ruling coalition's greater reliance on support from ethnic groups.

We also use the V-Party data to measure the economic orientation of the government, LR . V-party coders score parties along the following metric: 'Please locate the party in terms of its overall ideological stance on economic issues. Parties on the economic left want government to play an active role in the economy. This includes higher taxes, more regulation, more government spending, and a more generous welfare state. Parties on the economic right emphasize a reduced economic role for government: privatization, lower taxes, less regulation, less government spending, and a leaner welfare state'. Parties are placed on a 7-point scale from far-left to far-right based on multiple coder decisions. Like our $EthnicSupport$ variable, we created a weighted sum based on each party's seat share.

This measure substantially improves on the commonly-used 3-category (left, right, center) variable from the Database of Political Institutions (DPI) which is derived from party naming conventions and non-systematic use of various historical sources (Scartascini et al., 2018). Our variable allows parties (and thus governments) to fall along a continuous spectrum in economic positions. This is well-suited

for our purpose as V-Party asks directly about parties' relationship with several class-based economic policies.

The construction of these measures is useful in examining how government positions change within and between countries over time. Figure 1 illustrates variation in *EthnicSupport* across countries and years. Each row along the y-axis represents an individual country. Columns along the x-axis represent years between 1980 and 2019, so that an individual cell represents the average *EthnicSupport* value in a country-year. Darker shades of blue indicate a government has higher levels of ethnic support, while white cells indicate missing data.

As expected, some countries exhibit no variation as their governing parties never find their core support among ethnic groups, visible in Figure 1 as rows that remain lightest blue across the entire period. Of 178 countries, 85 have constant values of *EthnicSupport* equal to 0. Most experience substantial variation over time; 73 countries have alternating periods of ethnic politics, where various governments have had zero and non-zero values of *EthnicSupport*. In an additional 20 countries, governments have consistently relied on some degree of ethnic support, with *EthnicSupport* values above 0 for the entire period.

Government reliance on ethnic support is clearly a changeable component of political competition that varies substantially over time.⁸ This variation allows us to investigate within-country changes in ethnic politics that would be impossible with other popular, but time-invariant, measures of ethnic politics.

Taken together, these two measures demonstrate that ethnic support and left-right economic orientation are continuous and that these concepts overlap to

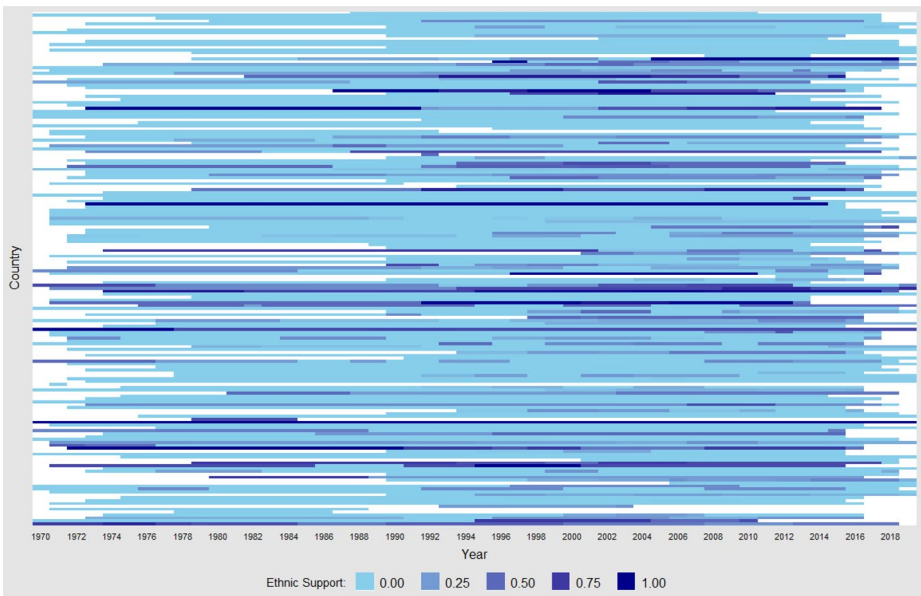


Figure 1. Values of *EthnicSupport* for all country-year observations. Rows represent countries while columns represent years. Each cell represents the value of the *EthnicSupport* measure for a country-year. Lighter shades of blue indicate lower values of *EthnicSupport*, while darker blue indicates higher values. White cells indicate missing data. Countries are not labeled on the y-axis for aesthetic clarity; they are ordered alphabetically. The figure is intended to demonstrate the variance in *EthnicSupport* across country and time.

define political competition. Figure 2 plots the average values of *EthnicSupport* and *LR* for each country across the sample period. The scatter plot does not display a clear pattern, indicating that *EthnicSupport* is not strongly related to the *LR* position. Importantly, the plot shows that governments engage in diverse combinations of ethnic support and economic orientation, indicating that class-based and ethnic-based support are not substitutes. We probe this further given concerns that governments that rely on ethnic support will have moderate economic platforms or policies. For example, an interaction between the two variables would be inconsequential if governments with high ethnic support were automatically coded as centrists on economic policy. To test this, we regress *EthnicSupport* on *LR* and its squared term and plot the predicted values from this model in Figure 3. If *EthnicSupport* led to centrist economic policies, we would expect a non-linear relationship. However, we see instead a flat prediction indicating that the two concepts are fairly independent.

We note that our *EthnicSupport* and *LR* variables require a national legislature to be measured. While this limits our inferences to countries with national legislatures, our sample includes both non-democracies and democracies. In the Appendix, we describe the details of the sample and conduct additional analyses to demonstrate that our results are not limited to democratic regimes.

Credit outcomes

We use four separate monthly measures of sovereign credit risk in 68 emerging market and developing economies between 1994 and 2016. Our primary analysis

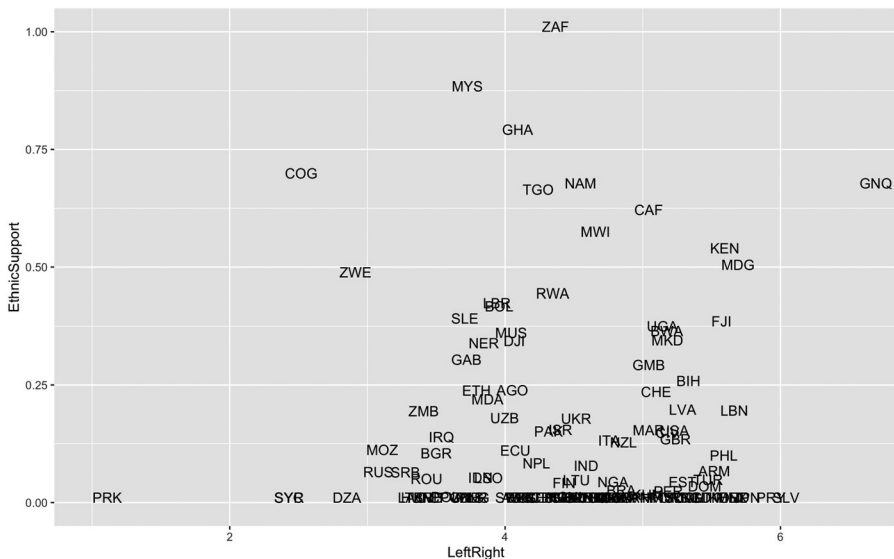


Figure 2. Country averages of *EthnicSupport* and *LR*, 1980-2019. This figure illustrates the average of the ethnic support measure and average of the left-right economic orientation measure for the period 1980-2019. *EthnicSupport* is a continuous scale between 0 (low ethnic support) to 1 (high ethnic support), and *LR* is a continuous scale between 0 (far-left) and 6 (far-right). The plotted averages are represented by each country's 3-letter ISO code.

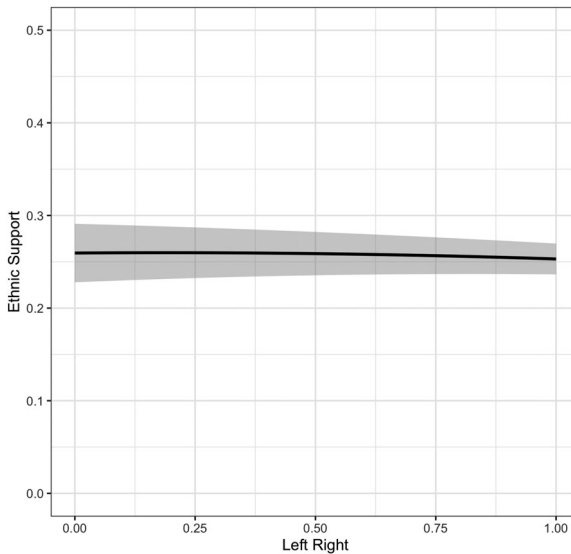


Figure 3. Relationship between left-right and ethnic support: the figure shows the predicted values and 95% confidence intervals resulting from a quadratic model predicting *EthnicSupport* as a function of *LR* ($EthnicSupport = \beta_0 + LR\beta_1 + LR^2\beta_2 + \epsilon$). The lack of a non-linear relationship suggests that *EthnicSupport* and *LR* are plausibly independent.

relies on monthly bond spreads from the emerging market bond index (EMBI), log-transformed. The spread indicates the difference between the yield on a government's bond and the yield on a benchmark bond, US Treasury bonds with similar maturities. The spread isolates a country's individual credit risk from global fluctuations in credit risk. The index includes 67 countries, each of which has met a threshold level of issued debt. It excludes countries that are excluded from credit markets or that borrow at low levels. Further, inclusion in the index is staggered due to these criteria, with newer entrants tending to be poorer and demographically smaller.

Second, we use country credit risk ratings from Standard & Poor's, Fitch, and Moody's for emerging markets formatted monthly. These ratings are the result of solicited evaluations of each country's probability of default by the rating agencies. The ratings are used as a shortcut by many creditors and often serve as important criteria that dictate investment decisions (Sinclair, 2018). However, they also suffer from selection bias as governments must request to be rated, and large states that are active in credit markets are more likely to be rated (Abbas & Rogoff, 2019). We convert rating agencies' letter grades to a 21-value numeric scale in which higher values mean lower default risk.

The four measures allow us to test the relationship using different sources of credit risk: Borrowing costs and credit rating agency evaluation. Each measure has its own limitations and coverage but readers can have greater confidence that the findings are not the product of the peculiarities of a single indicator. Each of the four credit outcomes cover a slightly different sample that we identify in the [Appendix](#).

Covariates and fixed effects

We address confounding between ethnic support, partisanship, and borrowing costs with several covariates. First, ethnic politics is often associated with violence and domestic political instability that can influence credit ratings outside of the mechanisms described above. We include measures of ongoing conflict from the Uppsala Conflict Data Program (UCDP) dataset (Gleditsch et al., 2002; Pettersson et al., 2021), the log of years since conflict, and coups (Peyton et al., 2021) to account for current and past conflict.

A variety of factors may jointly influence ethnic politics and economic outcomes. First, natural resource rents may encourage political organization along ethnic lines (Wegenast & Basedau, 2014) as well as heighten or diminish credit risk (Nooruddin, 2008). We include natural resource rents over GDP from the World Development Indicators (WDI) dataset (WDI, 2019).

Regime type plays a key role in creditor assessment of debt repayment or is at least correlated with credit risk (Ballard-Rosa et al., 2021; Beaulieu et al., 2012). Given the electoral costs of default and/or institutions to protect property rights (Biglaiser & Staats, 2012), democracies receive better average credit terms. It is possible that democracy is correlated with either ethnic support or left-right support. As such, we include the electoral democracy index from Lüthmann et al. (2020) in all models.

Next, we include several economic fundamentals taken from WDI such as GDP per capita, external debt to gross national income, inflation, current account balance to GDP, short-term debt to reserves, capital account openness, and economic growth. These variables help to address potential endogeneity if economic development shapes ethnic political competition and drives ethnic support. We also control for whether a country is experiencing an economic crisis and an indicator of regional diffusion as credit risk may be driven by spatial diffusion. Both variables are sourced from Brooks et al. (2015).

We also include country-fixed effects to account for time-invariant unobserved country-level confounders. Consequently, our estimates can be interpreted as within-country variation in our conditional effects. Looking at within-country variation helps address issues of endogeneity that plague other research on the effect of ethnic politics on economic outcomes, like public goods spending, because of the wide variety of historical antecedents to ethnic politics (Singh & Vom Hau, 2016). Further, country-fixed effects should pick up the effects of electoral systems and other country-level factors that may influence ethnic voting cross-nationally (Huber, 2012).

Lastly, global events dramatically impact credit access. While this is partially addressed in the bond spread indicator, this does not fully capture market volatility or the number of global defaults. As a result, we include year-month fixed effects to estimate out any time trends. We use the following estimation in our central models:

$$Y_{it} = \beta_0 + \beta_1(\text{EthnicSupport}_{it}) + \beta_2(LR_{it}) + \beta_3(\text{EthnicSupport}_{it} * LR_{it}) + \Gamma X + \theta_i + \psi_t + \epsilon_{it}$$

Y_{it} represents credit risk, θ_i and ψ_t indicate the country and year fixed-effects, and ΓX indicates a matrix of covariates and their coefficients.

Analysis

Table 1 presents coefficients from four models each estimating the effect of a government's reliance on ethnic support, its economic orientation, and their interaction on the log of bond spread.

The first model (1) shows a pared-down estimation that includes the interaction between *Ethnic Support* and *LR*, its constituent parts, and debt to GNI. The next two models proceed to include additional theoretically-informed confounders. The remaining two models include a lagged-dependent variable to account for the strong temporal dependence of bond spreads. Due to concerns about Nickell-bias we drop the fixed effects and include the US Treasury bond and the count of global defaults to address confounding by global credit market conditions.

In each model, the interaction terms and their constituent terms are in the expected direction. Interpretation of interaction terms from a linear model often assumes that marginal effects change at a constant rate and that there is common support across all values of the moderator. However, these assumptions may not hold for our analysis, and so we prefer to assess statistical significance and substantive impact by plotting the marginal effects.

We implement a kernel estimator *via* the Interflex package (Hainmueller et al., 2019) to estimate the marginal effect of ethnic support across the entire range of values of a government's economic orientation and allow for potential non-linear marginal effects. An added benefit of the Interflex package is that it implements the recommendation of Blackwell & Olson (2022) to not only model the main interaction effect, but also to consider that the moderator (here, *EthnicSupport*) may interact with other covariates in a substantively important way that may confound the interaction of interest. Since including all interactions would over-fit the model, Blackwell and Olson (2022) use a lasso estimator to select which moderator-covariate interactions are relevant to the main interaction of interest and omit all others with small effects. As such, note that the marginal effects plots do not directly correspond to the linear models presented in Table 1 but instead are the product of a more robust estimation process. This method accounts for non-linearity, lack of common support across the moderator(s), and potential bias from assuming there are no other additional interactions in the model.

Figure 4 presents the marginal effect plots corresponding to the specifications of the linear models (2-5) estimated in Table 1. The top two figures, corresponding to the specifications in Models 2 and 3, indicate a relationship consistent with our hypothesis. Both panels clearly show that ethnic support is associated with lower bond spreads, indicating lower risk, among left governments and higher bond spreads among right governments.

Given that bond spreads are log-transformed, a one-unit change in ethnic support (a change in its full value) is associated with 300% change and 81% higher bond spreads when a government is at the right-most value of *LR* based on the specifications of Models 2 and 3, respectively, when holding covariates constant. For far-left governments, a full change in ethnic support is associated

Table 1. Left-right, ethnic support & bond spread.

	(1)	(2)	(3)	(4)	(5)
	log EMBI	log EMBI	log EMBI	log EMBI	log EMBI
Ethnic Support	-0.070 (0.182)	-1.032*** (0.181)	-1.149*** (0.271)	-0.062* (0.027)	-0.189*** (0.052)
Left Right	-0.146*** (0.008)	-0.108*** (0.008)	-0.076*** (0.009)	-0.004* (0.002)	-0.001 (0.003)
Ethnic Support x Left Right	0.161*** (0.048)	0.410*** (0.048)	0.295*** (0.059)	0.024* (0.011)	0.060** (0.019)
Debt/GNI	0.007*** (0.000)	0.009*** (0.000)	0.017*** (0.001)	0.000 (0.000)	0.000+ (0.000)
LDV				0.967*** (0.005)	0.959*** (0.006)
Crisis		0.118*** (0.023)	0.042 (0.029)	0.045*** (0.009)	0.052*** (0.013)
Resource Rents		-0.016*** (0.002)	-0.012*** (0.003)	0.000 (0.000)	0.002** (0.001)
Polyarchy		-0.118 (0.083)	-0.481*** (0.112)	0.010 (0.013)	0.036* (0.018)
GDP percapita		0.000*** (0.000)	0.000*** (0.000)	0.000 (0.000)	0.000 (0.000)
Growth		-0.019*** (0.002)	-0.008** (0.003)	0.000 (0.001)	-0.001 (0.001)
Conflict		0.263*** (0.023)	0.029 (0.027)	0.002 (0.008)	-0.009 (0.011)
ln(Peace Year)		-0.016 (0.010)	-0.045** (0.014)	0.002 (0.002)	0.002 (0.003)
Coup		0.108** (0.033)	0.160*** (0.040)	0.009 (0.012)	0.021 (0.017)
In Default		0.073*** (0.015)	-0.054** (0.020)	0.008 (0.005)	0.008 (0.007)
log(years since default)		0.013*** (0.001)	0.007*** (0.001)	0.000 (0.000)	0.000 (0.000)
Short Debt/Reserves		-0.001*** (0.000)	0.001** (0.000)	0.000 (0.000)	0.000+ (0.000)
KAOPEN			-0.129*** (0.014)		-0.005+ (0.003)

(Continued)

Table 1. Continued.

	(1) log EMBI	(2) log EMBI	(3) log EMBI	(4) log EMBI	(5) log EMBI
Regional Diffusion			0.000*** (0.000)		0.000*** (0.000)
Current Account Balance			-0.004+ (0.002)		-0.004*** (0.001)
Deficit/GDP			-1.971*** (0.313)		-0.051 (0.093)
Treasury				0.000 (0.003)	0.004 (0.004)
Global Defaults				0.000 (0.001)	0.000 (0.001)
Ethnic Support x Left Right:				30.30	24.44
Long-run multiplier				0.728*** (0.333)	1.467*** (0.446)
Ethnic Support x Left Right:				6658	3663
Long-run steady state				0.955	0.955
Num.Obs.	7597	6670	3667		
R2	0.777	0.806	0.873		
Country FE	Yes	Yes	Yes	No	No
Month FE	Yes	Yes	Yes	No	No

+ $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.

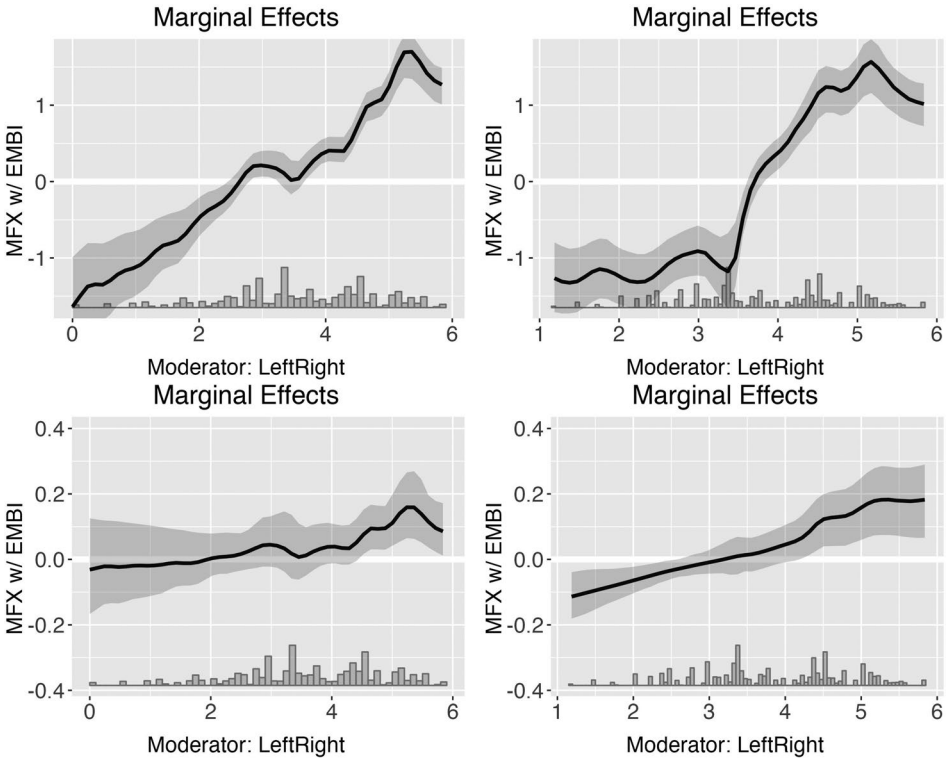


Figure 4. Marginal effect of ethnic support on log(bond spread) across left-right. Each plot indicates the marginal effect of *EthnicSupport* across values of Left-Right orientation based on kernel estimation with a bandwidth set at 0.5. Each plot corresponds with the model specification 2-5 estimated in Table 1 (left-to-right, top-to-bottom order). Black lines indicate the estimated marginal effect. Grey ribbons indicate the 95% confidence intervals.

with 64% and 81% lower spreads in Models 2 and 3. The non-linear marginal effects of the kernel models suggest even larger substantive differences. While most states will not make such a dramatic shift in one leadership change, Figure 1 shows that it is possible. In comparison, a standard deviation increase in Ethnic Support (0.25) leads to 22% lower bond spread among the left-most governments and a 41% increase in bond spreads among right-most governments when using the estimates from/model 2. These notable differences demonstrate the importance of ethnic politics in the determination of default risk.

Models 4 and 5 include lagged-dependent variables, and so the coefficients reported in the upper panel of Table 1 and the marginal effects plotted in Figure 4 reflect the short-run effect on bond spreads. Notably, a significant effect among left governments is conditional on the controls included in the estimation, while the positive association among right governments persists in both specifications. Given that these are dynamic models, it is important to examine the long-run steady state of the interaction term rather than the static coefficient as this reflects the total short- and long-run effect on bond spreads. We report the long-run multipliers⁸ and long-run steady state estimates at the bottom of Table 1 with standard errors calculated using the delta method. Both steady states are significant and

substantively large. The multipliers indicate that when considering both short- and long-term effects, the conditional effect of *EthnicSupport* on bond spreads is 25 to 30 times larger than the single-period estimates in Models 2 and 3. These dynamic estimates offer a significant improvement over the static specifications by explicitly modeling the slow adjustment of the dependent variable and reveal that ethnic politics has a substantively large effect on bond spreads in the long-run.

Table 2 presents the findings from models predicting credit ratings. Using the S&P ratings, which fall on a scale from 0-21 with higher values indicating better credit terms, results are again consistent with our central hypothesis. Far-left governments are associated with about a 12-23 point higher credit rating when they also have an ethnic support base compared to when they do not. Similarly, Models 7 and 8 predict a 7 or 9-unit decrease, respectively, in credit ratings when right governments also have an ethnic support base. In both cases, the differences are statistically significant. The models using the Fitch and Moody's ratings have similar substantive effects. Furthermore, the marginal effects plots presented in Figure 5 correspond closely with the linear models and exhibit tight confidence intervals.

One issue with relying on bond spreads and credit ratings is selection bias due to lack of creditor demand for bond issues and subsequent ratings. In the Appendix, we demonstrate that the results hold when using a more inclusive indicator of default risk from *Institutional Investor (II)* magazine. II ratings are more consistent as they were assigned to countries regardless of their credit market activity and were not solicited by governments. Results using the II ratings are very similar to those using the 'big 3' ratings.

Unlike many studies of borrowing costs and default risk that rely on a single indicator, we provide evidence using five measures of credit risk. Consequently, we have confidence that the hypothesized conditional relationship is present in the data.

Robustness of central analyses

In addition to the models above, we ran additional analyses to address concerns about variable construction, confounding, and other threats to inference. The results of these tests can be found in the Appendix.

First, we include several additional controls that may confound the relationship between ethnic support and credit outcomes. We include an indicator of political fractionalization from the DPI as this may facilitate common pool problems and complicate debt consolidation (Bawn & Rosenbluth, 2006). Ethnic support may also be caused by institutional factors, for example, where post-conflict power-sharing agreements shape the ability of ethnic groups to politically organize or control fiscal policy (Bormann et al., 2019). We include several indicators for institutional rules that limit the formation of explicitly ethnic or religiously-based parties (Ziff et al., 2021). We also include indices of property rights and the rule of law, which may co-determine credit outcomes (Biglaiser & Staats, 2012) and ethnic political competition (Huber, 2017). Controls for peace years and ongoing conflict are included in the main models, but creditors may be more attuned to the risk of future conflict, and so we add a measure of conflict risk from the International Crisis Research Group (ICRG). We include a measure of financial market transparency from Copelovitch et al. (2018) as this may be correlated with ethnic politics and credit

Table 2. Left-right, ethnic support & credit rating.

	S&P (6)	S&P (7)	S&P (8)	Fitch (9)	Fitch (10)	Fitch (11)	Moody's (12)	Moody's (13)	Moody's (14)
Ethnic Support	11.952*** (0.737)	12.570*** (0.725)	12.975*** (1.057)	15.647*** (0.845)	14.007*** (0.728)	10.031*** (1.056)	10.939*** (0.621)	9.487*** (0.563)	9.259*** (0.659)
Left Right	0.702*** (0.045)	0.558*** (0.044)	0.661*** (0.070)	0.847*** (0.058)	0.668*** (0.049)	0.562*** (0.056)	0.693*** (0.037)	0.493*** (0.036)	0.548*** (0.056)
Ethnic Support\LeftRight	-3.236*** (0.209)	-3.706*** (0.195)	-3.333*** (0.252)	-3.874*** (0.235)	-3.840*** (0.193)	-2.355*** (0.245)	-3.438*** (0.192)	-3.144*** (0.158)	-2.604*** (0.186)
Debt/GNI	-0.028*** (0.002)	-0.024*** (0.003)	-0.048*** (0.003)	-0.023*** (0.002)	-0.014*** (0.002)	-0.039*** (0.003)	-0.014*** (0.001)	-0.002 (0.002)	-0.027*** (0.003)
Crisis	0.158 (0.102)	0.158 (0.102)	0.900*** (0.134)	0.900*** (0.102)	0.095 (0.121)	1.452*** (0.133)	0.274** (0.089)	0.274** (0.089)	1.158*** (0.116)
Resource Rents	0.005 (0.009)	0.005 (0.009)	0.019 (0.013)	0.019 (0.013)	0.031*** (0.008)	-0.035** (0.012)	0.042*** (0.008)	0.042*** (0.008)	0.018 (0.013)
Polyarchy	1.844** (0.599)	1.844** (0.599)	3.642*** (0.627)	3.642*** (0.627)	2.814*** (0.488)	3.978*** (0.629)	5.805*** (0.473)	5.805*** (0.473)	5.000*** (0.626)
GDP per capita	0.000*** (0.000)	0.000*** (0.000)	0.000*** (0.000)	0.000*** (0.000)	0.001*** (0.000)	0.000*** (0.000)	0.000*** (0.000)	0.000*** (0.000)	0.000*** (0.000)
Growth	0.001 (0.009)	0.001 (0.009)	-0.091*** (0.014)	-0.091*** (0.014)	0.009 (0.009)	-0.046*** (0.011)	0.021** (0.008)	0.021** (0.008)	-0.005 (0.009)
Conflict	-0.982*** (0.113)	-0.982*** (0.113)	-0.258* (0.125)	-0.258* (0.125)	-0.648*** (0.149)	0.406** (0.146)	-0.014*** (0.135)	-1.691*** (0.135)	-0.826*** (0.130)
ln(Peace Year)	-0.162* (0.074)	-0.162* (0.074)	0.220*** (0.061)	0.220*** (0.061)	0.286*** (0.082)	0.373*** (0.064)	0.056 (0.066)	0.056 (0.066)	0.240*** (0.059)
Coup	-0.528*** (0.158)	-0.528*** (0.158)	-0.123 (0.135)	-0.123 (0.135)	-0.184 (0.125)	0.079 (0.109)	-0.393** (0.140)	-0.393** (0.140)	-0.232+ (0.128)
In Default	-0.206** (0.078)	-0.206** (0.078)	0.127 (0.103)	0.127 (0.103)	-0.396*** (0.091)	0.065 (0.107)	-0.287*** (0.063)	-0.287*** (0.063)	0.231** (0.086)
log(years since default)	-0.094*** (0.009)	-0.094*** (0.009)	-0.058*** (0.007)	-0.058*** (0.007)	-0.060*** (0.006)	-0.015* (0.006)	-0.066*** (0.005)	-0.066*** (0.005)	-0.031*** (0.005)
Short Debt/Reserves	0.001*** (0.000)	0.001*** (0.000)	0.000 (0.001)	0.000 (0.001)	0.000 (0.000)	-0.007*** (0.001)	-0.001*** (0.001)	-0.001*** (0.000)	0.000 (0.001)
KAOPEN	1.102*** (0.100)	1.102*** (0.100)	1.102*** (0.100)	1.102*** (0.100)	1.168*** (0.073)	1.168*** (0.073)	0.866*** (0.074)	0.866*** (0.074)	0.866*** (0.074)
Regional Diffusion	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000** (0.000)	0.000** (0.000)	0.000** (0.000)	0.000** (0.000)	0.000 (0.000)
Current Account Balance	-0.061*** (0.008)	-0.061*** (0.008)	-0.061*** (0.008)	-0.061*** (0.008)	-0.018* (0.008)	-0.018* (0.008)	-0.014** (0.005)	-0.014** (0.005)	-0.014** (0.005)

(Continued)



Table 2. Continued.

	S&P (6)	S&P (7)	S&P (8)	Fitch (9)	Fitch (10)	Fitch (11)	Moody's (12)	Moody's (13)	Moody's (14)
Deficit/GDP			15.536*** (1.462)			13.794*** (1.260)			9.601*** (1.324)
Num.Obs.	5280	4701	3034	5023	4500	2923	5307	4710	3009
R2	0.739	0.757	0.828	0.797	0.802	0.860	0.809	0.816	0.860
Country FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

+ $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.

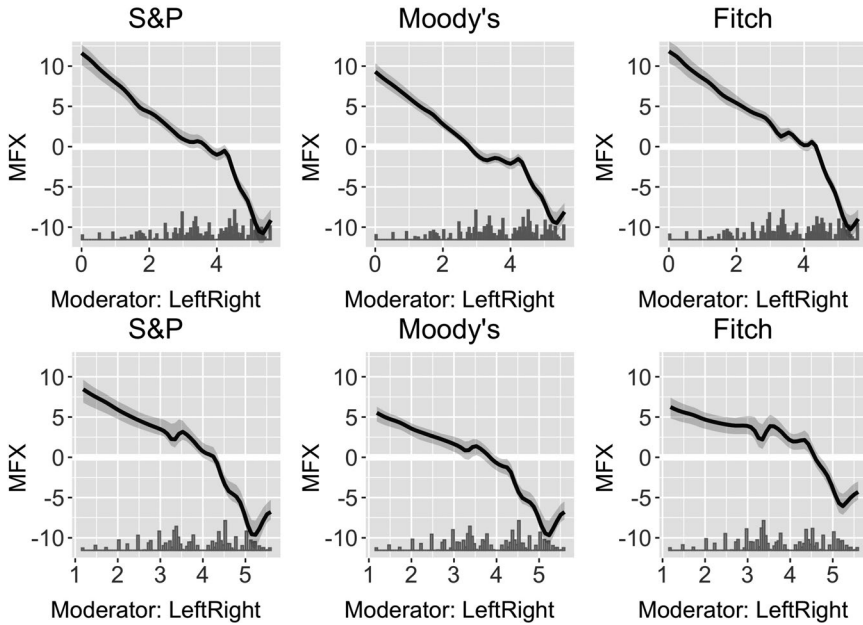


Figure 5. Marginal effect of ethnic support on credit ratings across left-right. Each plot indicates the marginal effect of ethnic support across Left-Right orientation based on kernel estimation with a bandwidth set at 0.5. Each plot corresponds with the model specification estimated in Table 2. The top row reflects the specification from the models 7, 10, and 13, and the bottom row reflects models 8, 11, and 14. Black lines indicate the estimated marginal effect. Grey ribbons indicate the 95% confidence interval.

outcomes. Finally, we control for executive and legislative elections as election cycles may intensify ethnic political competition and alter creditors' assessments. Our results are not substantially different when including these additional variables.

Next, we consider the role of regime type in our models. As discussed above, regime type may confound our results and is included as a control in all models. However, regime type may also condition the effect of ethnic support and economic orientation. We explore this in the Appendix through a triple interaction model and in split-samples between autocracies and democracies. There is little evidence that regime type conditions the effect of ethnic support, and our results are similar across autocracies and democracies.

Lastly, we consider the potential endogeneity of ethnic and class coalitions. For parsimony, we have largely assumed that the composition of the governing coalition is exogenous to credit outcomes, but this assumption may not hold in practice. We address this through an instrumental variables approach; as our models include an interaction term with a potentially endogenous regressor, we need to instrument for both the additive term (*EthnicSupport*) and the interaction term (*EthnicSupport* * *LR*). We instrument for *EthnicSupport* using distance from Ethiopia, following Ahlerup and Olsson (2012), and also instrument for *LR* using the global age-dependency ratio, building off of Shoukry Rashad et al. (2019). Using these instruments and leveraging their non-linear functional forms (Bun & Harrison, 2019), we find similar results as in the OLS models. More details on the instruments, the exclusion restrictions, and validation tests are found in the Appendix.

Default and restructuring risk

We have thus far demonstrated that credit market actors are particularly wary of the combination of ethnic and right-leaning politics. We argue that this is driven by creditors' assessments that ethnic support alters default risk, increasing the likelihood that right governments will fail to repay their commitments. To test this more directly, we examine the effect of ethnic support on default risk and spending commitments conditional on economic orientation. If our theory holds, we would expect that increasing reliance on ethnic support would increase spending commitments and the likelihood of default among right governments.

First, we estimate the effect of ethnic support, economic orientation, and their interaction on default probability using a linear probability model, shown in Model 1 of Table 3. The dependent variable is a binary indicator for if the country is in default, and controls include those shown in Table 1 Model 1 (except default and crisis). We find that ethnic support increases the likelihood of default as a government is more right-leaning. We plot the marginal effects in the upper-left panel of Figure 6, which demonstrates *EthnicSupport* has a null effect across left governments but increases default risk for right governments.

Default is an extreme choice for a government, so countries may attempt to restructure their debt obligations before default occurs. These restructurings represent a potential loss to investors as they often result in countries paying less than originally agreed to, forcing investors to take a 'haircut'. We find in Model 2 in Table 3 that *EthnicSupport* increases the risk that a state enters debt restructuring as governments are increasingly right-leaning (restructuring data taken from Asonuma and Trebesch, 2016). The marginal effects in the upper-right panel of Figure 6 are consistent with the default risk results in Model 1.

To further explore why ethnic-right governments have higher default risk, we consider the role of government expenditures. Typically, right governments do not use large, inflexible fiscal commitments to satisfy key supporters. Creditors may reward right governments because it is more politically feasible

Table 3. Left-right, ethnic support & government spending.

	(1)	(2)	(3)	(4)
	Default	Restructuring	Budget	Deficit
	Episode	Episode	Proportion (%)	
Ethnic Support	-0.415*** (0.094)	-0.463*** (0.053)	-22.901*** (5.050)	-12.889** (4.190)
Left-Right	-0.057*** (0.007)	-0.001 (0.002)	0.445+ (0.252)	-1.157*** (0.259)
Ethnic Support × Left-Right	0.062* (0.029)	0.111*** (0.016)	9.117*** (1.371)	4.724*** (1.237)
Constant	0.952*** (0.216)	-0.069 (0.084)	125.251*** (2.402)	7.980 (9.612)
R-Sq	0.65	0.30	0.62	0.76
Adj. R-Sq	0.65	0.29	0.61	0.76
N	6684	6684	3825	4617
Controls	Yes	Yes	Yes	Yes
Country FE	Yes	Yes	Yes	Yes
Period FE	Yes	Yes	Yes	Yes

* $p < 0.05$; Controls included, not shown.
Robust standard errors in parentheses.

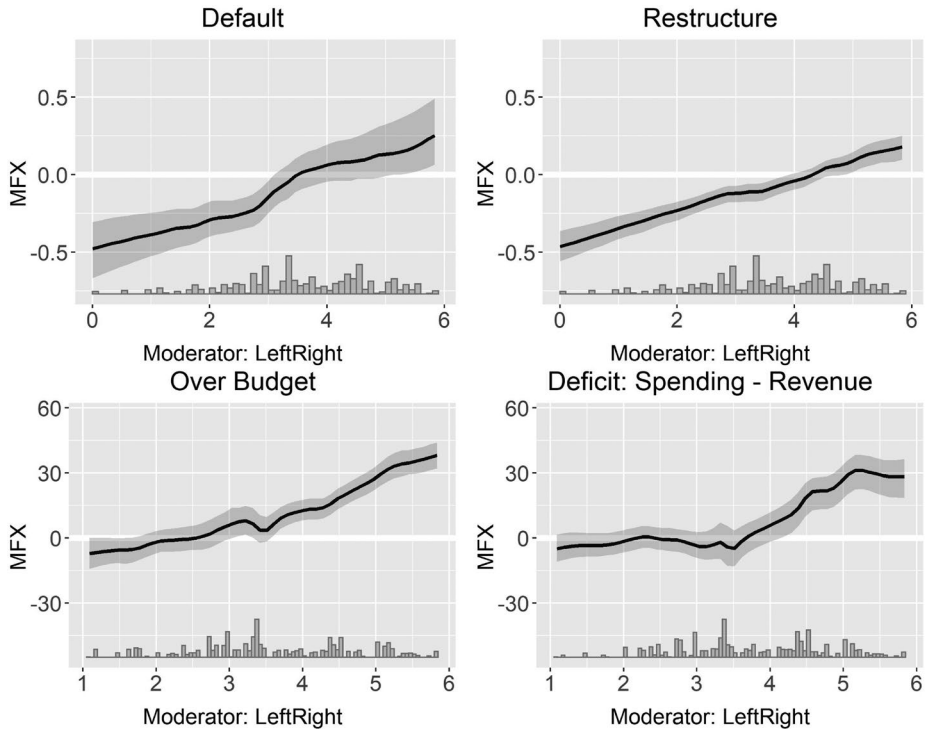


Figure 6. Marginal effect of ethnic support on spending: Each plot indicates the marginal effect of ethnic support across values of Left-Right orientation based on kernel estimation (bandwidth set at 0.8 for top panels and 0.5 for bottom panels). Each plot corresponds with the model specification estimated in Table 3. The black lines indicate the estimated marginal effect and the grey ribbon indicates the 95% confidence intervals.

for them to cut spending if necessary, reducing the risk of default. With ethnic support, however, right governments will need to use funds to reward key ethnic groups.

To test this expectation, we examine the effect of ethnic support on countries' budgetary processes. First, we regress government spending as a proportion of the planned budget on the interaction term, shown in Model 3. This budget proportion (measured using data from Indicators, 2019) captures how governments fulfill or break their fiscal commitments. We expect that right governments with ethnic support will exceed planned expenditure rates while left governments with ethnic support can keep government spending in line with budget plans. The results support our expectations: Right governments with no ethnic support generally spend as planned, but ethnic support pushes spending on average 9.1% over planned expenditures.

Next, we examine the conditional effects on budget deficits (expenditures minus revenues, recorded in local currencies) as a percentage of total revenue, shown in Model 4. Without ethnic support, right governments do run small deficits (1.2%) but ethnic support increases deficits by an average of 4.7%. We again illustrate the marginal effects of ethnic support on both budgetary proportion and budget deficit across economic orientation in the bottom left and right panels in Figure 6,

respectively. In the [Appendix](#) we include government spending and planned budgetary proportion as controls in models predicting bond spreads. The interaction between ethnic support and left-right remains significant and positive, although it is substantively smaller. This suggests that creditors assess the effect of ethnic support through default risk, but also incorporate ethnic politics into investment decisions *via* other mechanisms.

These results demonstrate one reason why creditors would be skeptical that right governments can maintain both their class-based and ethnic-based fiscal promises. In order for right governments to preserve ethnic support, they must commit to high, inflexible spending for their supporters. This creates a fiscal contradiction for right governments which will make it harder to cut spending in the future. While creditors reward right governments for their strong commitments to low taxes and spending, ethnic support makes those commitments less credible as fewer funds can be allocated towards debt repayment. As a result, default risk increases.

Conclusion

Ethnic politics alter governments' incentives to repay their creditors and thus shape the borrowing costs that governments face on the private credit market. While much of the work on the political determinants of default risk has focused on 'left-right' economic orientation, we propose that government reliance on ethnic support has a distinct effect on how creditors assess creditworthiness. Maintaining ethnic supporters requires that governments make a strong spending commitment, increasing default risk. For left-leaning governments traditionally beholden to a large, lower-class voter base, reliance on a smaller, more exclusive group of ethnic supporters may reduce their spending commitments and improve their ability to prioritize creditor interests. However, reliance on ethnic support may increase the default risk of right-leaning governments as they are forced to make larger spending commitments during economic downturns. Taken together, ethnic politics dampen the effect of economic orientation on credit outcomes, limiting both creditors' punishment of left governments and reward of right governments.

We find evidence of the conditional influence of a government's ethnic support across four measures of sovereign credit risk. Consistent with our expectations, our analysis shows that the correlation of a government's economic orientation with its credit risk diminishes as they rely more heavily on ethnic support. We further investigate the default risk mechanism by testing how the conditional relationship between left-right orientation and ethnic support depends on actual government spending and spending commitments. We find evidence that right-leaning governments are more likely to default on debts and exceed budget plans more frequently when reliant on ethnic support, demonstrating how ethnic politics alter governments' ability to prioritize creditors over domestic supporters. While we cannot rule out an endogenous process, we have attempted to address alternative explanations by subjecting our estimates to a variety of robustness checks.

As such, these findings can help explain the mixed evidence on the impact of left-right partisanship on credit risk. Creditors can use both economic

orientation and ethnic support to assess governments' fiscal priorities, and so credit access is influenced by multiple aspects of domestic politics. Examining the role of ethnic politics in borrowing costs may be particularly informative in emerging market countries where political competition is more likely to be multi-dimensional, and is another argument for expanding the scope of international political economy research beyond Western developed nations. Further, this work illuminates one of the current 'blind spots' in IPE by investigating how race and ethnicity determine international credit outcomes (Best et al., 2021; LeBaron et al., 2021). While we cannot determine whether creditors observe ethnic politics directly or indirectly, it is clear that they are responsive to ethnic political competition. Importantly, this runs counter to some prevailing research that shows international financial actors disregard racial and ethnic divisions when making investment and policy decisions (Helleiner, 2022; Vadlamannati et al., 2014). Our findings suggest that not only are financial actors aware of the fiscal implications of ethnic divisions, but that they use it to guide investment decisions. This raises important questions about how ethnicity is assessed by international finance and whether certain investors are more attuned than others to social divisions beyond class.

Our results show the value of considering how multiple sources of political support interact to influence economic and political outcomes. Scholarly research investigating government decision-making in fiscal policy and on sovereign credit markets currently focuses on how a single dimension, left-right economic orientation, defines government interests and political competition. Future work should investigate how race and ethnicity interact with left-right orientation in a wide set of quantities of interest such as debt issuance and relief. While we have argued that markets have good reasons to incorporate ethnic support into credit risk evaluations, we have limited means to demonstrate how credit rating agencies observe ethnic divisions. It may be interesting to investigate more systematically what information bond markets and credit rating agencies use to judge ethnic divisions and how these evaluations affect trading and rating decisions. Finally, future research should explore how ethnic political support influences creditworthiness at the sub-national level as ethnic landscapes vary greatly within countries.

Notes

1. <https://www.bloomberg.com/news/articles/2022-07-07/why-developing-countries-are-facing-a-debt-default-crisis>; <https://www.bloomberg.com/news/articles/2022-07-12/imf-chief-warns-of-debt-crisis-as-higher-rates-follow-covid-war>
2. There is more consensus that partisanship influences fiscal outcomes and borrowing decisions (Alt & Lassen, 2006; Ballard-Rosa et al., 2022; Cormier, 2023; Eslava, 2011).
3. See Dubois (2016) for a review.
4. Other scholars note that the assumption of perfect substitution between class and ethnicity is theoretically limiting (Auerbach et al., 2022).
5. As Huber (2017) notes, when ethnic groups do not allow governments to create a smaller winning coalitions, governments will retain class-based parties.
6. V-Party codes parties that received at least 5% of the national vote share.
7. We offer more detail on the distribution of *EthnicSupport* and *LR* in the Appendix.
8. The long-run multiplier is calculated by: $\beta / (1 - \rho)$.

Acknowledgements

The authors would like to thank Alexandre Afonso, Natascha van der Zwan, Sebastian Diessner, Fabio Bulfone, Alessia Aspide, Carl Muller-Crepon, and William Grimes for their feedback on earlier drafts.

Disclosure statement

No potential conflict of interest was reported by the authors.

Funding

This work was supported by the HORIZON EUROPE European Research Council under grant #852334.

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