

## Applying the Odious Debts Doctrine while Preserving Legitimate Lending

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### *Abstract*

Odious debts are debts incurred by the government of a nation without either popular consent or a legitimate public purpose. While there is some debate within academic circles as to whether the successor government to a regime which incurred odious debts has the right to repudiate repayment, in the real world this is not an option currently granted legitimacy either by global capital markets or the legal systems of creditor states. There are compelling reasons to reform the law of odious debts to allow for such a repudiation in strictly limited circumstances. Beyond the moral problem of requiring the formerly captive citizens of a tyrant to repay their oppressor's personal debts, the burden of odious-debt servicing can perpetuate the cycle of state failure which has direct national security consequences. In addition, a properly designed odious debt reform could function as an alternative sanctions mechanism to trade sanctions with far fewer harmful implications for the general population of the targeted state. Classical proponents of odious debt reform advocate a new legal rule under which successor governments could challenge the validity of debts incurred by prior regimes against the odious debt legal standard in a judicial-style forum. We make the case for an alternative "Due Diligence" model of reform which provides far greater ex ante certainty for lenders both as to which debts might be classified as odious debts and what steps the lender must take to protect its investments from subsequent invalidation. The Due Diligence Model also solves certain time-consistency problems inherent to the Classical Model.

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## Introduction

Odious debts are debts incurred by the government of a nation without either popular consent or a legitimate public purpose. This is a very specific subset of the general third-world debt issue that is separate from the issues of unsustainable debts incurred by democratic or quasi-democratic developing nations, or debts incurred by non-democratic regimes for legitimate public ends. Rather, we are concerned with the narrow problem of when dictators borrow money from foreign creditors and those funds are either spent for illegitimate ends, such as repressing the regime's population, or the money is simply looted and deposited into the private offshore bank accounts of the ruling class. Many legal scholars advocate that international law grants successor governments to regimes lacking public consent permission to repudiate those inherited debts which were incurred for non-public purposes. However, whether or not international law theoretically does or does not provide for such a remedy, the fact remains that for practical purposes successor governments to illegitimate regimes do not invoke the odious debt doctrine out of fear that doing so would deprive them of necessary access to global credit markets.

Odious debt is a moral issue, as it is manifestly unfair to demand that a population repay what are basically the personal debts of their former captors – loans which were in many cases used to actually fund the machines of public repression. But there are additional significant policy implications for creditor countries beyond the purely ethical plane. Successor governments to fallen dictatorial regimes are often placed in the position of rebuilding a shattered nation with scarcely adequate resources. This resource scarcity is severely compounded when the meager resources of the newly emergent government are diverted towards serving the odious debts of the prior regime (which were by definition incurred without any offsetting asset accumulated by the debtor nation), rather than investment in constructing a secure and sustainable platform for national development. This is a problem of economic development, but it is also a problem of national security. Failed states are increasingly recognized as posing significant threats to the security of the global community through such vectors as destabilizing broad neighboring regions, hosting potentially hostile non-state actors (e.g., Al-Qaeda), and providing breeding grounds for infectious diseases outside the reach of coordinated medical intervention. It is in the security interest of the global community to forestall state failure where possible and to facilitate the rebuilding of failed states in an expedient manner. A properly designed policy on odious debts can help to prevent state failure by limiting the spoils available to a potential autocrat from looting the state – thus hopefully discouraging some would-be state destabilizers at the margin – and it can also free resources for the use of post-authoritarian governments. These additional resources might in some cases make the difference between sustainable democratic redevelopment or a relapse into chaotic autocratic state failure.

A properly designed policy on odious debts also provides an attractive alternative or addition to trade sanctions as a tool of international diplomacy. Trade sanctions are often criticized as both harmful to the population of the targeted nation and ineffective due to the significant gains that defectors from the sanction regime can enjoy. However, a policy aimed at curtailing the non-legitimate borrowing of targeted governments would not only benefit the population of the target country (as they would not be saddled with mountains

of debt long after the present dictatorial regime had passed) but as we explain, there are far fewer incentives to defect from an odious debt sanctions regime than a trade sanctions regime.

Most supporters of reforms in the area of odious debt believe that democratic successors to illegitimate governments ought to be able to challenge the validity of debts incurred by their predecessors in a judicial-style forum. In this paper we raise some concerns with this policy approach. First, we argue that the determination of whether a certain regime does or does not enjoy popular consent for its actions is primarily a political rather than legal determination and thus a judicial-style forum may be an inappropriate venue for implementing an odious debt policy. Second, we are concerned with securing maximum ex ante certainty for creditors to sovereign governments. The importance of global capital flows to developing nations in today's globalized environment is significant and any policy which established a wide range of doubt for creditors over which of their loans might subsequently be deemed odious and void might cause more harm than benefit.

As an alternative to this traditional reform program, which we call the Classical Model, we describe a Due Diligence Model for the resolution of odious debts.<sup>2</sup> Our Due Diligence Model requires that a nation specifically be declared Odious Debt prone before any debts made after that declaration would potentially fall within the scope of invalidity. This safeguard, and the anticipated rarity with which nations would be placed on such a list, ensures that the vast bulk of sovereign lending to developing nations would be securely outside the scope of any potential interference. Under the Due Diligence Model, lenders to nations declared Odious Debt prone would need to cite the specific legitimate ends that the funds are intended for and the due diligence monitoring plan that the lender intends to implement to ensure that the funds go toward these stated uses. A loan would only be invalidated if the funds were diverted towards illegitimate ends and the lender failed to make a good faith effort to comply with its own pre-approved due diligence plan. This policy structure is a promising way not only to achieve most of the objectives of odious debt reforms, but to do so in a manner largely acceptable to creditor nations, global financial institutions, and investors in general.

In this paper we discuss several non-traditional rationales for why action in this area is necessary. We then present an economic model of odious debt, including an analysis of why it is that sovereign debt is repaid in the first place. Our model suggests that targeted loan sanctions may be a superior tool, where possible, to trade sanctions, and that properly

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<sup>2</sup> Two important contributions in this literature are Pogge, Thomas W. (2001). "Achieving Democracy," *Ethics and International Affairs* volume 15, 3-23; and Khalfan, Ashfaq and Jeff King, and Bryan Thomas (2002), "Advancing the Odious Debt Doctrine," Working Paper, Center for International Sustainable Development Law, McGill University. See also, Anna Gelpern, What Iraq and Argentina Might Learn From Each Other, 6 *Chicago Journal of International Law* 391 (2005); Kevin Anderson, International Law and State Succession: A Solution To The Iraqi Debt Crisis, 2005 *Utah Law Review* 401 (2005); Anupam Chander, Odious Securitization, 53 *Emory Law Journal* 923 (2004).

designed and credible loan sanctions might dissuade certain would-be tyrants from seizing control over fragile nations in the first place. Finally, we critique the Classical Model and make the alternative case for our Due Diligence Model as a model for policy reform.

## I. Reasons To Rethink The Status Quo

Can it truly be considered fair to demand responsibility of a population for debts that were not only incurred against its will, but were in many cases used to fund the mechanisms of its prior torment? We support the basic proposition that debt incurred by a governing regime for personal and/or nefarious purposes should be considered the personal debt of the illegitimate regime and that the country's citizens should not be held responsible for repaying this debt. Individuals do not have to repay money that others fraudulently borrow in their name, in the same way that a corporation is not liable for contracts that the chief executive officer or another agent enters into without the authority to bind the firm. Basic logic and justice demands that a corresponding rule exist for sovereign borrowing. Yet, while the moral argument is a strong one, there are additional rationales for a new policy approach towards odious debts with more direct roots in the national interests of the developed world powers. Below, we introduce three less conventional but nevertheless powerful arguments for why the governments of the West should seriously engage with this issue.

### 1. A Properly Designed Odious Debt Policy Can Provide A Superior Alternative To Trade Sanctions

While often criticized as blunt or ineffective, trade sanctions are a significant element of the international community's policy toolkit when dealing with problematic nations where diplomatic pressure is insufficient to the task of persuasion, but either the gravity of the offense or the pragmatic reality of the situation does not meet the stringent threshold required for military intervention.

Limiting a targeted regime's ability to borrow can be considered a new form of economic sanction with several attractive features relative to traditional trade sanctions. Section II lays out our argument in detail, but we briefly describe the ideas here. First, when trade sanctions are deployed, smugglers and even some national governments will likely flout them, enticed by profit opportunities that are enlarged by the sanction itself. Curtailing odious debt, in contrast, is a self-enforcing sanction. The key difference is that banks cannot break this sanction unilaterally since they rely on others to enforce the "reputational punishment" that operates in the debt market. Whereas trade sanctions are eviscerated by one or a few defectors even if there are a large number of abiders, with the "loan embargo," a critical mass of creditors and investors who are willing to lend to and invest in a country that has repudiated odious debt would eliminate any incentive for the country to repay the debt. A private bank would think twice before lending to a regime if the world's leading powers, international organizations, and financial institutions had declared that the regime lacked public consent and announced that they would consider successor governments justified in repudiating any new loans the odious regime incurs. For example,

when the United Nations imposed trade sanctions against the apartheid government of South Africa in 1985, it also could have declared that it would not consider debt incurred by the apartheid government as a legitimate obligation of the successor government. If banks doubted that successor regimes would repay loans issued after the announcement, they likely would have been unwilling to make such loans.

Second, when trade sanctions are not evaded, they are thought to impoverish the people they were intended to help because of the loss of national income. For example, if firms in the country are prevented from selling their products abroad, the loss of revenue might cause them to fire workers or decrease wages. In contrast, curtailing the ability of illegitimate regimes to borrow, loot, and saddle their people with large debts serving no public purpose would hurt the regimes but help their populations. The burden of repaying the debts would almost certainly outweigh any short-run benefit the population would obtain from any proceeds of the loans that trickled down to them.

More countries engage in foreign trade than in sovereign borrowing, so limits on borrowing could only be applied as a sanction in certain cases. Nonetheless, it could have a significant impact in these cases. For example, Franjo Tudjman of Croatia was arguably an odious ruler, having instigated violence against political opponents and looted public funds. In 1997, the International Monetary Fund (IMF) cut off aid that was earmarked for Croatia at the behest of the United States, Germany, and Britain, who were concerned about the “unsatisfactory state of democracy in Croatia.” Despite this, commercial banks lent an additional \$2 billion to the Croatian government between the time of IMF decision and Tudjman’s death in December 1999.<sup>3</sup> If our proposed institution existed, creditors might not have granted Tudjman the subsequent \$2 billion in loans, and the Croatian people would not bear the debt today. Such potential applications suggest that limits on borrowing should be part of the toolkit of policies available to the international community.

## 2. International Financial Markets Would Benefit From A Secure Prospective System For Resolving The Debts Of Newly Emergent Democracies

A precondition to the proper functioning of financial markets is a stable body of legal rules governing the full investment cycle from initial due diligence through liquidation. Without a known and transparent playing field of legal governance, the risk premium for making any investment is too high to qualify as anything but speculative gambling.

In the aftermath of the Iraqi invasion there were widespread calls across the political spectrum to eliminate what commentators from both the left and the right openly declared as Iraq’s “odious debts.”<sup>4</sup> For example, House Resolution 2482, introduced but not passed

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<sup>3</sup> “UK warns Croatia it risks losing aid,” *Financial Times*, 7/31/97; “Croats find Treasury plundered; state says former regime stole or misused billions,” *Washington Post*, 6/13/00. World Bank, 2003.

<sup>4</sup> Admittedly without extensive empirical investigation, we find it unlikely that there are many other policy initiatives for which Joseph Stiglitz and Oxfam on one side, and the Cato Institute and Heritage Foundation on the other, would unite in advocating. See, Joseph Stiglitz, “Odious Rulers, Odious Debts” in *Atlantic Monthly*, November 2003; Patricia Adams, *Iraq’s Odious Debts*, Cato Institute Policy Analysis No. 526,

by the 108<sup>th</sup> Congress with 28 co-sponsors on both sides of the aisle, called for the cancellation of loans made to Iraq by the multinational financial organizations. The bill argued for the necessity of canceling debts incurred by dictators on grounds that such debts not only impede a successful rebuilding of post-authoritarian states, but that the debts were never legitimate inheritances of the new government due to the doctrine of odious debts.

House Resolution 2482 should serve as a warning call to the international financial community that the status quo of traditional sovereign lending law could be radically reformed by legislative action with possible retroactive impact. While the Resolution failed to pass this time, its existence with non-trivial bipartisan supporter should alert lenders that the prospects for future legislative reforms in this area are far from negligible. It is therefore in the interest of the international financial community to embrace the issue head on and work to develop a fair body of prospective rules governing sovereign lending which address the issues raised by odious debt but cause minimal disruption of beneficial lending to developing nations. Purely prospective rules will not solve the problem of existing debts, but they will establish a stable framework to encourage present investors in new loans that there is not a contingent danger to their capital in the form of future legislative actions.

3. It is in the national security interests of the advanced industrial nations to deter state failure and to assist the reconstruction of post-authoritarian regimes

National security is rarely cited as a motivating factor behind campaigns to reform existing policies on odious debts. Yet changes in Western strategic doctrine following the September 11<sup>th</sup> attacks in the United States may offer an opportunity for traditional civil society advocates of odious debt reform to forge an alliance with the highly influential national security community. These changes revolve around a renewed focus upon failed states as a source of national security threats to the developed world.

In truth, the concept of a linkage between state failure and national security did not suddenly materialize on September 11<sup>th</sup>, 2001, and failed states were identified by the Clinton administration as a significant threat to U.S. interests.<sup>5</sup> However, domestic opposition to US military casualties stemming from failed state interventions, and a lack of bipartisan support for what was viewed in some quarters as global “social work” rather than defense policy, limited the consistent application of failed state doctrine as a core pillar of US national security policy.

The post-September 11<sup>th</sup> environment called for a reassessment of US national security policy and the result was a greater recognition of the linkage between state failure and

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September 2004; Nile Gardner & Marc Miles, *Forgive The Iraqi Debt*, Heritage Foundation Executive Memorandum #871, April 2003; A Fresh Start For Iraq, Oxfam Briefing Paper #48, May 2003.

<sup>5</sup> White House, *A National Security Strategy For A New Century* (December, 1999) at 2 : “Failed states: At times in the new century, we can expect that, despite international prevention efforts, some states will be unable to provide basic governance, safety and security, and opportunities for their populations, potentially generating internal conflict, mass migration, famine, epidemic diseases, environmental disasters, mass killings and aggression against neighboring states or ethnic groups – events which can threaten regional security and U.S. interests.”

national security.<sup>6</sup> In a blunt statement of this new recognition, the bi-partisan Commission on Post Conflict Resolution convened by the Center for Strategic and International Studies and the Association of the US Army stated that, “One of the principal lessons of the events of September 11 is that failed states matter – for national security as well as for humanitarian reasons.”<sup>7</sup> This change in outlook has not been limited to the United States security establishment alone, but has spread widely through the strategic views of the major developed world powers.<sup>8</sup>

Driving this reassessment is a greater recognition of the impact state failure can have outside the borders of the failed state. In the post-Cold War environment, non-state actors have assumed a far greater threat profile than they did during the relatively orderly state-state conflict of the prior half century. This is, of course, exemplified by the challenge posed by the transnational network Al Qaeda. Failed states strengthen non-state actor threats by providing safe havens where porous borders and the absence of security enforcement allow for effective operational bases.<sup>9</sup> For example, Al Qaeda utilized the near complete absence of any centralized state in Somalia following the failed US/UN intervention there to organize and stage operations such as the 2002 Kenya hotel attack. The case of Taliban-era Afghanistan providing another locus for Al Qaeda activity leading up to the September, 2001 attacks in the United States is another vivid example of this phenomenon. The confluence of natural resources and weak/failed states also permits hostile non-state actors to finance their operations through smuggling proceeds. State failures can also generate widespread regional conflicts, trigger collapses in nearby fragile states, result in destabilizing refugee flows, and provide the breeding grounds for cross-border disease epidemics – all tangible national security concerns for the developed world.<sup>10</sup>

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<sup>6</sup> It was considered notable that the Bush Administration, which had previously stated a preference for refocusing United States national security policy on “great power” relations, stated in its own 2002 National Security Strategy report: The events of September 11, 2001, taught us that weak states, like Afghanistan, can pose as great a danger to our national interests as strong states.” White House, *The National Security Strategy Of The United States Of America* (September, 2002) at ii. See also, “America is now threatened less by conquering states than we are by failing ones.” *Ibid*, at 1.

<sup>7</sup> *Play To Win: Final Report of the bi-partisan Commission on Post-Conflict Reconstruction*, Center for Strategic and International Studies and the Association of the United States Army (Washington D.C., 2003) at 1.

<sup>8</sup> UK Foreign Secretary Jack Straw stated in a speech delivered at the European Research Institute, Birmingham, UK on September 6, 2002: “I believe therefore that preventing states from failing and resuscitating those that fail is one of the strategic imperatives of our times.” The European Security Strategy report of 2003, approved by the European Council, places the prevention and mitigation of state failure at a similarly critical level of importance. *A Secure Europe In A Better World: European Security Strategy* (Brussels, 2003): “State Failure: Bad governance – corruption, abuse of power, weak institutions and lack of accountability - and civil conflict corrode States from within. In some cases, this has brought about the collapse of State institutions. Somalia, Liberia and Afghanistan under the Taliban are the best known recent examples. Collapse of the State can be associated with obvious threats, such as organized crime or terrorism. State failure is an alarming phenomenon, that undermines global governance, and adds to regional instability.”

<sup>9</sup> See Susan E. Rice, *The New National Security Strategy: Focus On Failed States*, Brookings Institution Policy Brief#116 (Washington D.C., 2003).

<sup>10</sup> See Commission On Weak States and US National Security, *On The Brink: Weak States and US National Security*, Center for Global Development (Washington D.C., 2004) at 9. See also, *State Failure Task Force*

How does a rising national security concern with the causes and consequences of weak and failing states intersect with the problem of odious debt? First, the ability of autocrats to loot the proceeds of foreign borrowing provides an incentive to seize power in the first place. If we are able to design new institutions which dissuade creditors from making such loans, we can reduce the incentives for potential autocrats to destabilize fragile regimes.

Second, by limiting the enforceability of odious debts in post-authoritarian environments, we can bolster the chances that emerging representative governments will sustain the path towards stable governance. For example, a Congressional Budget Office study released in January 2004 noted that servicing a reasonable estimate of outstanding Iraqi debt would “leave no funds in the Iraqi budget for capital investment and produce substantial shortfalls in the government’s ability to meet its day-to-day operating expenses.”<sup>11</sup> This is hardly a fiscal position conducive to rebuilding a conflict torn nation and establishing the popular credibility of a new government as an effective provider of basic state services. As the rebuilding of failed states has come to absorb a tremendous proportion of available Western defense resources, severely straining the strategic flexibility of the military, proposals which would assist in the rapid reconstruction of failed states are likely to gain a receptive ear in the national security community.

## II. An Economic Model Of Odious Debt

In this section we present an economic model of why the successor governments to odious debt prone (hereafter, OD-prone) regimes do not repudiate their odious debts.<sup>12</sup> We then establish that an alternative equilibrium could exist whereby odious debts would not be originated by creditors if they could be repudiated by successor governments without loss of access to credit. It is shown that under this alternative equilibrium, potential dictators might be dissuaded from overthrowing representative governments. Finally, we establish the superior merits of targeted loan sanctions versus trade sanctions as a policy tool.

### 1. Why do nations repay odious debts

Modeling loan sanctions requires an underlying model of why sovereign debt is repaid in the first place. In this section we embed the analysis of odious debt in a standard reputational model of borrowing. Later we discuss loan sanctions in a broader class of reputational models, and in models in which debt repayment is enforced with the threat of trade sanctions, exclusion from foreign assistance, or other similar penalties.

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*Report: Phase III Findings*, p. 18. This task force found that the odds of state failure were almost twice as high for countries with two or more neighbors experiencing a major, violent internal conflict.

<sup>11</sup> See “Paying for Iraq’s Reconstruction,” Congressional Budget Office: January 2004, p. 13.

<sup>12</sup> This section draws heavily on Jayachandran and Kremer, *Odious Debt*, forthcoming in the *American Economic Review*

## A. Setup of the model

**Production:** Suppose there is a set of countries each with a population normalized to 1. In each, period  $t$  the government allocates labor  $L_F(t)$  to harvesting fruit and  $1-L_F(t)$  to building palaces. Fruit production is  $A(t)L_F(t)$  if harvesters are paid at least  $w = \underline{w}$ ; if  $w < \underline{w}$  the harvesters are too sick to work.  $A(t)$ , the productivity stream, is uneven. For some of the countries,  $A(t) = a$  if  $t$  is odd and  $A(t) = A > a$  if  $t$  is even. For the others,  $A(t) = A$  if  $t$  is odd and  $A(t) = a$  if  $t$  is even. This unevenness generates a reason for either borrowing or saving, namely to smooth consumption. We focus on countries where first-period productivity is low: as discussed below, such countries will prefer to borrow in period 1 and continue with a pattern of borrowing in odd periods and repaying in even periods. We assume  $a > \underline{w}$  to ensure that fruit production is sufficient to support harvesting, even in bad years. Fruit is nonstorable.

Fruit can be bought and sold on international markets at price 1. A large number of countries that do not face the uneven productivity stream comprise the international markets. These countries also competitively produce marble, issue loans, and offer savings accounts, as discussed below.

Palaces are produced discretely using imported marble with price  $P_M$  and well-fed workers who can maintain their concentration. Marble is supplied by Bertrand competitors who can produce at cost  $P_M$ . Production is  $\text{int}(\min\{(1-L_F(t))/\mu, M/\mu\})$  if builders are paid at least  $\geq W > \underline{w}$  and 0 otherwise, where  $M$  is the amount of marble imported, and  $\mu$  is the number of workers and amount of marble needed to build one palace.

**Credit and savings markets:** Loan contracts are as follows. A creditor lends an amount  $d(t) = 0$  in period  $t$ , and the country is expected to repay  $d(t)R$  in period  $t+1$ . A country also can place assets in a foreign savings (demand deposit) account that earns interest rate  $R$ .

We assume assets that a country holds abroad can be seized by creditors to enforce debts. As shown by Bulow and Rogoff (1989), without this provision, reputation could not sustain sovereign borrowing. At some point the country would be better-off reneging on its debt, saving the funds that would have been used to repay the debt and using them to smooth its consumption in the future. Our assumption that fruit is non-storable implies there are no domestic savings (more realistically, domestic investments may be less attractive than diversifying internationally).

**Consumption:** Citizens' utility  $u(\cdot)$  is concave in fruit consumption and additively separable over time with discount rate  $\beta$ . Citizens receive no utility from palaces.

In the beginning of the first period, a potential dictator faces a utility cost of taking power distributed according to  $F(c)$  where  $F(0) > 0$ , so that given expected utility from being dictator of  $V$ , a dictator takes power with probability  $F(V)$ . Let  $G \in \{\text{odious, nonodious}\}$  be the government type in period 1, where  $G = \text{odious}$  if the dictator takes power. For simplicity we assume governments are always nonodious in subsequent periods.

A nonodious government maximizes the population's discounted utility. Dictators maximize their own utility  $v(p, f)$  which is increasing in palace ownership and fruit consumption. We assume preferences for palaces are satiated at one palace so that  $v(p, f) = f$  for  $p < 1$  and  $v(p, f) = \psi + f$  for  $p = 1$ . We also assume  $\psi = \mu(P_M + W + a - \underline{w})$ , or that an odious government's utility from palace ownership outweighs the input costs and forgone fruit production, implying that it constructs a palace, if possible.

These assumptions about  $v(p, f)$  generate a benefit to the population from an odious government's trading and possibly borrowing. Preventing an odious regime from importing marble deprives part of the population of the wage premium  $W - w$  associated with palace construction, as does a loan sanction if an odious government needs to borrow to pay for a palace (which is the case if  $a < \mu(P_M + W)/(1 - \mu) + w$ ).

Timing: At the outset of period 1, the dictator's takeover cost is realized, and the dictator decides whether to take over, determining  $G$ . Governments may enter loan contracts. Next, the government chooses a wage for the population and allocates the population's labor. Then simultaneously production occurs, the population receives its wage, the government receives any surplus production, and marble and fruit are bought and sold. Fruit is consumed. The government may make a debt repayment. Subsequent periods are identical except the government is always nonodious.

## B. Equilibria and the status quo of the sovereign debt market

We consider subgame perfect Nash equilibria of the model. The folk theorem implies there are multiple equilibria in this type of repeated lending game. In one equilibrium, creditors never lend: if they did, the governments would never repay their loans. In other equilibria, creditors lend to countries that have never defaulted, and countries repay since failure to do so would exclude them from future borrowing. Nonodious governments are able to smooth consumption by borrowing in odd-numbered periods and repaying in even periods. They maximize  $u(a + d(t)) + \beta u(A - d(t)/\beta)$  for odd  $t$ , trading off increased consumption at present with decreased consumption in the next period. Since credit markets are competitive, the interest rate will be  $R = 1/\beta$ . The solution to the first order condition,  $u'(a + d(t)) = \beta u'(A - d(t)/\beta)$  defines their optimal odd-period loan amount  $D = \beta(A - a)/(1 + \beta)$  which will enable the country to consume  $(a + A\beta)/(1 + \beta)$  in each period. Odious governments always want to borrow as much as possible since they do not care about future repayment.

We assume that nonodious governments are able to borrow their optimal amount. That is,  $D$  is less than the maximum loan that can be supported through reputation, denoted  $D^*$  and defined implicitly by  $u(A - D^*/\beta) + \beta u(a + D^*) = u(A) + \beta u(a)$ . The term on the left is the discounted utility for an even period and the next period if the country repays, and the term on the right is if the country defaults and lives in autarky. We also assume that  $\mu(P_M + W) - (1 - \mu)(a - \underline{w}) \leq D$  which ensures that governments can borrow enough to satisfy odious governments' desire for palaces.

Define a reputational equilibrium as a subgame perfect Nash equilibrium in which on the

equilibrium path creditors lend an amount no greater than  $D^*$  (which may be contingent on government type) in even periods and are repaid  $1/\beta$  times that amount from the successor government the following period. If any player has ever deviated from this behavior, creditors refuse to lend and governments borrow if possible but default on all loans incurred. All types of governments always choose  $L_F$ ,  $M$ , and  $w$  to maximize that government's utility subject to the budget constraint of borrowing or debt repayment and unit population size.

Proposition 1: Under the preceding assumptions about preferences, players, and technologies, there is a reputational equilibrium in which both odious and nonodious governments borrow  $D$  in odd periods and successor governments repay  $D/\beta$  in even periods.

Proof: Creditors' behavior is such that if a country did not repay  $D/\beta$  it would never be issued loans again. Since by assumption  $D < D^*$ , the maximum loan incentive compatible for countries, continued borrowing is preferable to autarky, so the country would repay the loan. The loans are zero profit and hence incentive compatible for creditors. Given the behavior of creditors (governments) off the equilibrium path, governments (creditors) prefer to borrow if possible but default (never lend) in response to non-equilibrium path behavior by creditors (governments).

The status quo of the sovereign debt market indeed seems to be that successor governments, concerned about their reputation, typically accept responsibility for debt, independent of the nature of the preceding regime. For example, Anastasio Somoza was reported to have looted between \$100 million and \$500 million from Nicaragua by the time he was overthrown in 1979. Daniel Ortega, leader of the Sandinista government that succeeded Somoza, told the United Nations (UN) General Assembly that his government would repudiate Somoza's debt, but he reconsidered when his Cuban allies advised him that doing so would unwisely alienate Nicaragua from Western capitalist countries. Similarly, the South African government, in order to remain in the good graces of investors, has distanced itself from the popular movement to nullify its apartheid-era debts.<sup>13</sup>

The equilibrium in the model that best characterizes this status quo is the one described in Proposition 1 in which both types of governments borrow  $D$  in odd periods.<sup>14</sup> If the government is odious,  $\mu$  workers are employed as palace builders and are paid  $W$ , and the remainder harvest fruit and are paid  $w$ . The government consumes a palace and fruit valued at  $D + (1 - \mu)(a - w) - \mu(W + P_M)$ . If the government is nonodious, all workers harvest fruit and are paid  $a + D$  in odd periods. In all even periods, the nonodious government repays existing loans and  $A - d(t)/\beta$  is passed along to the people, all of whom harvest fruit.

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<sup>13</sup> "Somoza Legacy: Plundered Economy" (*Washington Post*, November 30, 1979); "Cuba's Debt Mistakes: A Lesson for Nicaragua" (*Washington Post*, October 5, 1980); "S. Africa Shuns Apartheid Lawsuits" (*Guardian*, November 27, 2002).

<sup>14</sup> The status quo equilibrium could also be one in which odious governments borrow a different amount than nonodious governments (any  $D'$  satisfying  $0 < D' \leq D^*$ ). This would not alter our results substantively.

Of course, in addition to the equilibria discussed above with no lending or with lending in odd periods to all governments, the folk theorem supports a plethora of other equilibria. For example, there are equilibria in which loans made in time periods ending in the number 1 would not be repaid, and hence are not extended. There are also equilibria, as set forth in the next section, in which loans are issued only to nonodious governments.

## 2. What if there was no reputational consequence from repudiating odious debts?

From our model it follows that if the successor to an OD-prone regime repudiated debts regarded as odious without impacting the successor's access to credit then not only would it most likely repudiate those debts, but creditors would be unlike to issue the debt in the first instance.

**Proposition 2:** There exists a reputational equilibrium in which nonodious governments borrow  $D$  in odd periods and successor governments repay  $D/\beta$  in the successive even period, but odious governments receive no loans.

**Proof:** Suppose if a country did not repay loans issued to a nonodious regime it would never be issued loans again. Since  $u(A - D/\beta) + \beta u(a + D) > u(A) + \beta u(a)$ , the country would repay the loan. The loans are zero profit and hence incentive compatible for creditors. Suppose if a successor did not repay loans issued to odious regimes, the country would continue to receive loans in the future. Compared to repayment, non-repayment would imply a lump sum gain of  $D/\beta$  in period 2, raising the population's consumption by  $D(1 + \beta)/\beta$  in every period. The successor would not repay since nonrepayment maximizes the population's utility. Anticipating this, creditors would not issue loans to odious regimes. The remainder of the proof follows as in Proposition 1.

## 3. If Credible Ex Ante Trade Or Loan Sanctions Existed Then Potential Autocrats Would Have Less Incentive To Overthrow Fragile Governments

The incentive for a potential autocrat to seize control over a weak state is strongly correlated with the personal spoils that he seeks to siphon from the state. This is one reason why the presence of lucrative natural resources makes it more, not less, likely that a state will fail. The existence of credible trade or loan sanctions that eroded the scope of these spoils would thus, at least at the margin, dissuade some dictators from taking power.

**Proof:** The probability of a dictator's arising in period 1 is endogenous to the spoils from office, and a dictator's utility from being in office will be lower if he cannot trade or borrow. If odious governments can borrow up to an amount  $D$  and there are no trade restrictions, the utility from office is  $D + ? + (1 - \mu)(a - \underline{w}) - \mu(P_M + W)$ . If a dictator is able to borrow  $D$  but cannot trade, his utility is reduced to  $D + a - w$  since he cannot import marble to build a palace. If a dictator is able to trade but cannot borrow, his utility is reduced to  $? + (1 - \mu)(a - \underline{w}) - \mu(P_M + W)$  if he is able to pay for a palace by selling fruit; if he is unable to pay for marble and build a palace without borrowing, his

utility is the lower amount  $a - w$  obtained from allocating all labor to harvesting and consuming only fruit. If a dictator can neither borrow nor trade, his utility from office is  $a - w$ . In each of these cases, restrictions on trade or borrowing reduce the utility a dictator would obtain from being in power and therefore lower the probability that he takes over the country.

#### 4. Loan Sanctions Are A Superior Tool Against Targeted Dictators

In the context of our model, trade sanctions against a country consist of an agreement among all other countries to not allow native marble suppliers to furnish marble to the sanctioned country. Trade sanctions are fragile. Consider the case in which marble suppliers are Bertrand competitors. If one country with two or more marble suppliers does not agree to the sanctions, the sanctions do not affect the payoffs for the sanctioned government. Furthermore, there are strong incentives for marble suppliers to break the sanctions. A second weakness is that when trade sanctions bind, the population is made worse off. The government can no longer build palaces, which deprives a portion of the population of the efficiency wage premium  $W - w$ .

##### A. Loan Sanctions

Under the model, loan sanctions consist of legal changes made by countries to prevent assets held there from being seized to repay debt incurred by a particular regime.

Proposition 3: The imposition of loan sanctions against a particular regime eliminates equilibria with lending to that regime.

Proof. Suppose a creditor issued a loan of size  $d > 0$  to a sanctioned government. The sanction implies that even successor governments that default on the loan to the sanctioned government can save overseas at  $R = 1/\beta$  without assets being seized. If in period 2 the successor government does not repay the loan, the country's income stream for  $t=2$  onward is  $A, a, A, a, \dots$ , and its discounted utility is maximized by consuming  $(A + a\beta) / (1 + \beta)$  in each period. It achieves this by saving  $\beta(A - a) / (1 + \beta)$  in each even period and withdrawing  $(A - a) / (1 + \beta)$  in each odd period. Borrowing does not help with consumption smoothing, so with or without the ability to borrow, it chooses not to borrow. If the successor government instead repays the loan, the country's income stream net of debt repayments for  $t=2$  on would be  $A - d/\beta, a, A, a, \dots$  which gives lower discounted utility than the income stream  $A, a, A, a, \dots$ , regardless of whether the country is able to borrow. The successor does not repay loans issued to the sanctioned regime, so creditors will not issue loans to a sanctioned regime.  $\square$

The loan sanction eliminates the penalty a country faces for repudiating debt incurred by the sanctioned regime and, anticipating this, creditors would not issue loans to a sanctioned regime in the first place. This is a straightforward application of Bulow and Rogoff (1989) in which, if a country can use savings to smooth consumption in lieu of borrowing, a reputational equilibrium with debt cannot be sustained. With a system of loan sanctions, it remains the case that governments that renege on loans made to unsanctioned regimes

would have their savings seized; countries would have incentives to repay these loans, so reputational equilibria with loans to unsanctioned governments would continue to exist. Governments that inherit loans made to sanctioned regimes, however, would not value being able to borrow in the future since they could save abroad instead. The prospect of future loans cannot enforce repayment of loans issued in violation of a loan sanction. More generally, even if governments face more complicated income streams where borrowing might still be valuable, loan sanctions may shift creditors' behavior toward not viewing default on sanctioned loans as cause for curtailing future lending (as in the equilibrium of Proposition 2).

While trade sanctions are fragile since third parties have incentives to break them, loan sanctions are self-enforcing. Potential creditors have incentives to abide by a loan sanction, since any credit issued will not be repaid under the model.

In addition, loan sanctions have better welfare implications than trade sanctions for the population living under an odious regime. If a dictator needs to borrow to pay for palace building, loan sanctions, like trade sanctions, reduce the population's consumption in the short run because workers lose the wage premium  $W - w$ . If a dictator can pay for a palace without borrowing, the population does not suffer this short-term cost of lower wages. But in either case, loan sanctions make the population better off in future periods since it has no debt repayment to make. If the gain from not inheriting debt outweighs the short-term economic cost of a sanction, which seems plausible, then ex post a loan sanction is welfare-improving for populations ruled by an odious regime, even setting aside its effect on the probability that dictators come to power.<sup>15</sup> Proposition 4 formalizes this argument.

**Proposition 4:** If  $\frac{1}{1-\beta} \{u((A+a\beta)/(1+\beta)) - u((A+a\beta - d(1-\beta)/\beta)/(1+\beta))\} > \mu(u(W) - u(w))/\beta$ , a loan sanction imposed on an odious regime is welfare-improving for the population of that country relative to the population's welfare under an equilibrium in which the odious government is not sanctioned and borrows  $d$ .

**Proof.** By not repaying debt, the country gains  $d/\beta$  in period 2; it smoothes this windfall by consuming an extra  $d(1-\beta)/\beta$  in  $t=2,3,\dots$ . Its discounted utility increases from  $\frac{1}{1-\beta}u((A+a\beta - d(1-\beta)/\beta)/(1+\beta))$  to  $\frac{1}{1-\beta}u((A+a\beta)/(1+\beta))$ . The short-term cost of foregone efficiency wages is a utility loss of  $\mu(u(W) - u(w))$  in period 1.  $\downarrow$

Proposition 4 implies that loan sanctions may be particularly attractive instruments in cases in which the sanctioning government or international body does not want to make the population of the target country worse off, but simply its leadership. Another important point is that the loan sanction's attractive welfare properties for the people pertain only when the sanction is applied against regimes that are borrowing against the people's interests, i.e. governments defined as odious in the model.

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<sup>15</sup> If a trade sanction prevents a dictator from depleting a nonrenewable natural resource with no domestic market, the trade sanction could confer a similar benefit on the population. They would inherit a larger stock of natural resources.

Proposition 5: A loan sanction imposed on a nonodious regime during a low-income period (odd  $t$ ) is welfare-decreasing for the population relative to their welfare under an equilibrium in which the nonodious government is not sanctioned and borrows.

Proof: This follows from revealed preference since a nonodious government maximizes the population's utility. Because  $u(\cdot)$  is concave, the population's indirect utility is increasing in the amount borrowed in odd periods under a nonodious regime.

Proposition 5 highlights an important policy issue: a potential peril with loan sanctions—as with other sanctions—is that they could be applied at will by countries or international bodies. If in practice loan sanctions are imposed on a government that acts in the population's interest. For example because the major powers disfavor the government for foreign policy reasons and want to weaken the loan sanction hurts not only the government but also the people.

### III. From Theory To Practice

In this section we outline a new policy approach to the problem of odious debts. It is important to note that we do not address whether or not there is already a right for debtor nations to repudiate odious debts under an existing doctrine founded in customary international law. Rather, we train our focus on what an optimal doctrine of odious debts ought to look like were it brought into force by a positive act. Accordingly, while our proposal envisions reforms with solely prospective application to debts incurred subsequent to the enactment of our new policy, such enactment would not prejudice claims made by debtor nations that a customary international doctrine of odious debts existed prior to preemption by the new system, and that the pre-existing rules ought to govern already in force debts.<sup>16</sup> This is not to say that we take a position one way or the other on the subject - merely that it is beyond the scope of our work.

#### 1. Principles Of Design

There are three general principles which guide our search for a more desirable system of resolving odious debts. First, care must be exercised to develop arrangements which strike an appropriate balance between realizing the benefits of a more logical approach towards the resolution of odious debts and the corresponding potential for a chilling impact on legitimate sovereign borrowing. Extreme diligence must be devoted to ensuring that the new incentive structure does not discourage beneficial capital flows to the developing world. We envision that the application of any new odious debt policy will be sharply circumscribed in the frequency of its application. Global capital flows to the developing world, on the other hand, can be a force in alleviating the poverty faced by billions of men and women. In light of this imbalance, new policies must pass a test that any impairments on beneficial capital flows to the developing world are minimal to non-existent.

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<sup>16</sup> Our prospective focus is guided by several factors. First, as a matter of justice, rules with retrospective application to situations in which parties acted under previously settled rules should only be untaken in the most severe circumstances. Second, as a practical matter, it will be far easier to gain “buy in” from key governments and interest groups, such as the financial community, with a solely prospective proposal.

Second, new arrangements should be informed by a practical view towards their implementation by global financial institutions. This is in part a corollary of the first guiding principle as arrangements which place unworkable implementation burdens on financial institutions will raise the costs of sovereign lending beyond a point where even wholly legitimate loans can earn a sufficient rate of return. It is also a realistic statement that the chances a new policy towards odious debts will make the leap from theory paper to implementation are much greater if the opposition of powerful interest groups, such as the financial services industry, is not needlessly provoked. The primary interests of lenders are in clear ex-ante rules of the road and the potential costs of compliance. If lenders can be assured that a new policy both makes clear what they must do to ensure that their loans are granted legitimate status, and if the costs of that process are not so burdensome as to unreasonably impact the return on capital earned in sovereign lending, then resistance to the reforms should be relatively muted.

The third major principle to consider is the matter of bias. Recall that declaring a loan odious requires that the borrower regime lack public consent for its actions and that the loans be utilized for non-public purposes. No matter how well the conditions necessary to satisfy these categories are defined, as with any other matter of law, application of these rules to specific situations will always call for some degree of discretion – and with discretion comes the possibility of bias.

One possible vector of bias is creditor-debtor bias at the level of the institution charged with overseeing this policy. No legal rule is so precise that the biases of the implementing institution – be it a judicial or political forum – are not highly relevant. In our case, political ideology, external geo-strategic and economic relationships, or lobbying by affected interest groups could affect an institutional bias in favor of either creditors or debtors. To mitigate these risks, the institution could be empowered to invalidate sovereign loans only if the borrowing regime had been declared OD-prone prior to the loan's issuance. This will substantially increase ex ante certainty for lenders.

Furthermore, the institution will have stronger incentives to be truthful in evaluating the borrower regimes. Requiring an institution to judge regimes before loans are issued limits the potential for favoritism toward creditors. Even a small degree of concern for truthfulness or for the welfare of people in borrowing countries should be sufficient to prevent an institution from calling an OD-prone government legitimate. This is because before a loan is issued, the expected profits of a loan are very small, as lenders have many alternative uses for their capital. In contrast, outstanding debt is a “zero-sum game” between creditors and debtors, so a biased institution can help whichever party it favors. Because false rulings about regimes hurt the population of borrowing countries (through the accumulation of a debt burden without corresponding social benefits) and cannot substantially help creditors, an institution empowered only to regulate loans made to regimes previously declared OD-prone is less likely to make biased judgments in order to help creditors.

Another possible vector of bias is regime bias. This leads from the rather cynical yet factual observation that questionable regimes often have many more friends while in power than after they have been deposed. This is simply the fact of a world ultimately governed by *realpolitik*.<sup>17</sup> While we recognize that some ability for major powers to exert a level of protection for certain regimes on the basis of economic or geopolitical interest may be a cost of building sufficient support to enact our policy, one should aim to design a system that at least mitigates the most egregious abuses of this protection. Similarly, our institutions should establish obstacles to prevent targeted odious debt embargos from being falsely invoked against disfavored nations.

## 2. Critique of the “Classical Model”

The Classical Model of odious debt reform has two elements. The first element is the legal rule to determine if a debt qualifies as odious. This rule defines odious debts as debts contracted with an absence of consent, an absence of benefit, and subjective creditor awareness of the above two conditions.<sup>18</sup> The second element, most often left implicit but important nevertheless, is the forum in which this rule would be applied. Most advocates of the Classical Model envision that the rule would be applied in some form of judicial venue. Indeed, many advocates claim that the relief offered by the Classical Model already exists as a matter of international law and under the right circumstances and legal strategy this right will be recognized by either a domestic or transnational court of law.

However, there are several reasons why the Classical Model is sub-optimal if we define our task not as ascertaining what rights may already exist under international law but as designing an optimal policy *de novo*. First, the Classical Model contemplates that judicial institutions would be empowered to make the determination that a population did not consent to the debt transaction in question. In cases where the basis for this claim is that the debtor regime lacked sufficient institutional capacity to ensure that the loan proceeds were not excessively squandered via corruption, a judicial forum might be able to evaluate the appropriate evidence and rule accordingly. However, in cases where the claim rests upon allegations that the debtor regime’s structure of government was insufficiently democratic to form a basis for popular consent to government policies then the capacity of a judicial forum is far more questionable. There are simply no legal definitions of democracy or dictatorship with sufficient clarity for a judicial forum to rule upon.

Consider some of the difficulties posed by contemporary political structures: Iran holds popular elections but candidates for office are strictly screened by unelected religious authorities who bound the scope of the elected officials’ powers. The United States holds elections but the authority of elected officials is limited by lifetime appointed judges whose

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<sup>17</sup> Tangible examples of regime bias are almost too numerous to cite and there is no nation in existence which has not at some point cast its support to a repugnant regime in one form or another for calculated gain – whether strategic, diplomatic, or commercial. One need only observe the fact that no matter what was thought of the merits of the Iraqi war, Saddam Hussein’s regime had many more international friends prior to his fall than afterwards. The same can be said for nearly any fallen authoritarian regime.

<sup>18</sup> The Classical Model has its roots in the original work on the subject of odious debts by Alexander Sack, A leading contemporary work examining the Classical Model is Khalfan, Ashfaq and Jeff King, and Bryan Thomas (2002), note 1.

decisions can only be overridden by a process (constitutional amendment) so difficult and rare as to render it almost impossible. Certainly we can distinguish one of these forms as more democratic than the other, but doing so evades categorical, rule-based legal classification. One is reminded of the words of Justice Potter Stewart in a Supreme Court decision on pornography, who famously declared of the movie in question, “I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [of pornography]; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that.”<sup>19</sup> Unfortunately, the “I know it when I see it” standard of judicial review is hardly the basis for a system with sufficient *ex ante* clarity to prevent excessive interference with legitimate sovereign lending.

Jeff King proposes that we define four types of regimes – democratic, quasi-democratic, quasi-dictatorial, and dictatorial.<sup>20</sup> Where the debtor is dictatorial or quasi-dictatorial, we may presume that a given loan is not beneficial to the population. A quasi-democratic regime is defined as a government which is generally representative and accountable under regular elections but which may have a poorly informed electorate, monopolistic party system, limited franchise, or substantially unrepresented minorities. A quasi-dictatorial regime is a government that operates primarily without the consent of the population, but which may have a strictly limited franchise or highly limited forms of public representation. With due respect to King, who at least tries head on to tackle a question which most proponents of the Classical Model evade, these classifications remain too broad for clear application to the manifold political-institutional structures of the world’s nations. For example, how would Mexico during the era of PRI domination, or even America prior to enactment of the Voting Rights Act of 1965, fare under these standards? It is well possible that thinkers with more legal ingenuity than ourselves are capable of developing clear and precise rules to sort national governments into these categories. Yet, until someone does so, we must conclude that - as Stewart said of the effort to define pornography – defining democracy and dictatorship with adequate legal clarity may be “trying to define what may be indefinable.”<sup>21</sup> Some might argue that judicial fora have long been charged with the task of applying vague and general rules to specific situations, but this doesn’t quite work in the context of international adjudication where there is insufficient customary practice or other sources of authoritative reference to guide courts in their determination on the matter.

This indeterminacy would leave lenders floundering as to which of their loans are at risk of subsequent odious classification. In the absence of clarity, lenders will pursue one of two options – either they will withdraw from all lending which might possibly fall within the classification of odious debt, with a very wide margin of error, or they will substantially increase interest rates on sovereign lending to compensate for the risk of uncertainty. Either path will result in the significant curtailment of legitimate capital flows to

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<sup>19</sup> *Jacobellus v. Ohio*, 378 U.S. 184 (1964)

<sup>20</sup> King (2006), “The Doctrine of Odious Debt Under International Law: Definition, Evidence and Issues Concerning Application” in *Odious Debt Doctrine in International Law and Policy*, (eds.) Khalfan, Ashfaq and Jeff King, Cambridge University Press, forthcoming.

<sup>21</sup> *Jacobellus v. Ohio*, *supra* n. 16.

developing nations. Given the importance of those capital flows for global economic development, the cure for odious debt might be far more painful than the disease. In light of an anticipated tightening of sovereign credit, one would well expect an absence of widespread support for implementing the odious debt agenda among the nations of the developing world.

Finally, under the Classical Model, lenders must have subjective awareness that their loan lacks either consent or benefit. This is a definition which King understands to encompass actual knowledge, willfully shutting one's eyes to the obvious, and willfully and recklessly failing to make such inquiries as an honest and reasonable person would make.<sup>22</sup> We posit that this standard is too lenient on determining whether a creditor has awareness that a loan will not benefit the debtor nation's population. As we explain further in the following section, where a creditor has awareness that a regime is OD-prone, it should be required of the creditor to perform a higher level of due diligence. It is simply too easy to disguise fraud with sufficient camouflage to evade a willful and reckless standard of due diligence.

### 3. The Due Diligence Model Of Odious Debt Resolution

We attempt to address the shortcomings of the Classical Model with what we advance as the "Due Diligence Model" of odious debt resolution. The basic contours of this model are as follows: we propose that an international organization adjudicate *ex ante* that specified regimes are prone to odious debt. If, and only if, a regime has been so designated in advance, creditors to that government must employ reasonable best practices of due diligence to ensure that the proceeds of their lending will be utilized for a pre-specified public purpose.

A. An organization should be enlisted or designed to determine *ex ante* that specified nations are prone to odious debt

We propose that an international organization should be enlisted or designed to declare *ex ante* that specific governments are odious-debt prone – which is to say that the targeted government is either unwilling or unable to provide for a reasonable modicum of public consent to its policies. While the organization would be required to justify its decision on the basis of international law, it is anticipated that the decision would be made by diplomatic political appointees from member states to the organization.

This resolves several issues with the Classical Model. While the organization would justify its decision according to international legal standards, this model recognizes that the decision to declare a nation OD-prone will pragmatically be, in part, a political decision. It is highly unlikely that any odious debt proposal without this safeguard would ever make the transition to reality. For example, while there are serious deficiencies in the representative credentials of the governments of the People's Republic of China and Saudi Arabia, their geopolitical and economic importance ensures that any proposal which would threaten capital flows and diplomatic relations with either of these nations as a matter of automatic application without political safeguards would be a non-starter. While perhaps

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<sup>22</sup> Ibid

this level of discretionary application is not ideal from the perspective of a pure legal construct, we maintain that an implemented system which alleviates the odious debts of some sovereign borrowers is superior to a theoretically perfect system which is never put into place due to political resistance. Our system also resolves a key flaw with the Classical Model, which is the indeterminacy of trying to classify governments as democratic or dictatorial by strictly formal legal logic. In such a condition of formal legal indeterminacy, a political organization is far better positioned to make these decisions than a judicial forum.

The *ex ante* structure of the Due Diligence Model also minimizes the impact of the policy on legitimate sovereign lending. Only loans made to nations which were specifically targeted by the implementing organization prior to the loan's issuance would be at risk for possible invalidation. Since designating a nation as OD-prone would be a rare event, reserved for the most egregious violators of legitimate conduct, the vast bulk of sovereign lending would be unaffected by the policy and, accordingly, lenders will require no additional risk premium for sovereign loans to non-designated regimes.<sup>23</sup>

#### B. The Creditor To A Government Designated As OD-Prone Must Exercise Reasonable Best Practices Of Due Diligence To Ensure The Proceeds Of The Lending Will Be Used For A Legitimate Public Purpose

Under our Due Diligence Model, the designation of a government as OD-prone does not bar lenders from extending credit to it. Rather, lenders are placed on notice that to guarantee their loans will be enforceable in the event of regime change, they must utilize reasonable best practices of due diligence to ensure that the borrowed funds will only be utilized for pre-specified, legitimate purposes.<sup>24</sup> By due diligence we mean the structures utilized by the lender for on-going monitoring over the life of the loan to ensure that the loan proceeds are being used for their stated purposes. It is not enough to simply perform due diligence at the time the loan is originated; rather, it is necessary that structures of continuous monitoring are put in place to limit opportunities for funds to be diverted from legitimate purposes via corruption or intentional fraud.

How would lenders comply with such a standard? The term "best practices" makes this a ratcheting standard which evolves over time as innovative techniques of auditing technologies and deal structuring are developed. But this requirement is modified by a secondary rule of reasonableness. Factors which would weigh upon whether a given plan of due diligence is reasonable in a specific situation should include the cost of compliance relative to the importance of the public purpose underlying the loan, the degree of corruption in the debtor government, and the potential harm that the debtor could cause

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<sup>23</sup> There is a question of whether lenders might demand an additional risk premium for loans to non-designated regimes if they feared that subsequent designation would trigger a liquidity crisis in the debtor nation. The policy should therefore permit the refinancing of pre-designation loans as a legitimate transaction for OD-prone governments. Also, the risk premium for loans to non-designated regimes should be lower under our proposal than under the current status quo, as today there exists some possibility that a court might find that the classical doctrine of odious debts exists under international law whereas our proposal makes clear that loans to non-designated regimes are safe from the odious debt standard.

<sup>24</sup> In the case of a bond debt rather than bank credit, this monitoring role would be assigned to a servicer.

through illicit diversion of the funds (i.e., a government engaged in a war of aggression not supported by its citizens could purchase additional weapons). Mechanisms of implementation might include the employment of certified outside auditors, escrow accounts, off-shore special purpose vehicles, or numerous other deal structuring technologies to lower the risk of illicit funds diversion.

To ensure that lenders have sufficient ex ante certainty that their loans comply with the requisite level of due diligence for the circumstances, the international organization implementing the agreement should establish a mechanism to issue “no action” letters. No action letters are a device frequently utilized by administrative agencies of the US government to reconcile the broad language of many American regulatory statutes and rules with the need for ex ante certainty in specific situations. For example, the US Securities and Exchange Commission describes a no action letter as “[a letter] in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated.”<sup>25</sup> In our system, the implementing organization would establish a system whereby prospective creditors could submit a detailed analysis of their loan proposal including the intended uses by the debtor government and the due diligence structures to be put into place to monitor the fund flows. If both the use of funds and the due diligence plan are approved, the enforceability of the loan in a regime change situation would be assured so long as the creditor has sufficient evidence that it made a good faith effort to comply with its pre-approved due diligence structuring.<sup>26</sup>

There are several advantages of the due diligence standard over the legal standard embedded in the Classical legal model. First, the pre-approval process for due diligence plans, and an emphasis on monitoring good faith compliance with that plan rather than trying to ascertain whether a lender had subjective knowledge that their funds were being put to illegitimate purposes as the Classical Model calls for, increases ex ante certainty for lenders. Were the Classical Model brought into force it is likely that most creditors would cease any lending to OD-prone regimes, or would demand exorbitant rates of interest to compensate them for their risk. The Due Diligence Model, however, establishes a secure channel for creditors to make legitimate loans to OD-prone regimes – for even the worst of regimes may from time to time consider the public interest. So long as creditors make good faith efforts at compliance with their pre-approved due-diligence plans, they are not penalized for outcomes which lie outside of their control. It is true that this places the potential cost of fraudulent evasion of the due diligence structures upon the populations of OD-prone regimes rather than creditors, but this is a necessary allocation of burdens to

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<sup>25</sup> Procedures Utilized by the Division of Corporation Finance for Rendering Informal Advice, Securities Act Release No. 6253, 21 S.E.C. Docket 320 n.2 (Oct. 28, 1980)

<sup>26</sup> It is true that determining whether a lender complied with their due diligence plan is to a limited degree an ex post decision which raises the previously discussed issue of a potential institutional bias against creditors or debtors. However, since the scope of the institution’s ex post inquiry will be limited to the empirical question of whether a creditor adhered to its set plan of due diligence rather than the more open ended and subjective Classical Model questions of whether loans were made with proper public consent and for a legitimate public purposes, the potential that creditor-debtor biases will significantly affect outcomes in our system is acceptably low.

keep lines of credit open to OD-prone regimes seeking loans for authorized public purposes.<sup>27</sup>

Second, the Due Diligence Model will be more effective than the Classical Model in situations where the debtor government is highly corrupt. The “willful and reckless failure to make inquiries” requirement of subjective knowledge for creditors under the Classical Model establishes incentives for lenders to make only the most glancing inquiries into the actual usage of their funds. The trivial level of due diligence required to meet the willful and reckless standard would almost certainly fail to check anything more than the most brazen cases of corruption, while lenders would be discouraged from going much deeper with their inquiries for fear that they might actually acquire the subjective knowledge that would imperil their lending relationship. Alternatively, the Due Diligence Model will require lenders to take reasonable best practice safeguards proportionate to the known corruption level of the debtor government. This may even have positive spillover effects for the debtor nation. Because the implementing organization may deem that certain debtor governments are so corrupt that any reasonable deal structuring to safeguard the borrowed funds is extremely onerous (an expense which will presumably be factored into the rates charged by the lender), the debtor government may have some incentive to improve its institutions of governance to access lower cost credit.

### 3. Venues For Implementation

There is a range of possible ways that an institution could be established to assess the OD-prone nature of regimes, from unilateral implementation through a system inclusive of all the world’s nations. From the standpoint of effectiveness there are two key dimensions to consider: critical mass and legitimacy. Critical mass refers to the aggregate quantity of credit controlled by the nation or nations which implement our proposal. Universal adoption of the proposal is not necessary to achieve much of our anticipated benefits from the policy. Consider a world in which nations controlling half the world’s credit supply adopted this proposal and half did not. OD-prone regimes would still have full access to credit from the non-participating nations of the world. However, non-participant nations would know that should the OD-prone regime collapse, the successor government in that country would have full access to the credit markets of participant nations if it repudiated its predecessor’s illegitimate debts. Since access to credit markets is a primary reason why successor regimes do not repudiate odious debts, if the participant nations control sufficient critical mass of the world’s credit supply that the successor government could safely meet its financing needs from participant nation creditors, it is most likely that even

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<sup>27</sup> We acknowledge that the problem of the fungibility of funds exists and is a difficult issue. For example, even if loan proceeds are used solely for pre-specified legitimate purposes, this may nevertheless free up general state revenues for illegitimate use. We are comfortable that we are at least improving upon the status quo. Currently, a given government has the capacity to spend its full fiscal resources, composed of internal fiscal resources and available borrowing capacity, on illegitimate purposes. Under our proposal, access to credit would be conditioned on at least some proportion of the government’s full fiscal resources going towards legitimate public spending. Thus, the total available fiscal resources which can be devoted to illegitimate ends is reduced. In reality, there are many variables which impact the determination of how great a problem this is in a specific situation, and it makes sense to leave these decisions to be made on a case by case basis, which the “no action” procedure we outline would allow.

non-participant nations would sharply restrict the supply of potentially odious credit to OD-prone regimes. This does raise the possibility that one entity such as the United States or the European Union could have the critical mass to implement our proposal unilaterally. That said, to maximize the appearance of legitimacy, a multilateral implementation may be preferable.

On possible venue for implementation is the United Nations. The United Nations has the advantage of preeminent global legitimacy and a pre-existing institutional architecture. The Security Council currently has the authority to impose trade sanctions and one can envision the Security Council also being the body that declares regimes OD-prone and supervises compliance, assisted by a dedicated bureaucratic staff. However, it is the UN's universal inclusiveness which raises questions over its suitability as an implementing venue. This is again a consequence of the legal indeterminacy in adjudicating whether or not a government falls into the category of OD-prone. So long as there is enough indeterminacy that this decision calls for some subjective value judgment, a coordinated odious debt policy is only possible among nations with sufficiently similar worldviews and interests. Gaining such a consensus at the level of the United Nations, even in the Security Council, could be problematic. Not all of the permanent or rotating Security Council members place equal priority on the goal of democracy promotion. That said, in some important historical cases such as apartheid-era South Africa or Tadjman-era Croatia it might well have been possible to gain necessary consensus for action at the Security Council level, so the United Nations should not be viewed as a wholly impractical implementation venue.

An alternative to the United Nations might be implementation among the advanced industrial democracies which comprise the G7 and OECD (although the implementation need not occur through these bodies themselves).<sup>28</sup> These nations encompass a sufficient quantity of the world's credit pool that the aims of a coordinated odious debt policy would be realized. In addition, while the interests and worldviews of the member nations are clearly not identical, there remains enough of a shared fundamental outlook so that implementing an odious debt policy would be more feasible than at the level of the United Nations. There are precedents for the advanced industrial democracies of the world to coordinate external policies on financial matters without universal inclusiveness to all the world's governments. For example, the OECD Convention Against Bribery of Foreign Public Officials in International Business Transactions makes it a crime for citizens of Convention signatories to offer, promise or give a bribe to a foreign public official in order to obtain or retain international business deals.

The actual structure of the organization would be designed with an eye towards minimizing the problem of regime bias. Negative regime bias, whereby some governments might falsely target a nation as OD-prone to advance an unrelated diplomatic agenda,

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<sup>28</sup> While the G7 and OECD as primarily economic bodies may not want to delve into sensitive matters of foreign relations, the odious debt issue which has a substantial economic component is not wholly beyond these groups' mandates. On the other hand, a new institution could also be forged with specific authorization over odious debts. Our larger point is simply that the advanced industrial democracies of the world have it in their power to implement our odious debt proposal should a wider scope of implementation not prove practical.

would be mitigated through the necessity of gaining some form of super-majority approval from the member nations to place a debtor government on the OD-prone list. No doubt this would allow certain participant nations leverage to shield their favored strategic allies. As a partial mitigation against this risk of positive regime bias, we recommend a parallel policy of disclosure. In this we draw inspiration from the Extractive Industries Transparency Initiative (EITI) – a movement to increase the transparency of transactions between governments and extractive industries. The EITI calls for “Regular publication of all material oil, gas and mining payments by companies to governments (“payments”) and all material revenues received by governments from oil, gas and mining companies (“revenues”) to a wide audience in a publicly accessible, comprehensive and comprehensible manner.”<sup>29</sup> Similarly, financial institutions of participant nations could be required to disclose the quantity and nature of their sovereign lending to a publicly accessible repository. Furthermore, it could be required that financial institutions disclose in their financial reports whether they have any subjective knowledge that the proceeds of their lending are being used for illegitimate purposes. Merely shining light on the financial relationships between lenders and sovereign governments might be sufficient to mitigate some of the most extreme situations where positive regime bias protects the debtor government from more formal monitoring.

## Conclusion

Odious debt arises as a topic of public debate on occasions when some particularly egregious example of a dictator’s borrowing and the consequences of servicing that debt for a successor government are revealed. In the past several years there was a dramatic upsurge in interest on the topic of odious debts in response to the collapse of Saddam Hussein’s regime. It was one of the fortuitous and rare instances where both the right and left came together to argue that Saddam’s odious debts should not be bequeathed to the newly emerging Iraqi government. Yet, even with all of this attention, while Saddam’s debts were partially mitigated through several rounds of global diplomatic arm-twisting, the broader doctrine of odious debts gained little real traction. One reason for this is that once a dictator has fallen and the impact of their borrowing on the reconstruction of his nation is revealed, it is largely too late to help that specific case. For very good reasons, the norm against retroactive application of legal rules such as changing terms for creditors after loans have been disbursed is quite strong.

This suggests that the best time to deal with the odious debt problem may not be in the context of an ex post response to the next discovered abuse of international borrowing. Rather, the time for putting the building blocks in place for a serious policy approach toward odious debts is now. We would anticipate that if our proposed policy is to become a reality it will stem from the need to sanction a specific regime in the future. However, the intellectual building blocks and discussions over working out certain pragmatic elements of implementation must be in place long before that particular crisis so that there is a sufficient base to enact a policy in response to the emerging situation in a timely fashion.

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<sup>29</sup> EITI Principles and Criteria at <http://www.eitransparency.org/principlesandcriteria.htm> August 14, 2005

In this paper we advanced a Due Diligence Model of dealing with the problem of odious debts. We believe that this model achieves most the goals that one would seek to accomplish in this area, but does so in a conservative manner that won't impact the vast bulk of global capital flows to the developing world, prove politically infeasible, or unreasonably curtail the legitimate borrowings of even autocratic regimes. Our model is structured so that its use will be rare. Curtailing the most abusive cases of odious sovereign borrowing would be a significant achievement and is achievable through a policy that is moderate enough to win broad support for implementation. A more sweeping, universal policy model would likely face much greater obstacles to move from academic discussion to policy adoption.

Much work remains to be done in translating the Due Diligence Model into the basis for actual policy. First, this paper does not discuss differences among the several types of sovereign lending. Sovereign lending can be bilateral (government to government), multilateral (i.e., World Bank), or private sector. The basic model presented in this paper assumes that all types of debt should be treated in the same manner but this is obviously an assumption which demands further analysis. Second, much work will be necessary to translate the concept of due diligence into real world deal structuring and auditing guidelines. For this, the insights of on-the-ground practitioners in law, finance, accounting, and other disciplines will be necessary.

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