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## Odious Debt

Michael Kremer, Seema Jayachandran

When the international community wants to put pressure on a government that suppresses democracy and human rights, a common approach is to impose economic sanctions. Traditional sanctions, however, are often criticized as either ineffective or inhumane. The targeted government can find ways to evade them, and the sanctions may hurt rather than help the people in the country. For example, when



Philippine President Ferdinand Marcos in 1985, the year before he was ousted.

trade sanctions are deployed, smugglers and even some national governments will likely flout them, enticed by profits boosted by the sanction itself. When trade sanctions are not evaded, the loss of national income can impoverish citizens. This policy brief proposes a new form of sanction that avoids these shortcomings and hence could be a valuable addition to the toolkit of sanctions available to the international community and national governments.

In this brief, we lay out a mechanism that limits the ability of dictators to borrow internationally, loot the borrowed funds, or use them to finance the repression of their people, and then saddle the people with the debt. Our starting point is the belief that debt incurred by a dictator for personal and nefarious purposes should be considered illegitimate and that the country’s citizens should not be considered 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 without the authority to bind the firm. If there were an analogous norm regarding fraudulent sovereign debt, banks would not issue loans to repressive or looting governments in the first place.

The United States argued along these lines during the 1898 peace negotiations after the Spanish-American War, contending that neither the United States nor Cuba should be responsible

for debt the colonial rulers had incurred without the consent of the Cubans and not for the Cubans’ benefit. Spain never accepted the validity of this argument, but the United States implicitly



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prevailed, and Spain took responsibility for the Cuban debt under the Paris peace treaty. This episode inspired legal scholars to elaborate a legal doctrine of “odious debt.” They argued that sovereign debt is odious and should not be transferable to a successor government if it (1) was incurred without the consent of the people and (2) did not benefit the people. Some scholars added the requirement that creditors be aware of these conditions in advance.

However, this doctrine has gained little momentum within the international law community, and countries are held responsible for repaying illegitimate debt under the international system’s current norm. South Africa is a case in point. The apartheid regime in South Africa borrowed from private banks through the 1980s, while a large percentage of its budget went to finance the military and police and otherwise repress the African majority. The South African people now bear the debts of their repressors. While the Archbishop of Cape Town has campaigned for apartheid-era debt to “be declared odious and written off,” and South Africa’s Truth and Reconciliation Commission has voiced a similar opinion, the post-apartheid government has deferred to the current international norm and accepted responsibility for the debt. South Africa seems to fear that defaulting would hurt its chances of attracting foreign investment and wants to be seen as playing by the rules of capitalism. Indeed, when apartheid was being dismantled in 1993, Nelson Mandela,

who would become president the following year, called for the world to normalize economic relations with South Africa; three days later, the finance minister announced at an investor conference in New York that South Africa would repay its sovereign debt.

Similarly, although Anastasio Somoza was reported to have looted \$100 million to \$500 million from Nicaragua by the time he was overthrown in 1979, and the Sandinista leader Daniel Ortega told the United Nations General Assembly that his government would repudiate Somoza’s debt, the Sandinistas reconsidered when their allies in Cuba advised them that repudiating the debt would unwisely alienate them from western capitalist countries.

There are a number of other cases in which dictators have borrowed from abroad, expropriated the funds for personal use, and left the debts to the population they ruled. For example, under Mobutu Sese Seko, the former Zaire accumulated over \$12 billion in sovereign debt, while Mobutu diverted public funds to his personal accounts (his assets reached \$4 billion in the mid-1980s) and used them in his efforts to retain power (e.g., payments to cronies, military expenses). Similarly, when Ferdinand Marcos lost power in 1986, the Philippines owed \$28 billion to foreign creditors, and Marcos’ personal wealth was estimated at \$10 billion.

Several countries have been granted

## When Debt is Not Odious: How to Approach Bailouts

In cases where legitimate governments borrow to finance economically disastrous policies, an approach similar to the one we propose for odious debt might be useful. If the population of a country chooses such a government, some would argue that it is their prerogative, and it would be a breach of international sovereignty to block the government's ability to borrow. However, many contend that the international financial institutions (IFIs), such as the World Bank and the IMF, should not have to subsidize wasteful spending, but that they sometimes do so in the form of international aid packages to countries whose economies have collapsed. This is the familiar moral hazard argument: the expectation of bailouts from IFIs encourages commercial banks and bondholders to make loans that governments could not reasonably repay on their own.

The IFIs could discourage this type of opportunistic lending by private creditors in the following way. Unlike the odious debt case, a panel of independent jurists is not needed, and the IFIs could assess the creditworthiness of governments

themselves on purely economic grounds. They could announce that, in their view, the policy a government is pursuing is likely to make it unable to fulfill its debt obligations. The IFIs could also announce that they will be willing to provide aid to the country once it resumes pursuing sound policies, but not to help repay debt issued after the announcement. In particular, a condition of future IFI assistance would be that countries not be simultaneously repaying any loans made after the IFI announcement. In this way, the IFIs would avoid encouraging private lending to the country motivated by anticipation of a bailout. Unlike in the odious debt case, loans would not be considered illegitimate and unenforceable. If creditors thought the country could repay without an IFI bailout, they would continue to lend.

With this approach, the IFIs would be able to continue to give aid packages to countries that followed good policies but suffered bad luck. However, they would not bail out creditors who had opportunistically lent to countries that were following risky policies.

debt relief under the Heavily Indebted Poor Countries (HIPC) initiative, which considers the level of debt and the income of the country as the criteria for debt relief, but not the circumstances under which the debt was incurred. Thus, countries that are not as impoverished but have a plausible claim that their debts are illegitimate are not on the current list of debt relief candidates.

Indeed, South Africa, the Philippines, and Croatia do not qualify for debt relief under the HIPC Initiative.

### POLICIES TO CURTAIL ODIUS DEBT

We argue for establishing an independent institution, which could assess whether regimes are legitimate and could declare any sovereign debt subsequently incurred



*“Like other sanctions, the threat of limits on borrowing could create incentives for regimes to reform.”*

by illegitimate regimes odious and thus not the obligation of successor governments. This could restrict dictators’ ability to loot, limit the debt burden of poor countries, reduce risk for banks, and hence lower interest rates for legitimate governments that borrow.

Currently, countries repay debt even if it is odious because if they failed to do so, their assets might be seized abroad and their reputations would be tarnished, making it more difficult for them to borrow again or attract foreign investment. However, if there were an institution that assessed whether regimes are odious and announced its findings, this could create a new equilibrium in which countries’ reputations would not be hurt by refusal to repay illegitimate debts, just as individuals’ credit ratings are not hurt by their refusal to pay debts that others fraudulently incur in their name. In this equilibrium, creditors would curtail loans to regimes that have been identified as odious, since they would know that successor governments would have little incentive to repay them. This argument draws upon a well-known result in game theory that repeated games have many possible equilibria, and simply making some information publicly known can create a new—and, in this case, better—equilibrium.

While a public announcement that a regime is odious might curtail lending to such regimes, there is no guarantee that everyone would coordinate on this new

equilibrium without some means of enforcement. Two enforcement mechanisms could ensure that lending to odious regimes is eliminated. First, laws in creditor countries could be changed to disallow seizure of a country’s assets for non-repayment of odious debt. That is, odious debt contracts could be made legally unenforceable. Second, foreign aid to successor regimes could be made contingent on non-repayment of odious debt. In other words, donors could refuse to give aid to a country that, in effect, is handing the aid over to banks that have illegitimate claims. If the foreign aid were valuable enough, successor governments would have incentives to repudiate odious loans, so banks would refrain from originating such loans.

#### ADVANTAGES OVER TRADITIONAL TRADE SANCTIONS

As noted in the introduction, limiting an odious regime’s ability to borrow can be considered a new form of economic sanction that has several attractive features relative to traditional trade sanctions. Like other sanctions that the international community uses to pressure governments without resorting to war, the threat of limits on borrowing could create incentives for regimes to reform. Governments might loot less to retain the ability to borrow. Would-be dictators might even be discouraged from seeking power if sovereign borrowing were not one of the spoils of office.

Limiting borrowing also avoids two key

shortcomings of trade sanctions. First, third parties have incentives to evade most trade sanctions, while curtailing odious debt, in contrast, is a self-enforcing sanction. The difference arises because successor governments will have incentives to repudiate odious debt as long as there are a few creditors and investors who are willing to continue lending to and investing in the country. If repudiation of odious debt is not a blight on a country's reputation, banks know that they will lose money if they disregard the sanction and issue odious debt. A private bank would thus think twice before lending to a regime if the world's leading powers, international organizations, and financial institutions had declared the regime odious and announced that they would consider successor governments justified in repudiating any new loans the odious regime incurs.

A second problem with trade sanctions is that they often inflict harm on the people they were intended to help. 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 dictators' ability to borrow, loot, and saddle the people with large debts would hurt illegitimate regimes but help their populations. The burden of repaying the debts would almost certainly outweigh any short-run benefit the population would obtain from proceeds of the loan that trickled down to them. (If a regime

loots only a small amount and most of the proceeds flow to the people, the regime probably should not be considered odious.)

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 suppressed the media, 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 IMF decision and Tudjman's death in December 1999. If the 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.

### INCENTIVES FOR TRUTHFULNESS

For such a limit on borrowing to improve upon the status quo, it is necessary to provide incentives for the institution

*“A private bank would think twice before lending to a regime if the world's leading powers had declared the regime odious.”*



assessing the legitimacy of debt to do so truthfully. An institution that cares about the welfare of the people of developing countries more than that of banks and other creditors might be tempted to declare legitimate debt odious so that the country will not have to repay it. However, if creditors anticipate being unable to collect on even legitimate loans, they will be wary of lending at all, and the debt market will shut down. This danger is one of the main reasons why the doctrine of odious debt has gained little support within the legal community.

To overcome this risk, the institution could be empowered only to rule on future loans to a government and not on existing debt. Then creditors would not face the uncertainty that loans they issue will be declared odious later. Moreover, the institution will be more likely to be truthful. Even if the institution is more concerned with the welfare of debtors than of creditors, it would have incentives to judge a regime honestly because honesty benefits the population. If the institution falsely calls a legitimate government odious, it deprives a country of profitable investments financed by loans. If it falsely calls an odious government legitimate, the government can borrow and loot the country.

Restricting an institution to rule on the legitimacy of loans before they are incurred also limits the potential for favoritism toward creditors. An institution that favors creditors and rules on existing

debt might fail to declare some debts odious. However, if it rules only on future loans, 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 odious government legitimate. This is because before a loan is issued, the expected profits of a loan are very small for banks, as they 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 future debt hurt the population of borrowing countries and cannot substantially help creditors, an institution empowered only to block future lending is unlikely to make biased judgments in order to help debtors or creditors.

There remains a possibility that an institution that rules on future debt may be biased for or against certain governments. If the major powers regard a country as an important trade partner or strategic ally, the institution might fail to brand the government odious regardless of potential misdeeds. For instance, it is unlikely an institution would brand either China or Saudi Arabia as odious. Since such regimes with powerful friends can borrow presently, biased decisions in their favor would simply maintain the status quo. If instead the institution disfavors a government for foreign policy reasons, even though the government has the consent of the people or spends for their

benefit, the institution might falsely term it odious, thus cutting it off from lending. For example, the United States might wish to block loans to Cuba under Fidel Castro, independent of whether the regime satisfies the definition of odiousness. If this happened, citizens of the country would be worse off than under the status quo. The institution could be designed under a “do no harm” principle. Requiring unanimity or a two-thirds vote to declare a regime odious could safeguard against the possibility that a country would falsely be branded odious due to the biases of a few members of the institution.

### INHERITED DEBT

It also is important to consider how the new policy would affect an odious regime that inherits legitimate debt from the previous government. Even under the status quo, an odious regime likely would prefer not to repay its creditors and instead keep the repayment money for itself. It would be difficult to extract these resources from the regime; the best it may be possible to do is to prevent it from procuring more resources. To reduce the probability of the regime defaulting on its obligations, the international community might consider providing specific exemptions for the rollover of existing loans.

### WHO SHOULD ASSESS REGIMES?

A key question is which institution might judge odiousness. The United Nations Security Council already imposes

sanctions against governments, so it is a natural candidate. The United States and the other permanent members (China, France, Russia, and the United Kingdom) might prefer this option since they would have veto power. Another option is a new international judicial body that hears cases brought against particular regimes and is composed of professional jurists representing several countries, similar to the International Court of Justice or the newly established International Criminal Court in the Hague.

Another approach is for major creditor countries to implement this system using solely domestic institutions. If the United States changed its laws to prevent seizure of a foreign government’s assets when it repudiates odious debt, an American court ruled that a regime was odious, and the United States announced it would oppose IMF or World Bank aid packages to a successor regime that repaid illegitimate debt, then banks even outside the United States would likely be reluctant to lend to that regime, fearing that successor governments would not repay.

It might also be possible for civil society to begin putting pressure on banks not to lend to illegitimate governments. If a well-respected nongovernmental organization identified odious regimes and promulgated a list of them, creditors might be reluctant to lend to governments on the list.

In short, the international community or even a few major countries, possibly in

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concert with nongovernmental agencies, could create a new norm under which a country is not responsible for odious debt, and creditors therefore do not issue odious debt in the first place.

This new policy could help legitimate debtors and their creditors. Creditors would benefit from knowing the rules of the game in advance. Currently, there is a movement to nullify some debt on the grounds of odiousness, but it is hard for creditors to anticipate which loans will be

considered odious in the future. If odiousness were declared in advance, banks would avoid lending to odious regimes in the first place and no longer face the risk of large losses if a successful campaign nullifies their outstanding loans. Greater certainty would ensure that interest rates for legitimate borrowers would be lower. Most important, dictators would no longer be able to borrow, loot the proceeds—or use them to finance repression—and then saddle their citizens with the debts. B

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