

THE LEGITIMATE REPUDIATION OF A NATION'S DEBTS

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INTRODUCTION

At various times in the past, particularly in the nineteenth century and in the 1930s, a number of nations have repudiated their debts. Since World War II, there have been many reschedulings of sovereign debt,¹ but there have been very few outright repudiations. The only cases mentioned by Sachs [1982, 199] are North Korea and Ghana, and the latter was changed afterward to a rescheduling. However, the knowledge that debtor nations have the power to repudiate their debts provides a reason for creditors to accept reschedulings that they would otherwise reject.

In an ideal world, no globally useful purpose would be served by the power to repudiate sovereign debts. All loans to sovereign nations would increase the well-being of the citizens of the borrowing nations. The possibility of repudiation would only raise interest rates and inflict arbitrary redistribution when it occurred. In the world as we find it, many loans have negative net benefits for the citizens of borrowing nations. The most egregious examples occur when a transitory dictator absconds with money borrowed in the name of the people leaving its repayment for future generations of that nation. Such cases suggest exploring the range of reasons why a nation might justly say, "These are debts that we should not be expected to pay." If there are a significant number of cases that fall into this category, then the creation of an impartial international tribunal before which debtor nations could argue the justice of their contemplated debt repudiations might improve both efficiency and justice. In that context, this paper asks: If nations that contemplated repudiation of their sovereign debts were to argue their cases before an impartial tribunal, what arguments might they advance?

THE VALUE OF NOT BEING COMMITTED TO DEBT REPAYMENT

Creditors continually impress upon debtor nations the value of repayment, warning that future flows of funds are contingent upon consistent adherence to repayment schedules. If a nation were known to be completely reliable, then creditors would not add any risk premium to its interest rate. Nor would they ration its credit. Therefore a reliable debtor will have access to more credit and at lower interest rates. However, as explained above, there are circumstances under which the possibility of repudiating debts is valuable to a nation's citizens.

The value of retaining the possibility of repudiating a financial commitment for an individual is well-established. For example, if people persistently find themselves persuaded by door-to-door salespersons to make purchases that they regret within a few days, it is attractive to have a law that any contract with a door-to-door salesperson can be canceled within three days of its signing. For a nation, a parallel case of irrational contracting arises when an international financial institution pressures a nation to accept a loan that is not in its best interests. Similarly, if money lent to a government is stolen by its dictator and he is later overthrown, then the citizens are worse off if they are bound to repay that loan.

A STRATEGY OF SELECTIVE REPAYMENT

If there are many loans about which nations can say, "Our citizens would be better off if these loans had not been made," then there may be reason for nations to adopt policies of selective loan repayment. Suppose debtor nations began to repay only the loans that appeared, at the time that payment was due, to represent prudent borrowing. What would the consequences be? Lenders would exercise greater care in developing and evaluating loan proposals, trying to confine their loans to ones that later would be judged wise. They would also adjust the interest rates they charged, to the extent that they perceived changes in risk.

When a loan can be seen *ex post* to have been unwise, it is difficult to know whether that should have been recognized *ex ante*. A nation that seeks to make such determinations about its own past commitments can easily reach conclusions that are biased in its own favor. Lenders, witnessing this or expecting it, would respond by raising risk premiums and reducing credit limits. However, the general efficiency argument for selective repayment requires that the practice lead to wiser borrowing. Wiser borrowing can be expected only if determinations of what constitutes unjustified borrowing are seen to be impartial and reliable. For this reason it would be wise for a nation contemplating a policy of selective repayment to seek a disinterested judicial process to determine what constituted unjustified borrowing.

At present there is no forum where such questions can be addressed impartially. The only places that nations seeking relief from debts can now go are to the "Paris Club" of creditor nations and the "London Club" of creditor commercial banks. These forums are biased in favor of creditors and tend to regard any concessions they make to debtors as largesse. The impartiality that is necessary requires another forum.

ARGUMENTS IN SUPPORT OF RELIEF FROM SOVEREIGN DEBT

Suppose, then, that there is an impartial international tribunal that grants or withholds approval of proposed repudiations of sovereign debt. A nation asks this tribunal to decide if it ought to be expected to pay some of its debts and announces its intention to abide by the decision. What arguments might the nation make in support of its view that some loans were unworthy of repayment?

Fraud

One of the most telling arguments that a nation might advance to support non-payment of debts would be that the nation had been enslaved under, rather than represented by, its previous government. The previous government had privately appropriated the borrowed money rather than using it for public purposes. Therefore the borrowed funds had conferred no benefit on the general public and were no longer available to the nation. The loan, as an obligation of the populace, was essentially a fraud. The new government could say to the tribunal that the lenders should have known better than to expect citizens to honor such a debt after they had thrown off their yoke of servitude.

One possible difficulty with this argument is that a tradition of success of such arguments can give lenders an incentive to prop up corrupt debtor governments, lest they lose their investments. International lenders should be expected to forswear the role of providing critical support for corrupt regimes and acknowledge that, if they make such loans, they ought to accept the loss of their investments rather than expect freed populations to honor the debts.

Lack of Valid Approval

There are circumstances under which individuals, and states and local governments in the U.S., are relieved of the obligation to fulfill their signed contracts. For example, individuals are not able to sign binding contracts if they are minors or are under duress. Many states and local governments in the U.S. are not able to borrow legally without voter approval. Thus, it would not be unprecedented to question the ability of government officials to commit their populations to the repayment of a loan simply with their signature. If a nation were to implement a rule that debt could be incurred only with approval in a referendum, then it is conceivable that the nation could argue convincingly that lenders should have known better than to think that previous loans could be valid without such approval. The nation could also argue that any reasonable lender would have known that most voters would not have approved earlier loans.

Unconscionability

Suppose a failed project was poorly designed largely by the lender with a little input from the borrowing nations. The leaders of the debtor nation might assert that the nation should be granted relief from this debt because the project failure is the responsibility of the lender.

The situation has similarities to cases that have arisen in private contract law. At least one court suggested that it is unconscionable, and therefore not contractually valid, for a seller "to sell to a person who is recognizable to any prudent seller as one who later will almost certainly regret making the contract" [Goetz, 1984, 155]. Wisconsin allows courts to consider, among other indicators of unconscionability, whether (1) a practice unfairly takes advantage of the lack of knowledge, ability, experience, or capacity of customers, or (2) those engaging in the practice know of the inability of customers to receive benefits properly anticipated from the goods or services involved [Goetz, 1984, 156]. Similarly, an impartial tribunal might rule that borrowing nations should not be expected to repay loans when lenders should have foreseen that they would regret borrowing. The cost of poor loans could also be divided between borrowers and lenders on the basis of an assessment of their relative negligence. These shifts of liability toward lenders would improve incentives for good project development and evaluation by lenders.

Bankruptcy

Another way in which a nation might seek relief from its debts is by petitioning for a declaration of bankruptcy. Suppose that the nation borrowed for purposes that were attractive *ex ante*, but natural disasters reduced the return from the loan. Perhaps the nation invested in a large dam that was destroyed by an earthquake, or drought caused a crop failure. The nation was forced to borrow to avoid starvation, and crop yields continued to be too low to permit repayment of the loans. A declaration of bankruptcy might be appropriate in these circumstances.

Before considering the bankruptcy of nations, it is useful to examine some aspects of individual bankruptcy. Individual bankruptcy can be considered a device for recognizing the limited connection between the selves of different times. The passage of time creates uncertainty as to whether the person called upon to repay is really the same as the one who incurred the debt. Are you really the same person you were ten or twenty years ago?

The difficulty of knowing whether the self who is called upon to repay is the one who incurred a debt is avoided when loans are secured by property. If you wish to claim that you are not the person who took out the loan on your car, then clearly you have no claim to the car.

The institution of bankruptcy can be seen as a device for permitting a person to sever, as much as possible, the connection with his or her past and begin again. Through bankruptcy, a person who is prepared to renounce claims to assets bestowed

by past selves is permitted to repudiate the debts of past selves as well. Such a bankrupt person is permitted to retain a certain minimum of clothes, tools, a "homestead" and other things regarded as essential for survival.

Turn now to nations. For nations, even more than for individuals, the idea that there is a lack of identity between those who borrowed and those who are called upon to repay is plausible. If individuals can repudiate the obligations of their former selves and begin again, then certainly a nation, where governments come and go and never represent all persons and where generations succeed one another, should be able to do the same. A nation should be able to say, "Those who incurred the debts were not us. We do not want our earnings encumbered by the obligation to repay the debts." However, the cost of taking such a stance is that the nation loses its claim to the capital with which it has been endowed by those who formerly embodied the nation.

Then the question arises: What, for a nation, corresponds to the things essential to survival that a bankrupt person is entitled to keep? The equivalent essentials for national survival would certainly include social overhead capital, such as schools, roads and government buildings and equipment that are needed for the provision of essential government services. If such social overhead capital had been financed by loans, then those particular loans could be retained for repayment, so that the incentive to lend for essential social overhead capital would be maintained.

Like an individual declaring bankruptcy, a nation would renounce its claims to all assets other than the exempt essentials. It would part with any foreign exchange reserves and any government-owned manufacturing capital, such as steel mills. But what about government-owned land and natural resources such as oil? The nation may assert that its control over these resources represents not ownership based on purchase, but rather trusteeship for all its citizens of all generations, of a birthright provided by nature. If such a claim is backed up by a plan for using the resources in a way that will benefit all generations, then these resources should not be regarded as government property, and therefore should be beyond the reach of the bankruptcy proceeding.

Thus the sole legitimate security of a nation's debts in a bankruptcy setting is the capital owned by the government. A nation that wants to break its links to its past and start over should be prepared to relinquish to its creditors all of the readily removable government-owned capital in the nation. But, it should then be accorded the right to a new, debt-free start, with the wages of its citizens and its land and natural resources unencumbered.

CONCLUSION

This paper has explored the process by which a nation might legitimately repudiate its debts. Justice requires that such an action not be taken unilaterally, but rather upon the approval of an impartial tribunal.

The paper also has considered four types of arguments that debtor nations might advance before an impartial tribunal: (1) a debt is fraudulent, having originated in

a transaction such as a loan to a corrupt leader who stole the proceeds; (2) a loan lacked valid approval, not having been approved directly by citizens; (3) it would be unconscionable to require repayment, because of the negligence of the lender; and (4) a nation should be able to declare bankruptcy.

The practice of seeking approval of repudiations of sovereign debt from an impartial tribunal would increase economic efficiency and social justice, by giving lenders new incentives to ensure that the loans they create will be in the interest of the citizens of borrowing nations.

NOTES

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1. Craig [1988, 128-37] lists 99 post-war reschedulings for a sample of 29 countries. More complete, though more scattered, data on reschedulings can be found in International Monetary Fund [1983], Organization for Economic Cooperation and Development [1985] and the World Bank's *World Debt Tables*.

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