

Odious or Just Malodorous?

Why the odious debt proposal is likely to stay in cold storage

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SOMETHING terribly wrong happens when debt is incurred by a sovereign government that does not have good claim to represent the will of the people of the country, and its proceeds are not used for their benefit. Take the case of South Africa under the apartheid regime, which borrowed, in part, to finance a military machine that was used to repress the majority African population. The debt thus incurred was doubly odious, for not only were the proceeds used to suppress the African majority and keep the apartheid regime in power but the suppressed also eventually ended up being responsible for the debt repayment. The post-apartheid government accepted that responsibility. Yet, the case seems to have all the hallmarks of a situation where “something ought to have been done” to remove the “odious debt.”

But what should be done in such a case? One suggestion is to institute an international commission (say under the United Nations) that will determine which regimes have neither popular legitimacy, nor the interests of their people at heart. Once the commission declares the regime and its debt odious, successor regimes could be absolved, through international agreement, of having to repay the debt incurred by the odious regime. Also, creditor country laws could be altered so as to make it difficult for creditors from that country to enforce debt payment from another country once that country’s debt is declared to be odious.

The possibilities of such a mechanism are dramatic. If a commission had declared Mobutu Sese Seko odious early on in his

regime, he would not have been able to build up the debts of former Zaire (now the Democratic Republic of the Congo) to \$12 billion, or to use \$4 billion of it in building his own personal assets. He might not even have lasted long in power if he had not been able to borrow to keep his regime afloat. Certainly, the objectives of those advocating mechanisms to declare debt “odious” are compelling (see “Odious Debt,” *F&D*, June 2002, p. 36).

Unfortunately, the mechanism would not work as precisely as this example suggests—it would be more of a neutron bomb than a laser-guided missile. Not only would it make it more difficult for odious regimes to borrow, but it would also make borrowing more difficult for any legitimate regime that had even a remote possibility of being succeeded by an odious regime. A fledgling democratic regime, struggling to borrow to avoid the consequences of drought, might find the going even harder if creditors were also attempting to judge the possibility that the regime might collapse. If the regime gave way to a nasty successor, the debt would be declared odious, imposing huge losses on the creditors. Anticipating this, the creditors would not lend, making regime change more likely. How, then, does one prevent the odor of future odious debt from polluting all prior debt and making borrowing more difficult for all countries that have even a remote possibility of future regime change?

A clever proposal is simply to restrict odium to future debt (Kremer and Jayachandran, 2002). In other words, successor regimes could legitimately escape repay-

ment only of the debt that is issued after the commission declares a regime's debt odious. The beauty of this idea is that markets would not be left guessing about whether their debt would be legitimate. Moreover, to the extent that the regime could not borrow to finance theft or build monuments to its own glory, resources would be preserved to service the old debt, thus enhancing its value.

But would it work? The trouble is that implementation of the proposal could have other, unintended, consequences. Though creditors would not be forced to guess whether the loan they made to a country would be viewed as legitimate, they might still be left guessing whether it would be valuable. Here is why: Few developing countries or expanding firms can repay all the debt they have contracted or even generate substantial income unless they have access to further financing. This is because countries and firms rely on growth—a steady stream of new projects and continuing old projects to provide both the cash flows to service debt incurred to set up those projects as well as a residual amount—to service older debt. Countries and firms typically grow their way out of debt.

But if future debt were declared odious, the country would no longer be able to borrow to continue old projects, let alone finance new ones (assuming, of course, that the odious regime was not bent on driving the country into immediate economic collapse—if it were so destructive, few would be willing to lend in the first place, and there would be no need for a special procedure to declare its debt odious). Even if the odious regime had the intention of servicing its debt, the declaration that the regime's future debt was odious would make it very difficult for it to do so. When coupled with the fact that the incentives to repay debt come, in part, from the attraction of continuing to be able to borrow, it might well be that the regime defaults on existing debt as soon as it is declared odious, with adverse consequences for its valuation. The proposal to declare only future debt odious might mitigate some of the concerns associated with the original odious debt mechanisms, but it would not eliminate them by any means.

Another variant is to single out past debt that was used for nefarious purposes such as repression or theft and declare only that odious and uncollectible (see, for example, Adams, 2004). Such a mechanism would make lenders responsible for the end use of their funds. But this suggestion is also not without problems. For one, it is hard to know whether steel that is being imported will be used to make cradles or cannons. Even guns and bullets may have legitimate uses if the police use them to combat crime. If lenders were held responsible for end use, they would shy away from financing

a large number of legitimate activities. Moreover, this proposal assumes that money is not fungible. What is to prevent the government from funding roads and ports with foreign loans while using taxpayer funds to buy tanks and submarines?

If there are potential costs to such proposals, then a re-examination of the benefits becomes important. Would dictators really be stopped in their tracks? Would the truly corrupt not simply sell the country's existing assets at bargain basement prices for cash? Would we not see an increase in trafficking in antiques, endangered animals, wood, and drugs? Is it possible that the country could be worse off if the dictator stole through unusual channels than if he stole by building up debt?

The point is that while the odious debt proposal is well motivated, it is unlikely to provide a panacea. We have to recognize there will be trade-offs—the up-front costs to any

fragile democracy from the odor of possible future odium, weighed against the possible benefits of curbing corrupt dictators financed by overeager bankers. If there are many odious regimes today but little chance that currently democratic regimes will switch to being odious, the benefits of the proposal outweigh the costs. If there are few odious regimes today, and many possible switches, the reverse is true.

In sum then, one does not need conspiracy theories to explain why the odious debt proposal has not gone anywhere, or why newly legitimate governments like that of post-apartheid South Africa have accepted

the responsibility of servicing the potentially odious debts they inherited. The concern that debt markets might be disrupted is well-founded. But there are also potential benefits that deserve further investigation. If researchers had their way, we would pick one petty dictator through a random draw, declare his debt odious, and watch what happened. This suggestion is unlikely to find many takers—the notion of experimenting with countries seems repugnant to most. So in the absence of research that will use existing data cleverly to inform us, or fortuitous natural experiments, it is not surprising—nor even unfair—that the odious debt proposal is likely to stay in cold storage. ■

References:

Adams, Patricia, 2004, "Iraq's Odious Debts," Policy Analysis, No. 526 (September 28) (Washington: Cato Institute).

Many of the facts in this article are drawn from "Odious Debt," a Working Paper by Michael Kremer and Seema Jayachandran, published by the National Bureau of Economic Research in May 2002.