

Chapter 1

Odious debt – human rights and debt cancellation

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Development requires debt relief. Swiss non-governmental organisations (NGOs) submitted a petition to the Swiss parliament in the 1980s entitled *Development requires debt relief*. In it they called upon the Swiss government to send a signal of solidarity to developing countries on the occasion of the 700th anniversary of the founding of Switzerland and to cancel their debts owed to Switzerland. In Switzerland's anniversary year of 1991, government and parliament approved the first comprehensive Swiss debt relief programme and authorised CHF 500 million for debt relief measures in developing countries. Poor heavily-indebted countries were the main beneficiaries of the debt relief programmes implemented. The "creative debt relief" measures initiated, such as a counterpart fund, were meant to ensure that the funds freed up by the debt relief programme benefited the poorer sections of the population. NGOs were involved both in managing funds locally as well as in the monitoring process in Switzerland.¹

The Swiss initiative can certainly be credited with the fact that creditors at an international level developed sympathy for creative debt relief strategies for the welfare of disadvantaged population groups. The Swiss initiative disregarded an important factor in the issue of debt relief, however, namely the question concerning the legitimacy of creditors' claims.

The policy of granting debt relief in individual cases, as has been practiced by informal meetings of creditors, such as the Paris Club or the London Club, up until now, cannot deliver a just solution to the global debt problem. Internationally recognised, actionable rules for debt relief based on international law and binding on all parties are required to free developing countries from bondage to their creditors.

Two human rights-based debt relief concepts have been discussed in detail for some time now, mainly by NGOs. These are an insolvency law for heavily-indebted states, and the doctrine of odious debt.

1. An insolvency law for heavily-indebted states

This approach centres on the question of how bearable the debt burden is. If the debt burden exceeds a state's economic potential to such an extent that servicing the debt endangers the very survival of the state and its people, then that state should be able to present its inability to pay (insolvency) before an independent international court. An insolvent state can then either have its debts partially or completely cancelled, or it can be freed from servicing its debt for a certain period. Such an insolvency law can free a

¹ www.swisscoalition.ch

heavily-indebted country temporarily or completely from the unbearable burden of its debt and save the country from economic collapse.

2. Odious debt

Creditors' claims have to be examined for their legitimacy independently of whether a country is solvent or not, for not all debts that are imposed on a state are legitimate. The doctrine of odious debt states that loans which a ruler takes up without democratic consent and which are not used for the benefit of the people cannot be charged to a democratically-elected successor government's account. In this case an undemocratic regime's successor government should be able to refuse to repay the loan and service the debt. The onus of proof for the legitimacy of the claims has to be on the creditors. Both debt relief mechanisms are necessary components of fair international debt policies, as the concepts should be applied as complementary procedures. In a debt relief lawsuit it will thus be necessary to first examine which claims are legitimate. The decision as to whether the limit of what can be borne has been transcended can only be arrived at in a subsequent procedure.

Debt relief programmes to date– a shambles

Creditors have tried to find solutions for individual heavily-indebted countries with ever new mechanisms and sets of regulations since the outbreak of the South's modern debt crisis in 1982. The primary aim thereof has been to re-establish debtor solvency. But financial injections and the HIPC initiative (an International Monetary Fund (IMF) initiative to cancel the debts of the most heavily-indebted poor countries) did not produce the desired reassurance in international financial markets. The shock of the massive financial crises of the 1990s forced creditor countries to think about new debt cancellation mechanisms.

At the autumn 2002 annual meeting of the International Monetary Fund and the World Bank, the IMF discussed insolvency proceedings for heavily-indebted states. A politically and economically independent arbitration committee would examine creditors' claims when a country reached insolvency and - in the context of a so-called sovereign debt restructuring mechanism (SDRM) - elaborate solutions with the participation of all parties concerned. The proposal was brought to fall again as soon as the 2003 IMF spring meeting, however, when it was vetoed by the US government under George W. Bush and international banks.²

Odious debts

The question concerning the legitimacy of [certain] debts has assumed a large role in international civil society over the last few years. A differentiated examination of a country's debt situation has led to a shift in the focus of organisations addressing the issue of Third World debt, away from a charitable approach and towards a rationale based on law, and in particular on human rights.

² www.evb.ch

The doctrine of odious debt is based upon a case which set a precedent in international adjudication. This precedent states that in certain cases an illegitimate regime's democratically legitimised successor government can reject its predecessor regime's international debts. This applies when the debts originated in loans which were not used for the welfare of the majority of the population, but were rather deployed against their interests, and when the creditors knew of this fact.

Many dictatorial regimes leave enormous external debts behind at the end of their rule. The question in the odious debt debate is whether such debts can legally be considered illegitimate, and should thus be cancelled, and if so in which cases.

The doctrine of odious debt is a legal approach which could lead to the unconditional cancellation of a large proportion of developing countries' debts in certain cases, and thus free many poor states from the bondage of servicing and repaying the debt. The legal debate concerning these abhorrent debts is more than 100 years old. Countries' debt structures have become more complex and multi-faceted in the meantime. Thus the odious debt doctrine has to be adapted to today's circumstances. It is interesting to have a brief look at a few cases which were decided in favour of debt cancellation on the basis of the odious debt doctrine, in order to understand the complexity of the legal debate.

An initial judgement concerning a case of illegitimate debt was pronounced in 1898. After the Spanish-American War the USA refused to take over Cuba's debts owed to Spain. The US government argued at the time that this debt was odious (hated, detestable) and non-actionable, because the loans had been taken up against the will of the Cuban people, that is to say had been imposed upon it by armed force. The lenders had acted with knowledge of the risk involved in such an investment when they granted this abhorrent loan. The highest US American court found in favour of the government.³ After World War I several countries such as Russia and Poland invoked the US reasoning to describe their external debt as illegitimate. The doctrine of odious debt was derived from this by Russian international law practitioner Alexander Nahum Sack. According to Sack the doctrine applies when the use of the money loaned contravenes the public interest and the loan was granted against the background of this knowledge. An important element of Sack's definition consists of the fact that he shifts the onus of proof to the lenders. If they cannot plausibly demonstrate before an international court of law that the loans were paid out for projects which would have benefited the people and that there was no suspicion of misappropriation of the funds at the time when the loan was granted, then it is not legitimate to let the people pay back the debt.⁴

Sack's definition is now considered the classic definition of odious debt and this meaning has been variously applied since then.

³ Queck, Antje / Reese, Niklas (ed.), 2003: Handbuch illegitime Schulden [Illegitimate debt handbook]. Düsseldorf.

⁴ Sack, Alexander N., 1927: *Les Effets des Transformations des États sur leurs Dettes Publiques et Autres Obligations Financières* [The effects of the transformations of states on their public debt and other financial obligations]. Paris.

The highest US court of law declared the Royal Bank of Canada's loans to Costa Rican dictator Federico Tinoco to be null and void in an international arbitration procedure in 1923, as the Canadian bank was not able to prove that the loans had been used for the welfare of the people. The granting of the loans took place at the time when the dictator was trying to prevent the introduction of democracy.

After Ethiopia was freed from Italian colonial control a Franco-Italian commission decided, in 1947, that the new Ethiopian government did not have to bear the debt owed to Italy, as these funds had been used to maintain Italian rule in the country. In 1949 the new Indonesian government refused to repay the loans which the Dutch colonial power had taken up to repress the Indonesian independence struggle.

In 1982, when the loans being granted to the South African Apartheid government peaked, lawyers for the First National Bank of Chicago warned the bank not to lend South Africa any money which might later be subject to the doctrine of odious debt. The banks should insist on precise information concerning the purpose to which the funds will be put, in order to be sure that "if the debt of the predecessor is deemed to be 'odious', [...] then the debt may not be chargeable to the successor."⁵

South Africa's Apartheid debts are undoubtedly odious in the classical sense, but unfortunately it was not possible to convince democratic South Africa under Nelson Mandela to refuse to pay back the Apartheid regime's debts. Nelson Mandela, hoping for good economic cooperation with the European countries and the USA, assured the countries concerned too quickly that the debts accrued during the Apartheid regime would be repaid. Thus the South African president disastrously failed to initiate a broad public debate on this most obvious and internationally-recognised case of illegitimate debt at the beginning of the 1990s, and thus advance international recognition of the illegitimacy of certain debts. South Africa set a good example with its model behaviour when it cancelled Namibia's and Mozambique's illegitimate debts in 1994, with specific reference to the illegitimacy of these debts. But a refusal to repay the debts owed to Europe and the USA would certainly have been capable of triggering a far broader debate of worldwide interest. Thus South Africa remains the prime example for the application of the doctrine of odious debt, and civil society organisations are leading international campaigns to recognise and concretise this debt relief doctrine.⁶

In July 2000 the highest Argentinian court of law pronounced a judgement concerning Argentina's debt accrued during the 1976-1983 military dictatorship. The court came to the conclusion that a large part of the military dictatorship's debts had been unconstitutional, and showed that the country's external debt had arisen out of [risen due to] creditors' active participation in arbitrary and authoritarian economic policies. It

⁵ Cited in Queck 2003.

⁶ On South Africa see also Egli, Martina / Madörin, Mascha / Sekinger, Urs (ed.), 2001: *Entschädigung ist ein Menschenrecht. Konzepte und Analysen zur Debatte um Wiedergutmachung bei Menschenrechtsverletzungen* [Reparations are a human right. Concepts and analysis of the debate on making amends for human rights violations]. Basel.

was not possible to convict anyone, on account of the statutory period of limitation having expired and partially because of the immunity which still applied to members of the regime. The Argentinian case is of great significance and can be important for the international conduct of cases beyond the borders of the South American country. Ministers, bank directors and state officials were questioned in an 18-year investigation, after all, which revealed substantial facts concerning the dubious links between national and international capital.

The latest debate concerning debt cancellation on the basis of the doctrine of odious debt - which is simultaneously the one conducted at the highest levels so far - concerned the case of Iraq. Shortly after the first bombs fell on Iraq in April 2003, US deputy secretary of defence Paul Wolfowitz and US secretary of the treasury John Snow demanded the cancellation of the dictatorial regime's debts. Surprisingly enough they availed themselves of the reasoning underlying the odious debt debate and declared that it would be unjust if a new Iraqi government had to pay for the debts of Saddam Hussein's regime. The fact that a large part of the loans granted to the former Iraqi dictator should really be described as odious in the classical sense is probably clear to all involved. Creditors have nevertheless avoided categorising the debts of Saddam Hussein's dictatorship as odious at all debt relief conferences until today, in the clear knowledge that at a multilateral level such a decision might trigger an avalanche of justified claims for debt relief.

Initial debates in the IMF

In the meantime the debate concerning the legitimacy of certain creditors' claims has reached the multinational institutions. A study on odious debt written at Harvard University was presented to the IMF at its spring meeting in 2002. Authors Michael Kremer and Seema Jayachandran⁷ proposed the creation of an internationally-recognised, impartial body that would examine whether a government is worthy of credit when odious debt criteria are taken into account. If a regime that violates the most basic democratic rules or systematically misappropriates state funds was to be declared "odious" by this body, then the granting of loans to this regime would automatically be interpreted as illegitimate business and the democratically legitimised successor government freed from repaying the loans. Such a measure would be largely able to prevent governments that are declared odious from receiving capital with which to further expand their power.

The biggest problem for a democratic government that inherits a dictatorship's debt lies in the fact that such a government currently cannot afford to refuse debt repayment, despite all the justified reasoning. If it does so anyway it risks being considered unreliable by the international capital markets, which has a negative effect on the future availability of loans. Thus the authors propose that the new government only be

⁷ Kremer, Michael / Jayachandran, Seema, 2002: Odious Debt. *Finance and Development*, June 2002, pp. 36 ff.

categorised as worthy of credit again when it refutes claims from loans granted to the illegitimate regime. Such a precarious legal situation surrounding the return of loaned funds would certainly have a deterrent effect on potential creditors.

The fact that the legitimacy of granting loans to undemocratic and odious regimes was questioned in the IMF for the first time at its 2002 spring meeting is gratifying. What is also noteworthy is that Kremer and Jayachandran envisage positioning the proposed independent monitoring body under the overall auspices of the UN, and not of the IMF. The strengthening of the UN vis-à-vis the multilateral finance institutions is very welcome.

To this day the IMF has not gone beyond a non-committal hearing for the results of the study, and the application of the proposals cannot be expected in the near future. This makes the role of international NGOs all the more important.

International networking as a means of applying pressure

The increasing global networking of regional initiatives and campaigns is an important way of building up pressure at the level of civil society. International conferences and seminars on illegitimate debt have been taking place regularly on all continents for a few years now. The NGOs' demands are clear. Whoever makes financial contributions to - and thus supports - a regime that is not democratically legitimised, is corrupt and violates human rights is guilty by association of the regime's criminal activities and should not be given any legal support to claim its interest on the debt, or to reclaim the loan itself. In the event of a new regime assuming power it should be possible for such debts to be declared illegitimate by an internationally-recognised authority in an independent legal procedure, and for the democratically-elected successor government to be freed from servicing and repaying the debt.

Things become more difficult when it comes to elaborating enforceable and legally correct proposed procedures with which to assess creditors' claims. This particularly raises the issue of what possibilities there are to define binding legal guidelines for debt cancellation in national and international law, and what legal reasoning would be able to free the states concerned from the burden of illegitimate debts today. For the most important challenge facing organisations fighting for debt relief today is to establish a legally binding internationally-recognised set of rules and regulations which are able to enforce the cancellation of illegitimate debt, also against the interests of the creditors.

Advancing the Odious Debt Doctrine, a study written by Ashfaq Khalfan, Jeff King and Bryan Thomas of the Centre for International Sustainable Development Law and published by McGill University (Canada) in 2002, outlines important legal guidelines for political work in this context. It represents the legal basis of the doctrine of odious debt, analyses eleven court cases in which the doctrine was applied, and shows the legal possibilities for a debt cancellation procedure based on the illegitimacy of the debts concerned. The study specifically points out that in order to engage in political work

utilising the doctrine of odious debt it is necessary to consider the possible legal procedures in detail. Thus great store is laid by precise criteria with which to assess debts, for example. For it is essential that non-governmental organisations fighting for fair and transparent debt relief policies agree on a definition that is both legally correct and politically applicable if they want to fight actively to free countries from this illegitimate debt burden. It will not suffice to use the doctrine of illegitimate debt only for information and mobilisation purposes. The legal definition of odious debt includes three conditions.

1. The people concerned neither agreed to the loans being taken up nor to their utilisation.

International law envisages that binding contracts may only be concluded with the legitimate government. The people, that is to say all or the majority of the people in a state, have to give the government their consent for acts of state. As it is the government's duty to act in the people's interests it has to be authorised to represent the people. In principle a government is legitimised in international law by free and democratic elections. This only applies however, if the government is elected at regular intervals by an informed electorate with universal suffrage.

No dictatorial regime fulfils this condition. Things are more complicated in cases of democratically legitimised governments misappropriating funds. Elections mandate a group of people to act in the framework of the constitution and for the welfare of the people. Public office bearers' corrupt or criminal activities are not legitimised simply because they have been democratically elected.

Taking up a loan can be considered legitimate if it is at least authorised by parliament, the parliamentary decision came about through a transparent and public process, and the government gives the public a truthful account of how the money will be used.

2. The use to which the loan is put does not benefit the people, or even harms them.

The funds which a state has at its disposal basically have to be used in the interests of the state, that is to say the population of a state territory. Taking up a public loan is illegitimate if the money is not used in the interest of the state, or even if it is taken up or used against the interests of the people. This is the case when a government misappropriates funds or uses them for personal enrichment, if they are used for projects which merely benefit a clearly-defined minority or if the acquisitions made or services procured with the funds harm the people.

It is often very difficult to prove that an entire loan was not used in the interest of the people, particularly when loans are not allocated to clearly-defined projects, but rather flow into the national budget. In this context it is worth noting that funds which relieve the overall national budget often make it possible for other funds to be used for projects which are not in the people's interests. If there is a comprehensible connection in this

matter, then such loans have to be defined as illegitimate too and as not legally reclaimable.

3. Creditors knew about the illegitimate use of the funds, or did not make an effort to find out about them.

Lending money is a high-risk business. Creditors always have to bear in mind that debtors will not be able to pay their debts back. Creditors come together in informal meetings, such as the Paris Club or the London Club, in order to represent their interests vis-à-vis debtor states and to bring pressure to bear for the repayment of loans.

Creditors' responsibilities not only include a realistic assessment of the economic risk, however, they also have to take political responsibility for the results of financing a specific project. The doctrine of odious debt envisages that creditors be held legally responsible, at least when it can be proved that they knew about the inadequate democratic legitimisation for the loan to be granted, as well as of the fact that it did not benefit the people.

It will not suffice, however, simply not to make any inquiries and hence not to know the unpleasant information. A creditor has to carefully assess any possible negative ramifications that its business activities may have on the people concerned before the funds are spoken. For it is not only a creditor's effective knowledge that is of significance for the legal assessment, but also the failure to gather information.

The McGill study provides the legal basis to bring the demands - which have remained rather abstract up until now - down onto a tangible political and legal level. One of the biggest and most important tasks currently facing international movements fighting for the recognition of the doctrine of odious debt in multinational institutions is a detailed analysis of individual court cases under the aspect of the legal criteria discussed above. The aim of the inter-linked efforts has to be to arrive at the first case of debt cancellation on the basis of the odious debt criteria in multinational bodies. The movement can subsequently aim to work towards the criteria for illegitimate debts becoming an integral component of debt assessment on the one hand, and on the other hand for the granting of loans to be based on internationally-recognised and actionable guidelines in future, with clearly defined ethical, social and political criteria.