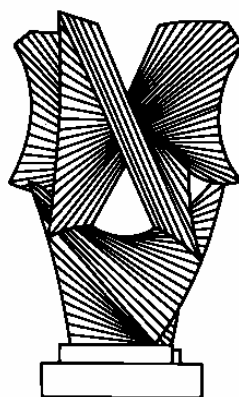


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A Critique of the Odious Debt Doctrine

Albert H. Choi¹ & Eric A. Posner²

December 11, 2006

Abstract. Defenders of the odious debt doctrine, which bars creditors from collecting sovereign debts that financed the personal consumption of former dictators, argue that this rule would benefit populations following dictatorships and discourage would-be dictators from staging coups in the first place. We show that optimism about the doctrine is based on unrealistic assumptions about the motives and practices of dictators. With more realistic assumptions, the odious debt doctrine could be beneficial or harmful, depending on circumstances. Defenders of the doctrine have not made the empirical case that the net benefits would be positive if the doctrine were incorporated into international law, and there is ample reason for skepticism that they would be.

The western liberal states have practical and humanitarian interests in preventing other states from being taken over by dictatorships and in encouraging democratic reform in existing dictatorships. Dictatorships often mistreat and impoverish their own citizens and commit atrocities. Dictatorships also produce refugee crises, fight with their neighbors, and provide havens for terrorists. Because dictatorships rarely enjoy the broad support of their own citizens, they are vulnerable to insurgencies and civil war.

Yet liberal states have taken an ambivalent attitude toward dictatorships. On the one hand, governments of liberal states make clear that they disapprove of dictatorships and usually subject them to diplomatic pressure. Particularly bad dictatorships may be subject to sanctions of various sorts, including economic sanctions; and some bad and dangerous dictatorships are subverted or attacked. Recent examples include the invasion of Iraq, the intervention in Kosovo, the sanctions imposed on Sudan, and the long-running sanctions on Cuba. In rare instances, dictators are prosecuted for their crimes. On the other hand, western governments cooperate with many dictatorships. They authorize trade, including the sale of weapons; they authorize private investment; they even give foreign aid to the dictatorships. Indeed, cooperation is the more common practice. China, Russia, Egypt, Saudi Arabia, and many other authoritarian states that routinely abuse their citizens are permitted to join international organizations, enjoy liberal trading relationships with the western powers, and in some cases receive foreign aid. During the cold war, the U.S. and its allies supported dictatorships that took a hard line against the Soviet Union.

The ambivalence reflects the conflicting interests of the Western states. They have humanitarian and strategic interests in encouraging democracy and respect for human

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rights; but they also have strong strategic interests in trading, entering military alliances with, and in other ways cooperating with dictatorships, especially powerful dictatorships. Indeed, even humanitarian reasons can be given for such cooperation; it is often argued that engagement is more likely to lead to reform than isolation, and in any event it is often the case that western powers need the assistance of dictatorships in order to perform humanitarian missions. For example, China and Russia wield vetoes on the Security Council, so any lawful humanitarian military intervention needs their permission, which they are likely to withhold if they believe that western states seek to isolate them.

These complexities suggest that liberal states will usually have to take a flexible approach to dictatorships—constantly adjusting the degree of cooperation or isolation in response to events. States need to take account not only of liberalizing tendencies, which they will want to reward; they also have to keep in mind the extent to which a dictatorship may become more or less important for its strategic interests. A government that tries to isolate Syria because of its terrorist ties might end up needing to cooperate with it in order to resolve the conflict in Iraq.³ States also worry that the sanctions that they impose might fail to dislodge the dictator while imposing hardship on the public—the opposite of their purpose. The sanctions on Iraq from 1993 to 2003 had just this effect. It is thus not surprising that empirical studies of sanction regimes suggest that they usually fail to accomplish the stated ends of the states that imposed the sanctions.⁴

Frustrated with the limited success of sanction regimes, some scholars and advocates argue that sanctions should be legalized—that is, sanctions should be required by international law when certain conditions are satisfied, rather than imposed episodically on the basis of political considerations. Current interest focuses on the odious debt doctrine, which provides that a successor regime is not responsible for paying the debts of a prior regime if those debts were incurred by an authoritarian government and used to enrich its members rather than to benefit the public.⁵ The legal status of the doctrine is controversial but it has many advocates.⁶

It should be clear that the odious debt doctrine is not meant as an overall solution to the problem of how to treat dictators. It does not interfere with trade or travel or other things that dictators might care about; it interferes only with lending. Thus, one puzzle raised by the doctrine is why lending, rather than trade, should be subject to legal regulation, and whether there is any point in restricting cooperation along one dimension

³ Iraq Study Group, *The Way Forward: A New Approach* (2006).

⁴ See Gary C. Hufbauer et al., *Economic Sanctions Reconsidered: History and Current Policy* (2nd ed. 1990).

⁵ For recent discussions of the doctrine and its history, see e.g., Lee C. Buchheit, G. Mitu Gulati, and Robert B. Thompson, *The Dilemma of Odious Debts* (Draft 2006); Adam Feibelman, *Contract, Priority, and Odious Debt* (Draft 2006).

⁶ See, e.g., Seema Jayachandran & Michael Kremer, *Odious Debt*, 96 *Amer. Econ. Rev.* 82 (2006); Centre for International Sustainable Development Law, *Advancing the Odious Debt Doctrine* (2003); Patricia Adams, *Loose Lending, Corruption and the Third World's Environmental Legacy* (1991). Some authors reject the doctrine but support its premises and seek other legal means for operationalizing them. See, e.g., Buchheit, et al., *supra* (describing domestic legal analogies); Feibelman, *supra* (advocating a contractual mechanism).

while maintaining it along others. The odious debt doctrine also does not address the benefits of cooperating with dictators; it does excuse a dictator who arrests terrorists at the request of western governments, or who takes in refugees from a conflict in a bordering country, or who provides assistance in a humanitarian intervention.

Despite these problems, the odious debt doctrine has been endorsed by a large group of scholars and advocates. We will argue that this endorsement is premature and probably unwise. We show that it is unclear whether the doctrine will improve the welfare of the population that might be subject to a dictatorship. Although a selective application of the doctrine can improve welfare in principle, it is unlikely that such selective application would be practicable. If incorporated into international law, there is a danger that the odious debt doctrine would do more harm than good.

I. The Normative Case for the Odious Debt Doctrine

Defenders of the odious debt doctrine often rest their case on the simple and apparently morally compelling claim that an impoverished population that has recently overthrown a dictator should not have to pay sovereign debt incurred by the dictator to pay for his own lavish personal consumption. But the well-being of the post-dictatorship population cannot be taken in isolation; one needs to consider the likely impact of the doctrine on the well-being of the population before the dictator is overthrown and on the well-being of populations who are never able to escape a dictatorship. To do this, one needs to take an ex ante perspective, comparing the well-being of affected populations in the world in which the doctrine exists and the world in which it does not exist.

The conventional ex ante defense of the rule does just this. Suppose creditors know that they cannot collect if they lend money to a dictator in order to finance private consumption. Creditors will respond to the rule by declining to make such loans or by charging a higher interest rate. As a result, dictators will not be able to, or will decide not to, borrow for private consumption, and more money will be left for the future generations of the population. As the dictator is just a single person with a lot of money already, and therefore obtains a small marginal gain from an additional dollar, and as the future public is poor and thus will value an additional dollar a lot, the restriction on lending should, by transferring wealth from the dictator to future public, produce a welfare gain.

Potentially of even greater importance, would-be dictators may be deterred from taking power if they anticipate that they will not be able to borrow for personal consumption once they control the government. If so, the odious debt doctrine will, in the long run, reduce the number of dictatorships and in this way improve the well-being of populations that would be subject to dictatorships but for the deterrent effect of the doctrine. Meanwhile, the loss of the lending opportunity to creditors, most of which are firms with relatively wealthy shareholders, is likely to have a small impact on utility. In the short run, profits might be somewhat smaller but the international lending market is highly liquid and investors should be able to find nearly as good opportunities. In the

long run, lending opportunities will not be reduced because creditors can lend to the additional states that do not have dictatorships as a result of the odious debt doctrine.

One should observe that this argument in favor of restrictions on lending is no different from an argument in favor of any other sanctioning regime, and thus whether it is true or not depends on the basic consideration for and against sanctioning that we discussed in the Introduction. We think this point is obvious but we mention it because some commentators might be read to say otherwise.⁷

II. A Model of the Odious Debt Doctrine

The argument described above is excessively optimistic; it overlooks significant practical difficulties. To address some of these difficulties, we provide a model of odious debt financing. We are particularly interested in whether the dictator, who attempts to stay in power for a long period and to maximize his personal consumption, will borrow from abroad for short-term consumption or for a longer-term investment. We analyze how the odious debt doctrine will affect the dictator's choice and how that, in turn, will affect the public. The model will demonstrate that while the dictator will prefer the lending regime without the doctrine, whether the public will benefit from the doctrine is unclear and depends on complex factors.

A. The Model

There are four periods in the model. At $t=1$, a potential dictator decides whether to stage a coup. Although we do not explicitly model the cost of staging a coup, we assume that it is costly and the dictator's decision depends on his expected utility from success. If he comes into power, at $t=2$, he borrows money from abroad and spends either on private consumption or on a quasi-public investment. He can also decide not to borrow at all, in which case he will rely only on the resources provided by the country. Borrowing from abroad is accompanied by a promise to pay back at $t=4$. At $t=3$, the dictator is overthrown with some positive probability. We assume that it is costly for the public to overthrow the dictator and the public's decision depends, in part, on its expected gain from overthrowing him. At $t=4$, if the dictator is overthrown at $t=3$, then a more representative government, depending on whether the odious debt doctrine is in place, either pays back the money that was borrowed in $t=2$ or successfully repudiates it. If the dictator is not overthrown at $t=3$, the dictator must pay back the loan he borrowed at $t=2$. We will assume that if the odious debt doctrine is not in place, both the representative government and the dictator will pay back the money at $t=4$ because they are concerned about their future borrowing capacity.⁸

⁷ See Jayachandran & Kremer, *supra*, at 88 ("loan sanctions make the population better off in future periods (than trade sanctions do), since it has no debt repayment to make"). However, Jayachandran & Kremer acknowledge in a footnote that this is false if the dictator can trade nonrenewable resources (*id.*, 88 n.7), which in our view is fatal to their claim. See *infra*.

⁸ Our model ends at $t=4$, but we can imagine that this is just one stage game in a repeated game framework. For instance, if the dictator is not overthrown at $t=3$, we can think of the fourth period as being equivalent to the second, whereas if the dictator is overthrown at $t=3$, we can assume that the game starts again from $t=1$.

Suppose at $t=2$ and $t=4$, the country generates a cash flow of $r>0$ per period that the dictator can extract for his own benefit or (at $t=4$) the government can use to satisfy the debt that was borrowed at $t=2$. At $t=2$, let's assume that the dictator can borrow amount d from abroad. For the sake of simplicity, there is no time discount and the interest rate that is charged by the competitive international banking industry is 0. Let's also assume that the probability (p) of overthrowing the dictator at $t=3$ is either p_1 if the odious debt doctrine is in place and p_2 if not, where both p_1 and p_2 are strictly between zero and one. If the dictator does not borrow in $t=2$, the probability of being overthrown at $t=3$ is p_0 . Finally, the country generates enough cash flow to satisfy the debt at $t=4$: $r>d$.

After the dictator comes into power at $t=1$, he cares about his expected utility, given by $c_2+(1-p)*c_4$, where c_2 and c_4 are the amounts of resources the dictator consumes in periods 2 and 4. The level of consumption will depend on the amount of resources he extracts from the public, money borrowed from abroad, and the cash flow that is generated by the quasi-public investment. The public's utility is given by $u(b_2)+p*u(b_4)+(1-p)*u(b_4')$, where b_2 , b_4 , are b_4' are the levels of consumption the public enjoy in period 2, 4 with overthrow, and 4 without overthrow. We assume that if the dictator takes away \$1 from the public, the loss of utility to the public is larger than the utility the dictator gains, i.e., $u'>1$. Also, assume that u' is constant. If the (potential) dictator does not come into power at $t=1$, we assume that his utility is zero and the public consumes the cash flow r in each period: its utility is $u(r)+u(r)$.

1. The Case of No borrowing

Suppose there is no international borrowing. Conditional on being in power, the dictator will take away the entire cash flow r in $t=2$ and again in $t=4$ for his private consumption. The public will have something for its own consumption only when the dictator is out of power in period 4. At $t=3$, the public, by overthrowing the dictator, expects to gain $u(r)$. Overthrowing the dictator is costly and this will lead to some probability p_0 that determines whether the dictator will be in power. The dictator's utility, therefore, is $r+(1-p_0)*r$ and the public's utility is $u(0)+p_0*u(r)$. At $t=1$, a potential dictator will compare the expected benefit $r+(1-p_0)*r$ with the cost of staging a coup and this will determine the probability of the dictator coming into power: q_0 .

2. Borrowing for pure consumption

Suppose the dictator is in power and borrows d at $t=2$ for personal consumption. Consumption does not generate any future cash flow. How much the international banking community will charge for this loan will depend on the existence of the odious debt doctrine. If the subsequent government at $t=4$ can (and will) repudiate the debt under the odious debt doctrine, since the banks can recover their lending only under the dictatorial regime, they will demand, as repayment at $t=4$, $d/(1-p_1)$. If the subsequent government must pay back the loan, they will demand d .

Without the odious debt doctrine, the dictator will borrow d at $t=2$, consume $r+d$ at $t=2$ and repay d at $t=4$ if he is in power. At period 4, he will again extract everything for his personal consumption. His utility, therefore, is $(r+d)+(1-p_2)(r-d)$, which is equal to $r+(1-p_2)r+p_2*d$. The public receives no money at $t=2$ but is saddled with the obligation of repayment after the dictator has been overthrown. The public's utility is $u(0)+p_2*u(r-d)$. If the doctrine is in place, the banks can recover from the dictator only if the dictator is not overthrown at $t=3$. The dictator's utility is $(r+d)+(1-p_1)(r-d/(1-p_1))$, which is equal to $r+(1-p_1)r$. The public enjoys $u(0)+p_1*u(r)$. Not surprisingly, the public enjoys a higher utility level with the odious debt doctrine, and the dictator enjoys higher utility without the doctrine.

When the odious debt doctrine is not in place, the problem of dictator's borrowing from abroad for personal consumption is that it exerts a negative externality onto the future government, because the future government must bear the burden of repayment. The difference in the two cases for the dictator is the amount of this externality: approximately $p_2*u(d)$. What the odious debt doctrine does, then, is to make the dictator internalize this negative externality by paying back more in case he stays in power. In some cases, the size of the repayment demand will be large enough, i.e., $d/(1-p_1)>r$, to prevent the dictator from borrowing for personal consumption altogether.

Now it is easy to understand what the potential problem of the odious debt doctrine is. Because the doctrine causes the dictator to internalize only the negative externality (by having to pay back more in case he stays in power), any project that has some positive externality for the public will become less attractive for the dictator. The banking community does not care about the amount of positive externality that a project (at $t=2$) can impose onto the public. It cares only about repayment. We can illustrate this with the following example.

3. Borrowing for a quasi-public investment

Suppose the dictator can borrow d at $t=2$ to implement a project. The project generates a cash flow of x and also a public benefit of $u(y)$ in period 4. We will assume that the dictator can take the entire x away but not $u(y)$. We can think of x as the additional cash flow and $u(y)$ as some intangible, consumption benefit that accrues to the public. For the project to be worthwhile for the dictator, we will assume that $x>d$ and $u(y)$ to be greater than or equal to 0. As an example, the project might be building some sort of infrastructure (like drilling an oil well, digging a mine, building a road, constructing a power station) that generates cash flow that the dictator can grab but also generates some benefit for the public. We allow for the possibility that the investment only generates cash flow that the dictator can grab ($u(y)=0$). Meanwhile, we will assume that the initial revenue r will be consumed by the dictator.⁹

Without the odious debt doctrine, the banks will demand d for repayment at $t=4$. Conditional on implementing the project, the dictator will enjoy the utility of $r+(1-$

⁹ Although the dictator can use the existing resources (r) to finance the project, borrowing from abroad will be more beneficial for him since it leaves for more his consumption.

p_2)*($r+x-d$). At $t=2$, the dictator will extract the entire r for personal consumption and borrow d to implement the project. At $t=4$, once the project generates the cash flow of x , the dictator takes all of it while paying back the d that was borrowed. The public will enjoy the utility of $u(0)+u(y)+p_2*u(r+x-d)$. At $t=2$, the public gets no money. But, from the project the public enjoys the utility of $u(y)$ and also the added benefit of $u(x-d)$ in case the dictator is overthrown.

With the odious debt doctrine, let's assume that the international community cannot tell whether the dictator has spent the borrowed money on a quasi-public project or on pure personal consumption. After all, the proponent may argue that since the dictator's motive for borrowing is for investment that generates more wealth for his own pocket in the future (especially when $u(y)=0$), the doctrine should still apply to this type of spending.¹⁰ Now, for borrowing d in $t=2$, the bank demands $d/(1-p_1)$ in $t=4$ in case the dictator is not thrown out. The dictator will enjoy the utility of $r+(1-p_1)(r+x-d/(1-p_1))$. The public will enjoy the utility of $u(0)+u(y)+p_1*u(r+x)$. The difference from the previous example is that while the dictator gets to enjoy the cash flow benefit of the project only with probability $(1-p_1)$, he has to bear the entire borrowing cost. The project, through the odious debt doctrine, generates a positive externality for the public.

4. Choice among investment, consumption and no borrowing

The choice that the dictator faces at $t=2$ is to either borrow and invest in the project, borrow for pure personal consumption, or not borrow at all. When the odious debt doctrine is in place, by not borrowing or borrowing for personal consumption, the dictator realizes the expected utility of $r+(1-p_1)*r$. The public receives an expected utility of $u(0)+p_1*u(r)$. If he were to borrow to invest in the project, he gets an expected utility of $r+(1-p_1)(r+x-d/(1-p_1))$, while the public receives an expected utility of $u(0)+u(y)+p_1*u(x+r)$. Hence, when the dictator is deciding whether to borrow to invest or consume, he will borrow to invest only when $x-d/(1-p_1)>0$ or $(1-p_1)x>d$.

	With the odious debt doctrine	
	Dictator's utility	Public's utility
No borrowing	$r+(1-p_1)*r$	$u(0)+p_1*u(r)$
Personal consumption	$r+(1-p_1)*r$	$u(0)+p_1*u(r)$
Quasi-public project	$r+(1-p_1)(r+x-d/(1-p_1))$	$u(0)+u(y)+p_1*u(x+r)$

Without the odious debt doctrine, between investing in the project and not borrowing at all, the dictator will invest. By investing, he realizes the utility of $r+(1-p_2)*(r+x-d)$, while the public enjoys $u(0)+u(y)+p_2*u(r+x-d)$. If he were to borrow for personal consumption, on the other hand, he gets $r+(1-p_2)r+p_2*d$ and the public receives $u(0)+p_2*u(r-d)$. Between borrowing to invest and to consume, if $(1-p_2)(x-d)>p_2*d$, he will invest, while if $(1-p_2)(x-d)<p_2*d$, he will borrow for personal consumption. The comparison is between the magnitude of the negative externality he can impose on the

¹⁰ It is clear that this is the view of many supporters of the doctrine; see note ____, *infra*.

public for consumption borrowing versus the amount of benefit he receives from investing in the project.

	Without the odious debt doctrine	
	Dictator's utility	Public's utility
No borrowing	$r+(1-p_2)*r$	$u(0)+p_2*u(r)$
Personal consumption	$r+(1-p_2)r+p_2*d$	$u(0)+p_2*u(r-d)$
Quasi-public project	$r+(1-p_2)*(r+x-d)$	$u(0)+u(y)+p_2*u(r+x-d)$

What is interesting about this comparison is that, if the doctrine does not affect the probability of overthrowing the dictator, i.e., if $p_1=p_2=p$, the decision of the dictator as to whether to borrow to invest or borrow to consume does not depend on the regime. Whether or not the doctrine is in place, the dictator will borrow to invest rather than to consume if and only if $(1-p)x>d$. While surprising at first, the logic is intuitive. Consider first the case with the doctrine. Compared to the case where the dictator borrows for personal consumption, borrowing for investment provides an additional benefit of $(1-p)x$ to the dictator while imposing the (debt) cost of d . He bears the full cost of the debt because the banking community increases the repayment amount, from d to $d/(1-p)$, to eliminate their risk of no repayment in case the dictator is overthrown.

When the doctrine is not in place, by borrowing for personal consumption, the dictator is able to impose a negative externality onto the public in case he is overthrown. The benefit of this to the dictator is $p*d$. If he decides to borrow for investment, therefore, he must bear not only the cost of repayment, $(1-p)d$, but also this forgone opportunity. So, the full cost of borrowing for investment is d . On the benefit side, he enjoys the additional cash flow of x only when he is not overthrown. So, the dictator will decide to invest with the borrowed money if and only if $(1-p)x$ is larger than d , which is the same as in the case with the doctrine.

What will be different between the two cases, however, is the probability of being overthrown at $t=3$ and the probability of a dictator coming into power at $t=1$. We focus on the differential probability of being overthrown first. With the doctrine, because the public has more to gain from overthrowing the dictator, they are more likely to overthrow than not. Conditional on p , the public's utility is strictly higher under the regime with the odious debt doctrine than without. Hence, we can assume that $p_2<p_1$ in equilibrium, so that $d/(1-p_2)<d/(1-p_1)$. Since the dictator now faces a different probability of being able to stay in power, his decision about whether to borrow to invest or to consume will also be different. We have to consider three possible cases.¹¹

¹¹ It is also possible that, within each regime, the dictator's choice between investment and personal consumption will affect the probability of overthrowing. For instance, with the doctrine, when the dictator borrows for personal consumption, the public, by overthrowing, gets the additional utility of $u(r)$. If the dictator invests, however, the public receives the additional utility of $u(x+r)$. Hence, investing can actually provide more incentive to the public to overthrow the dictatorial regime. Our analysis on how the probabilities are different across the two regimes will not be affected, however.

Case 1: if $x < d/(1-p_2) < d/(1-p_1)$, under both regimes, the dictator just borrows from abroad for his personal consumption. The dictator prefers the regime with no odious debt doctrine, $r+(1-p_2)r+p*d > r+(1-p_1)*r$, since, without the doctrine, not only can he impose a negative externality onto the successor government but also he is more likely to stay in power at $t=4$ because the public has a lower incentive to overthrow his government. The public realizes $u(0)+p_1*u(r)$ with the odious debt doctrine and $u(0)+p_2*u(r-d)$ without. The public strictly prefers the imposition of the odious debt doctrine for the same reasons: they do not want to bear the negative externality imposed by the dictator and also they are more likely to set up a representative government at $t=4$. Stepping back further, given that the dictator earns a higher utility under the regime without the odious debt doctrine, the dictator is more likely to attempt a coup at $t=1$ when the odious debt doctrine is not in place.

Case 2: if $d/(1-p_2) < d/(1-p_1) < x$, the dictator makes the quasi-public investment under both regimes. The dictator realizes a higher expected utility under the regime without the odious debt doctrine: $r+(1-p_2)*(r+x-d) > r+(1-p_1)(r+x-d/(1-p_1))$. This is because (1) the dictator does not need to bear the full cost of debt and (2) he is more likely to stay in power without the odious debt doctrine. For the public, since $p_1 > p_2$ and $x+r > x+r-d$, the public, again, strictly prefers the regime with the odious debt doctrine. They receive the positive externality from the dictator's investment without having to bear the debt cost and are more likely to overthrow the dictator at $t=3$. Since the dictator realizes a higher expected utility without the odious debt doctrine, the probability of coup at $t=1$ will be higher without the doctrine.

Case 3: when $d/(1-p_2) < x < d/(1-p_1)$, the dictator implements the quasi-public project when there is no odious debt doctrine but borrows for personal consumption when the doctrine is in place. The dictator expects utility of $r+(1-p_2)*(r+x-d)$ without the doctrine and $r+(1-p_1)*r$ with the doctrine. Since $p_1 > p_2$ and $x-d > 0$, the dictator prefers the regime with no odious debt doctrine: $r+(1-p_2)*(r+x-d) > r+(1-p_1)*r$. Without the doctrine, he can get the benefit of the investment and is less likely to be overthrown. The public's relative utility, on the other hand, is ambiguous. With the doctrine, the public earns $u(0)+p_1*u(r)$, whereas without, it earns $u(0)+u(y)+p_2*u(r+x-d)$. Even if we assume that $u(y)=0$, the public's utility might be lower with the doctrine because it does not receive the benefit of the quasi-public investment undertaken by the dictator. While $p_1 > p_2$, $u(r+x-d) > u(r)$. Particularly, if $u(y) > 0$, the public is more likely to be worse off with the doctrine than without. However, since the dictator realizes a higher utility with no odious debt doctrine, the dictator is more likely to stage a coup at $t=1$.

We can make a few generalizations from the examples. First, the dictator will always prefer the regime with no odious debt doctrine. The reason is that it allows him to stay in power longer and gives him a higher expected utility from being in power, either through additional consumption that imposes a negative externality onto the public or through quasi-public investment. Thus, the odious debt doctrine makes the coup at $t=1$ less likely.

Second, on average, the odious debt doctrine makes it more difficult for the dictator to implement the quasi-public project. The dictator, instead, prefers to borrow for personal consumption. When the doctrine is in place, the dictator decides to implement the project only in the second case.

Third, it is unclear whether the doctrine benefits the public. Conditional on the investment being made or not, the doctrine increases the public's utility by (1) decreasing the probability that the dictator will stay in power; (2) decreasing the probability that a would-be dictator will come to power; and (3) either eliminating the negative externality imposed by the dictator's consumption or allowing the public to better enjoy the positive externality from the dictator's quasi-public investment. However, because the dictator is less likely to make the quasi-public investment under the doctrine, the public is less likely to be able to enjoy the fruits of such investment. Especially when $u(y)$ is large, the loss of (potential) benefit to the public will outweigh the gains.

B. Empirical Premises

In principle, the odious debt doctrine could be selectively applied to avoid harming the public. Suppose we are in case 3, where the dictator fails to make the quasi-public investment with the doctrine. If the public's benefit from the investment is large, the doctrine should not be imposed, whereas if small, it should. The determination should be based primarily on two factors: the size of the benefit, both tangible and intangible, to the public ($u(y)$ and $u(x-d)$) and the differential probability of overthrowing the dictatorial regime (p_1 versus p_2). If $p_1 * u(r) > u(y) + p_2 * u(r+x-d)$, the doctrine should be imposed; otherwise, the doctrine should not be imposed.

We doubt that decisionmakers can reliably perform these calculations on a case by case basis, and suspect that, in an aggregate sense, the inequality does not hold. Let us consider the empirical premises of this inequality.

1. The doctrine will deter borrowing for personal consumption without interfering excessively with borrowing for quasi-public investment that benefits the public

Consider, first, the variable y —the benefit that the public receives from projects. Some of the literature implies that dictators frequently borrow money for the express purpose of building themselves unnecessary palaces. However, dictators generally become wealthy by taking kickbacks on public contracts and similar forms of corruption. They build roads, airports, power plants, dams, and ports, and, although they skim off profits, the resulting infrastructure benefits the public, at least a little.¹² For example, a government might use a loan to build a bridge or some other public project but would demand kickbacks from the contractor. If a \$10 million loan is used to build a \$9 million bridge, with government ministers skimming of the extra \$1 million, is this an odious debt? If so, the doctrine discourages an investment that could benefit the public; if not, the doctrine will have little effect on actual behavior. No doubt the dictators prefer this form of corruption because it gives them some political cover but, by the same token, this

¹² See Adams, *supra*; Martin Meredith, *The Fate of Africa* (2006).

form of corruption is not as bad as borrowing for personal consumption alone. Although there are well-known cases of prestige projects that yielded no gain to the public, most serious defenders of the odious debt doctrine do not argue that dictatorial governments should be deprived of credit for legitimate projects, even if they turn out to be failures.

During the past half century, numerous dictatorial regimes borrowed money from foreign creditors and made investments in infrastructure and industry, investments that have paid off for future generations. Chile under Pinochet, South Korea under Park, and Singapore under Lee, are classic development success stories. China's authoritarian regime has borrowed tremendous sums, and currently China is enjoying rapid economic growth. Even the authoritarian regimes that have been less successful in promoting economic growth cannot, in most cases, be accused of using foreign debt for personal consumption. The Latin American dictatorships, for example, did not squander their loans on consumption; they invested poorly. And even the worst kleptocratic dictators in Africa did not consume all of their loans. They used them mainly to pay off political supporters and finance the army. All regimes must, to some extent, make transfer payments in order to keep domestic peace, and to finance the army in order to protect the country from domestic unrest and foreign invasion; these types of payments are quasi-public investments because the public benefits from peace and domestic order.

Even more troublesome, straightforward borrowing for personal consumption is not necessarily harmful to the public. One cannot determine whether a particular debt is odious in isolation. Governments obtain funds from tax receipts and loans. There is no sense in which the two sources can be kept separate from each other. Thus, a dictator can evade the odious debt doctrine by arbitrarily designating bank loans as the source for public projects and tax revenue as the source for the dictator's consumption. The only way that the doctrine could limit borrowing would be if the dictator seeks to spend more money on himself than he could obtain from tax revenues alone. However, in nearly all realistic cases extremely greedy dictators can satisfy themselves from the tax revenues. By contrast, the original example of odious debt was a rare instance where borrowed funds went directly into the pocket of the dictator.¹³

The main effect of the odious debt doctrine is to encourage dictators to be short-sighted. Because they are less likely to collect the return on investment, they are less likely to invest. If the odious debt doctrine increases the probability of being overthrown by a great enough amount, the dictator will borrow in order to consume rather than borrow in order to invest. In the limiting case, he will not invest at all. Although the public does not have to repay the debt for his consumption, it will also suffer from lower economic growth because he did not invest.

2. The doctrine will substantially increase the probability that the public will overthrow a dictator and replace him with a representative government

¹³ As Buchheit et al., *supra* at 22, observe, the modern defenders of the odious debt doctrine appear to defend a broader version of the rule, one which apply to any debt incurred by a dictator. A clear example is Adams, *supra*.

One might think that an argument in favor of the odious debt doctrine would be that it increases the probability that the public will overthrow the dictator by offering the public debt relief if the attempt to overthrow succeeds. However, as we explained above, this argument ignores the way that the prospects of being overthrown affects the incentives of the dictator and hence public welfare. If the odious debt doctrine increases the risk of being overthrown, the dictator has less incentive to make quasi-public investments.

Ironically, the case for the odious debt doctrine is strongest if the doctrine has no effect on the probability that the dictator will be overthrown. If it has no effect, then the dictator's choice between investing and consuming will not be affected by whether the doctrine is in place. Thus, the only effect of the doctrine would be to release the public from debt if the overthrow occurs—a straightforward utility gain.

One might argue that this is in fact the case. Overthrowing a dictator is dangerous and risky, and the public is subject to a collective action problem. In practice, the question for members of the public is whether to throw their support behind opponents of the government. The public can do so by engaging in strikes, protesting in the streets, and so forth. But these are highly costly actions—dictators typically react to them by torturing and murdering opponents—and so the incentive to free ride will be high. And the public might expect that the opponents, when in power, will be no better than the dictator.

However, we are skeptical that the odious debt doctrine would have no effect on the probability of the dictator being overthrown. It is true that overthrowing a dictator is risky, but this is true whether or not the doctrine is in place. Given the background risks, debt release increases the reward. The doctrine ensures that the public has much to gain from the overthrown—debt relief—and the worse the dictator, the greater the benefit of overthrowing him. And typically revolutions against dictators are led by political entrepreneurs who will internalize some of the gains.

3. The doctrine will substantially reduce the probability that would-be dictators will seek power

While this premise might be correct, it does not necessarily lead to the conclusion that the odious debt doctrine will unambiguously benefit the public. Suppose, for the sake of argument, that having a representative government is always better than having a dictatorial regime regardless of the dictator's choice between investment and consumption: $u(r)+u(r)$ is larger than both $p_1*u(r)$ and $u(y)+p_2*u(r+x-d)$. We might think that if would-be dictators are less likely to seek power because of the doctrine, the public will also be more likely to overthrow the authoritarian government with the doctrine than without.

If the odious debt doctrine makes the dictator more short-sighted and less likely to make quasi-public investment, however, while the probability that a dictator comes into power is lower, conditional on having a dictator the public is also worse off. In other words, although the public is less likely to face a dictator, in case it does its condition

may be more miserable. The net welfare effect of the doctrine, therefore, will depend on how much the public will be worse off under a dictatorial regime and how much less likely would-be dictators will seek power because of the doctrine.

4. The doctrine will, if applied correctly, reduce the debt burdens of representative governments

It is not clear representative governments can afford to repudiate even odious debts. A government that repudiates debts, even with legal sanction, may be adjudged a high credit risk and refused further loans, or only at a high rate of interest. Thus, it is quite possible that the odious debt doctrine would have no effect.

Why might this be the case? Suppose that there is some uncertainty about whether an existing government's loans will be subsequently treated as odious debt. Creditors might fear that although the government is nominally a representative government, a later decisionmaker will determine that the representative institutions were nominal only and power was exercised behind the scenes by a dictator. Suppose further that there is uncertainty as to whether a future decisionmaker will decide that loan proceeds were used to pay for a dictator's consumption or for a public project. Creditors will be unwilling to lend to this government.

Now, if the government seeks to maintain its creditworthiness, one way it can do so is by repaying the odious debts of the prior government. This will signal to creditors that future governments will behave in the same way, and this will resolve its concerns about lending to it.

One solution to this problem is to stipulate that the odious debt doctrine will apply to loans only after an international institution or important nations designate a regime as being odious.¹⁴ However, this would significantly weaken the odious debt doctrine, since international agreement on these matters is difficult to achieve for reasons that will be discussed in Part III, below.

C. A Comparison to Jayachandran & Kremer

Jayachandran & Kremer provides a defense for the odious doctrine.¹⁵ In their model, as in ours, a would-be dictator decides whether to seize power, and is more likely to do so if his utility in power will be higher. The government (dictator or not) decides whether to allocate resources to a productive activity (fruit-growing, in their example) or to activity that mainly benefits the government (palace-building). The government can also authorize international trade in fruit, and can buy the inputs (marble) for palaces from foreign firms. Citizens are paid a wage whether they build palaces or harvest fruit, but if resources are devoted to fruit-growing, they also benefit from the consumption of fruit. Productivity varies across time, and governments can borrow during productive years so that they will have greater funds during unproductive years.

¹⁴ Jayachandran & Kremer, *supra*.

¹⁵ *Id.*

Good governments will borrow in order to smooth the consumption of citizens across time: that is, they borrow from foreign creditors during the unproductive year, use the money to buy fruit for citizens, and then pay back the loan during the productive year, when the excess harvest is sold internationally. Bad governments will borrow in order to ensure palace production during unproductive years; they leave office and subsequent populations must repay the loan.

In the absence of the odious debt doctrine, there is a reputational equilibrium where all creditors are repaid, whether or not the debt was odious, because they have a credible threat to sue a government that defaults. If a government defaults, creditors bring suit in a country in which the government has assets. Domestic and international law provides that, indeed, the assets of the debtor country can be seized by creditors. The odious debt doctrine provides that the creditors cannot seize the assets of the debtor in the creditors' countries if the debtor is a successor government to a dictatorship that used the borrowed funds to enrich the rulers rather than to benefit the public.

Under these assumptions, Jayachandran & Kremer show that the odious debt doctrine improves the welfare of the affected population. Specifically, the doctrine destroys the reputational equilibrium in which the successor government voluntarily repays the odious debt that is incurred by the previous dictatorial regime. In equilibrium, creditors lend to nonodious governments and refuse to lend to dictators, and this reduces the incentive of would-be dictators to take power in the first place. The reduced probability of a dictator benefits the public. And even if dictators come to power, they are prevented from borrowing money to build palaces, and so cannot force a future generation to pay interest on a loan that does not benefit the public.

Jayachandran & Kremer's model differs from ours in three main ways. First, they do not permit the dictator to make a quasi-public investment. Dictators can only consume, that is, build a palace at the expense of growing fruit, with the borrowed money. As a result, dictators' activity is unambiguously bad. As we saw above, this assumption is unrealistic. Dictators build roads to transport troops that the public can use as well. Dictators build better mechanisms to extract natural resources that benefit later generations. Dictators fight insurgents who injure civilians as well as threatening the security of the dictatorship. Thus, Jayachandran & Kremer's model is biased in favor of shutting off credit. They acknowledge that the odious debt doctrine is only attractive if it is "applied against regimes that are borrowing against the people's interests,"¹⁶ but they fail to acknowledge that the assumption about the absence of quasi-public investments is unrealistic.

Second, Jayachandran & Kremer assume that the dictator is always overthrown after one period: the probability of being overthrown is 1. This assumption also biases the dictator's incentives in favor of short-term consumption rather than long-term investment because the dictator cannot enjoy any of the returns from the investment. In our model, the dictator has only a risk of being overthrown. If he invests, he has a chance of

¹⁶ Id. at 89.

obtaining a return, and that return motivates the dictator's investment. In our model, the sole reason the dictator would want to invest in a project is to be able to build an even bigger palace tomorrow. But, if the dictator is thrown out before the palace is built, the public may be able to enjoy the returns on that investment. Furthermore, if the investment itself has some benefit to the public that the dictator cannot capture, $u(y) > 0$, trying to provide incentive to the dictator to favor that quasi-public investment may be beneficial to the public.

Third, Jayachandran & Kremer focus on comparing loan and trade sanctions, which we do not explicitly analyze. Jayachandran & Kremer argue that the historic weakness of trade sanctions should not discourage us from adopting a system of loan sanctions because their model shows that loan sanctions are more likely to work, and have better welfare properties than trade sanctions do. However, this argument is problematic.

Jayachandran & Kremer assume that loan sanctions are enforceable because creditors can collect only in one or a limited number of countries, whereas odious governments can trade with people in any state.¹⁷ Thus, the collective action problem in enforcing trade sanctions is greater than the collective action problem in enforcing loan sanctions. This claim is important for Jayachandran & Kremer because they acknowledge that trade sanctions have been unsatisfactory.¹⁸ The problem with this argument is that governments can choose not to place assets in, or can choose to withdraw assets from, countries that will not make them available to creditors if the governments default. Thus, if the U.S. and the EU countries adopted the odious debt doctrine, then new dictatorships would remove their assets from these countries and place them in other countries, which would be happy to take them in return for a fee or other diplomatic benefits. Western investors could easily invest in firms operating in those countries which in turn would lend to the odious dictators. The collective action problem is identical to that in the trade area, unless only a small number of countries can be trusted to hold assets and dispose of them properly. This is unlikely, and in any event similar limitations apply to trade—for example, only certain countries are reliable suppliers of marble, etc.

In addition, the superior welfare benefits of loan sanctions are also driven by an assumption that the dictator will not respond to loan sanctions by selling more nonrenewable resources to the international market. Jayachandran & Kremer admit as much in a footnote,¹⁹ but do not acknowledge the importance of this fact. History shows that odious regimes typically sell nonrenewable resources such as oil (Nigeria), diamonds (Sierra Leone), etc. If a dictatorial regime cannot borrow because of the odious debt doctrine, the regime might attempt to extract and sell inefficiently large quantities of

¹⁷ Note that on the assumption that mere reputation is not sufficient to support sovereign borrowing, there must be an additional sanction, such as loss of assets.

¹⁸ The literature on trade sanctions is large, and the evidence of their effectiveness is mixed and hard to summarize. The classic monograph on the topic is Hufbauer et al., *supra* (finding 34 percent success rate in 116 postwar cases).

¹⁹ Jayachandran & Kremer, p. 88 n.7.

nonrenewable natural resources to build a palace whereas with a trade sanction but no loan sanction, there may be less depletion, benefiting the future population.

Our view is that there is no inherent reason to think loan sanctions are superior to trade sanctions. If loan sanctions are applied routinely, then states will withdraw assets from the states in which they would otherwise store the assets. There may be limits on the extent to which states can do this, but there is also no reason to think that depriving dictatorships of places to store assets is any more or less effective a type of sanction as other forms of diplomatic pressure or use of resources (such as withdrawal of foreign aid).

III. A Note on External Benefits from Cooperating with Dictators

Foreign powers, including western powers, have frequently cooperated with dictators rather than isolating them. Cooperation has had many motivations. First, many dictators preside over long-suffering populations. In many instances, a dictator is the cause of the population's suffering but in many other cases he is not. A western government that seeks to aid a population wrecked by famine, drought, disease, economic distress, ethnic conflict, and so forth, almost always must work through the government. Authoritarian governments frequently condition access to the populations on payments to the government—or simply structure or control the aid distribution in a way that ensures that they receive a piece of it. Donors face a difficult choice, and many rationally bribe the dictator, or tolerate kickbacks and other forms of corruption that benefit the dictator, so that he will allow them to help his population.

Second, many dictators control states that have strategic value or that are simply too important to ignore. During the cold war, the U.S. and other western powers frequently felt that they had to support dictators in order to limit the spread of Soviet influence.²⁰ Today, the U.S. needs dictators to help track down terrorists, control drug smugglers, resolve conflicts, and provide military bases. Dictators must always be bribed, in cash or in kind, for their support.

There are many ways that a western government can bribe dictators. It can give them cash payments, and this is done frequently. It can give them technical assistance or military support. It can offer favorable terms of trade. And it can offer credit or access to credit. Obviously, offering credit is inconsistent with the odious debt rule. But it would be odd to deny credit under the odious debt rule while engaging in the other types of transfers. As we have seen, isolating dictators is frequently not a viable strategy—because it just leads to greater suffering for the population or interferes with other important strategic interests. As long as this is the case, there is no reason to single out credit for restriction.

The larger point is that international relations are fluid and governments need flexibility to deal with dictators. One could at least imagine a legal regime that required

²⁰ See Odd Arne Westad, *The Global Cold War: Third World Interventions and the Making of Our Times* (2005).

isolation of dictators; if states stuck by it, at least it would have a meaningful effect. Or one could continue with the current regime, under which pressure is exerted in an episodic fashion, and mainly against states that have nothing to offer. But a regime that singles out credit while preserving all the other forms of cooperation, including aid, makes no sense at all.

The need for flexibility in regulating access to credit can be seen by comparing loan sanctions with trade sanctions. Hufbauer and his coauthors' empirical survey suggested that trade sanctions tend to work only when certain conditions are satisfied: (1) the target must be relatively weak, and the goals must be relatively limited; (2) more states participate; (3) the target must be an ally or have some friendly relationship with the state that imposes the sanctions; (4) the sanctions must be applied quickly rather than incrementally; (5) and the sanctions cannot be too costly for the sanctioning country.²¹ If this is true for trade, it is surely true for loan sanctions. But because the odious debt doctrine does not incorporate these factors—and how could one have a legal rule that is applied only against the weak?—it is not likely to work as intended.

A final problem is that efforts to pressure dictators can be undermined by geopolitical rivalries. For example, current western efforts to pressure Sudan to halt the genocide in Darfur are being undermined by the China, which purchases Sudanese oil and seeks to enhance its influence in Africa. Rivalries of this kind have been a common problem for trade sanctions and are likely to be a problem for loan sanctions as well. The frequent lack of international agreement about whether a dictator should be pressured or not provides grounds for skepticism about Jayachandran and Kremer's proposal that an international organization have the authority to declare when a regime is officially odious, as does historical experience with such institutions, which tend to be controlled by the states that fund them.²²

Conclusion

Loan sanctions pressure dictators to give up power and may deter would-be dictators from taking power in the first place, but they also harm the dictatorship's public when dictators are not deterred and interfere with diplomatic efforts to obtain cooperation from dictators in matters of general interest. The odious debt doctrine as currently formulated and defended does not take account of all morally relevant factors.

The traditional backward-looking defense of the odious debt doctrine, which suggests that the doctrine is costless because it releases a suffering population from an unjust debt, is seriously incomplete. Our model makes clear that because the dictator controls the government, the doctrine necessarily harms the public if it is to affect the

²¹ Hufbauer, *supra*, at 94-105.

²² They propose this institution in order to reduce uncertainty, so that creditors will not refrain from lending to a deserving nation for fear that it will subsequently be declared odious. See also Seema Jayachandran, Michael Kremer, & Jonathan Shafter, *Applying the Odious Debts Doctrine while Preserving Legitimate Lending*, *Ethics and Inter'l Aff.* (forthcoming 2006). For reasons given in the text, we are skeptical about the viability of such an institution. On this problem, see Paul Stephan, *The Institutional Implications of an Odious Debt Doctrine* (Draft, 2006).

incentives of the dictator. Although in specific cases the benefits of loan sanctions may exceed the costs, the defenders of the doctrine have not made the empirical case that the net benefits are sufficiently high in the aggregate as to warrant routine application of loan sanctions to odious dictators. In the absence of such a showing, there is no reason to think that the odious debt doctrine would be a desirable rule of international law.

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