Debt Audits and the Repudiation of Odious Debts

James K. Boyce and Léonce Ndikumana,[1]
Department of Economics and Political Economy Research Institute (PERI), University of Massachusetts Amherst

James Boyce and Léonce Ndikumana are co-authors of Africa's Odious Debts: How Foreign Loans and Capital Flight Bled a Continent *(2011) and teach economics at the University of Massachusetts, Amherst. Léonce Ndikumana is Director of the African Policy Program at PERI. James K. Boyce is Director of PERI's Development, Peacebuilding and Environment Program.*

African countries continue to rely on external borrowing to fill their resource gaps in financing development. By 2010, the total stock of external debt outstanding for the continent stood at $297 billion and its annual debt service bill was $22 billion. To the extent that debts are used for productive purposes, the direct and indirect returns for the debt-financed investments should enable the debtor countries to honor their debt obligations. In practice, however, foreign loans are often either squandered on ill-designed projects or even worse embezzled to finance private wealth accumulation in offshore centers.

When African governments borrow in the name of their countries and their people, they are expected to do so if, *ex ante*, the expected benefits from the loans outweigh the costs of loan repayment. They are supposed to act in good faith in the interest of the people they represent. The lenders, in turn, are expected to exercise due diligence so that they issue loans when they have sufficient evidence that the activities being funded will yield adequate returns and that the borrower has established adequate institutional arrangements to ensure proper execution of the projects. Having issued the loan, the lender is expected to monitor the use of the proceeds and take corrective measures as needed. Due diligence and monitoring are key tools for minimizing default, which ultimately is in the interest of both the borrower and the lender.

In practice, however, public debts often benefit less the people of the debtor countries than the government officials entrusted to manage them as well as their bankers. Some of the debts accumulated by African countries have financed genuine projects that have contributed to economic and social development. However, some of the debts did not. Analyzing the relationship between inflows of external borrowing and outflows of capital flight, we found that roughly fifty cents on each borrowed dollar exits the country in the same year – a finding that suggests substantial debt-fueled capital flight (Ndikumana and Boyce 2011a, 2011b).

Debts from which the people derived no benefit, and which were contracted without their consent, in situations where the creditors knew or should have known these circumstances, can be classified as 'odious' debts under international law. In current practice, however, all debts are shouldered by African populations until fully paid, whether they benefited from them or not.

Of course, sorting out which loans served legitimate development purposes and which were odious can be a monumental task. But a well-organized systematic audit of external debts can help shed light on the legitimacy of external debts and establish objective grounds for selective repudiation of odious debt. This paper discusses how this can be done and the potential benefits for Africa, its creditors, and the global financial system.

1 The authors are grateful to Theresa Owusu-Danso for excellent research assistance.

Debt audit, its scope and purpose

International networks and organizations, including the Jubilee Movement, continue to press for an international system of fair and transparent arbitration for dealing with illegitimate debt and default. Debt audits would be an indispensable tool for making such a system effective.

A national debt audit involves a thorough examination of a country's external debts with the aim of establishing their legitimacy and identifying the benefits derived in terms of social and economic development as stated in the official initial justifications of the loans by the debtor government and its lenders. A debt audit focuses on three important sets of principles:

(1) *Legal principles:* This analysis scrutinizes the conditions of the debt contracts and assesses whether they conformed to the laws of the borrowing country, the laws and rules of the lending institutions and governments (e.g., provisions of the Securities and Exchange Commission in the case of the United States), and international law.

(2) *Equity and ethical principles:* A debt audit also investigates whether the loan procedures followed the principles of responsible lending, including due diligence and monitoring of the use of the loan proceeds, and whether appropriate measures were taken to protect the interests of both the borrowing nation and the lenders. It also investigates any evidence of undue coercion on the borrower and aims to establish whether external debts were contracted with the consent of the people, i.e., through appropriate authorization, such as parliamentary approval.

(3) *Developmental criteria:* Finally, a debt audit seeks to establish whether loans were utilized to serve the interest of the people, i.e., whether they financed *bona fide* development programs. The audit examines whether the loans were in line with the country's overall development strategy and the lenders' stated developmental goals, and whether they ultimately benefited the people.

To be successful, debt audits must be implemented objectively, methodically, thoroughly, and transparently. Success requires strong political leadership in addition to popular support. Table 1 summarizes the key steps of the debt audit process, the material covered, and the areas and subjects to be investigated.

The most significant example of a systematic debt audit was that of Ecuador in 2007-2008. Following sustained campaigning by civil society organizations, in July 2007 Ecuadorian President Rafael Correa established the Internal Auditing Commission for Public Credit, an independent entity, to undertake a comprehensive audit of the country's foreign debts. In September 2008, the Commission submitted its report, which showed critical issues for some of the country's debts. The report found numerous irregularities, ranging from the use of two-thirds of borrowing to finance military expenditures by the dictatorship that ruled the country in the late 1970s to the negotiations over the subsequent restructuring of the debt as global bonds (Jubilee USA 2008).

The report concluded that creditors imposed unfair conditions on the country in connivance with corrupt national leaders: "*Multinational organisms, foreign banks and other lenders, with the participation of national authorities and officials, imposed their conditions on the country, forced it to accept a higher level of debt and successive 'restructuring' procedures that were not transparent and that generated the transfer of private debts to the State.*" (Ecuador, Internal Auditing Commission for Public Credit 2008, 132)

On the basis of the findings of this report, Ecuador unilaterally defaulted on more than $3 billion in global bonds. In June 2009, the country reached an agreement with foreign creditors to buy back more than 90 percent of its defaulted debt at 35 percent of its face value (Economist 2009). President Correa

announced that this would save the government approximately $300 million per year in interest payments. In 2010, Ecuador's total external debt service payments were less than half their average level in the previous four years.

Table 1: Key Components in National Debt Audits

Component	*Description*
General conditions	Evolution of the rules and regulations of the monetary authority; evolution of the debt stock; financial flows of resources and associated conditions; main creditors, intermediary agents, final borrowers.
Legal analysis	Approval procedures; general conditions of contracts; special conditions of contracts; clauses and conditions under the law and international principles.
Analysis of evidence	Volume and destination of resources; characteristics of funded projects; objectives; time of execution; rate of return; verification of necessity; criteria of prioritization of projects; beneficiary sectors.
Procedural aspects	Audit period; scope of the debt to be analyzed; Composition of the audit commission and technical expertise; information sources; reporting; publicity; transparency mechanisms.

The example of the Ecuadorian experience has not been lost on other indebted countries. In Latin America, the President of Paraguay has decided to initiate an exhaustive audit of his country's external debts. Similarly, the Bolivian Parliament has passed a resolution to set up a commission to review Bolivia's debts.

In Tunisia, following the fall of the Zine el-Abidine Ben Ali regime in 2011, the new government vowed to challenge the legitimacy of inherited debts (Madraud 2012). In June 2012, President Moncef Marzouki refused to endorse a proposal for an increase in Tunisia's quota share in the IMF (by about $370 million), pending passage of a bill to audit the debts incurred under the Ben Ali regime. The bill authorizes an investigation to determine whether the debts were used in the interest of the country or as an "instrument of dictatorship and repression," the new President told the *Agence Tunis Afrique de Presse* (Ennouri 2012). If Tunisia follows through, this will set a historic precedent that other African countries may emulate.

On the donor and lender side, the Norwegian government has been in the forefront of efforts to address the issues of responsible lending and odious debt. In August 2012, it announced plans for an independent audit of all bilateral debt that nine developing countries have with Norway. The aim is to promote financial transparency and to test the Principles on Promoting Responsible Sovereign Lending and Borrowing, which were launched by the United Nations Conference on Trade and Development (UNCTAD) in April 2012.

Odious debt repudiation

Debt audits can help distinguish between debts which are legitimate and those that are not, on the basis of the legal, ethical, procedural and developmental criteria described above. They can thus establish a basis for declaring selected debts as odious and therefore fit to be considered for unilateral repudiation.

Historically the term 'odious debts' was first used in reference to 'war debts' or 'hostile debts.' Thus at the conclusion of the Spanish-American War, the United States Government, which had gained control over the colonies of Cuba, the Philippines, Puerto Rico, and Guam, rejected the Spanish claim that the new Cuban government should repay the debts inherited from the past regimes. The key argument advanced by the U.S. negotiators was that the debt "had been imposed on the people of Cuba without their consent and by force of arms" and that "the creditors, from the beginning, took the chances of the investment." The United States prevailed, and the new Cuban government was relieved of the debt inheritance, while the creditors were left to attempt to recover their dues from the Spanish government (Wong 2012, 5).

More recent cases include the write-off of Iraq's debts following the fall of Saddam Hussein. It was argued that it would be unethical to require the people and the new government of Iraq to bear the burden of repaying the loans incurred by a dictatorship that used borrowed funds to build its repressive apparatus. The debts were repudiated and the successor government was given a clean slate to begin mobilizing financing for development.

The legal doctrine of 'odious debt' was first codified by the scholar Alexander Nahum Sack (Sack 1927). In the most commonly used definition, a nation's debt can be considered odious if (1) the debts were incurred without the consent of the people; (2) the loans were not used for the benefit of the people; and (3) the creditors were aware, or should have been aware, of the above two conditions.

Some debts are virtuous in the sense that the benefits to the people of the country exceed the costs. One would hope that is the case for the majority of loans that finance *bona fide* economic and social development programs. Other debts are onerous in the sense that the costs exceed the benefits. Onerous debts take two types. The first is imprudent loans, where the funds were used to finance ill-designed projects or 'white elephants,' but the loans were actually used in the country for arguably legitimate purposes. The second type is odious debts, which include loans that financed the criminal accumulation of private wealth and loans used to finance a dictator's repressive apparatus. Systematic debt audits can help to categorize past debts and provide an objective and transparent basis for repudiation of odious debts (Ndikumana and Boyce 2011a).

Arguments and counterarguments

Criticisms of debt audits and debt repudiation, whether well founded or not, have held back efforts to address the legacy of illegitimate debts and advance the agenda for responsible lending. As of today, there is no international body formally charged with debt arbitration. Debtor countries are left at the mercy of the powerful creditor clubs and vulnerable to exploitative transactions and claims.

One criticism is that debt audits may amount to a politically motivated 'witch hunt' used by current governments to settle scores against former rulers. Secondly, it is sometimes alleged that the audit process cannot be fair if audit commissions include representatives of anti-debt organizations with biased views against lenders. Thirdly, critics argue that it is not really in the best interest of debtor countries to engage in debt audits, let alone debt repudiation, because they would be penalized by financial markets and lose access to further loans. Finally, there are concerns that debt repudiation would encourage irresponsible borrowing by governments in the expectation that debts might not have to be repaid in the future.

Concerns about the objectivity of debt audits can be alleviated by ensuring representation of all key stakeholders from both the debtor country and the lending institutions and governments. The credibility of the process rests on transparency, independence, fair representation, and appropriate expertise.

The threat of credit rationing is in practice a paper tiger. Many severely indebted countries currently pay more to their creditors than they receive as new loans. The result is a negative net transfer. For these countries, a zero net transfer would be an improvement.

In addition, a well-executed debt audit can be a mark of strong and effective national leadership. By freeing resources from the servicing of odious debt, the government becomes better able to support productive investments that will improve its economic performance in subsequent years. Such positive effects were demonstrated in the case of Ecuador, which recorded higher growth in the post-repudiation period, despite condemnations from financiers who labeled President Correa a 'leftist' and Ecuador a member of the 'axis of evil' in Latin America' (Anderson and Watkins 2008). If economic conditions improve, lenders will in fact return to seek higher returns on their investments.

Finally, repudiation of odious debt, if properly implemented, is selective rather than indiscriminate. Creditors who lend in good faith for legitimate projects have no reason to fear a fair and transparent process, and no cause to withhold new lending. Indeed by freeing governments from the burden of servicing illegitimate debts and strengthening incentives for responsible lending, the strategy yields a better climate for legitimate borrowers and legitimate creditors alike.

But if debtor countries are likely to benefit from debt audits and selective debt repudiations, why have African governments not taken advantage of this opportunity? If the process is likely to lead to lower risks in international lending, a more stable global financial system, and increased gains from international development assistance, why have more lenders and donors not supported it?

These are good questions. The answer lies in large part with leadership. The gains from debt audit and selective repudiation will accrue mostly in the medium to long term through improved fiscal governance and economic performance. Investing in these gains requires a future-oriented leadership that is committed to the interests of the people. If, in contrast, leaders are more concerned about meeting short-term financing needs–or worse, about profiting personally from more irresponsible borrowing at the people's expense–it may indeed make more sense to placate the lenders.

Lenders and donors, in addition to fearing the write-down of assets from debt repudiation, may be reluctant to set precedents even when they believe that some debts are indeed odious. But such fears that debtor governments may abuse the privilege of debt repudiation can be alleviated by establishing an independent international arbitration agency, as part of the international financial architecture. Such an agency, the creation of which is long overdue, can assist in the debt audit process and in the adjudication of contentious cases of debt repudiation.

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