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Debt relief by internationalizing Chapter 9 insolvency proceedings

Aid has frequently been abused to bail-out either private banks, IFIs or donors themselves for too many years. In such cases it has been given with the main objective of keeping creditors afloat rather than mainly promoting economic development. Nevertheless 'donors' recognize it as aid. Unless the debt problem is solved, this abuse is bound to go on. Debt relief is both necessary to free resources for development and to remove the disincentive to private economic activity posed by arrears of unserviceable debts.

The case for debt relief has become very strong after the Mexican fiasco in 1995, when the optimistic claim that the debt crisis was over, at least for Latin American countries with renewed 'market access', became untenable. The $50 billion price tag for the stabilization of Mexico also proved convincingly that the costs of further debt crises could be very high. On the other hand all banks - even US money centre banks - have meanwhile provided for their remaining exposure to SCs ?Southern Countries?. The debatable argument of the 1980s that debt reduction would lead to a crash of commercial banks and to an international financial crisis has long ago lost any validity it might have had initially. The need to find a permanent and viable solution of the debt problem makes itself felt again in a most forceful way.

This need was also seen by G-7 governments and politicians. The option of some kind of international bankruptcy was discussed informally before the Halifax Summit of June 1995. In contrast to the 1980s, when it was initially proposed, international insolvency is seen with more sympathy in 1995.

Shortly after the Mexican crash the Chairman of the Federal Reserve System, Alan Greenspan, suggested thinking about an international insolvency as an appropriate mechanism to settle the debt problem. The *Financial Times* reported that US Treasury Secretary Robert Rubin said he carefully avoided the term 'international bankruptcy court' but that some procedures to work out the debt obligations of debtors were needed. In an article in the *Wall Street Journal* of 10 April 1995 Rep. Jim Leach, the Chairman of the House Banking and Financial Services Committee, recommended international insolvency proceedings: 'What is needed today is a Chapter 11 [insolvency of firms] process for the global financial system, a technique to keep nation-states and their people from the impoverishing implications of insolvency.' Mentioning the little known Chapter 9 proceedings [for debtors with governmental powers, so-called municipalities] briefly, he specifically emphasized its basic understanding that (local) government must continue to function. US Chapter 9 is therefore particularly well suited for sovereign debtors. Its essential elements are participatory, fair, democratic, and economically viable procedures safeguarding

human dignity. In short, it would embrace all the principles advocated and proposed by the donor community under the heading of political conditionality.

Nevertheless Northern governments are not keen to introduce a solution so obviously in line with their own preaching. International insolvency was not mentioned at the Halifax G-7 meeting. Interestingly the German government opposes any insolvency proceedings particularly strongly, although Germany itself benefitted from very generous debt relief in the 1950s. The so-called London Accord halved the present value of Germany's foreign debt in a *de facto* insolvency, putting the country on the road to reconstruction and economic success. Furthermore Indonesia was given the same treatment at the end of the 1960s (cf. Raffer, 1990a) with active support of the German government, which also went along in the case of Poland. Germany's present opposition to treating other countries in the same way it was treated by its own creditors is therefore somewhat peculiar. It is difficult to see Germany's citing moral and economic reasons as perfectly honest arguments.

DAC-governments considering any form of insolvency proceedings for sovereign debtors want the IMF to act as the bankruptcy court. This is a very dangerous and ill-advised proposal. First, the IMF, as well as all other IFIs, is itself a creditor. Furthermore it is controlled by a majority of creditors. This would remain so even if the Fund stopped lending to SCs and all its own claims were settled before proceedings started. According to any decent legal system and in fact the principle of the rule of law itself this contradicts the requirements of a fair, equitable and impartial procedure.

Second, present Structural Adjustment policies have not been able to achieve any lasting positive results, although the IMF started adjustment policies (see Chapter 12) as early as after 1973. In the case of Mexico IFI policies since 1982 have brought about an even bigger debacle than the crises of the 1980s. Applying the most basic principles of a market economy to the IFIs themselves would make a discontinuation of these policies mandatory, particularly so as even IFIs agree that they have created great hardship.

Debtor countries' debt services have to be brought in line with their abilities to pay under present, protectionist conditions, while safeguarding a minimum of human dignity of the poorest. The fairest and economically most sensible way to do so would be the internationalization of Chapter 9 of US insolvency laws. As this idea, initially proposed in 1987, was elaborated in detail elsewhere (Raffer, 1990a) the essential elements of this solution with a human face are presented briefly. It deals with debtors having governmental powers, and protects those affected by the composition plan, giving them a right to be heard. Both the indebted municipality's employees and tax payers expected to pay more have the opportunity to object. Creditors are to receive what can be reasonably expected under the circumstances, and humane living standards of people living in the indebted municipality are protected.

The essence of this kind of debt relief, which contrasts vividly with the treatment debtors with governmental powers receive at present, recommends itself as a solution to the international debt crisis. Chapter 9 insolvency combines necessary debt relief in general with the flexibility demanded by individual cases, accommodating the case-by-case approach within a general framework. It could be applied internationally at once with very minor changes. Thus a neutral court of arbitration - as usual in international law - would have to replace national courts to avoid decisions influenced by national interests of creditor or debtor countries. The interests of the

population affected by the plan could be defended by trade unions, grassroots organizations, religious or non-religious NGOs, or international organizations such as UNICEF. This right to be heard in fair and equitable proceedings and the possibility of describing the expected effects on the poor in public would certainly have mitigating effects, contributing to an adjustment with a human face. Besides the arbitrators would have to take particular care to ensure that a minimum of human dignity of the poor population in the debtor country is safeguarded - exactly as the court would do in a US Chapter 9 insolvency case. This law has been successfully applied within the US for decades and there is no reason why it should not be applied to sovereign debtors. It differs very strongly from the solution allowing the IMF to function as the court.

Where the removal of protectionist barriers can be expected to lead to higher export revenues a trade-off between more repayments and less protection or higher debt reduction without reduced protection is necessary. Strictly symmetrical treatment of all creditors including IFIs is necessary as a means to increase allocative efficiency.

Unquestionably a need for reform within debtor countries exists. These reforms, monitored by the council of arbitrators - or if the Marshall Plan model of self-monitoring were adopted for SCs by an appropriate body within this framework - should adjust the debtor to the real international environment, not to a textbook illusion of 'free markets'. Realistic strategies have to drop the BWIs' predilection for one-sided liberalization by those countries that can be forced to do so. Import substitution should be encouraged where economically viable to form the basis of future economic diversification. Monitoring by the arbitrators, agreed upon in the plan, could help to overcome the problem of petrifying protection. Protection should allow domestic industries to compete with imports, and should be reduced as domestic industries become more efficient. The real experiences of successful East Asian countries (as opposed to the IBRD description of them) would be highly useful even though adapting rather than copying would be required. The Japanese perception that development strategies must take a country's specific characteristics and history into account must serve as the basis of pragmatic economic policies.

The introduction of Chapter 9 insolvency would make private lenders make loans basically if repayments can be expected from proceeds. Debts which have to be serviced out of the budget would and should remain the exception. Commercial lenders would stop lending if previous loans are not put to efficient use, as they would be sure to lose their money eventually. Briefly put, if international insolvency procedures had existed in the 1970s the burden of debt would be much lower, maybe there would not even be a debt crisis.

Financial accountability of donors

Reducing official bi- and multilateral debts by an international Chapter 9 insolvency would automatically introduce an element of financial accountability of donors and IFIs. Accumulated bad projects financed by loans or a string of unsuccessful programmes would eventually lead to insolvency reducing these creditors' claims. As donors and particularly IFIs control the use of loans, this would be a highly positive result. While the importance of decisions by donors and IFIs may vary from country to country, as well as over time, it has always been particularly strong in the poorest countries. Lack of local expertise to participate appropriately in decision making as well as high dependency on aid inflows are the reasons. Using a term coined by Svendsen (1987, p.27) we may call debts accumulated by such countries as 'creditor-determined'

or (mainly) the result of creditors' decisions. The present practice of letting 'recipients' pay for failures of their creditors is particularly unjustified in these cases.

As there is no sufficient proof that present Structural Adjustment or IMF programmes work while there is substantial evidence of their negative effects - even IFIs agree, for instance, that the poor were hurt considerably or that the effects on capital formation endanger future development - they should be discontinued. Strictly logically it does not even matter whether programmes do not work because of failures and inconsistencies, which appears to be the case (cf. Chapter 11), or because IFIs cannot make them work in SCs, as documented by their failures (cf. Chapter 12). There is no economically valid point to fund something that does not work but harms. Discontinuing programmes would also have the doubly beneficial effect that aid presently used to repair damages done by them would be free to be used in an economically better way. Present Structural Adjustment should be replaced by an international Chapter 9 insolvency, necessary and adequate reforms should be effected within this framework.

Discussing financial accountability one need differentiate between programmes and projects. As it is practically impossible to determine the fair share of one or more IFIs in failed programmes, Chapter 9 insolvency procedures provide a clear and simple solution, monitored by independent outside experts as suggested in Chapter 11. IFIs should lose the same percentage of their claims as other creditors. In SCs with high IFI involvement, which have been forced to orient their policies according to IFI 'advice' for quite some time, this is particularly needed and justified. As the shares of multilateral debts are relatively higher in the poorest countries, protecting IFIs from losses is done at the expense of particularly poor clients, often highly dependent on solutions elaborated by IFI staff.

As a consequence the IMF could either be dissolved or re-directed to other tasks unconnected to development. Both proposals to merge the Bretton Woods twins into one institution and proposals to take the Fund out of the development business have already been made, so this is not a wholly new thought.

Although an improvement, symmetrical treatment is not a satisfactory solution to the problem of financial accountability of donors and IFIs. In the case of projects accountability must go further. As errors can often be isolated and proved with less difficulty donors and IFIs should be liable for damage done by them in the same way private consulting firms are liable to their clients. The present practice of 'IFI-flops securing IFI-jobs' (Raffer, 1993, p.158), to some extent also valid for donors, must stop.

Economically viable projects that earn their amortization and interest payments pose no problem. If a project goes wrong the need would arise to determine financial consequences (cf. ibid.). In the simplest case borrower and lender(s) agree on a fair sharing of costs. If they do not the solution used between business partners or transnational firms and countries in cases of disagreement could be applied: the decision of a court of arbitration. This concept is well introduced in the field of international investments. If disagreements between transnational firms and host countries can be solved that way there is no reason why disputes between donors or IFIs and borrowing countries could not be solved by this mechanism as well.

A permanent international court of arbitration - different from insolvency arbitration mentioned above, but composed in the same way - would be ideal. If necessary this court might consist of

more than one panel. It decides on the percentage of the loan to be waived to cover damages for which the IFI is responsible. The right to file complaints should be conferred on individuals, NGOs, governments and international organizations. As NGOs are less under pressure from IFIs or member governments their right to represent affected people is particularly important. The court of arbitrators would of course have the right and the duty to refuse to hear apparently ill founded cases. The need to prepare a case meticulously would deter abuse. The possibility of being held financially accountable would act as an incentive for donors and IFIs to perform better and protect the poor from damages done by ill-conceived projects.

Last but not least it must force donors and IFIs to respect human rights when financing projects, enabling victims of aid projects to receive damage compensation. Quite often people living on land wanted for development projects are expropriated without proper or even any compensation. Forced resettlements occur to make room for dams, highways or harbours, but also for BWI conferences. The Morse Commission concluded 'that the abuses in Sardar Sarovar were not an isolated exception, particularly with respect to the mistreatment of thousands of forcibly resettled rural poor: "The problem besetting the Sardar Sarovar Projects are more the rule than the exception to resettlement operations supported by the Bank in India."' (Rich, 1994, p.252)

According to Cernea (1988, p.44) about 40 IBRD projects 'will cause the relocation of at least 600 000 people in 27 countries' during 1979-85. He warns however that 'the number of people needing to be resettled is *chronically underestimated*.' (*ibid*., p.45, stress i.orig.) The author concedes that forcefully resettled people often get a raw deal, which allows the project to be implemented more cheaply. If they get any their compensation it is often inadequate, leading to impoverishment, particularly so in the case of dams. Cernea cites the destruction of productive assets, higher morbidity and mortality, ecological desaster and the destruction of social structures as effects of development projects with compulsory resettlement. Susan George (1988, p.158) reports that people resisting resettlement under the huge Indonesian transmigrasi project were crushed by security forces. In several countries people unwilling to clear their land for large development projects were killed. While NGOs blamed police or military death squads, governments did not find any proofs for such accusations.

While IFIs and donors keenly preach human rights or respect of private (especially foreigners') property they have not seen great problems in financing projects violating these values, particularly so when the victims were indigenous people. The right of victims to make donors accountable for what they facilitate is needed to improve the lot of the poor, whose human rights and sometimes whose lives are too often considered unworthy of respect by their governments as well as their governments' public financiers.

Financial accountability would thus be beneficial to donors and IFIs themselves. It would give their staffs a good argument against pouring money into regions just because of lending targets as well as against political interference by important politicians or shareholders including demands to bail out other creditors. Projects and programmes actually financed under these conditions of accountability would therefore have a much better success rate and more positive impacts on development.

The root of the problem, non-accountability and the systemic failures it causes, would be eliminated. Bilateral donors have already acknowledged the necessity of debt relief for quite some time by reducing official debts. IFIs, by contrast, still do not. Naturally it would cost IFI-

shareholders something to clean up the failures of the past but there is no more reason to spare IFI-owners than any other shareholders of a firm. But as Mexico proved convincingly, a big bail-out costs money as well. If development banks cannot survive being financially accountable dissolving them would be the economically indicated solution, because no project at all is preferable to a costly flop - at least for those who have to pay for it. If subject to economic scrutiny and damage compensation claims the amount of ODA might, and IFI-activities will, strongly decrease to fewer but economically more viable projects. Considering the increasing involvement of IFIs in Eastern Europe and the former Soviet Union the problem of efficiency and accountability becomes even more important. Pouring money there just to meet regional targets would certainly not be indicated.

Financing institutional reforms and social agenda by grants

The close scrutiny of how loans are used, which would result from implementing the proposals made above, does not mean the end of concessional lending. Nor does it mean the end of financing social agenda or projects in the poorest countries. In the case of concessional interest rates debt service can be covered with relatively lower income streams. As shown in the last Chapter institution building, social agenda and projects for the poor must be financed by grants unless a recipient is sufficiently liquid, which is however extremely unlikely in the case of most SCs.