THE ROADBLOCK TO A SOVEREIGN BANKRUPTCY LAW

Jeffrey D. Sachs

Bankruptcy law is a necessary feature of a modern economy, and the principles for a bankruptcy apply whether the debtor happens to be a sovereign or not. The essential point is that markets cannot handle situations of extreme financial distress or debtor-creditor workouts in an efficient manner without a sound legal framework. Indeed, Adam Smith himself was a champion of applying bankruptcy processes to insolvent sovereign debtors, arguing that when the situation warranted it, bankruptcy was a sensible alternative to the chaotic ways that sovereign insolvency was otherwise handled.[1] Thus, the fact that the private financial community continues to oppose a sovereign bankruptcy law is quite unconvincing, especially since an enormous number of countries has had a sovereign workout at some point in history.

Debt Relief to Promote Growth and Democracy

When the Berlin Wall fell and I was advising the Polish government on how to handle the debt it inherited from the Soviet Union, I knew that we needed to get the debt canceled so that free post-communist Poland would have a chance to resume economic growth, regain social stability and develop its democracy. The big opponent at the beginning was Germany, so I went to the Library of Congress and took out the 1953 London Debt Agreement that granted Germany a

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[1]In Book V, Chapter III of *The Wealth of Nations*, Smith ([1776] 1937: 883) writes, "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both the least dishonourable to the debtor, and least hurtful to the creditor."

substantial reduction of its pre-war and post-war debts to allow the new German government to function and to consolidate democracy. I gave the Polish Finance Minister Leszek Balcerowicz a copy of the London Debt Agreement for his meeting with Chancellor Kohl. At first the Chancellor rejected the idea of debt forgiveness, but when Balcerowicz handed him the London Debt Agreement, he looked at it and said, "Well, we may have to do something about this indeed!" Germany then became a supporter of Poland's debt cancellation and the rest is history.

Although there have been dozens of cases in which bankruptcy-type principles were eventually applied, there has never been a proper system for dealing with them. Managing sovereign insolvency is all politics—whose favored pupil or geopolitical ward you are, or perhaps whose enemy you are. Countries of special geopolitical or military concern to the United States get special treatment. Israel and Egypt got debt cancellations from the United States, as did Indonesia in 1969. Poland, the bulwark of NATO and Eastern Europe, got its debt cancellation. Quite obviously, these debt cancellations were driven by politics, foreign policy, and the interest of the major governments. But other countries needing help like Tanzania, Ghana, Malawi or others in acute distress often need to wait 20 years or more before receiving the kind of treatment that a more influential country receives in short order. It is too late to protest the basic concept of debt cancellation for insolvent sovereigns—since a great many countries of the world have availed themselves of this opportunity at one point or another in their history—and it is far too late to say that the current nonsystem is fair, efficient, or logical, rather than being fundamentally political.

The Social Benefits of Bankruptcy Law

Bankruptcy law exists because the decentralized actions of creditors cannot do the two things that bankruptcy law is designed to do: handle collective action problems (arising when multiple creditors confront an insolvent debtor) and spread risk in a world of incomplete financial contracts. In other writings (e.g., Sachs 1995), I have put enormous stress on the collective action problems at all stages of a multicreditor workout (preventing a creditor grab race at the onset of insolvency, permitting debtor-in-possession financing in the course of a workout, and avoiding strategic holdouts in the context of a final settlement). But it is equally important to stress the role of risk spreading as well, which is quite distinct from the problem of collective action, and indeed can arise if there is only one creditor. The discharge of debt under bankruptcy is a form of risk spreading, since it is a way to release debtors from the most extreme and egregious states of nature, essentially regardless of how they got there. Before bankruptcy law existed, all of the property and even the sovereignty of the insolvent used to be confiscated. Insolvent individuals were literally put into slavery or into a servile position vis-à-vis their creditors, in order to maximize the repayments from the debtor to the creditor. Nowadays, the standard is no longer the maximization of repayments because the interest in preserving the sovereignty of the debtor is held to be paramount.

We have realized that from an *ex ante* point of view it is more efficient (beyond the mere moral issue) to protect the freedom of an individual (or in the United States, of a municipal) borrower, rather than risk the chance that the borrower might lose its very sovereignty in the event that the debts can not be repaid. From the point of view of *ex ante* expected utility, it does not make sense to permit the risk that an individual eventually loses his freedom as a result of insolvency, or that an overly indebted government is unable to function. Thus, from the start, a loan contract should embrace the possibility that the debt may have to be canceled. In a world of complete contracting, a loan contract would spell out the conditions under which a loan will indeed be canceled. In practice, bankruptcy law does that instead by laying out legal principles for the discharge of debt of both individuals (Chapter 7 and 13 in the U.S. Bankruptcy Code) and sovereign borrowers (for municipalities in Chapter 9 of the U.S. legal code).

The municipality chapter of the U.S. bankruptcy code, Chapter 9, says that cities under bankruptcy do not have to sell all of their possessions; they do not have to liquidate their assets; and they do not have to raise taxes at the demand of the creditors in order to pay everything possible. Indeed, the court may not interfere with the exercise of the municipality's political or governmental powers. There is no expectation that repayments are maximized, but rather that the plan of municipal debt restructuring (and debt discharge) represents a reasonable effort of the debtor. The goal is to preserve the functioning and the autonomy of the municipality due to the vital public services that it renders.

The High Costs of Failure to Adopt a Sovereign Bankruptcy Law

Today there is no mechanism in place to resolve sovereign debt crises in a timely fashion. When countries fall into extreme duress they are dragged for years and years and told to liquidate ("privatize") whatever assets are possible, no matter how terribly they collapse. In the poorest countries, the cost of debt servicing is literally death, because the debt service is coming at the cost of closing down health services and failing to meet people's most basic needs.[2] Roughly 8 million people die every year of readily preventable and treatable communicable diseases in these poor countries, according to the conclusions of the Commission on Macroeconomics and Health of the World Health Organization. The overhang of excessive debt is certainly not the only or even main cause of this public health disaster, but it is certainly a contributing factor. And the debt continues to be collected from these countries, at the cost of mass suffering, because the existing debt management process does not include effective means of risk sharing in the event of sovereign debt crises.

Creditor Opposition

The world community needs a sovereign bankruptcy process; we need risk spreading as well as collective action mechanisms for dealing with sovereign debt crises. Why hasn't this happened? It hasn't happened because at any given starting date for such a system, creditors are likely to suffer a capital loss. I do not think it would be a large loss, but it would be a loss nonetheless. That is what the private sector is concerned about, and it makes sense from their point of view to be concerned about it. What is true about this issue is that there is clearly a much more efficient approach to managing sovereign debt, but it is also true that getting there would likely involve a capital loss incurred by some existing creditors. New creditors would have a chance to factor a new pattern of default risks into asset pricing; existing creditors would see some of their existing loans written down in the interests of discharging insolvent sovereign debtors from their current agony. Of course, one could think about various transition mechanisms and compensation schemes to buy out the current resistance, but those would be very hard and complex to implement. The vested interests of current creditors, not the long-term merits and logic of reform itself, is what is stopping us from dealing intelligently with insolvent sovereign debtors, and most urgently the poorest of those countries.

[2]For a discussion of the debt crisis of the poorest countries, see Sachs (2002).

References

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