**Towards a Just Sovereign Debt Default Framework**

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# 1. Introduction

When a country borrows money from a lender, it becomes indebted and the borrowing amount becomes a sovereign debt. For the borrowing and lending of money at least two parties are involved: debtor and creditor. In the case of sovereign debt, the sovereign is the debtor. When the two parties engage in borrowing and lending, the debtor can use the money to fulfil its goals and the creditor will receive a return on its loan by the debtor over time. Several circumstances can prevent the sovereign to repay its debt. For instance, when natural disasters or financial crises lead to financial distress whereby countries cannot fulfil the next debt payment. When a country threatens to default, or actually defaults, it does not follow the same procedure as private agents. In sovereign debt defaults there is no uniform legal debt default mechanism that deals with these options.

The current sovereign debt default process can be characterized as ad-hoc in which the debtor country and different creditors have to negotiate about the financial and non-financial terms of the debt contracts. The lack of a well-ordered default mechanism has led to different treatments of government debt defaults and there is a wide range of differing outcomes, including the costs, the duration and the conditions.

One feature of the current process is that creditors can undertake legal steps to claim their share, aggravate the process that may even lead to defaults. The reason that individual creditors can undertake legal steps against debtors is that the current legal principle of respecting contracts is most important in sovereign debt in mostly less-developed countries (i.e. developing and emerging market countries), where most defaults occur.[[1]](#footnote-1) Respecting contracts can lead to unjust outcomes, high costs and different treatments between debtors and creditors. This leads to the central question of this thesis: what can be a more just framework and mechanism for sovereign debt defaults for all countries? Regarding framework, it is meant the justice structure to consider sovereign debt defaults. The mechanism relates to sovereign debt policies and governance that regulates sovereign debt defaults. In this thesis a justice framework will be proposed that is based on Nussbaum’s capabilities approach in which capabilities can be seen as rights. The related sovereign debt default mechanism is based on the U.S. legal bankruptcy regime where sovereigns can go bankrupt.

In chapter 2 the features and purposes of sovereign debt and the sovereign debt default process will be discussed. Additionally, in chapter 3 features of the current practice, whereby a distinction is made between legal and economic perspectives will be discussed. The feature of respecting contracts will be criticized, because it can lead to unjust and costly outcomes as individual creditors can sue debtor countries, thereby making default processes costly. In chapter 4 restrictions of current perspectives will be taken into account in discussing philosophical sovereign debt justice frameworks. It will be argued that due to the problems related to these frameworks, another justice framework will be proposed. This capability approach framework takes the restrictions of previous chapters into account. Lastly, a sovereign debt mechanism is proposed that should lead to a more just default practice.

# 2. Sovereign debt

## 2.1 Purposes and features

In the practice of borrowing and lending, two parties are involved: debtors and creditors. Borrowing leads to indebtedness of the borrower. Debt is called sovereign debt when the borrower is a state. Lenders can be commercial banks, bondholders or other public agents, such as countries. In general, governments borrow for the purposes of smoothing their short-term and medium-term transactions or investment in longer-term projects.[[2]](#footnote-2) The purpose of smoothening is when the expenditures and revenues of governments differ due to short-term differences in tax revenues and government spending or mid-term recessions. The other borrowing purpose of long-term investing, such as infrastructure, is due to the high expenditures related to the long period of investments. Government budgets are insufficient for these investments. Instead of increasing current taxes to cover all costs, governments borrow and share the costs with future citizens. The economic rationale suggests that the current investments will lead to extra productivity, economic growth and income, and thereby enhancing the future government revenues via increasing taxes so the extra debt can be serviced.

Although the aim of countries is to repay their debt, it is possible that a country becomes financially distressed, leading to its inability to repay. When this happens a debt default could occur. To prevent a debt default, countries can restructure their debt. Debt restructuring is defined as “an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new debt instruments or cash through a legal process.”[[3]](#footnote-3) When this is insufficient a debt default will probably possibly occur. Debt default is defined “as the failure of the government to make a principal or interest payment on due time.”[[4]](#footnote-4) All sorts of sovereign debt exist including a principal amount and additional interest payments, where the latter is the price for lending money. It was mentioned that the default will *probably* occur and this relates to a special feature of sovereign debt. Unlike private agents, such as individuals and corporations, countries cannot go bankrupt. Private agents can go to court and settle their debt with their creditors, whereas countries cannot settle all their debt contracts with their creditors via a bankruptcy court. Instead, they have to negotiate all their debt contracts with their creditors. There is no structured legal framework but an ad-hoc debt resolution process where the debtor negotiates the financial and non-financial terms with its creditors.

## 2.2 Debt default resolution

The resolution process of debt defaults has evolved over time. Before World War II (WOII), the main source of foreign financing was via the bond market and the main creditors were public and private bondholders. Debtors were legally protected and due to no international sovereign debt resolution, bondholders commonly lost money in the process.[[5]](#footnote-5) After WOII, government-to-government lending for developing countries was the only international financing opportunity. When financial trouble hit in the 1950s, western creditor countries formed the Paris Club. With this association, western governments jointly negotiated with the debtor country. Once the general agreement was negotiated, the debtor country also had to negotiate the specific details with each Paris Club member. Moreover, the debtor was required to seek comparable terms with the other creditors. Before the 1990s, the club did not grant debt relief to countries. However in 1996, debt relief arrangements was provided for the heavily indebted poor countries (HIPC) with the aim to reduce debt via post-relief sustainability for countries with unsustainable debts. Under coordination of the International Monetary Fund (IMF), debt relief programs are still implemented.[[6]](#footnote-6) The debt relief program is conditioned where developing countries need to comply before debt reductions can take place.

Multilateral creditors like the IMF were set up after WOII to stabilize the international monetary system, in which the monetary relations among the states were governed.[[7]](#footnote-7) The IMF was established to ensure global financial stability. From its inception, countries in serious financial trouble sought out IMF for financial assistance (also known as the ‘lender of last resort’). Countries then need to prepare and implement a stabilization program before the IMF steps in. An IMF program is also a precondition for a Paris Club negotiation. Thus, IMF only lends under certain conditions and demands policy changes by the debtor country. The organization can be seen as the unofficial leader of the creditors in debt defaults and crises, and has therefore a ‘preferred creditor’ status based on developed convention, not on its official mandate.[[8]](#footnote-8)

In the 1970s and 1980s the commercial banks were the largest creditors of sovereign debt to developing countries. Commercial banks lent money in this period to developing countries via syndication where many banks participated. The loan contracts were constructed where one default against a bank was a default against all banks.[[9]](#footnote-9) The syndicates formed Bank Advisory Committees (BACs) and London Clubs for negotiations with one lead manager of the syndicate of the debtor country.[[10]](#footnote-10) As bank loans were only written off when debtors were in default, there was an incentive to structure the debt where loans could still be serviced as the economy recovered. In the late 1980s some countries were still over-indebted after several debt restructurings. Commercial banks were pressured by the U.S. government to grant debt relief. This was done by exchanging the bank loans for long-term bonds as issued by the indebted countries with sizeable value decreases.

Although banks are still nowadays sovereign debt creditors, the main creditors have become bondholders from the mid-1990s.[[11]](#footnote-11) Compared to bank loans, government bonds are more liquid and easier to trade with, making the bond market more efficient. The international market for government bonds reemerged after WOII with developed countries as issuers.

Commercial and investment banks are the intermediaries in government bond markets, advising and arranging government bond issues. They also have another role as an investor. Together with institutional investors, they hold government bonds as investment in their portfolio. The investors find assets with good risk-return characteristics as to obtain a well-balanced portfolio and thus allowing for their customers to be repaid over time. Other investors like hedge funds have a shorter investment horizon where trading of government bonds can occur more actively. Their aim is to ‘beat the market’ and earn higher returns than the average investor.

When a country cannot service its debt, it defaults on government bonds. As the bond is a contract between bondholders and the government, the contract is unilaterally broken and stipulates what happens next.[[12]](#footnote-12) Bonds are valued on a daily basis and the losses therefore occur directly. As a result, every individual bondholder can try to collect the remaining contract. This is what Barry Herman calls the ‘race to the courthouse’. This leads to creditor litigation where individual creditors try to collect what is owed to them.[[13]](#footnote-13) If a default occurs, the country has already tried to restructure its debt without success. After the default, the sovereign debt will be restructured in a resolution process whereby the debtor negotiates with different creditors such as the Paris Club, the London Club and bondholder clubs. Moreover, the debtor will make restructuring plans for the IMF before financial support is given.[[14]](#footnote-14) The outcome of the negotiations, which include non-financial and financial terms, will be offered to all creditors where they can accept or reject the offer. When they reject the offer, they can individually undertake legal steps to enforce better terms on their debt claim. The voluntariness of creditors to participate in the default process may lead to problems, such as the ‘holdout’ problem, where individual creditors can frustrate the process by suing the debtor individually for the total debt amount.

Besides the difficulty of the process, defaults could also be costly for both parties. Debtor costs consist of capital market exclusion, higher borrowing costs, trade sanctions and potential domestic costs.[[15]](#footnote-15) The latter refers to the inefficient reallocation of capital that leads to lower economic activity of the country. Creditor costs consist of loss in the principal or interest payments that are called ‘haircuts’. Although debt defaults can be costly, they occur.[[16]](#footnote-16) In sum, the debt default resolution process can be difficult and costly. As there is no official legal framework and the process is ad-hoc, it raises the question of which principles are present in the debt default practice? Furthermore, can the current practice be qualified as just?

# 3. Legal and economic perspectives on sovereign debt defaults

There is no official sovereign debt default mechanism. Nevertheless, the lack of a structured default mechanism does not indicate there are no principles guiding the debt default process. Which ones drive the current process? In this section these will be discussed and derived from legal and economic views. Although both views are intertwined in the process, the separation is made to emphasize the different features of the sovereign debt process. Furthermore, it will be argued that the justness of the process can be questioned. The restrictions derived from the views in the debt process will be addressed and later, the justice framework will be discussed. Moreover, the political aspect in debt defaults falls outside the scope of this thesis.

## 3.1. Current legal perspective in sovereign debt defaults

In this section relevant legal principles will be discussed in relation to sovereign debt default practice, which relates to less-developed countries. With practice, the treatment of sovereign debt contracts is implied. The important principle of respecting contracts has some restrictions and these will subsequently be discussed.

### 3.1.1 Principle of respecting contracts

Debtors have become less protected in sovereign debt defaults. Before WOII, the sovereign immunity principle was the notion that protected debtors from creditors.[[17]](#footnote-17) The rationale behind sovereign immunity was the equality of nations under international law, which implied that sovereigns couldn’t have their disputes settled in one of their courts. The advantage from the perspective of governments was that private commercial interests were not involved in diplomatic and political relations.[[18]](#footnote-18) After WOII, the principle eroded due to the Cold War because the United States and Russia did not want to grant other sovereign entities immunity anymore. In the late 1970s this view was embodied in the Foreign Sovereign Immunities Act of 1976 that allowed private parties to sue a foreign government in U.S. Courts if the complaint related to commercial activity - sovereign debt is seen as a commercial activity. Sovereigns can be held legally accountable for breach of commercial contracts.[[19]](#footnote-19) In the 1980s the immunity principle had weakened. This deterioration of debtor protection can be illustrated by the increased number of litigation processes of creditors during the 1980s.[[20]](#footnote-20)

Currently, debt contracts have three main features.[[21]](#footnote-21) Firstly, they are rigid, which means debt is paid according to regular schedules without considering the changing circumstances of the debtor and creditor. Secondly, contracts are neutral and the purpose of the loan does not affect the claims of creditors. Thirdly, contracts are extensive in the sense that no present and future citizens of the debtor are protected against the repayment of loans.

By the weakening of the immunity principle, the basic norm that lies behind sovereign debt contracts is that contracts should be respected, also known as ‘pacta sunt servanda’.[[22]](#footnote-22) It is of most importance in less-developed countries and in defaults, mostly less-developed countries,[[23]](#footnote-23) the debtor breaches the contract and is under obligation to repay the full amount of the loan, and with additional interest stipulated by the contract. There is no legal place where debtors can claim that an obligation under the contracts should be considered invalid.[[24]](#footnote-24) In contrast to private individuals, sovereigns cannot go bankrupt because there is no legal mechanism settling sovereign debt contracts. Debtors have to renegotiate with creditors about the terms of contracts. Unless a creditor decides to ‘forgive’ a debt, it retains its full rights to claim it. [[25]](#footnote-25) Furthermore, the word ‘forgive’ suggests that the debt was the sole responsibility of the debtor and that the potential costs borne are with his account. The debt reduction comes from a voluntary action from the creditor side. However with the aim of debt restructuring for bondholders to achieve a high participation rate, debt restructurings can achieve high voluntary acceptance of creditors.[[26]](#footnote-26) The voluntary rationale can also explain the fact that there is no clear mechanism for sovereign debt default, because creditors can refer to their voluntariness and decide on a case-by-case basis what their action will be in the case of debt defaults.[[27]](#footnote-27)

The voluntariness of the negotiations and the focus on binding contracts are causes of the holdout problem. Creditors do not have to agree with the outcome of the negotiations and can unilaterally sue the debtor country for better terms in courts, such as London and New York.[[28]](#footnote-28) The increasing focus on contracts and their binding characteristics has led to the emergence of debt investors called ‘vulture funds’. These hedge funds buy government bonds from distressed countries, mainly on the secondary market against a ‘haircut’, and sue them for the initial amount, thereby aggravating the debt default process.

Argentina is an example of the consequences of the holdout problem. The country defaulted in 2001 and after four years of negotiation, the restructured debt was accepted by a majority of the creditors.[[29]](#footnote-29) In the subsequent years the country also reached agreements with other creditors—in 2006 with the IMF, and last year with the Paris Club.[[30]](#footnote-30) However, some bond creditors did not accept the restructuring and tried to force Argentina to pay the full amount. Vulture funds bought government bonds, listed in the U.S., on the secondary market and sued Argentina in the U.S. Court. Last year the U.S. Supreme Court decided that Argentina had to pay the full amount to the holdout creditors, thereby causing a technical default because when Argentina pays the holdout creditors, it should also pay the other creditors the full amount. Yet Argentina lacked the financial resources. By not paying the holdout creditors, it is technically in default. Argentina launched legal action against the U.S. at the International Court of Justice with the claim that the country restricts Argentina’s sovereignty via the U.S. Court decision.[[31]](#footnote-31)

### 3.1.2 Objections

The Argentina example shows that the sovereign debt process has restrictions and does not have to lead to just outcomes. Debtors also have other duties that are more important than respecting debt contracts. Countries must guarantee that they can provide essential resources and services to their citizens for an adequate standard of living. This ‘*sacrifice*’ argument will be discussed. Countries have other values that could be more important than respecting debt contracts. Countries need have the freedom to pursue their own ends. When a country is seriously deprived from this inability due to debt defaults, it can be argued that debt contracts can be outweighed. This second argument called ‘*self-determination’* will also be discussed. The third argument to be discussed is called ‘*contract* *conditions*’ and is based on that certain conditions have been met for entering contracts. However in sovereign debt, these conditions can be questioned.

The first argument is based on the assumption that sacrifices must be made by the debtor country to repay debt that are too high. The sacrifices relate to the citizens of the debtor country as that countries have primary duties to their citizens. When debtor countries need to cut back on their expenditures that inevitably affect citizens’ lives, this is then a sufficient reason for debtors to not respect their debt contracts. States must provide their citizens with enough food, shelter and other services to guarantee an adequate standard of living. Indeed, we can refer to entitlements or (social) human rights as norms that pose a viable objection against the principle of respecting contracts. As Kunnibert Raffer mentions, “that one must not be forced to fulfill contracts if it leads to inhumane distress, endangers one’s life or health, or violates human dignity.”[[32]](#footnote-32) Although it can be argued that (social) human rights serve as a legal principle in sovereign debt contracts, these rights are being neglected by lenders in less-developed countries in practice.[[33]](#footnote-33) The rigidity of contracts seems unjust because the costs of debt and defaults can be too high for the citizens of debtor countries. It is noteworthy to mention that in the 1930s, the governments of France and Great Britain used the sacrifice argument as a reason not to repay their debt.[[34]](#footnote-34) Giving its citizens their basic needs was more important than repaying their debt.

A reply to the argument may be that the causal relation between respecting human rights and debt-servicing is not obvious. There is no reason to assume that when debt servicing will be cancelled, the citizens will receive adequate support from their government. Governments are sometimes corrupt or not able to manage public resources.[[35]](#footnote-35) When governments face these serious challenges there is no reason to believe that countries will promote the lives of their citizens by debt cancellation. A first reaction to this reply is that the objection only is valid for corrupt, inefficient regimes. In the case of France a century ago, the sacrifice was due to the high debt coming from wars, not from a corrupt regime. Therefore the assumption was reasonable that not servicing debt would benefit the citizens of France. Secondly, even in the case of corrupt regimes the sacrifice may be too high and there can be a causal relation. If a regime is corrupt, it does not imply that there is no causal relation between not servicing debt and improving the living situation of a country’s citizens. However, the cancellation of debt service should be accompanied by additional policy requirements to guarantee benefits for the citizens. These extra requirements prevent corrupt governments to not spend the extra money for their own benefits.

The second argument is based on the inability of a debtor country to go bankrupt, so that the current sovereign debt default regime undermines the self-determination of states.[[36]](#footnote-36) Private agents can go bankrupt in the case of financial distress. The contracts that private debtors have with their creditors will be settled, thereby allowing the debtor to start again. The settled contracts have freed the individual from its financial ties and he can again interact with others on a free and equal basis. In sovereign debt, a state cannot go bankrupt and the contract remains. So when a state finds itself in financial distress, multilateral creditors, such as the IMF, become involved. Often states are required to come up and implement reform programs before the IMF provides financial assistance.[[37]](#footnote-37) Multilateral creditors then could dictate these reforms. For instance in the HIPC initiative, the IMF coordinated the process where poor countries need to fulfil reform criteria before they get debt relief. From its start in the 1990s and until recently, around half of the countries did not receive debt relief because the changed norms have not been met.[[38]](#footnote-38)

The consequence can be that countries do not have the freedom anymore to pursue their own policies and lose their self-determination. Self-determination in this context “indicates the capacity of states to be their own masters by making, and effectively implementing, meaningful discretionary choices on institutional, political, socio-economic, and foreign policy matters.”[[39]](#footnote-39) The philosophical implications of self-determination will be discussed in the next chapter. Without making its own policies, a country loses one of its reasons to exist and does not have the ability to shape its future. John Rawls sees self-determination as one of the values all countries should have in order to come to a just international society.[[40]](#footnote-40) If we see self-determination as a value of a just society, it can be argued that contracts may be outweighed so they do not undermine a just society. An illustration is the Argentinian example. The country filed a case against the U.S. at the International Court of Justice after the verdict of the U.S. Supreme Court to repay the full amount to holdout creditors thirteen years after their default. The decision violates Argentina’s self-determination, because if they pay, they cannot fulfil their own policies and goals.

The third argument relates to the assumption underlying the legal principle that contracts need to satisfy some conditions in order to be binding. In sovereign debt contracts, these conditions may be lacking.[[41]](#footnote-41) In the ideal picture, when agents have a debt agreement, the underlying conditions have been met. Unfavorable outcomes in debt defaults for debtors are then regrettable but not unjust. Yet if outcomes always tend to disfavor debtors, the conditions can be questioned. Some relevant conditions and their problems will be briefly discussed as based on the justice analyses from Christian Barry and Lydia Tomitova.[[42]](#footnote-42) The first condition is rational individualism. Ideally both agents are simple rational agents with different preferences and behave rationally in order to satisfy their preferences. However, real world countries and other organizations are complex agents. The person who settles the contracts and those who are harmed or benefit from them is often different people. Furthermore, representation of the government can be too limited, thereby not legitimately representing the country. Thus the validity of the contract can be questioned because the people of the country are not represented. However, this also depends if the people will benefit from the debt contracts.

The second and third conditions are formal and substantive freedom. Formal freedom suggests agents are free, so other agents do not have the right to dictate their action. Substantive freedom is that neither agent can exercise unilateral control over the terms of their interaction. Both agents have meaningful options to act. The issue with these conditions is that although both parties have formal freedom, the substantive freedom of countries and creditors differs because borrowers of debt rely financially on it during difficult times. Creditors can then influence the terms without the consent of debtors, as that refraining from entering the contract is not an option to the debtors. Borrowers can typically be seen as poor and have access only to limited sources of credit. In contrast, creditors have enough lending options with potential borrowers.[[43]](#footnote-43) Especially poorer countries face the risk of being disadvantaged by their creditors in the terms of contracts due to the asymmetrical power-balance. This inequality between countries undermines the validity of debt contracts, because the weaker countries will become disadvantaged in the contract terms. However, unbalance in power will always be present due to countries differences in important aspects, e.g. on economic and cultural aspects. Some relate to power, such as capital. States with capital can use it to pursue their policies with the possibility to favor their policies over other countries policies.[[44]](#footnote-44) There should then be a threshold where power irregularities would not lead to situations where countries cannot pursue their own goals and policies. How to define the threshold is a difficult empirical question, but it is sufficient to say that the threshold level needs to be set so debtors can interact with creditors without being financially disadvantaged.

The fourth is informational adequacy, which means that both parties have adequate information about the risks and benefits to make agreements. The issue is related to the former condition, as markets are imperfect and creditors tend to have more information about the lending criteria.[[45]](#footnote-45) Again, weaker countries face the highest risk due to their lack of resources and expertise compared to creditors, such as investment banks. With the third condition, the inequality of informational adequacy between the agents also needs a threshold so agents can make agreements that are not severely one sided.

The final condition is that the agent’s environment needs to be relatively stable so that both sides can comply with the contract in the present and future. This condition seems not to be satisfied either in the current financial environment. The instability of the financial system has been stressed by the IMF and in their latest stability outlook, the risk on further economic instability rose.[[46]](#footnote-46) The current economic and financial crisis can be seen as an exponent of increased systemic instability. Therefore the condition is problematic and the rigid feature of debt contracts does not seem to be just when it is related to the underlying legal principle of respecting contracts.

As an objection to the above conditions, it is difficult to meet all the requirements. What is the meaning then of debt contracts if these conditions cannot be met? As a reply to this objection, it seems difficult to meet all conditions because some are inherently related to the nature of the agents (condition one) or global (condition five). However, it shows that the justness of contracts in sovereign debt defaults can be questionable.

The three discussed arguments in this section point to several restrictions of the legal principle in respecting contracts in debt defaults. Firstly, sometimes the debtor can have other duties that can outweigh servicing its debt. Secondly, when the self-determination of countries is severely constrained because they cannot pursue their own policies and goals, this can outweigh the repayment of debt. Lastly, the underlying conditions of debt contracts can be questioned. For instance, the inequality between debtors and creditors can be too severe to meet the conditions of substantive freedom and informational adequacy. These three restrictions will be considered discussing justice frameworks in the next chapter.

## 3.2. An economic perspective in sovereign debt defaults

The idea behind borrowing is that both debtor and creditor benefit from it. Debtors can invest the money efficiently and creditors receive interest on loans. Debt defaults can be costly and the economic literature focused on debtor costs to understand why they repay debt in the absence of an official default mechanism. The costs exist of credit market exclusion; costs of borrowing; trade sanctions; and domestic costs. Two approaches, that emphasis on the first three costs, have been traditionally discussed in the literature.[[47]](#footnote-47) First, the ‘reputation approach’, based on Eaton and Gersovitz, argues that defaults may have adverse consequences for the debtor government’s access to capital, leading to higher borrowing costs and exclusion from capital markets.[[48]](#footnote-48) Second, in the ‘direct-punishment approach’ of Bulow and Rogoff, debtors and creditors bargain their contracts. Default costs consist of trade sanctions against the debtor.[[49]](#footnote-49) These costs have also been empirically investigated.[[50]](#footnote-50) Besides these costs, domestic costs such as drops in economic growth and investments, have been empirically investigated.[[51]](#footnote-51) Due to the prominence of the first two approaches in academic literature more emphasis will be shown to these approaches in the next section. Subsequently, the objection, considerations and limitations of the discussed approaches will be discussed.

### 3.2.1 Costs

The reputation approach suggests that the threat of capital market exclusion forces the debtor to repay debt. In this equilibrium model debtors borrow money up to a maximum limit to smooth their consumption while maintaining a good reputation in the credit market. The threat of market exclusion is sufficient for debtors to repay debt. Several authors refined this approach,[[52]](#footnote-52) including Grossman and Van Huyck, who allow debtors to partial default. This means that depending on the state of the economy, debtors can repay more in good times and less in bad to creditors.[[53]](#footnote-53) The empirical support for the reputation approach suggests that the capital market exclusion is especially concentrated during default periods. Moreover, defaulting countries regained access within a few years.[[54]](#footnote-54) Empirical results on the cost of borrowing seem to follow the same pattern. By following a default, the borrowing costs are higher but this effect decreases in later years.[[55]](#footnote-55)

The direct punishments approach poses direct trade sanctions on the debtor via the threat of seizing debtor assets abroad or stopping bilateral trading. In this equilibrium model contracts can be renegotiated at any time and the borrowing amount is determined by the amount creditors can extract in the debtor negotiation. This means that creditors directly benefit by obtaining the debtor trade gains from bilateral trades. The direct punishment approach takes moral hazard into account, creditor taxpayers can be harmed due to disruptions of trade with the debtor.[[56]](#footnote-56), [[57]](#footnote-57) The empirical evidence for trade sanctions is in line with the previous costs.[[58]](#footnote-58)

Domestic debtor costs consist of negative economic consequences, such as reduction in investments, potential financial crisis and political costs. Empirical research suggests that debt crises have negative effects on the economy of defaulting countries and that defaults shorten life expectancy of governments and ofﬁcials in charge of the economy.[[59]](#footnote-59), [[60]](#footnote-60)

Defaults are costly but are they too costly? Panizza et al. argue that distortions could cause too high default costs.[[61]](#footnote-61) Distortions such as incomplete information and debtor moral hazard complicate attributing costs towards debtors. They refer to the extended reputational approach of Grossman and Van Hucyk to argue that without distortions creditors can adequately discriminate between debtor defaults that are ‘excusable’ and ‘inexcusable’. Economic bad shocks are excusable when defaults happen through external circumstances, while inexcusable defaults occur with overborrowing. When creditors cannot distinguish the shape of the economy of a debtor due to (inexcusable) overborrowing via moral hazard or (excusable) bad shocks, they do not know when to inflict costs on debtors, e.g. debtors exclusion from credit markets. Costs then may be imposed on debtor countries that didn’t overborrow and resulting in overall higher costs. Moral hazard in sovereign debt arises when someone decides to accumulate debt and not bear the full costs of a debt crisis.[[62]](#footnote-62) A ‘third party’ shares the burden in moral hazard. In debtor moral hazard the debtor borrows too much knowing the international community will bail him out, resulting in the international taxpayer bearing the burden. Moral hazard can lead to overborrowing when the level of debt is inefficiently large and the debt structure is suboptimal compared to a situation when the debtor refrains from actions that hurt other parties.[[63]](#footnote-63) Panizza et al. propose creating more complete contracts between creditors and debtors by adjusting the current contracts or via the creation of new institutions that substitute for more complete contracts. Current contracts may cause high costs and better contracts could reduce costs.

### 3.2.2 Objection, considerations and limitations

Two problems can be mentioned that relate to the discussed approaches and costs. First, based on the reputational perspective, creditors can inflict costs on debtors via adequately distinguishing between inexcusable (moral hazard) and excusable defaults (bad shocks). But that means that it is possible to distinguish between excusable and inexcusable defaults. This is questionable because defaults consist of several causes, domestic as well as international causes. And all causes can happen at the same time. How can we objectively tell which one is inexcusable and which one is excusable? This seems difficult because there is a myriad of causes. A financial crisis can happen at the same time when a country borrows more because it expects to invest the money in a productive way. Probably the causes are also intertwined. For instance, when there is a credit boom countries want to borrow more. And when the boom bursts, leading to a financial crisis, then the crisis and the internal borrowing will impact the countries. It seems then difficult to disentangle the excusable from the inexcusable causes. Notice that this problem applies to the reputational approach.

Second, in the reputational approach the emphasis is on aggregate costs. The problem with the emphasize on aggregation is that it can neglect distribution. Consequently, basic interests of debtor citizens could be neglected or violated when default costs are been seen on aggregate level, such as in social security cut backs by the debtor. Consider the proposal for better contracts by Panizza et al. to reduce default costs. This does not have to mean that the welfare of debtor citizens will increase when default costs decrease. For example, default costs of country A can be decreased by speeding up negotiations. Assume that debt contracts stipulate that the debtor cuts on social services as requirement for creditors to join together. Aggregate default costs can be lowered due to improved negotiations. But they may come at the expense of debtor citizens. Due to social cutbacks their welfare could even drop to levels below an adequate standard of living. It can even be stated that especially the citizens whom the government should be most concerned about would be the ones most likely to be harmed during defaults.[[64]](#footnote-64) The consequence could be that aggregate default costs can be reduced, but that it can harm third parties, such as debtor citizens.

In the direct punishment approach both debtors and creditors negotiate on aggregate level. The risk then is in line with the argument above that negotiations could lead to favorable aggregate results, but that individual interests can be severely deprived. Moral hazard is considered in the approach by including creditor taxpayers on an aggregate level. However, debtor citizens are not considered, only the debtor country on aggregate level. Subsequently, negotiations between debtors and creditors could lead to outcomes where costs are borne by debtor citizens. Individual interests need to be considered in debt defaults and this relates to the first restriction of the legal perspective, namely that individuals need to have at least an adequate level of living.

Some considerations and limitations about the discussed academic economic perspective will be discussed. First, this thesis could not incorporate all economic perspectives, but focused on the ones related to the academic literature about (mostly debtor) costs. Other perspectives could also relate to costs that include forward looking market views. The assumption then is that economic practice relates to the discussed approaches and costs. Also the sustainability of sovereign debt is a subject that falls outside the scope of this thesis. Second, there may be other economic perspectives that might take individual interests into account. For instance, Jospeph Stiglitz advocates that in debt defaults of less-developed countries the people often bear the costs. He gives examples where defaults led to depriving social conditions for those countries and their citizens. He mentions that it is socially unjust if we benefit at the expense of someone who is poorer.[[65]](#footnote-65) He does not work out this normative view but suggests a solution, a global bankruptcy mechanism, that fits with the argumentation line in this thesis. Third, political aspects can influence debt defaults costs. Suggestions for more optimal contracts could be influenced via the political process. However, this aspect falls outside the scope of this thesis.

## 3.3. Conclusion

The discussed perspectives suggest that defaults can be costly and emphasize respecting contracts that can lead to default costs that are initially borne by (less-developed countries) debtors. Also creditors share in the costs but debtors have to negotiate with creditors from a vulnerable position since they are in financial distress and have a weaker bargaining position. In debt defaults especially the interests of debtor citizens may be at stake in debt defaults. Costs are seen on an aggregate level and servicing debt may come at the expense of citizens via, for instance, social service cutbacks. Citizens interests may be succumbed against creditors interests, where actions from investors such as vulture funds may decrease the ability of countries to provide essential public goods to their citizens. The emphasis on contracts may increase the costs of defaults, implying that the discussed perspectives divert on this point. Notice that the costs could also be influenced via the political component, which is outside the scope of this thesis.

The emphasis on contracts and aggregate costs has some restrictions. Primarily, although for different reasons, both discussed perspectives tend to neglect individual interests of citizens (of debtors). With the emphasis on aggregate costs and respecting debt contracts, the direction is more on a collective state level. An important duty of states is to provide basic services to their citizens and this should also be applicable around sovereign debt defaults. This first restriction is called ‘*sacrifice*’. Furthermore, because debtors cannot go bankrupt the possibility exists that the self-determination of debtors could be (severely) deprived as their policies could be conditioned by other agents (creditors such as IMF). This second restriction is called ‘*self-determination*’. Moreover, the conditions of debt contracts can be questioned. For instance, the inequality between debtors and creditors can be too great to meet the condition of substantive freedom. This third restriction is called ‘*contract conditions*’. These three restrictions will need to be considered in a just debt default framework and will come back in the next chapter.

# 4. A justice sovereign debt default framework

The restrictions discussed in the previous chapter need to be taken into account to come to a just sovereign debt framework. These restrictions can be seen as requirements because every justice framework needs to incorporate them. Based on the requirements, the present justice sovereign debt frameworks in the academic philosophical literature will be critically discussed. Due to problems with the frameworks, a justice framework will be proposed in the subsequent sections which is based on the capabilities approach.

## 4.1. Current justice frameworks sovereign debt

In this section, justice frameworks will be critically discussed based on the requirements from the previous chapter. The justice sovereign debt frameworks of Sanjay Reddy, Gabriel Wollner and Barry and Tomitova will be discussed. It will be argued that due to problems with all frameworks another framework needs to be proposed.

## 4.1.1 Sovereign debt

Agents engage in sovereign debt to enhance their interests. Depending on the agent these interests can differ. For instance, states borrow money so they can invest in projects thus allowing them to provide public resources for their citizens. Investors lend money to earn a good return on their investment to pursue their public or private aims. In sovereign debt and in defaults, the interests of individuals as part of group or as an individual are of primary importance.[[66]](#footnote-66) Individuals cooperate with each other, in states or companies, with the aim to live a worthy life. To live such lives, individuals need to fulfil their fundamental interests. That is why individuals need to have a decent level of living to function with dignity in society. Individuals in groups also have certain interests that need to be fulfilled to interact with other agents as free and equal. For instance, states need to have self-determination to pursue their own policies in the world. The three requirements as discussed in the previous chapter relate to these interests.

## 4.1.2 Contingent sovereign debt contracts

Reddy proposes the use of contingent sovereign debt contracts to come to a just framework. The author argues that because states have ‘interpersonal externalities’ the deontological obligation to respect debt contracts for states should be less strict than for individuals.[[67]](#footnote-67) Unlike individual debt, interpersonal externalities is meant that sovereign debt is intergenerational, whereby debt also can extend to future generations and the individuals that benefit and bear the costs of sovereign debt can differ.

Reddy mentions that consequentialist arguments should also play a role in agreeing upon a justifiable theory of sovereign debt. He proposes to introduce contingent debt contracts that include clauses to allow for contingent circumstances, a feature that current traditional contracts do not have. The inclusion of these contracts should lead to more efficiency due to more efficient distribution of risks.[[68]](#footnote-68) For instance, under such contracts debtors can repay more in ‘good’ states of the world and less in ‘bad’ states of the world. Next to this economic rationale the proposal includes circumstances that take other normative considerations into account. Debt repayments for example can be made contingent on factors that influence the foreign payment obligations of countries.[[69]](#footnote-69) When creditor countries influence the ability of debtor countries to repay their debt significantly, they can be seen as partially responsible and the repayment schedule of the debtor could be flexible.[[70]](#footnote-70)

The general problem with Reddy’s proposal is the focus on contracts. This causes problems with all three requirements. The sacrifice requirement is problematic in Reddy’s approach because contingent contracts are voluntary. The problem with voluntary clauses is that contracts without these clauses do not protect the citizens of debtor countries when things go wrong. All citizens have the right to an adequate level of living and this is not optional. In debt defaults countries should have the possibility to fulfil these rights and not depend whether they have contingency clauses in their contract.[[71]](#footnote-71)

The focus on contracts is also problematic for the self-determination requirement because Reddy’s approach neglects the fact that states can still default. When debtors do not have contingency clauses or these clauses are insufficient, debt defaults will then occur. The current debt default practice in which debtors can be deprived in their freedom to pursue their own goals is then still present.

Regarding the contract conditions requirement, Reddy does not include the following conditions in the analysis: formal and substantive freedom, and informational adequacy. Yet his approach depends on debt contracts. If these conditions are not met because of too much inequality between debtors and creditors, this will affect the terms of the contingency contracts. The possibility that the weaker side then receives contingency terms that are unfavorable and unfair is present in Reddy’s proposal.

## 4.1.3 Conditions debt contracts

Similarly to Reddy, Barry and Tomitova concentrate on sovereign debt contracts but include more conditions. They discuss how to determine what the obligation is for sovereign debt repayments. They start by distinguishing debt where the debtor has and has no ethical obligation to repay. In this framework the fairness of the repayment of debts depends on the ethical status of debt. To determine the status of debts, the authors refer to conditions and the basic norm of respecting contracts in sovereign debt contracts.[[72]](#footnote-72) Features such as rigidity, neutrality, extensiveness, and the basic norm of respecting contracts are relevant in sovereign debt practice, as discussed in section 3.2. To justify the basic norm the authors argue that sovereign debt contracts need to fulfil some conditions. As discussed in section 3.2, the five conditions are: rational individualism; formal freedom; substantive freedom; informational adequacy; and stability.

Barry and Tomitova propose several reforms to try to alter features of the present sovereign debt contracts by considering the actual relationship between debtors and creditors in sovereign debt contracts.[[73]](#footnote-73) The character of contracts should be changed by making them less rigid, neutral and extensive. The purpose of the authors is not to fully endorse the reforms but to stimulate creations of alternatives for the existing practice.[[74]](#footnote-74) Two reforms will be briefly mentioned. One reform is also proposed by Reddy, namely to reduce the rigidity of debt contracts by using contingency contracts. Another reform is to shift the power balance in bargaining in debt defaults by forming debtor cartels. As a group, debtors can increase their negotiation power when negotiating with creditors such as the Paris Club.

Barry and Tomitova focus on sovereign debt contracts in which debtors and creditors are collective agents. The problem with the sacrifice requirement regarding this approach is that the interests of the citizens are not the primary concern and thus cannot outweigh contractual sovereign debt obligations. The debtor is the country and the scope of the authors’ analysis is primarily related to the debtor-creditor relationship. There is no reference to debtor and creditor citizens, and as Julie Nelson mentions a large central group of children and women is often left out in the analysis about sovereign debt because the ‘single’ agent is the nation as a whole.[[75]](#footnote-75) The consequence is that vulnerable citizens can be hit hard due to sovereign debt defaults and fall below an adequate level of living without generating enough moral power to outweigh debt contracts.

The problem with the self-determination requirement is that values such as self-determination are not taken into account. Barry and Tomitova do not say when debt contract repayments are permissible; they only indicate that certain contractual conditions are not fulfilled in sovereign debt. The authors give no guidance when it is to repay or not repay sovereign debt. This means that sovereign debt could be repaid even when debtors’ self-determination will be severely limited. For instance, this could be in debt defaults when debtors need to fulfil severe austerity measures for servicing external debt or debt relief. When self-determination is seen as a value in a just international society, this should then guide sovereign debt and be placed in a justice framework. The third requirement is based on the conditions raised by Barry and Tomitova and is integrated in their approach.

## 4.1.4 Complaint model

The first two frameworks concentrated on debt contracts and their conditions are seen from country perspectives. In Wollner’s approach the interests of individuals in sovereign debt function as starting point. He challenges the institutional design that leads to costly and chaotic default processes that skews costs towards debtors. The first of two arguments from Wollner is based on the idea of global background justice where international order needs to maintain background conditions against which states are free and equal,[[76]](#footnote-76) such as bargaining power between states not being too great. The sovereign debt process undermines these background conditions. Background justice in sovereign debt is relevant because the sovereignty of states is at stake in the current practice. Highly indebted states can lose their effective sovereignty, their ability to achieve social justice and their effective freedom. The second argument is in line with Barry and Tomitova’s argument and challenges the binding force of sovereign debt contracts because certain conditions are not met.[[77]](#footnote-77)

Wollner proposes the complaint model as justice framework for debt defaults where individual interests are the ultimate concern.[[78]](#footnote-78) Policies can be compared and the morally preferred one cannot be reasonably rejected. Complaints are the criteria to assess policies. The three complaints in sovereign debt are: well-being interests; autonomy interests; and justice interests. Wollner argues that people want to advance these interests in credit markets. Well-being interests are relevant to enhance e.g. economic growth. Autonomy interests fulfill individual options. Justice interests are relevant because sovereign debt influence individual’s interests to live in just societies. The size of the complaint is crucial because the model requires that the greatest individual complaint should be chosen.

Wollner suggests two alternative policies: the introduction of new debt instruments; and a more systematic default regime. The first alternative contains the introduction of ‘contingent debt instruments’ like contingency bonds as seen with Reddy’s proposal of contingency contracts. The second consists of a structured default regime including collective action clauses and a global bankruptcy court. Wollner offers a simplified version of the argument why the alternative is preferable against the current practice, however Wollner also mentions that a conclusive answer will depend on several empirical claims.[[79]](#footnote-79) For instance, could debtors have acted otherwise and did creditors play a role in creating unfavorable circumstances?[[80]](#footnote-80)

The problem with the sacrifice requirement is that because the three complaints being weighed, it is possible that the adequate standard of citizens will be below a threshold. Let’s assume that the complaint of the delivery of social justice can be seen in line with an adequate standard of living. This complaint can be outweighed by the two other complaints. This means that the model does not allow that certain interests should have a minimum level, with the consequence that other interests may outweigh them. The same problem applies for the self-determination requirement, because the interests of individuals as a group and their ability to govern themselves needs to be at a certain level.

Hence the question of which interests are more important and how should they then be weighed against each other? In the complaint model, the size must be measured to weigh them. Yet who decides the size of the complaints? The model is based on individuals but it seems empirically hard to investigate the size of the complaint for all individuals. The size also depends on the absolute position of individuals and their responsible part in debt defaults. Did they benefit from the debt? Did they have the chance to avoid the default if acted differently? These are empirically hard questions to answer.[[81]](#footnote-81)

Additionally, how must the complaints be weighed against each other? Wollner addressed this question and offered strategies to deal with the problem, however not all strategies were satisfying.[[82]](#footnote-82) In one strategy Wollner suggests that the different complaint dimensions can be put in one single metric. The difficulty with this option is the assumption that all values are similar enough to combine them. It is difficult to find a uniform metric for one value, economic well-being for example. GDP as a measure for well-being is heavily criticized and alternatives have been developed to give a more broader perspective on well-being.[[83]](#footnote-83) To combine several values seems difficult to achieve.

Wollner takes the sacrifice and self-determination requirements into account but the framework seems to have limitations in the applicability of sovereign debt. The problems of weighing the complaints and determining the size seems more suitable on an abstract level, but faces empirical hard questions.

## 4.1.5 Conclusion

Reddy’s framework takes changing circumstances into account and suggests contingency contracts that lead to more welfare. Barry and Tomitova also focus on debt contracts and consider several conditions, but do not give guidance when debt contracts repayments are obligated. Individual interests and the country’s self-determination are not represented in both frameworks. Wollner’s approach starts from individuals interests and includes the sacrifice and self-determination requirements in his framework. Yet the approach has problems with weighing the different individuals interests and these can be traded. The alternative proposed approach will also start from individuals interests to include the sacrifice and self-determination requirements. Furthermore, the alternative proposal incorporates conditions of debt contracts.

## 4.2. Capability approach

Due to problems with the discussed justice frameworks in debt defaults I propose another framework based on Nussbaum’s capability approach in this section. The framework takes the three requirements into account and seems suitable for sovereign debt defaults.

### 4.2.1 Capability approach

The capability approach is chosen as justice framework because the approach takes all three requirements into account. First, the interests of individuals are of primary importance. States have duties to fulfil the basic needs of their citizens at all times and the approach takes these duties into account. Second, states need to have self-determination so they can pursue their own policies, even during debt defaults. The capability approach takes these interests into account. Third, the approach relates to the debt contract conditions. To see how the three requirements are met by the approach in more detail, an elaboration will be expanded upon regarding the approach.

The approach is a framework where the primary concern is on the development of capabilities. Martha Nussbaum has developed the approach as a theory of social justice where a list of basic capabilities functions as a set of requirements for human beings to live a dignified life. A society is minimally just when its citizens have the capabilities stated in the list. The approach makes a distinction between functionings and capabilities. Functionings are various states of being plus the activities that a person can undertake. For example, playing sports or being educated. Capabilities are derived from functionings and are the opportunities for people to achieve functionings. For every function there is a capability to function in that way. For example, two basic capabilities are life and physical health. The former capability is to live a normal life that entails e.g. no premature death. The latter capability is the opportunity to live in good health.

Because humans have a minimal level of agency they have dignity and deserve respect. As capabilities are needed to live a dignified life, dignity can be seen as the foundation of the list.[[84]](#footnote-84) The capabilities approach shares the focus on dignity with human rights approaches, in which dignity is the founding concept and the “ultimate value that gives coherence to human rights.”[[85]](#footnote-85)

The reference to dignity is one aspect where the approach and other human rights approaches relate to each other. Furthermore, capabilities can be seen as entitlements and basic capabilities as a special kind of human rights.[[86]](#footnote-86) The list includes many entitlements that are also highlighted in human rights movements, such as political liberties and other rights. Just as human rights, capabilities can be seen as pre-political, universal and inalienable.

Entitlements can be seen as a form of rights and as capabilities are essential entitlements, there are correlative duties involved. In the case of essential entitlements, people claim they should be recognized in positive law and protected by the government.[[87]](#footnote-87) These rights are overriding and trump other obligations that do not share these features.

### 4.2.2 Capabilities and sovereign debt

**Two capabilities**

In debt defaults the interests of states and their citizens are at stake. The three requirements are related to these interests. How do they apply to Nussbaum’s capability approach? In the approach individuals are the units of ultimate concern and their interests are protected by rights. In sovereign debt both debtors and creditors consist of collective agents. What does this mean for the application of Nussbaum’s capabilities framework? In sovereign debt relationships, capabilities have an indirect structure and are derived from the debtor’s individual citizens. To clarify this point, Rutger Claassen refers to a well-known phenomenon in rights theory, namely that some rights are meant to protect the interest of a third party.[[88]](#footnote-88) Parents have certain rights that protect the interests of their child, such as the right of child support for an adequate level of living. In sovereign debt, debtor countries have rights (capabilities) that protect the interests of their citizens.

Which capabilities are relevant in debt defaults? The first two requirements as previously discussed are: 1) states can deliver public services for their citizens; and 2) states have self-determination to determine their own ends. Two general collective capabilities are proposed to cover these requirements. States are collective agents and capabilities are rights of individuals. States also have certain collective capabilities to ensure that individuals have their individual capabilities. The reason is that individual capabilities are not socially independent from society. The societal structure is needed for individuals so they have the opportunity to achieve their capabilities. For instance, the capability to achieve good health with health care depends on the institutions and social arrangements in society. Without affordable hospitals and health services, it is not possible for individuals to achieve good health. Individual capabilities depend on the structure of a society. Severine Deneulin refers to this as the structures of living together in a society and it provides the conditions for individuals to achieve their capabilities.[[89]](#footnote-89) The author states that collective capabilities are then needed in a society so that individuals can have their capabilities.

The first collective capability in sovereign debt and defaults is *the capability of states to deliver subsistence capabilities*. The subsistence capabilities is a set of basic capabilities that include: the opportunities of nourishment, shelter, clothing and basic healthcare.[[90]](#footnote-90) On the individual level people have these basic capabilities and based on Nussbaum’s list they can be seen as the socio-economic rights that are similar in human rights lists. The translation to the collective level is that states can deliver these important capabilities to their citizens for an adequate standard of living. In sovereign debt and defaults, states still have the possibility to fulfil duties for their citizens in meeting an adequate level. As those capabilities are rights, they are overriding and of primary importance in sovereign debt and defaults. Debt contracts then could be overridden by these rights.

The second collective capability is the *capability of states for self-determination*. States should have the opportunity to be their own masters by making and implementing policies. This collective capability does not have an exact equivalent individual capability as in Nussbaum’s approach, yet it is similar. Nussbaum’s approach is a freedom theory in which people have the opportunity to achieve certain things to live a dignified life. Individuals must have freedom to pursue their own goals. On the collective level, individuals in groups (i.e. states) must have the freedom to determine which goals to follow and implement. Not only ‘negative’ freedom is needed, but also ‘positive’ freedom.[[91]](#footnote-91) Negative freedom is freedom from intervention. Positive freedom is choosing and pursuing own goals. In sovereign debt, states borrow to pursue their own policies and goals. However in sovereign debt and defaults, their self-determination can be severely undermined due to mandatory conditions. The right to obtain self-determination gives states the opportunity to still interact with other agents without being forced to implement policies that deprive the freedom of states and their individuals.

One can respond that in debt defaults, debtors need to implement austerity and reform policies from creditors to advance their economic growth and restore their debt repayment capacity. When the IMF offers financial assistance and functions as a lender of last resort, this could justify these ‘conditions’ that restrict debtor’s self-determination.[[92]](#footnote-92) Debtors therefore cannot have the freedom to pursue their own goals.

To reply to the argumentation more elaboration on self-determination is needed. Self-determination requires that countries have *enough* positive and negative freedom. Negative freedom is external freedom in the sense that it enjoys immunity from external intervention.[[93]](#footnote-93) Positive freedom is internal freedom in the sense that states can decide which policies to choose and implement. It is positive freedom that can be infringed due to conditions. But what is *enough* positive freedom? At least the following criteria can put forward. First, countries can pursue policies that carry democratic legitimacy. The democratic legitimacy of multilateral lenders to enforce policies upon debtor countries can be questioned.[[94]](#footnote-94) For instance, the IMF is not chosen by the debtor citizen to determine their policies. Besides, the governance of the IMF is based on the contribution of countries to the Fund, which makes developed countries more influential. This influences the nature of their policies and how countries in financial distress are treated. Then multilateral lenders cannot solely dictate the policies. Debtor governments need to have at least some influence on decisions about which policies to pursue and implement. Furthermore, the government must have minimal democratic legitimacy from their citizens, a point later to be discussed.

Second, countries have the freedom to provide their citizens public goods to obtain or maintain an adequate level of living. Too high debt levels or conditions imposed by multilateral lenders could have serious adverse effects on debtors. The UN mentions that in developing countries the consequences of servicing high levels of debt can deprive the capability to fulfil basic needs of citizens.[[95]](#footnote-95) Furthermore, conditions can have adverse effects on countries to realize the basic needs of their citizens and contributed to increasing poverty and marginalization of the poor in many debtor countries.[[96]](#footnote-96) Moreover, the risks and responsibilities of conditions are borne by debtors.[[97]](#footnote-97) When policies fail, the consequences fall on debtors.[[98]](#footnote-98)

Third, countries need to have enough bargaining power to interact with other international agents.[[99]](#footnote-99) Without bargaining power other agents can determine the internal policies of debtors. For instance, when debtors are in a vulnerable position due to defaults or high indebtedness, stronger agents can force policies upon them. Privatizations of state enterprises, trade liberalizations and deregulation of markets could be imposed under (creditor) agents conditions.[[100]](#footnote-100)

**Third requirement**

How do the contract conditions (third requirement) of sovereign debt contracts relate to the approach?

The first condition, complex agents, is taken into account because of the states and collective capabilities involved. The complex nature can lead to problems due to interpersonal features. Elites may benefit while their citizens bear the costs. What does this mean for sovereign debt? The analogy of Leif Wenar regarding natural resources may be helpful.[[101]](#footnote-101) Countries that have natural resources often have authoritarian regimes.[[102]](#footnote-102) He argues that these regimes need to fulfil minimal conditions before they sell their natural resources on markets. The reason is that natural resources belong to the citizens and their government needs to represent them. The three conditions are that citizens: 1) find out about the sales; 2) can stop the sales without incurring severe costs; and 3) not be subject to extreme manipulation by the seller for authorization of selling the goods. These conditions require that citizens need to have the freedom from oppression and freedom to form a public opinion about their government and can start investigations. To see which countries may not comply with these conditions, Wenar suggests the use of Freedom House, an independent NGO that gives all countries ratings on their political and civil freedoms.[[103]](#footnote-103) The lowest rated countries do not fulfil the criteria and suggests to other countries and organizations to not buy their natural resources.

Sovereign debt may be seen as something that belongs to all citizens and should be used to benefit all citizens of a country, not only some. Citizens are represented by their governments and governments borrow money. This means that citizens need to authorize their government to make decisions that can impact them. If sovereign debt belongs to all citizens then one could argue that Wenar’s conditions also apply to sovereign debt. Wenar refers to freedoms that citizens need if countries can fulfil the conditions. The capability approach is a substantive freedom approach, which means that people need to have the opportunity to achieve their goals. When citizens lack freedom, then the three conditions cannot be met and citizens cannot authorize their governments to borrow money.

As a consequence, lenders should not lend money to authoritarian governments that do not fulfil the three conditions.[[104]](#footnote-104) The chance is that only the elite will benefit from debt. However, the drawback is that perhaps the debt will improve the living standard. In these circumstances debt could also benefit the citizens. Without finance, the regime has fewer possibilities to productively invest and to fulfil duties to their citizens. The capabilities approach ultimately is in the interest of individuals, so therefore it may be permissible to provide debt to illegitimate governments under strict conditions to improve the basic interests of their citizens.

A related subject is how to treat ‘odious debt’ for current governments and citizens in regime transitions. Odious debt means the debt accumulated during illegitimate governments where citizens were not benefitted. Absent conditions in odious debt are citizens: 1) that did not consent to the debt; 2) did not benefit; and 3) the lender was aware of these absences.[[105]](#footnote-105) Odious debt should then be relieved if the debt was lent to illegitimate governments and the lender was aware of the absences. The capabilities approach can add that to have the opportunity to achieve goals, countries and citizens should not be bound to odious debt if this deprives the achievement of capabilities. Because individuals and countries need to have basic capabilities to live a dignified life. When odious debt deprives capabilities, debt relief could be an option. However, several implications can be mentioned. First, when odious debt does not deprive the capabilities of citizens, the approach does not give guidance. Second, the new regime needs to have minimal democratic legitimacy; otherwise the odious debt will continue to grow. Then the new odious debt will replace the old one. The depriving capabilities of the citizens will not change. Third, the creditors were aware of the illegitimate regime and their debt loss will not bring them below capability levels.

The second and third conditions of the third requirement, formal and substantive freedom, are considered because Nussbaum’s approach is based on substantive freedom. Individuals and states have ‘real opportunity’, not merely formal freedom to achieve their interests.[[106]](#footnote-106) A capability is only valid when an agent has not only the theoretical formal right, but also the actual opportunity to exercise that entitlement. Creditors and debtors can differ in substantive freedom in sovereign debt due to power asymmetries. This is why there needs to be a minimum level of equality between the agents, which means that the power asymmetry is not too great so that all agents have substantive freedom. Although power symmetries between states will be present, if they seriously affect the bargaining position of debtors where they have no choice and have to accept unfair conditions, then the inequality is too great. The same speaks for the fourth condition of adequate information, in which agents need to have a minimum level of equality so that both sides have enough resources to obtain adequate information about the debt contracts. In this way, those with more information cannot easily take advantage of those without or with less information. This leads to preventing unfair terms in debt contracts that could lead to depriving collective capabilities of countries and related individual capabilities for citizens. The fifth condition, stable environment, is considered because capability justice is about equality of capabilities. Capabilities function as threshold and once this is set, everyone has an equal right to that minimum, although there can be differences above that threshold.[[107]](#footnote-107) In an unstable environment the capabilities still apply to all agents.

**Duties**

With collective capabilities comes corresponding duties. Who are duty holders and what are the duties? Nussbaum mentions that every person should have basic capabilities. Everybody has the duty to make sure these capabilities will be met. The derived duty holders are institutions because they are better equipped to fulfil these duties.[[108]](#footnote-108) States are duty bearers on domestic level. Nussbaum suggests that on the global level the institutional structure should be limited and decentralized.[[109]](#footnote-109) As a consequence, the primary duty holder are then also states.

In sovereign debt the collective capabilities are attached to debtor states. As there is no world state, the primary duty holders should first be the creditors and second be the international community. Creditors have a direct relationship with debtors and the conduct of one side may impact the other side. In sovereign debt the creditors may directly impact the interests of debtors. Because the collective capabilities of states relate to individual capabilities of their citizens, and their interests are of ultimate concern, creditors may be the primary duty holders. Citizens’ interests are also of international concern because all humans have dignity and equal value. Corresponding capabilities are universal and when debtors cannot fulfil their citizens’ basic interests due to sovereign debt, public international agents may also be seen as duty holders. International agents are e.g. other countries, and other supranational institutions, such as the UN.

What are then the duties? As rights are fundamental and non-optional, the duties will need to apply to all creditors. The obligation related to the collective capability of substance capabilities is to allow debtors to fulfil their basic duties to their citizens during the debt relationship. So when high indebtedness and debt defaults occur, creditors have the duty to *allow* debtors to give their citizens sufficient resources and services so they can have a decent living. Notice that there is an empirical claim underlying this obligation. There is a causal relationship between the debtor country not servicing its debt and fulfilling the essential capabilities of its citizens. When there is a weak link between sovereign debt and the capabilities, the duty weakens or diminishes.

One can respond that this is an empirically hard claim to fulfil. A possible reply may be that currently capabilities are being measured in the Human Development Index (HDI). To link capabilities with debt can be difficult but not impossible. The HDI shows that capabilities can be measured and these could be linked to debt servicing. The causality can be determined before and during debt crisis where the link can be examined. When capability measures evolve, the quality and acquaintance with them will increase. Notice that the evolvement also depends on the political will of governments.

The obligation to the self-determination capability is that creditors refrain from coercion when debtors do not have enough positive freedom, thus allowing debtors to implement at least some own policies. The consequence is that the conditions from creditors could be diminished or not allowed when they violate the self-determination of debtors. Conditions may be austerity policies with large cuts in social services and privatisation of public companies or property. The empirical question that needs to be answered regarding this duty is when the conditions undermine the debtor’s self-determination. The criteria for enough self-determination have been discussed and could function as broad guidelines to answer the empirical question.

### 4.2.3 Conclusion

Nussbaum’s approach as justice framework incorporates all requirements. The capability of states to deliver subsistence capabilities may outweigh debt contracts if they deprive the state’s ability to deliver goods for their citizens. The capability self-determination may trump debt contracts when states do not have enough positive freedom to interact with other agents. The corresponding duties to the capabilities include duty holders allowing the debtor to fulfil their duties to their citizens, because they are of ultimate moral concern that refrains from conditions when these severely violate self-determination of the debtor. Due to the sovereign debt relationship, creditors are the primary duty holders, and due to the universality of individual interests the international community is the secondary duty holder.

The third requirement, contract conditions, relates to the capabilities and approach but is not directly translated into capabilities. When these conditions cannot be fulfilled, it may also lead to voiding debt contracts. The complex nature of states causes problems with illegitimate authoritarian governments. Although it can be argued that citizen’s authorization is needed for governments to borrow, it might be permissible to lend to such governments when it will improve the citizens’ interest. Furthermore, the approach is a substantive freedom framework and in sovereign debt, states need to have at least some equality to have substantive freedom. The asymmetrical power between states can lead to unfair terms.

## 4.3 Objections and limitations

At least three objections can be made against the capabilities framework. First, one could object to the approach as it only gives a partial account of justice. Capabilities operate as a threshold that each society should reach for its citizens in order to call it minimally just. The approach does not say anything about justice above that threshold.[[110]](#footnote-110) In sovereign debt, agents also pursue well-being interests that can be well above the capability threshold level. A just debt default framework should also consider the distribution of well-being above these levels between the relevant parties. A reply may be that there is no reason why justice is needed above a certain level. For instance, consider the individuals’ well-being regarding sovereign debt. States enter debt relations to provide their citizens capabilities so they can live a dignified life. Yet there is no justice involved and no duties related to states to provide more than these capabilities. Why should their justness be involved if states borrow money so their citizens achieve well-being well beyond the capability level? Why should the economy grow with a percentage if all citizens are already well above the capability level? States do not have duties to make all citizens happy or, more extreme, millionaires.

One can respond that when capabilities are well beyond the threshold, there is no justice question related in these defaults. Wealthier debtors have to suffer the costs. A response to this follow-up objection may be that debt defaults do not happen when countries can easily afford to repay their debts. This implicates that countries are not wealthy enough to repay their debt. If there may be costs involved in debt defaults, it seems implausible that countries default when they can afford their debt repayments.[[111]](#footnote-111) Moreover, also less poor countries can become below decent living standards during defaults. For instance, in Argentina nearly half the population was pushed below the national poverty line after their default and following crisis in 2002.[[112]](#footnote-112) However, in defaults (debtor) moral hazard can be present, which means that countries may default earlier when third parties share the burden. Probably every framework needs to consider moral hazard and capabilities need to be measured and monitored in such a way that moral hazard of countries will be minimized.

Second, one can ask how countries will set the threshold so capabilities can function as overriding entitlements in debt defaults. Without the ability to measure capabilities, they will be unable to function in debt defaults. A reply against this objection is that the approach has already been used in a framework as an alternative to current economic indicators where capabilities are measured. As an alternative for GDP as well-being measure, capabilities have been utilized in the HDI.[[113]](#footnote-113) For instance, in this index a decent level of living is incorporated which implies that capabilities can be measured, also regarding sovereign debt. States, together or via supranational organizations such as the UN, can decide thresholds for capabilities. Notice that social empirical research is needed to define these thresholds and measure the capabilities.

The third objection is related to the self-determination capability. If states are their own masters and pursue goals independently, then the negative consequences are also their responsibility and costs are borne by them. This line of reasoning, followed by luck egalitarians, assumes that if everybody had equal opportunity to run a particular risk, the result due to voluntary choices whose consequences could reasonably be foreseen by the agent should be borne by the agent.[[114]](#footnote-114) Negative outcomes can then be seen as just.

A first reply to the objection is that in certain circumstances the need to help debtors is so high that other states have a duty to help. Consider the analogy with individuals. Assume that individuals have the freedom and autonomy to make their own choices. Individuals need to take responsibility for their actions and obligations.[[115]](#footnote-115) When individuals as a consequence of their actions come into serious problems due to high indebtedness, society will probably help if the burden is too high (e.g. when the person cannot afford to buy food) and share the burden. When states are in such high needs that they cannot serve basic needs for their citizens due to e.g. too high indebtedness or defaults, then other states, or the international community, have a duty to help. In circumstances where the need is high, the burden will probably be shared.

This brings us to the second reply, because also differences with individuals weakens the objection. Reddy mentions that due to the interpersonal nature of states, citizens who benefit from the debt and bear the costs could differ.[[116]](#footnote-116) Unlike individuals, the responsibility of states is not causally related. This can be demonstrated in cases where the government is illegitimate and the enforcement of debt for future regimes and citizens can be questioned. A second difference is that individuals can decide where they are going to live, but states are stuck to their territory. This can reduce their choices of policies because it can limit the structure of their economy and the products they trade. Furthermore, what weakens the objection is that it seems difficult to determine the ‘bad luck’-factors that luck egalitarians need to determine so states can be accountable for their choices. How will countries’ history be treated, such as colonialism in developing countries? How will the global economic system with its asymmetric power be treated? These are no simple factors to determine and complicate the distinction between own and ‘bad luck’-choices.

At least two limitations of the approach can put forward. First, the approach does not directly take efficiency into account in sovereign debt. The emphasis is on states’ capabilities and individual interests. Yet for states to be able to fulfil certain duties to their citizens, there must be enough public goods be produced to distribute among citizens. One might say that indirectly efficiency need to play a role in the approach. When states have duties to provide citizens enough food, then such goods need to be produced before they can be shared. There needs to be some kind of efficient production process that allows states to divide public goods. The level of goods and their distribution is another question. But efficiency is not directly incorporated in the approach.

Second, there is an inherent tension between the collective capabilities adequate living and self-determination regarding illegitimate countries. At one side, for self-determination minimal democratic legitimacy is needed and citizens need to authorize the government’s borrowing. At the other side, states have essential duties towards their citizens. When they lack the financing to fulfil these interests, they are not able to fulfil these duties. It may then be permissible to lend such authoritarian governments money. The consequence is that borrowing such money can be under conditions and infringe the self-determination. Assuming that only democratic countries have self-determination, then authoritarian countries are neglected that they also have to deal with their citizens’ needs. Because individuals interests are universal, we cannot neglect them.

# 5. Sovereign debt default mechanism

With the justice framework in place the question is which debt defaults mechanism promotes the framework. I will argue that a sovereign debt bankruptcy court will promote the capabilities approach.

## 5.1 Sovereign debt bankruptcy

To make the current default practice more just, I propose the installment of an international bankruptcy court for sovereign debt defaults. The general idea is proposed by others as well, such as Joseph Stiglitz, and I will argue that such a governance change will promote the justice of debt defaults.[[117]](#footnote-117) In particular, the bankruptcy proposal suggested by Kunnibert Raffer will be followed, thereby focusing on the general features. The proposal is based on the U.S. bankruptcy law (‘chapter 9’) that regulates the bankruptcy of municipals and governmental organizations. In analogy with this bankruptcy law, states can settle their debts via court. To settle sovereign debt, a neutral international court would have to be established. As usual in international law, the arbitrators of the court should be nominated by debtors and creditors, so both sides nominate the same number of people.[[118]](#footnote-118) These members would nominate a chairperson to achieve an uneven number. The court will not be located in the countries of the debtors or creditors, thereby avoiding partiality. All creditors would be treated equally, thereby avoiding preferred treatments of debt.

A debt composition plan for the court would be made between debtors and creditors, experts, international organizations, and representatives of the people affected by the plan, while benefiting from Chapter 9 protection. The debtor will initiate the plan and propose the plan to the court. The protection means that the court may not interfere with the choices of sovereigns as to what services and benefits they will provide to their citizens.[[119]](#footnote-119) There are no automatically enforced conditions in the plan that interferes with the political and governmental powers of debtors. Besides, there will be a stay on litigation during the debt resolution, which means that no other creditors may sue the debtor. Furthermore, Chapter 9 allows the citizens affected by the plan to voice their arguments via representatives.[[120]](#footnote-120) This means that claims from e.g. pensioners and employees can be taken into account via unions and other organizations.

How will the bankruptcy mechanism promote justice in sovereign debt defaults and affect the capabilities framework? The first collective capability, subsistence capabilities, will become achievable for more states as they have the opportunity to default. At least two advantages can be put forward. First, the mechanism allows countries to settle their debt quicker. The negotiation time could decrease due to fewer negotiations with different creditors. Extra time offer debtors the chance for earlier recovery of their development and instead of servicing high levels of debt, they can provide public goods to their citizens. However, one can argue that decreasing negotiation time does not result in better default terms. When austerity conditions have been agreed upon, large public cutbacks could follow and then there will be no positive effect on the capability. A reply to this response leads to the second advantage. The neutral court shifts the bargaining power from creditors to debtors. The chance for debtors to reach better terms will be more likely when both parties have more equal bargaining power. For instance, when bargaining power becomes more equal due to the neutral court, then the consequence is that default outcomes may result in more favorable default terms for debtors, thereby increasing their opportunity to fulfil their duties.

The self-determination capability will become achievable to more debtors due to the bankruptcy mechanism due to at least two reasons. First, the bankruptcy option allows debtors to regain their self-determination sooner than in the current debt default practice. The argumentation is in line with the previous capability. In the bankruptcy mechanism the debtor can initiate the composition plan and if the court agrees with it, the plan is binding and all debts are settled. Second, by settling debts, the chance that debtors will be bound by conditions will decrease due to the composition plan, thereby not automatically allowing creditors to interfere with debtors’ policies.[[121]](#footnote-121) Yet the possibility remains that both debtors and creditors agree in the composition plan for conditions to improve the debtor’s future development. Furthermore, the advantage of the bankruptcy mechanism seems that eventual conditions might be more favorable for debtors due to the neutral and independent court. The impartiality of the court will probably favor the weakest party, which in sovereign debt is mainly the defaulting debtor.

The bankruptcy proposal also promotes the fulfilment of contract conditions. The first condition of complex agents will be promoted towards odious debt in regime transitions. Due to a bankruptcy mechanism, new regimes have a neutral legal place to argue for debt relief for odious debt. This relief does depend on several criteria as discussed in section 4.2.2. But instead of discussing odious debt with separate creditors, the bankruptcy option gives these regimes opportunities to discuss in an international neutral setting.

The formal and substantive freedom conditions will be promoted because the bankruptcy mechanism will decrease power asymmetries between debtors and creditors. Debtors can gain an opportunity to settle their debt and to make a fresh start. This gives debtors more power to discuss the terms of debt contracts with creditors. The fourth condition, information asymmetry, could be promoted but not necessarily regarding entering the contracts. The inequality in information can still exist. However, the mechanism gives debtors and creditors an incentive not to disadvantage each other too much, because debtors have the possibility for bankruptcy. This might mitigate the negative consequences that may come from information inequality, such as lending too much or too expensive debt.

It can be argued that the fifth condition, economic stability, can be improved due to a systematic default mechanism. The process has more clear procedures and is less ad-hoc. The threat of vulture funds will be decreased due to the settlement of all creditors in bankruptcy. Costly and uncertain situations will then be prevented. One can respond that it creates economic uncertainty because debtors can more easily default. That uncertainty could impact upon the provision of financing to developing countries due to higher borrowing costs.[[122]](#footnote-122) The respond to this objection will be discussed in the next section.

In sum, a bankruptcy mechanism may improve the debtor’s collective capabilities, whereby debtors and creditors will be treated fairly and equally. The mechanism increases the chance that more less-developed countries have the ability to provide essential goods to their citizens and pursue their own goals. The neutral court increases the chance of fair cost sharing and faster default resolution. Contract conditions will more likely to be fulfilled. The mechanism can be seen as improved governance to void or alter debt contracts, thereby promoting a just debt default process.

## 5.2 Objections

At least two objections can be put forward. First, one can argue that when debtor countries have the possibility to default, it will lead to significantly more bankruptcies. This will lead to less certainty for creditors that debtors will repay their debts. The consequences will then be higher borrowing costs and decreasing borrowing opportunities for debtor countries. The access of money for less-developed countries diminishes. A reply to this objection is that default costs will stay unappealing for debtors and a bankruptcy mechanism does not have to lead to significantly more bankruptcies. Default costs such as exclusion from the capital market, economic downturns and political unrest will negatively affect debtors. Defaulting is not an attractive option and it is questionable if the number of defaults will significantly increase.

Second, moral hazard will be stimulated due to the mechanism. When countries know that they can go bankrupt, they will become less prudent in their borrowing. The consequence will be that overborrowing and debt defaults will occur more often. A counterargument could be that although countries can go bankrupt in the alternative mechanism, it does not imply they lose their liability. When countries overborrow there will still be costs involved. Debtors could lose lending options or borrow (much) less due to higher borrowing costs. Furthermore, it could lead to political unrest or economic downturns.

# 6. Conclusion

Sovereign debt defaults can be characterized as ad-hoc processes in which the lack of an ordered mechanism can lead to different treatments and outcomes. Defaults can be costly and the principle to respect contracts, in less-developed countries, may lead to unjust circumstances, whereby citizens’ basic interests can be neglected and (debtor) states do not have the ability to pursue their own goals and policies. Three arguments have been put forward that may outweigh debt contracts. Firstly, states need have the ability to provide basic goods to their citizens. Next, states need to have enough self-determination to pursue their own policies and goals. Lastly, debt contracts need to fulfil certain conditions to be binding.

As that the present philosophical frameworks about sovereign debt defaults do not take all requirements into account, a framework was proposed based on Nussbaum’s capabilities approach. In this approach individual interests are of primary concern, which is also applicable in debt defaults. Two collective capabilities have been proposed. First, the capability of states to deliver subsistence capabilities to deliver public goods towards their citizens. Second, the capability self-determination may trump debt contracts when states do not have enough positive freedom to interact with other agents. Furthermore, contract conditions are not translated into capabilities but relate to the approach. For example, the approach is a substantive freedom framework and states need to have at least some equality to exercise this freedom in sovereign debt interactions.

An international bankruptcy mechanism was proposed to promote the justice in debt defaults. This will increase the chance that more less-developed countries can achieve their collective capabilities so that more individual interests will be fulfilled. Furthermore, the chance that contract conditions will be met will increase because the mechanism will probably decrease power asymmetries between debtors and creditors. This is due to the impartiality of the international court where both sides are treated equally. Besides, another probable consequence is that the mechanism will increase the chance of fair cost-sharing and faster resolving defaults. Overall, the mechanism increases the (legal) opportunities to void and alter contracts, thereby promoting fair default outcomes between debtors and creditors and increasing justness of debt defaults.

Several limitations and opportunities for further research have been (briefly) discussed. First, the political dimension was not taken into account. Further research could incorporate this dimension, which could enrich the justice framework and mechanisms. For instance, the risk of losing elections may influence politicians to avoid defaults and new political frameworks like the European Union will probably affect debt default processes. Second, not all economic views were taken into account. Perhaps the inclusion of all views could lead to richer justice frameworks and mechanisms. A further integration of justice, economic and other social science frameworks could also be an interesting multi-disciplinary field for further research.

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1. An recent overview of the IMF shows that defaulting countries were less-developed countries the last decennia.

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2. Barry Herman, “Introduction: The Players and the Game of Sovereign Debt," *Ethics & International Affairs* 21, (2007), 5-32. [↑](#footnote-ref-2)
3. Das, Papaioannou and Trebesch, “Sovereign,” 7. [↑](#footnote-ref-3)
4. Das, Papaioannou and Trebesch, “Sovereign,” 8. [↑](#footnote-ref-4)
5. Kunibert Raffer, "Risks of Lending and Liability of Lenders," *Ethics & International Affairs* 21 (2007), 85-106. [↑](#footnote-ref-5)
6. On their site the IMF monitors the HIPC program.

   https://www.imf.org/external/np/exr/facts/hipc.htm (consulted 22 May 2015). [↑](#footnote-ref-6)
7. The World Bank was the other organization that was set up in the Bretton Woods system with the aim to overcome international financial market imperfections and transferring financial resources to developing countries through the intermediation of the World Bank. The bank issued bonds and the regional development banks would lend to developing countries on terms that these individual countries could not achieve. [↑](#footnote-ref-7)
8. Herman, “Introduction,” 24-25. [↑](#footnote-ref-8)
9. Herman, “Introduction,” 13. [↑](#footnote-ref-9)
10. Herman, “Introduction,” 13. [↑](#footnote-ref-10)
11. Herman, “Introduction,” 15. [↑](#footnote-ref-11)
12. Herman, “Introduction,” 17. [↑](#footnote-ref-12)
13. Herman, “Introduction,” 18. [↑](#footnote-ref-13)
14. Das, Papaioannou and Trebesch, “Sovereign,” 8. [↑](#footnote-ref-14)
15. Ugo Panizza, Federico Strurzenegger and Jeromin Zettelmeyer, “The Economics and Law of Sovereign Debt and Default,” *Journal of Economic Literature* 47 (2009), 675-682. [↑](#footnote-ref-15)
16. From the nineteenth century until present, defaults are regular events. In a large part of the nineteenth century more than 20% of the states were in default or restructuring and during the interwar period that percentage reached over 40%, mainly due to the WOI aftermath and the depression in the 1930s. A significant part of the Western countries were included. In the post-WOII period the number of countries in default and restructuring dropped to below 5% in the 1970s, and in the 1980s and 1990s this number increased due to the debt crisis of several emerging market countries. In the 1980s the Latin American and African countries defaulted or restructured and the same applied for the Asian countries and Russia in the 1990s. [↑](#footnote-ref-16)
17. Panizza, Strurzenegger and Zettelmeyer, “The Economics,” 653. [↑](#footnote-ref-17)
18. Panizza, Strurzenegger and Zettelmeyer, “The Economics,” 653. [↑](#footnote-ref-18)
19. The United Kingdom adopted similar legislation in 1978 and many other jurisdictions followed.

    Panizza, Strurzenegger and Zettelmeyer, “The Economics,” 653. [↑](#footnote-ref-19)
20. Panizza, Strurzenegger and Zettelmeyer, “The Economics,” 671. [↑](#footnote-ref-20)
21. Christian Barry and Lydia Tomitova, "Fairness in sovereign debt," *Social Research* (2006), 649-694. [↑](#footnote-ref-21)
22. Barry and Tomitova, "Fairness,” 53-55.

    Gabriel Wollner, “Morally Bankrupt: International Financial Governance and the Ethics of Sovereign Default,” (unpublished), 3. [↑](#footnote-ref-22)
23. Das, Papaioannou and Trebesch, “Sovereign,” 32-33. [↑](#footnote-ref-23)
24. Barry and Tomitova, "Fairness,” 53. [↑](#footnote-ref-24)
25. Barry and Tomitova, "Fairness,” 53. [↑](#footnote-ref-25)
26. Das, Papaioannou and Trebesch, “Sovereign,” 22. [↑](#footnote-ref-26)
27. Barry and Tomitova, "Fairness,” 55. [↑](#footnote-ref-27)
28. Das, Papaioannou and Trebesch, “Sovereign,” 41. [↑](#footnote-ref-28)
29. Das, Papaioannou and Trebesch, “Sovereign,” 20-46. [↑](#footnote-ref-29)
30. Bloomberg, “Argentina Will Repay Paris Club Debt 13 Years After Default,” 2015.

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32. Raffer, "Risks,“ 93. [↑](#footnote-ref-32)
33. Raffer, "Risks,“ 85. [↑](#footnote-ref-33)
34. Raffer, "Risks,“ 87. [↑](#footnote-ref-34)
35. Christian Barry, “Sovereign Debt, Human Rights, and Policy Conditionality,” *The Journal of Political Philosophy* 19 (2011), 286-287. [↑](#footnote-ref-35)
36. See Julia Maskivker, who discusses just debt relief for highly indebted poor states and sees self-determination as a basic liberty that all countries need to have in order to act as equal agents. See also Gabriel Wollner, who refers to “global background conditions” in his (unpublished) paper about a just sovereign debt framework that has to be met and what is at stake is the agency of states.

    Julia Maskivker, “A Non-Cosmopolitan Case for Sovereign Debt Relief,” *Journal of Global Ethics* 6 (2010), 57-70.

    Gabriel Wollner, “Morally,” 1-23. [↑](#footnote-ref-36)
37. Herman, “Introduction,” 21-23. [↑](#footnote-ref-37)
38. Celine Tan, "Life, debt and human rights: contextualising the international regime for sovereign debt relief," *Warwick School of Law Research Paper* (2011), 1-20. [↑](#footnote-ref-38)
39. Miriam Ronzoni, “Two conceptions of State Sovereignty and their Implications for Global Institutional Design,” *Critical Review of International Social and Political Philosophy* 15 (2012), 577. [↑](#footnote-ref-39)
40. John Rawls, “The law of peoples," *Critical Inquiry* (1993), 46-47. [↑](#footnote-ref-40)
41. See also Sanjay Reddy and Gabriel Wollner who refer to the problematic conditions of sovereign debt contracts.

    Sanjay G. Reddy, "International debt: The constructive implications of some moral mathematics." *Ethics & International Affairs* 21 (2007), 81-98.

    Gabriel Wollner, “Morally Bankrupt,” 9-12. [↑](#footnote-ref-41)
42. Barry and Tomitova, "Fairness,” 56, 59-64. [↑](#footnote-ref-42)
43. Joseph E. Stiglitz, "Ethics, market and government failure, and globalization," in *Vatican Conference at the Ninth Plenary Session of the Pontifical Academy of Social Sciences* (2003), 2-6.

    Barry and Lydia Tomitova, "Fairness,” 16. [↑](#footnote-ref-43)
44. Brian Barry defines power between agents as follows: “A has power over B if A has the ability to bring about desired actions on the part of B by exploiting B’s belief that A can make B worse off contingently on B’s behaviour.”

    Brian Barry, “Capitalists Rule Ok? Some Puzzles About Power,” *Politics, Philosophy and Economics* 1 (2002), 161. [↑](#footnote-ref-44)
45. Stiglitz, "Ethics,” 5-6. [↑](#footnote-ref-45)
46. Das, Papaioannou and Trebesch, “Sovereign,” 9. [↑](#footnote-ref-46)
47. Eduardo Borensztein and Ugo Panizza, "The costs of sovereign default," *IMF Staff Papers 56* (2009), 684. [↑](#footnote-ref-47)
48. Jonathan Eaton and Raquel Fernandez, “Sovereign Debt,” in *Handbook of International Economics*, ed. Gene M. Grossman and Kenneth S. Rogoff (Amsterdam; New York and Oxford: Elsevier,1995), 2031-2077. [↑](#footnote-ref-48)
49. Jeremy Bulow and Kenneth Rogoff, “Multilateral Negotiations for Rescheduling Developing Country Debt,” *IMF Staff Papers* 35 (1988), 644-657.

    Jeremy Bulow and Kenneth Rogoff, “A Constant Recontracting Model of Sovereign Debt,” *Journal of Political Economy* 97 (1989), 155-178. [↑](#footnote-ref-49)
50. Das, Papaioannou and Trebesch, “Sovereign,” 60-63. [↑](#footnote-ref-50)
51. Das, Papaioannou and Trebesch, “Sovereign,” 61-62, 64-66. [↑](#footnote-ref-51)
52. See e.g. Mark Aguiar and Manuel Amador, ”Sovereign Debt,” in *Handbook of International Economics*, ed. Gita Gopinath, Elhanan Helpman and Kenneth Rogoff (Amsterdam and Oxford: Elsevier Science, 2014), 647-684. [↑](#footnote-ref-52)
53. Herschel Grossman and John Van Huyck, “Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation and Reputation,” *National Bureau of Economic Research Working Paper* No. 1673 (1985), 1-19. [↑](#footnote-ref-53)
54. Das, Papaioannou and Trebesch, “Sovereign,” 60. [↑](#footnote-ref-54)
55. Panizza, Strurzenegger and Zettelmeyer, “The Economics,” 677.

    Borensztein and Panizza, "The costs,” 722. [↑](#footnote-ref-55)
56. Bulow and Rogoff, “Multilateral,” 651. [↑](#footnote-ref-56)
57. Bulow and Rogoff have discussed other distinctions between the two approaches.

    Jeremy Bulow and Kenneth Rogoff, “Why sovereigns repay debts to external creditors and why it matters,” VOX, June 2015.

    http://www.voxeu.org/article/why-sovereigns-repay-debts-external-creditors-and-why-it-matters (consulted 15 June 2015). [↑](#footnote-ref-57)
58. For instance, Borensztein and Panizza show that sovereign defaults are costly for export-oriented industries by using industry-level data.

    Panizza, Strurzenegger and Zettelmeyer, “The Economics,” 679. [↑](#footnote-ref-58)
59. The IMF report in their empirical survey of sovereign debt defaults and restructurings between 1950-2010 that the economic output losses of between 2-5 percent of GDP were found, where the size of the output costs depends on whether debt crisis simultaneously occur with banking and currency crisis.

    Das, Papaioannou and Trebesch, “Sovereign,” 61. [↑](#footnote-ref-59)
60. By investigating the in 19 defaulting democracies Borenstein and Panizza found that the ruling political parties in 18 countries lost votes in the subsequent elections. Furthermore, in 50 percent of the cases there was a change in the chief of the executive either in the year of the default episode or in the following year.

    Borensztein and Panizza, "The costs,” 718, 722. [↑](#footnote-ref-60)
61. Panizza, Strurzenegger and Zettelmeyer, “The Economics,” 690-691. [↑](#footnote-ref-61)
62. Federico Sturzenegger and Jeromin Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crisis* (Cambridge: MIT Press, 2006), 42-44. [↑](#footnote-ref-62)
63. The inefficiency arises because lower borrowing combined with appropriate transfers of income between persons could in principle lead to a Pareto improvement.

    Reddy, "International debt,” 14. [↑](#footnote-ref-63)
64. Daniel M. Hausman and Michael S. McPherson, *Economic Analysis, Moral Psychology, and Public Policy*, 2nd edition (Cambridge: Cambridge University Press, 2006). [↑](#footnote-ref-64)
65. Stiglitz, "Ethics,” 2. [↑](#footnote-ref-65)
66. Rights-based theories defend that rights are needed to protect the fundamental interests of humans.

    Rutger Claassen, “Financial Crisis and the Ethics of Moral Hazard,” *Social Theory and Practice* 41 (forthcoming), 4. [↑](#footnote-ref-66)
67. Reddy, "International debt,” 3-10. [↑](#footnote-ref-67)
68. Reddy, "International debt,” 16. [↑](#footnote-ref-68)
69. Reddy, "International debt,” 19. [↑](#footnote-ref-69)
70. Reddy gives an historic example when the U.S. raised its interest rates in the 1980s with the intent of reducing its inflation. This was one (important) factor that contributed to the fact that several developing countries could not service their foreign currency debt anymore, leading to the 1908s debt crisis.

    Reddy, "International debt,” 19. [↑](#footnote-ref-70)
71. Reddy also explicitly mentions this that he does not want to challenge the current norm of respecting contracts, but his approach will permit the slogan to be more comprehensively adhered to in practice.

    Reddy, "International debt,” 17. [↑](#footnote-ref-71)
72. In this review I focus on the contract conditions and not on the contract features which are also discussed by Barry and Tomitova. [↑](#footnote-ref-72)
73. Barry and Tomitova, "Fairness,” 20. [↑](#footnote-ref-73)
74. Barry and Tomitova, "Fairness,” 19. [↑](#footnote-ref-74)
75. Julie Nelson, “Ethics, evidence and international debt,” *Journal of Economic Methodology* 16 (2009), 176-177. [↑](#footnote-ref-75)
76. Wollner, “Morally bankrupt,” 6. [↑](#footnote-ref-76)
77. Although the division is different, the line of reasoning is in line with Barry and Tomitova. See for more details about the problems with these conditions section 3.2. [↑](#footnote-ref-77)
78. Wollner, “Morally bankrupt,” 13. [↑](#footnote-ref-78)
79. The simplified argument is given by Wollner because a complete version would be too extensive. [↑](#footnote-ref-79)
80. Wollner, “Morally bankrupt,” 19. [↑](#footnote-ref-80)
81. Reddy mentioned for instance that it is very difficult to measure which citizens benefit from public debt due to the interpersonal nature of sovereign debt. [↑](#footnote-ref-81)
82. Gabriel Wollner, “Justice in Finance: The Normative Case for an International Financial Transaction Tax,” *The Journal of Political Philosophy* 22 (2014), 470. [↑](#footnote-ref-82)
83. See e.g. Martha C. Nussbaum,”*Mogelijkheden scheppen. Een nieuwe benadering van de menselijke ontwikkeling*, trans. Rogier van Kappel, 3rd (Amsterdam: Ambo, 2014). [↑](#footnote-ref-83)
84. Martha C. Nussbaum, “Capabilities, Entitlements, Rights: Supplementation and Critique,” *Journal of Human Development and Capabilities: A Multi-Disciplinary Journal for People-Centered Development* 12 (2011), 25. [↑](#footnote-ref-84)
85. Jack Donnelly, *Universal Human Rights in Theory and Practice, 3rd ed* (Ithaca and London: Cornell University Press, 2013), 28. [↑](#footnote-ref-85)
86. Nussbaum, “Capabilities,” 23. [↑](#footnote-ref-86)
87. Claassen, “Financial,” 4. [↑](#footnote-ref-87)
88. Claassen, “Financial,” 6. [↑](#footnote-ref-88)
89. Séverine Deneulin, "Beyond individual freedom and agency: Structures of living together in Sen’s capability approach to development," in *The Capability Approach: Concepts, Measures and Application* (Cambridge: Cambridge University Press, 2008), 110-111. [↑](#footnote-ref-89)
90. Rutger Claassen, “The Capability to Hold Property,” *Journal of Human Development and Capabilities* (2014), 6. [↑](#footnote-ref-90)
91. Miriam Ronzoni argues that the freedom of sovereigns must be seen in the ‘negative’ and ‘positive’ manner. Ronzoni, “Two conceptions,“ 574. [↑](#footnote-ref-91)
92. Herman, “Introduction,” 23. [↑](#footnote-ref-92)
93. According to Ronzoni negative freedom is arguably the central concept of contemporary international law. Ronzoni, “Two conceptions,“ 577. [↑](#footnote-ref-93)
94. Axel Dreher, IMF conditionality: theory and evidence,” *Public Choice* 141 (2009), 243. [↑](#footnote-ref-94)
95. Cephas Lumina, “Sovereign debt and human rights,” in *Realizing the Right to Development United Nations* (2013), 293. [↑](#footnote-ref-95)
96. Lumina, “Sovereign debt,” 295. [↑](#footnote-ref-96)
97. Herman, “Introduction,” 9. [↑](#footnote-ref-97)
98. Stiglitz mentions several defaulting less-developing countries in which IMF conditions or policy advice led to depriving social circumstances of the country’s citizens. For instance, Indonesia, Moldavia and Argentina.

    Stiglitz, “Ethics,” 7, 8-10, 13. [↑](#footnote-ref-98)
99. Wollner, “Morally bankrupt,” 7. [↑](#footnote-ref-99)
100. Lumina, “Sovereign debt,” 295. [↑](#footnote-ref-100)
101. Leif Wenar, “Property rights and the resource curse,” *Philosophy & Public Affairs* 36 (2008), 2-32. [↑](#footnote-ref-101)
102. Wenar, “Property,” 3. [↑](#footnote-ref-102)
103. Wenar, “Property,” 22-25. [↑](#footnote-ref-103)
104. This is in line with Wenar’s argumentation. [↑](#footnote-ref-104)
105. Alexander Cappelen, Rune Hagen and Bertil Tungodden, “National Responsibility and the Just Distribution of Debt Relief,” *Institute for Research in Economics and Business Administration Working Paper* 31/06 (2006). [↑](#footnote-ref-105)
106. Claassen, “The Capability,” 2. [↑](#footnote-ref-106)
107. Claassen, “The Capability,” 5. [↑](#footnote-ref-107)
108. Martha C. Nussbaum, *Grensgebieden van het recht. Over sociale rechtvaardigheid,* Trans. Rogier van Kappel en Peter Diderich (Amsterdam: Ambo, 2006), 262. [↑](#footnote-ref-108)
109. Nussbaum, *Grensgebieden,* 268. [↑](#footnote-ref-109)
110. Samuel Freeman, “Frontiers of justice: The capabilities approach vs. Contractarianism,” *Texas Law Review* 85 (2006), 387-388, 409-410. [↑](#footnote-ref-110)
111. As indication for the affordability of countries, one can mention that debt defaults in the last decennia were less-developed countries. They are less wealthy than developed countries. This can be an indication that when countries have a certain level of welfare, it is not likely that they stop servicing debt and default. [↑](#footnote-ref-111)
112. Barry, “Sovereign Debt,” 285. [↑](#footnote-ref-112)
113. Nussbaum, *Grensgebieden,* 90-95.

     United Nations

     http://hdr.undp.org/en/content/human-development-index-hdi (consulted 15 June 2015). [↑](#footnote-ref-113)
114. Elizabeth Anderson, “What is the Point of Equality?” *Ethics* 109 (1999), 295. [↑](#footnote-ref-114)
115. Reddy uses the term moral personhood that is essential for individuals to take responsibility.

     Reddy, "International debt,” 3. [↑](#footnote-ref-115)
116. Reddy, "International debt,” 11. [↑](#footnote-ref-116)
117. Several authors proposed a form of sovereign debt bankruptcy, e.g. Kunibert Raffer (1990), Ann Pettifor (2003), Joseph Stiglitz and Gabriel Wollner.

     Kunibert Raffer, “Applying chapter 9 insolvency to international debts: an economically efficient solution with a human face,” *World Development* 18 (1990), 301-311.

     Ann Pettifor, “Resolving International Debt Crisis Fairly,” *Ethics & International Affairs* 17 (2003), 2-9.

     Joseph Stiglitz, “Sovereign Debt: Notes on Theoretical Frameworks and Policy Analyse,” *Initiative for Policy Dialogue Working Paper* (2002), 1-24.

     Wollner, “Morally,” 1-23. [↑](#footnote-ref-117)
118. Raffer, “Applying”, 304. [↑](#footnote-ref-118)
119. Raffer, “Applying”, 303. [↑](#footnote-ref-119)
120. Raffer, “Applying”, 303.

     Stiglitz, “Sovereign,” 20. [↑](#footnote-ref-120)
121. Raffer, “Applying”, 303. [↑](#footnote-ref-121)
122. In fact the United States did that when they voted against the UN proposal as first step in bankruptcy.

     United Nations, “Resolution on Sovereign Debt Restructuring Adopted by General Assembly Establishes Multilateral Framework for Countries to Emerge from Financial Commitments,” 2014.

     http://www.un.org/press/en/2014/ga11542.doc.htm (consulted 15 June 2015). [↑](#footnote-ref-122)