

Odious Debt and the Effectiveness of an International Judging

Institution

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Abstract: There has been increased pressure on foreign governments and international institutions to forgive the debt of poor countries based on an argument of the odiousness of the debt accrued. This paper reviews a working definition of odious debt and a possible solution to the problem proposed by Kremer and Jayachandran (2002). They suggest setting up an international committee that would judge régimes as ‘odious’. Such a declaration would signal to international lenders that the debt accrued would not be binding once a régime has been changed. The efficacy of this arraignment in reducing odious debt is explored using a game-theoretic model of sanctions. The paper shows that if such an organization were able to operate, and the financing sanctions were credible, such an institution could reduce the overall amount of odious debt in the world by discouraging takeovers by potential odious régimes. They could not, however, eliminate the possibility of an odious régime coming to power.

1. Introduction

The amount of debt accumulated in many developing countries has invigorated a movement demanding debt be forgiven for the poorest countries in the world. The Jubilee Network has been established to promote the cause of debt forgiveness for developing countries and is endorsed by celebrities such as Bono from the band U2, the San Francisco Forty-Niners (Vieth 2002), and the Catholic Church (Pope John Paul II, 1999). The effort has received so much support that in 1999 Jubilee handed over a petition signed by 17 million people asking leaders of the richest countries to cancel the debts of the world's poorest countries ("Hand-over.." 1999).

The Jubilee Network's platform (2004) offers three conditions that qualify a country for debt forgiveness: 1) when paying back the debt inhibits the government from meeting the basic needs of its population, 2) when repudiation of the debt would help the impoverished country's minorities, or 3) when the debts were found to be illegitimate or odious through a just and equitable process not controlled by the creditors. The IMF has attempted to address some of the concerns of the first two platforms by creating the Highly Indebted Poor Countries Debt Initiative to reschedule debt and organize debt relief (IMF and World Bank Staff, 2001). The effectiveness of this initiative and other forms of debt relief has been well researched (Allen and Weinhold, 2000; Arslanalp and Henry, 2003). However, the idea that some debt is not the responsibility of citizens to pay because of the way in which it was incurred has not been studied as intensely.

This paper will concentrate on the work being done to define and reduce the amount of odious debt in the world. Using a working definition of odious debt introduced by King (2003), the ability of Kremer and Jayachandran's (2002) proposed international odious judging institution to reduce odious debt is evaluated. A game theoretic model of sanctions is used to determine the effects of such a judging institution. It is found that if such an organization were able to operate, and the financing sanctions were credible, such an institution could reduce the overall amount of odious debt in the world by discouraging takeovers by potential odious régimes. They could not, however, eliminate the possibility of an odious régime coming to power.

Section two reviews the history and presents some traditional examples of odious debt. The formal and working legal definition of odious debt proposed by King is

discussed in Section three. Section four presents Kremer and Jayachandran solution to the odious debt problem; setting up an international judging institution.. Section five addresses the efficacy of such a proposed international judging institution using a sanctions game theoretic framework. Section six contains the conclusions and areas of possible extended research.

2. History and Examples of Odious Debt

Historically citizens of many countries have suffered under the hands of self-gratifying governments. Leaders of such governments accrue huge national debts enriching themselves, their families, and friends at the expense of the population over which they are stewards. If a country is lucky enough to escape the rule of such selfish officials, it will be strapped with large amounts of debt. Jubilee along with many others would argue that it is not fair for those citizens to be held responsible for paying back the funds misused by their previous leadership.

The odious debt argument was first used by the United States after the Spanish-American War and the “liberation” of Cuba. The United States argued that neither they nor Cuba was responsible for Cuba’s debt incurred by the Spanish colonial rulers. They argued that the loans the Spanish government was asking to have repaid were not used for the benefit of the greater Cuban population and the burdens of those loans had been imposed on Cuba without the consent of its people (King, 2003).

Other governments’ debts have been singled out as odious in various contexts. Post-apartheid South Africa is a common example; much of its debt was accumulated by the apartheid régime to suppress the majority black population and solidify the position of the ruling white majority. Hanlon and Pettifor (2001) give a large list of possible odious régimes. This includes leaders who have stolen blind from their countries such as Somalia’s Mohammad Siad Barre, Liberia’s Samuel Doe, Sudan’s Gafaar Nimeiri, and Mobutu Sese Seko of Zaire. Mobutu stole so much that when he died he was the world’s richest man, worth an estimated \$4-\$10 billion. His country, on the other hand, had over \$13 billion in debt.

Military leaders in Argentina in the 1970s, Nigeria in the 1980s, the previous Mexican government, the former Prime Minister of Pakistan, and the president of Gabon

all had large British, American, or Swiss bank accounts to siphon off loans their countries were given. Directly before the collapse of the ruble an emergency loan from the IMF to Russia went out of the country and into foreign bank accounts almost overnight. In each of these cases, the general population received little benefit from the debt that was incurred.

In addition to outright stealing, Hanlon and Pettifor identify other possible sources of odious debt. They cite a number of public projects undertaken in developing countries that were ineffective or grossly overpriced. A few examples include a nuclear power plant in the Philippines built on a fault line, a platinum refinery in Bolivia using untested technology that never produced platinum, and 26 failed agricultural projects in Tanzania. There were also loans granted to build dams in Indonesia and Zaire that were constructed at astronomical prices to cover bribes and corruption in those countries. The authors also point to governments, such as General Suharto's in Indonesia, that have been granted many loans because of political support from the West, but also have a record of gross human rights violations and used much of the money to suppress his own population.

3. Definition

In order to confront the issue of odious debt it is important to have a precise definition. Should all of the examples presented by Hanlon and Pettifor be considered odious? Could a debt that was incurred for a legitimate project be declared odious if the project turned out not to be successful? Countries that seek to have their debt declared odious, and lending institutions that work with developing countries all need a working legal definition of "odiousness" in order to legitimately protect their interests.

Jeff King (2003) has advanced a legal study of the doctrine of odious debt. He first surveys original studies on this subject by Alexander Sack, Ernst Feilchenfeld, O'Connell, Frankenburg, and others to piece together the following three criteria for a debt to be odious:

“(1) debt that has not received the general consent of the nation (2) the borrowed funds are contracted and spent in a manner that is contrary to the interests of the nation, and (3) the creditor lends in awareness of these facts.”

King uses evidence of state practices of repudiation, qualifications in law when debt repayment is viewed as non-obligatory, possible international conventions, general principles of international law, existing doctrine, and judicial decisions to show how the doctrine of odious debt has been elaborated and supported in international law. These premises could be used to justify bringing a case of repudiation based upon unjust indebtedness to a court. Once in court, a capable lawyer would have to prove absence of consent, absence of benefit, and awareness on the part of the creditors.

Guidelines as to what would prove absence of consent, absence of benefit, and awareness are less straightforward. The rest of this section summarizes King's interpretation of sufficient proof according to past decisions, but law continually changes especially with how untested this doctrine is in the court systems. Therefore, the guidelines set out by King are the best now but could be adjusted if use of this doctrine becomes more widespread and refined in the court systems.

Proving absence of consent is relatively straightforward if the government in power was not elected democratically or does not hold regular fair elections, called quasi-democratic (measures of election fairness and regularity are monitored by some non-profits such as the Center for Democracy, www.centerfordemocracy.org). There are democratically elected governments that incur debt in ways that are not in the interest of its people such as Nigeria in the late 1970s or Pakistan after independence. Proving absence of consent is much more difficult in this case, two alternative solutions have been offered to address this difficulty.

Kremer and Jayachandran (2002) suggest excluding such countries' debt from being declared odious because 1) exclusion is consistent with establishing the countries' prerogative and interfering would violate their sovereignty, 2) exclusion reduces the chance that a regime be falsely accused and prosecuted as odious for political reasons, and 3) exclusion reduces the attractiveness of coups because non-democratically elected regimes have a good chance of being declared odious, thus reducing the possible payoffs of taking over undemocratically. They suggest that in such a case international financial institutions could announce that they believe the practices by the country in question will lead to them to be unable to pay back their loans. Thus any debt incurred from that point will not be subject to bail-out in a future date. From that point, private lenders are

responsible for their own risks and cannot count on a bail-out. In this way, the rights of the citizens are not restricted, but lenders are required to be more cautious in their lending.

Such a solution requires decisions and commitments that international finance institutions most likely will not want to make. King, on the other hand, argues that once a debt is shown to have no benefit for the population, it easily can be argued that the population did not consent to the agreement. Therefore, in King's argument, first absence of benefit needs to be established and then the argument should be made that the population did not consent to such abuses when they elected that individual. This has yet to be used in any historical case, so this remains an uncertain point in the criteria for odiousness.

King argues that the absence of benefit may be presumed when the loan is granted to dictatorial or near dictatorial governments and must be proven when the loan goes to democratic or near democratic governments. *Prima facie* cases where odiousness could be established are when the loan is spent on personal enrichment, used for military purposes against the interests of the general population, spent on infrastructure distributed discriminatorily, and used to develop, maintain, or enhance oppressive institutions. A country that can prove that any of these things occurred under a previous regime can declare their debt odious.

Note, this definition does not mention loans that are used in projects that simply fail, such as in Tanzania. A development project that was not successful because of mismanagement or that was ill advised, at this point does not have a legal precedent in contributing to a declaration of such debt as illegitimate. One possible solution in such situations is similar to the argument presented above by Kremer and Jaychandran: have international financial institutions evaluate projects and announce whether such loans would be subject to a bail out if it were required in the future.

The last of King's criterion that must be met is that creditors have knowledge that their loans will be used in an odious way. Such a stipulation could make it difficult to establish odiousness. Loans may be used for purposes not intended by the lending institution, yet the country, even without consent or benefit, would be saddled with the debt.

King suggests that there be no blanket loans issued and that every loan be issued with a specific purpose and contract as to exactly what the funds will be used for and then issue the disbursements in installments dependent on whether the funds were used for the specified purpose. Though a possible solution, such a requirement could unnecessarily restrict the credit market, and increase costs associated with monitoring. This could lead to higher interest rates for all countries, including those with legitimate governments.

Existence of an authoritative judging institution could overcome this problem. Once a régime has been declared odious by this institution, any loan made after that point will be given with full knowledge that the loan will be labeled odious. The difficulty of proving knowledge is eliminated.

In addition, such an arrangement actually helps legitimate governments needing loans. First, they will see lower interest rates because some of the risks lending institutions take on are eliminated (IMF and World Bank staff, 2001). Second, extra-constitutional (non-democratic) takeovers are discouraged because potential rivals realize that such actions make the possibility of a loan embargo very high.

4. A Judging Institution

A successor government, especially in less developed countries where future lending is needed for growth and stabilization, finding itself burdened by odious debt, has reason not to apply for a declaration of its accumulated debt odious. A major problem arises when a country's credit rating falls if it hints at default of a debt, even if the debt was inherited odiously from a previous régime. This damages the country's reputation in the credit market, and thus the ability to seek funds for socially legitimate projects under the new government (Easterly, 2001).

Post-apartheid South Africa and post-Somoza Nicaragua, provide two examples of successor governments that have chosen to retain their inherited debt, even though the debt would meet most criteria for odiousness. King finds only ten historical cases where odiousness arguments have been used to repudiate debt, two of which were made by world powers on behalf of countries they had liberated or occupied. Thus, the perceived benefits of repudiating debts, even incurred illegitimately appear to be less than the reputation costs in most cases.

Kremer and Jayachandran (2003) introduce a game theoretic model of sovereign debt with penalties for default, including seizure of assets and loss of reputation. They show that if there were a hypothetical institution that truthfully announced whether a régime is odious or not, one possible equilibrium allows for repudiation without a loss of reputation. In order to insure that the above desired equilibrium occurs, enforcement mechanisms must be in place to insure that the institutions passing judgment have authority.

Two possible enforcement mechanisms exist. First, creditor country law can be changed to forbid the seizure of the assets from a country that repudiates an odious debt (as declared by the “judicial” institution). Second, donors could bind themselves to withhold foreign aid from countries that are paying back loans that were declared odious.

Under these conditions, if a régime *a priori* has been declared odious by this truth-telling institution, lending institutions have incentives not to lend to these governments. If there is a régime change then the bank is guaranteed not to get any money back on their loan. This near guaranteed of default on the loan makes it much less likely that odious loans will be issued in the first place. Therefore, the existence of an institution that truthfully judges whether a régime is odious or not, introduces a new solution to the odious debt problem. It provides another form of statecraft for the world to use to deter illegitimate or irresponsible governments. Having such an institution introduces the ability to create an effective loan embargo.

An effective loan embargo prevents illegitimate authorities from having access to international money, thus curbing odious debt before it happens. In addition, illegitimate authorities will have a disincentive to try and assume power. International statecraft is introduced to apply pressure for change in the behavior of current illegitimate governments. In this way the idea of odious debt not only can relieve some of these beleaguered countries of illegitimate debt, it can help countries collectively create a loan embargo policy as a means of inducing improved governance worldwide.

Kremer and Jayachandran point out that it is very possible that biases will exist within the “judicial” institution, and they propose a solution to this problem. They show that if the institution were to be biased toward the welfare of either the debtor country or the creditors, false rulings will occur. If this institution were allowed to rule only on the

odiousness of future loans then they are induced to be truth telling whether or not they have bias toward one of the parties involved. A more difficult problem arises when the institution has a bias towards one régime or another. Even an *ex post* ruling on the odiousness of a régime still could induce a false ruling. Kremer and Jayachandran suggest that rules be put in place that constrain the institution to error on the side of assessing régimes' debt as non-odious. This, they argue, still would be an improvement over the status quo.

Giving the “judicial” institution power to only judge *ex post* makes using the doctrine of odious debt only viable as a sanction to stop abuse and not a tool for relieving debt for those already yoked by it. A constantly changing political world would require this institution to review governments periodically and evaluate the use of funds or loans granted to those régimes. If a government uses these loans in a way that was not in the benefit of their own population, then that country would be declared odious and hence, any new loans received declared odious as well. This declaration would not negate the loans that were used prior to the declaration, but any loan granted after that declaration, according to the enforcement laws that would have to be in place, would be repudiated if there were a change in régime.

The existence of an *ex post* “judicial” institution still could discourage non-democratic takeovers as the expected benefit from a coup are decreased. If a potential dictator knows her ability to steal from the country is limited, she may not decide to be aggressive.

To complete the discussion on the judicial institution it is important to determine how this institution should be set up. Kremer and Jayachandran suggest that absence of consent could be judged by a non-profit institution, such as the Center for Democracy, or non-governmental organizations, such as Transparency International. The institution could be composed of jurists who serve long terms and represent a number of countries. This panel could include former heads of state of debtor countries, international lawyers, human rights scholars, or other well respected and informed jurors.

As shown in Section three the definition of odiousness is still in early stages of development. To solidify this definition and strengthen it this institution would need be set up like a court. Each lawyer would present evidence showing lack of benefit or not

and the court would make a decision, much like the U.S. Supreme Court. Decisions would further refine the definition of odiousness. Any particular country must not overly influence this institution and its member should not be publicly elected. Political influences must be minimized in order to get as fair a judgment as possible.

5. The Loan Embargo

With the difficulties involved in setting up such an institution and coordinating changes in law and current practices, it is important to have an idea of how effective such a set up would be in deterring odious debt. Sanctioning literature provides a number of different ways to approach the issues that are involved in sanctioning. Public choice theory (Kaempfer and Lowenberg, 1988), general equilibrium theory (Grossman, 1999; Gershenson, 2002; Garoupa and Gata, 2002), and different forms of game theory (Tsebelis, 1990; Smith, 1996) have been used in modeling the effects of sanctions.

While there is little agreement on the best way to model sanctions, each has its own strengths and weaknesses. This paper will follow a game theoretic analysis of the effectiveness of sanctions introduced by Tsebelis (1990). The advantage is this model is in its simplicity and accuracy in describing the situation facing potential odious régimes and the judging institution. In his model there are two players: the target of sanctions and the sender of sanctions. The sender has two options - to sanction or not to sanction - and the target has two options - violate or comply. The payoff matrix of the game is as follows (from table 1 in Tsebelis):

| | | Sender | |
|--------|---------|------------|-------------|
| | | Sanction | No Sanction |
| Target | Violate | a_t, a_s | b_t, b_s |
| | Comply | c_t, c_s | d_t, d_s |

This is the general payoff matrix used for all possible variations of the game.

The paper assumes that if the sender did not sanction then the target would rather violate, $b_t > d_t$. If this were not the case sanctioning would not be an issue because the target would never violate the norm of the sender. Next, it is assumed that the sender

would not sanction if there were no norm violated, $d_s > c_s$. Further he assumes that sanctions at maximum capacity have a deterrent effect, $c_t > a_t$. Finally, it is assumed that the sender country will react if their norm is violated, $a_t > b_t$. A simple look at the payoff matrix shows that there is no pure strategy equilibrium for either player. To look at what the mixed strategy would be in this case, assume payoffs for each player are linear functions and have the following utilities:

$$U_t = (d_t - c_t - b_t + a_t)xy + (c_t - d_t)y + (b_t - d_t)x + d_t$$

$$U_s = (d_s - c_s - b_s + a_s)xy + (b_s - d_s)x + (c_s - d_s)y + d_s$$

Where x is the level of violation by the target ($x=1$ means complete violation) and y is the level of sanction by the sender ($y=1$ means complete sanctioning). If both were to choose their action at the same time each would independently decide on their respective level of violation or sanction. The solution to this problem gives the mixed strategy equilibrium:

$$x^* = (d_s - c_s) / (d_s - c_s + a_s - b_s) \quad (1)$$

$$y^* = (b_t - d_t) / (b_t - d_t + c_t - a_t) \quad (2)$$

Tsbeleis shows that this equilibrium holds in the long run under simultaneous or sequential moves; perfect rationality or adaptive behavior; perfect information or incomplete information; and under dichotomist choices or continuous choices. If the choices facing the target and sender are discrete then this mixed strategy can be interpreted as the optimal frequency of mixing its two pure strategies. This will be referred to as case 1.

Two other possible situations can be thought to occurring. For case 2, $c_t < a_t$, the target county prefers to violate no matter what the reaction of the sender. This could happen because the sender country is weak and unable to inflict a serious penalty or because the sender is strong but lacks political support in its own country or abroad. This makes it hard for the sanction to be effective because there are enough countries outside the sender to do business with the target and break the sanction. In this case the target has a dominate strategy and will always violate and the sender will sanction only if

$a_s > b_s$. When $a_s > b_s$ the sender prefers to react with sanctions, because of reputation or to set an example for other rouge states, even if it knows the target will choose to violate no matter what. If this were the case the sanction would be ineffective, but a more likely outcome would be that the target violates and the sender complains but does not sanction.

Case 3 would be when $a_s < b_s$, the sender will never sanction. This could happen because the violation is so small or because the cost of sanctioning is very high. The outcome to this case is that the target will choose to violate.

These results give a framework to discuss the outcome of creating an institution designed to judge the odiousness of particular régimes. The sender would be the judging institution that has a discrete choice of declaring a target odious or not. The target is a particular government who is choosing the amount to steal from its country. For now assume that they have a discrete choice to be odious or not.

The establishment of a judging institution would have two different types of effects. First, it would reduce the number of outcomes that arise from case two and case three. Recall case two and case three had as equilibrium that the target would always violate, in our case the illegitimate leadership would choose to steal from their country to enrich themselves, suppress the population, or other odious activities. The only way to overcome these two cases is to influence the payoffs of the target so that they would comply if sanctioned (moving from case 2 to case 1) and to influence the sender's payoffs to make them sanction if the target violates (moving from case 3 to case 1).

An odious judgment institution and the resulting loan embargo would do this. First, the institution would not be weak and serious penalties would be imposed. The institution, with the support of enforcement laws, would be an authoritative body that would cause all long-term legitimate lenders to cease lending to the target régime. There would only be the black market and short-term loans available to the country and no incentive for another group to break the embargo¹, a problem common in trade embargos (Hufbauer and Schott, 1985). In addition, the relative independence of the institution from political factors increases the strength of the institution. These factors will affect the payoffs of the target and push the model toward a case one equilibrium. Second, the

¹ In the extreme case of politics it would be possible for a government to break the loan embargo and give money to the odious regime as a transfer, but I would consider such cases to be in the minority.

establishment of an institution and the laws requisite for enforcement would send a message that the world is serious about ending the existence of odious governments. This would increase the sender's inconvenience of the target's odiousness, thus increasing the benefits of sanctioning. In addition, the *ex post* nature of the judgment decreases the costs of sanctioning relative to a trade sanction because all it is doing is preventing future loans and making the lending market less risky. This effect causes a move from case three to case one.

In addition to moving from one case to another, there is also an effect on the frequency of violations in case one. Notice that in case one, odious targets will still exist. There will also still be successful and unsuccessful sanctions because of the mixed strategy equilibrium, but the frequency of these episodes can be affected. It is important to notice that the frequency of violation depends only on the sender's payoffs and the frequency of sanctions depends only on the target's payoffs. These results make sense if one avoids the Robinson Crusoe fallacy, failing to recognize that decisions by each player are made not against nature but against another rational player. In the long run it is the action of the second player that matters most to the first because the first player adjust their behavior based on the actions of the second².

Therefore frequency of odiousness is affected by the institutions payoffs and frequency of sanctions is affected by the targets payoffs. Because the judging institution is strong and its penalties are tough, the targets payoffs change (c_t increases) and the institution will change its behavior. In this case equation (2) shows that it will decrease the frequency of sanctions they impose. The fact that the establishment of an institution increases the benefit and decreases the cost of sanctioning affects the payoffs of the sender (a_s increases). Equation (1) shows that the increase in a_s will lead to a reduction of the frequency of violations by the target.

6. Conclusions

According to the game-theoretic sanction theory, a loan embargo through the mechanism described by Kremer and Jayachandran does lead to less odiousness and sanctions. It

² This does not have to be a sequential game for the logic to hold, even if both players are acting simultaneously they still consider what the other will do.

would reduce the frequency of odious Nash equilibriums outcomes. It would also reduce the frequency at which sanctions are imposed. Expectations that such an institution will completely end the problem of odious debt are not supported because of the mixed Nash equilibrium that results. There are still questions left to be answered that have not touched on in this paper. For example, there would most likely be a run on loans granted and sought prior to the decision made by the institution. This may have a significant effect on the payoffs for the sender and target and change the frequencies in equilibrium. The welfare effects of loan sanctions on the population also needs to be addressed (Weiss, 1999). In addition, setting up a judging institution that would be effective would require a huge coordinated effort by all nations to put in place the proper enforcement mechanism. The difficulty in modeling political costs makes it hard to effectively compare the feasibility of this plan, but is a good area for future research. The results are encouraging though, if an institution could be set up that had the support of enforcement laws the frequency of odiousness régimes would decrease, and as a result the problem of odious debt in the future would decrease.

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