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ON THE ETHICS OF STATE BANKRUPTCY

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SUMMARY

The aim of this paper is to establish whether states are bound by a moral obligation to pay their debts and how sovereign insolvencies should be treated.

The state is a contractually based secondary moral agent which has supreme powers. Many states have gone bust but there are no laws governing the bankruptcy process for them.

The state's existence has intrinsic value. It is more important to safeguard an insolvent state than it is to collect its debts. This is the principle of the ethics of state bankruptcy. At the same time debt is a moral relationship between the debtor and the creditor, and the state has moral obligations as a borrower. Without moral flavour there is little trust, and without trust bonds are vague and credit yields shoot up.

Ethics speaks for bankruptcy institutions that have power to discharge sovereign debts in an organised manner.

KEYWORDS: Ethics, state, sovereign, bankruptcy, insolvency, credit, debt, bond, contract, promise, moral agent, trust

ON THE ETHICS OF STATE BANKRUPTCY

When a state runs out of cash the effects are felt all around the world. The purpose of this paper is to examine the ethical issues arising from sovereign insolvency. My focus will be on the ethical problems relating to the moral nature of sovereign debt and on the just response to a sovereign debtor's default. The aim is to establish whether state borrowers are bound by a moral obligation to pay their debts and how insolvent supreme powers should be treated.

The history of credit is as long as human history. Credit predates money - indeed, it has been argued that money was introduced out of the need to measure and pay debts.¹ Credit represents a pattern of social behaviour. As such, it is not infallible, but subject to human weaknesses and environmental conditions. There is no causal, let alone logical, necessity ensuring that what has been given as a loan will be repaid. On the contrary, default is a chance that is always present.

The question of why debts should be paid cannot be answered, in the ethical sense, by saying that this is what the law requires. The law could just as well be that debts should not be paid. Actually, this is the regime in the case of the bankruptcy laws of many countries. In order to ethically justify debt enforcement we have to go beyond positive law and give moral reasons for the obligation to honour debts. A debt is, legally, most often a consequence of a contract. Fundamentally, a contract is a promise.²

DEBT AS A PROMISE

The key to the moral obligation to pay a debt lies in the act of promising.³ If we have a moral duty to keep our promises, it also applies to our contractual debts. This infuses debt with ethics. Next, then, we may

¹ Hawtrey (1950, p. 2.); Homer and Sylla (1991, pp. 17-24); Wray (1991, pp. 8-9).

² Fried (1981, pp. 16-17).

³ Kilpi (1998, pp. 51-64).

ask upon what the moral bindingness of promises is based? The answers to this question vary depending on their association with the major traditions of moral philosophy.

The three most interesting theories of promising are utilitarian ethics emphasising the usefulness of promise-keeping, deontological ethics connecting promises to the autonomous will and moral agency of a person, and contractual thinking which explains promises as conventions of social interaction. Without examining these theories in any detail we may conclude that none challenges, *prima facie*, the moral principle that promises should be kept. This unanimity, not so common in philosophy, is a good reason to accept that contracts, as a species of promises, contain moral obligations.

Promises should be kept, therefore debts should be paid. A person's financial failure and subsequent incapacity to keep his promises does not undermine the morally obligatory nature of promises. Now we face the core dilemma of the ethics of bankruptcy: What to do with an insolvent debtor? Is a discharge of his debts justifiable?

THE ETHICS OF BANKRUPTCY

We have a duty to keep our promises and pay our dues. However, an insolvent is not able to keep his promise. A problem emerges, and in the case of natural persons and corporations it is the task of bankruptcy laws to solve this problem. The solution involves reorganisation of the relations between debtors and creditors. This may end a corporation's existence, but natural persons must continue to live even as bankrupts.

Two legal traditions part ways in how to treat personal bankruptcy. The Anglo-American culture lays the emphasis on debtor protection. An honest insolvent's debts are promptly discharged to give him a fresh start in life. Many European countries have chosen another path. They uphold creditors' rights till the debtors' death. Lately these two traditions have begun to converge as debt reorganisation schemes have been created in continental Europe as an option for insolvent natural persons.

Those who oppose bankruptcy laws protecting debtors are afraid of the erosion of social and commercial morality. Are they right to fear this? In the United States the advantage of bankruptcy varies from one state to another since the states have the power to legislate on the amount of exempt property (i.e. property not distributable to the creditors). Experience has shown that larger exemptions do not increase the susceptibility to bankruptcy.⁴ Another finding is that in those states where personal bankruptcy rates are high the creditors' losses do not rise in the same proportion.⁵ This supports the fact that bankruptcy is the last resort for the poor, not a safe haven for fortune seekers. People do not find it easier to file for bankruptcy if it leaves them with a few thousand more, nor do forced down bankruptcy numbers guarantee less losses to the creditors.

Empirical evidence suggests that hardships imposed upon honest debtors do not bring any additional benefits. In addition, it seems unlikely that such benefits would be obtained if austerity measures scared crooks, as the identification of bankruptcy with crime is a delusion. In Canada a maximum of 2.4% of business bankruptcies may have involved fraud⁶, and in the United States the figure is of the same magnitude.⁷ Likewise, in personal bankruptcies dishonesty is found to be a very rare factor.⁸ The suggestion that harsh laws are justified because they may reduce fraud falls short of the mark because bankruptcy is not exploited by profiteers and crooks to any significant extent. Fraud deserves a punishment, but this does not justify deterrents which punish all bankrupts collectively.

What, then, is the ethical justification for wiping out the debts?⁹ Bankruptcy laws providing relief from unbearable debts are ethically just in the utilitarian sense. There is little benefit to any of the parties involved if an honest insolvent is denied discharge. Deontological ethics, looking at insolvency from the

4 Sullivan *et. al.* (1989, p. 241).

5 Shuchman (1973, p. 433).

6 Sutherland (1988, p. 924).

7 Altman (1971, p. 24); Stanley and Girth (1971, pp. 11-112).

8 Ryan (1989, p. 69); Sullivan *et. al.* (1989, p. 329).

⁹ Kilpi (1998, pp. 67-82). My book *The Ethics of Bankruptcy* focuses on the ethical problems of personal and corporate bankruptcy. This paper expands the scope to state bankruptcy.

perspective of autonomy, supports discharge as well. A bankrupt is overwhelmed by his liabilities. His autonomy withers away if he is nothing but a debtor. The solution is to treat him as a person and grant him a discharge. It safeguards autonomy, a human characteristics with moral worth similar to that of an individual's body and life. A promise that would destroy the autonomy of the promisor, the morally relevant essence of his human nature, is null and void in the moral sense.

The ethics of bankruptcy uncovers discharge in personal bankruptcy as an inalienable human right. As far as corporations are concerned, rights are more a matter of expediency, but ethical analysis does not raise obstacles to corporate reorganisation and similar measures giving insolvent companies a chance to put their finances in order.

How is it with a sovereign bankrupt? First, we need to look at what kind of debtors they are. Should we treat them differently as moral agents because they have legislative powers?

THE STATE AS A MORAL AGENT

There is little doubt among philosophers that natural persons are moral agents. Recently a wide agreement has emerged that corporations are moral agents too – although most ethicists attach qualifications like 'ascribed' or 'secondary' to corporate moral agency. Kenneth Goodpaster and Patricia Werhane are renowned American business ethicists whose theories recognise our ascription of responsibility to corporations, establish corporate agency and social responsibility, but fall short of granting the corporation a fully independent personhood.¹⁰ According to these philosophers, it is rational to project ethical responsibility onto corporations, as not all corporate actions can be reduced down to the actions of individuals. However, these projections do not make corporations full persons but rather give them what Werhane calls secondary autonomy and personhood, which is sufficient to make corporations ethically responsible for their actions.

The state's moral agency has received surprisingly little attention from philosophers despite philosophy abounding with theories of the state's origin and functions. Sovereign states are the supreme legislators in their territories. They are not bound by bankruptcy laws. Are they moral agents? Do states have a moral obligation to comply with international law? No, they do not, according to contemporary legal theorists Mary Maxwell and Eric Posner who rather explain a sovereign's obligations in terms of evolutionary processes and self-interest.¹¹

My view is that there is a strong analogy between the state and the corporation. We have good reasons to consider both as secondary moral agents. The corporate moral agency emanates from contractual basis. Modern jurisprudence, economics and business ethics share the view that a corporation is a nexus of contracts.¹² It is a legal fiat which gains personality from a web of agreements and promises - tacit and explicit, oral and written.

The contracts bringing about a corporation are promises and therefore contain moral obligations. Having been born from promises a corporation extends the chain of morality initiated by the contracts that brought it into existence by paying respect to the universe of moral obligations within which it exists. A corporation lives by its charter and in doing so it keeps generating new promises and honouring the moral obligations they create. Thus, a corporation is a moral agent with peculiar characteristics which require the qualification 'secondary' to be attached to its agency.

In the same vein, in political philosophy social contract theories give good reasons to take the state as an agent that performs moral deeds and is bound by moral rights and duties. I shall here set aside the question of the nature of social contract. Regardless of whether social contract is merely a theoretical explanatory construction or built upon explicit or tacit consent of the citizens, it is a powerful philosophical argument for a civil state. If contractually based corporations are moral agents, it is hard to see why a contractually based sovereign state would not be a moral agent.

¹⁰ Goodpaster (1993), Werhane (1985).

¹¹ Maxwell (1990), Posner (2003).

¹² Kilpi (1998, pp. 172-176).

Social contract is the moral foundation of the state and its institutions, including those passing and enforcing laws. The moral entitlement to a sovereign's existence comes from contracts which are promises by their moral nature. The state is created and kept alive as a contractual expression of moral autonomy, and it has to abide by the moral nature of this expression in order to remain ethically justified as a sovereign. Thus, a sovereign state is a secondary moral agent and it is bound by the duty to keep its promises.

Although the state shares with corporations the hallmarks of secondary moral agency - contractual basis, capacity to actions distinct from citizens' actions, and ascriptions of responsibility to the agent for its actions – the state differs from corporations in one important respect. The existence of a state is necessary for humans. I noted above that within the controversial multitude of philosophical views it is widely agreed that there is a moral duty to keep promises. Now we should pay attention to the fact that, in general, philosophers also agree that a state is necessary for humans to coexist. Theories may disagree on how powerful a state should be and what the relationship between a citizen and the sovereign is, but usually the state is seen as a necessary ethical good – or at least an inevitable evil.

My analysis has now reached the point in which we can take the state as a necessary contractually based secondary moral agent which has supreme legislative powers. This helps us to answer how we should treat a bankrupt sovereign.

THE ETHICS OF STATE BANKRUPTCY

In ordinary language 'bankruptcy' stands for inability to pay one's dues. It is commonly thought that sovereign states cannot go bankrupt. This is an error. A bankrupt is a debtor entity which cannot meet its financial obligations. Many states have gone bust¹³ but there are no laws governing the bankruptcy process for sovereign states as there are for natural persons and corporations. Reorganisation of state assets and debts depends on voluntary contracting or unilateral decisions of the parties involved. What kind of ethics applies to sovereign defaults?

A bankrupt individual's inalienable human rights turned out to be morally superior to his obligation to pay his overwhelming debts. Expediency and creditors' interests count most when it is decided whether an insolvent corporation will live on or be wound down. Unlike a corporation, the state is a secondary moral agent necessary to humans. Thus, the state's existence has intrinsic value, like the life and autonomy of a natural person. It is more important to safeguard the intrinsically valuable existence of the state than continue to collect a sovereign's debts. This is the principle of the ethics of state bankruptcy.

At the same time we should keep in mind that as a contractually based agency, the state has moral obligations. One of these is the duty to keep its promises, including debt contracts. It is a moral duty regardless of the current absence of institutions dealing systematically with sovereign insolvencies. This institutional void may actually now encourage us to think of states as supreme powers outside the realm of moral obligations. In the financial markets, this attitude leads to lack of mutual trust. However, trust is needed to issue and trade bonds.

In the world of finance, credit establishes between the lender and the borrower a relation inherently moral in character. In examining the debts of natural persons and corporations we found that they are based on contracts which are promises, and promises are acts of autonomous persons. These acts carry a moral connotation, thus debt is a moral relationship between the debtor and the creditor. This moral aspect is reflected in everyday language of finance: one needs only to consider the etymology, meaning and use of terms like 'credit', 'bond' and 'trust'. Without moral flavour there is little trust, and without trust bonds are vague and credit yields shoot up.

The ethics of state bankruptcy rests on a principle which puts priority on the state's existence and functioning over the full and timely settlement of overwhelming debts. On the other hand, it reminds us that sovereigns are moral agents who are under obligation to keep their commitments. This obligation stems from the state's contractually based moral agency in accordance with deontological ethics built

¹³ Kolb (2011), Mitchener and Weidenmier (2010)

upon human autonomy, and it is also supported by utilitarian reasoning. Strong moral commitments nurture the issuing of bonds.

Here I cannot resist the temptation to make a metaethical digression. So far we have found that deontological, utilitarian and contractual ethics are all in accord over the fundamentals of promising, indebtedness and bankruptcy. Promises should be kept, debts should be paid, and the functioning of insolvent debtors' moral agency should be protected. This consensus speaks well for objectivist metaethics. If different strains of normative ethics point to similar values that are also compatible with legal theory and economic facts, we have good reason to accept that we have come across propositions of moral good and right that are truth-functional. What a remarkable and unexpected outcome of a philosophical analysis of such a controversial issue as state bankruptcy!

The best way to show that a philosophical argument can support the truth-value of an ethical principle is to show it. Or, as Michael Smith has put it in his book *The Moral Problem*:

If we are interested in the final resolution of meta-ethical questions – in whether or not there *really* are any moral facts – then it seems to me that we therefore have little alternative but to engage in normative ethical debate and see where the arguments that we give ultimately lead us.¹⁴

Thus, I shall next look at where my arguments have led us in regard to the ethics of state bankruptcy.

CONCLUSIONS

The need to orderly deal with personal bankruptcies has been recognised for thousands of years. Contemporary bankruptcy laws have direct links to the laws of ancient Rome. Corporate insolvencies have been dealt with in an organised manner for as long as corporate laws have existed. Institutions clearing financial failures exist all over the world, and have existed throughout the ages. The contents of laws vary considerably. What does not vary is that bankruptcy as an institution has always been found to be a greatly beneficial economic and administrative tool.

In the case of sovereign bankruptcy, should we also have in place an institutional arrangement, a framework of contracts as well as executive and judicial bodies, to reap the benefits of an organised bankruptcy process? Undoubtedly yes, we would be better off if competent judges, trustees, auditors and financiers settled sovereign financial failures and put them in the past. Like with individuals and corporations, the future would be brighter if the slate of states' past mistakes could be wiped clean without excess stigma and reproach. "Debts which are forgiven will be forgotten"¹⁵ is a true proposition that applies to all kinds of moral agents, both in an ethical and empirical sense.

The ethics of state bankruptcy reveals that the fundamental ethical problem in sovereign, corporate and personal insolvency is the same: Who is to suffer from past misjudgements? Over the course of history the focus of bankruptcy laws applying to corporations and people have shifted from punishing insolvents to protecting and helping them. Yet the debtor protection in contemporary bankruptcy laws extends only to honest debtors, those who have neither intentionally lived beyond their means nor sought credit through misrepresenting facts.

Laws also presume that an insolvent leads a modest life while in reorganisation and does not commit new defaults. In a bankruptcy procedure a debtor's property is liquidated to pay off the debt. In other words, bankruptcy laws only shelter insolvents who have got into debt *bona fide*, and who sincerely seek a way out of their anguish. These principles of handling an insolvent individual can also be applied to sovereign bankruptcy. Going bust is always painful, but it may be the start of a better future too. In deciding how to deal with a sovereign bankrupt, we make a choice about who is to suffer and how much. This choice is based on ethics and values, and in choosing we have to take into account the economic implications of our decision. Moral philosophers have a lot to offer here, as Robert Kolb says in his remarkable recent book *Sovereign Debt: From Safety to Default*.

¹⁴ Smith (1994, p. 202).

¹⁵ Bulow and Rogoff (1989, p. 49).

... the theory of sovereign debt attempts to explain the occurrence of lending and repayment in strictly economic terms. That is, the explanations that economists offer turn merely on the self-interest of the lender in extending credit and the borrower in making repayments. Economists never attempt to explain lending or borrowing by reference to moral obligation of fulfilling the promise to repay that borrowers make when they secure loans.¹⁶

In contemporary politics and financial markets it has been said that the exoneration of sovereign debts would be a default that would inflict catastrophic consequences on the world economy. The ethics of bankruptcy does not support this scare. My analysis suggests that a relief to honest debtors does not cause commercial morale to collapse. Without going any deeper into the matter, I would like to add that if insolvents have not been honest, then the ethically most dubious solution is to keep on stretching their credit lines.

Neither the ethics nor the history of bankruptcy support the doomsday scenario some associate with the discharge of excess sovereign debt. On the contrary, the discharge of individual and corporate debts has proved to be an ethical and efficient social safety net which respects human autonomy, encourages economic activity and distributes the brunt of past mistakes equitably. As an indebted moral agent a state shares many characteristics with natural persons and corporations. This speaks for applying to a bankrupt sovereign the same cure which has worked well in personal and corporate bankruptcies. Therefore, I hope that the ethics of state bankruptcy helps us to get rid of our dread of sovereign defaults and of our primeval inability to handle them in an orderly manner.

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¹⁶ Kolb (2011, p. 4).

