# Is Audit the Solution to The Sovereign Debt Dilemma?

**Wissem Ajili Ben Youssef** [1]

**Abstract**

This paper focuses on audit as a rationalizing mechanism of sovereign debt in the case of emerging and developing economies. Firstly, the author analyzes the limits and failures of the current framework by contrasting the International Monetary Fund (IMF) inertia to the United Nations' determinism in favor of responsible and sustainable sovereign debt. Secondly, based on the agency theory contributions, the author argues that both international creditors and sovereign debtors would benefit from institutionalizing sovereign debt audit through strengthening market discipline. The author demonstrates that the IMF's position is not economically credible to the extent that it is contrary to the teachings of the signal theory. Consequently, the rejection of sovereign debt auditing would not be an optimal equilibrium of the international financial system.

In conclusion, the author supports that the international community would benefit from depoliticizing the debate on the public debt of developing countries. The institutionalization of the audit as a clause in debt contracts could create a mechanism for rationalizing sovereign indebtedness. Auditing may be the solution to the dilemma of sovereign debt, by limiting adverse selection and moral hazard problems, and strengthening market discipline.

**Keywords:** sovereign debt, audit, market discipline, agency theory, signal theory, transaction costs, sustainable development.

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[1]**Wissem Ajili Ben Youssef:** University of Carthage, ISG of Bizerte, Tunisia. ajiliouissem@yahoo.fr

## Introduction

In this paper, the author explores auditing sovereign debt, which is so rejected by the proponents of the contractual approach of the debt, including international financial institutions (IFIs) and some developed countries. The author argues that, paradoxically, the inclusion of debt auditing as a rule of the game, known and acknowledged by all players, could be beneficial to the market approach. Indeed, debt auditing could close the main loophole of the contractual approach, namely the lack of sufficient and reliable incentive mechanisms.

Nowadays, the mainstream of sovereign indebtedness regards debt auditing as the exception that should not become widespread: The market-based contractual approach ignores the potential role of auditing in rationalizing the process of sovereign debt. However, by engaging the responsibilities of the debtor countries and their creditors on an equal footing, the debt auditing could constitute a mechanism for encouraging respect for mutual commitments.

Consequently, the author supports that an ex-post debt auditing would be an effective and efficient instrument of rationalizing the process of sovereign debt by establishing the original conditions of the loan agreement. By rejecting debts granted by lenders who are informed about their illegal, illegitimate, odious or unsustainable[2] character, debt auditing could incite creditors to lend only to credible governments. Debt auditing could thus become the incentive mechanism for responsible and sustainable debt in emerging and developing countries.

In addition, the author argues that concurrent debt auditing could increase the accountability of the co-contracting parties to their initial commitments. By reducing information asymmetries and making the information flows more fluid, debt auditing could ultimately strengthen market discipline.

The author's main objective is to investigate how institutionalizing auditing could solve the problem of moral hazard of the market of sovereign debt in emerging and developing countries and could in fine reinforce market discipline.

The paper draws on of the new neoclassical orthodoxy of property rights and agency relationship. It addresses the three key questions of this theoretical framework (Coriat & Weinstein, 2010): (1) The design of the contacts; (2) the establishment of the necessary and sufficient incentives for the contract execution; (3) the identification of the resulting transaction costs.

In the following, the paper is organized in five sections. In the first section, the author summarizes the inadequacies of sovereign debt, illustrates the contractual approach, and identifies the shortcoming of its measurement tools. Then, the author describes the institutional impasse in which the International Monetary Fund (IMF) finds itself in relation to the issue of sovereign debt, mainly in the case of developing countries. In the third section, the author focuses on debt auditing as a legal process as well as a political weapon some developing countries use. Next, the author demonstrates the crucial role the United Nations play in giving some credibility to sovereign debt auditing. In the last section, the author demonstrates the advantages of integrating auditing as a mechanism of rationalizing the process of sovereign debt.

[2] To distinguish between illegitimate, illegal, odious, and sustainable debt, see Sterdyniak (2015).

## 1. Sovereign Debt: Inadequacies of The Contractual Approach and shortcomings of Its Measurement Tools

In this section, firstly, the author discusses the shortcomings of the dominating approach to sovereign debt (i.e., the contractual approach). Then, the author reviews the limits of the various measurement tools.

### 1.1.The sovereign debt in the new neoclassical orthodoxy

In the last years, three competing approaches have dominated the debate on sovereign debt in developing countries (Conférence des Nations-Unies sur le Commerce et le Développement, 2015): Firstly, the contractual or market approach, which advocates an improvement in existing mechanisms based on the law of contracts; secondly, the institutional approach, which defends the institutionalization of some non-binding law principals (e.g., sovereignty, legitimacy, transparency, good faith or debt sustainability); thirdly, the judicial approach, which supports the development of a binding multilateral legal and institutional framework that would be applied to all concerned parties.

Despites its inadequacies and its inability to solve the recurrent sovereign debt crisis, the market approach continues to be authoritative, especially under the auspices of the International Financial Institutions (IFIs) and some developed countries. In 2015, countries such as Germany, Canada, the United States, Japan, and the United Kingdom voted against the United Nations' resolution on basic principles of the restructuring process of sovereign debt[3].

The contractual approach considers sovereign debt as a contract between two parties, namely the debtor and the creditor. While the former seeks funds at a lower cost, the latter cares rather about optimal repayment conditions, given the borrower's level of risk. Consequently, the resolution of problems related to this type of contract should focus on providing incentives to respect the repayment conditions, which both parties agreed upon initially.

This vision borrowed from private finance has its roots in Jensen and Meckling's (1976) agency theory. Nevertheless, it seems to ignore the intrinsic nature of sovereign debt as a contract between two entities that do not necessarily have comparable economic or political weight. It also ignores the lack of reliable incentive mechanisms between agent and principal in this type of contracts.

The incentive approach considers economic transactions as contractual relationships between free individuals. Both organizations and institutions are then defined as nodes of contracts and arrangements. The incentive approach consists of two branches: the theory of property rights (Alchian & Demsetz, 1973; Coase, 1960) and the agency theory (Jensen & Meckling, 1976). Although it complements the property approach, the agency theory is considered as the dominant analytical framework in the recent neoclassical developments. Some authors view agency theory as the general reformulation of the theory of property rights (Coriat & Weinstein, 1995).

Jensen and Meckling (1976) defined the agency relationship as a contract by which one or more persons, named the principal, hires another person, the agent, to perform on his/her behalf any task that involves delegation of certain powers of decision to the agent. As a result, the

[3] The United Nations' resolution 69/319 on basic principles on the restructuring processes of sovereign debt was adopted in September 2015. While 136 Countries voted for the resolution, 6 (i.e., USA, UK, Germany, Canada, Japan, and Israel) voted against. Furthermore, there were many (41) abstentions. The resolution was initiated by Argentina and submitted by South Africa.

agency relationship is general and may cover any contractual relationship between individuals or groups of individuals or even states.

Therefore, any public debt contract can be analyzed as a contract by which the principal (e.g., private or public entity, IFI, and financial institution) lends funds to an agent (often a state or a public entity) to fructify these funds and to be able to repay the borrowed capital and its fruits in the form interests at the agreed maturity.

The main corollaries of the agency theory are the following: (1) The contracts which bind the parties are inevitably incomplete; (2) in order to control the agent's action, the principal necessarily incurs in agency costs; (3) in any agency relationship, problems of moral hazard and adverse selection occur.

In any agency relationship, problems may arise when the interest of both parties (i.e., principal and agent) diverge or in a context of imperfect information, mainly of information asymmetry. Thus, the objectives of the agency theory are: (1) Defining the incentives and monitoring mechanisms enabling the principal to compel the agent to act in such a way as to maximize the utility function of the principal; (2) reducing information asymmetries, in order to tend towards the market allocative efficiency advocated under the perfect information assumption.

According to the agency theory, sovereign debt is an incomplete contract established in a context of information asymmetry. By its nature, it exposes the parties to the problems of adverse selection and moral hazard. In order to reduce these problems, the contracts of sovereign debt should provide incentives and monitoring. Without these mechanisms, the contract of sovereign debt cannot allow to allocate resource efficiency.

#### 1.1.1. Adverse selection and moral hazard problems in contracts of sovereign debt

Based on the founding paper of Coase's (1937) firm theory, Williamson (1985) developed the new institutional economics or the transaction cost theory. In contrast to the neoclassical framework of pure and perfect competition, this author introduced two behavior hypotheses: (1) The limited rationality principle; and (2) the opportunistic behavior of economic agents.

The limitations of rationality are of three types: (1) The costs of processing information and complexity of calculation in any optimal decision-making process; (2) the costs of collecting information; (3) uncertainty about the future state of nature and the economic agent's behavior. The implication of the limited rationality principle is the incompleteness of the contract.

At the same time, the incompleteness of the contract will induce to an opportunistic behavior of economic agents. An opportunistic behavior is any behavior an economic agent adopts to favor his/her personal interests. Opportunism is based on an incomplete, distorted or falsified disclosure of information from the agent, particularly about his/her abilities or preferences. Opportunism can be ex ante, that is before the contractual relationship between the two parties is established, and results from a problem of information asymmetry. Ex-ante opportunism refers to the adverse selection problem as defined by the agency theory. Opportunism can also be ex post, that is during the performance or at the end of the contract. In this case, opportunism refers to the problem of moral hazard due to the incompleteness of the contract, the limited rationality, and the assets specificities.

The examination of the contractual relationship between the sovereign debtor and its international creditor highlights the incompleteness of the contracts, thus opening the door to opportunistic behavior on the part of both party's ex ante and ex post. Thus, the sovereign debtor would be tempted to cheat as its ability to honor its financial commitments, the soundness of its macroeconomic fundamentals, and the profitability of the projects to which the borrowed funds will be directed. Also, the sovereign debtor would try to reduce its credit spread and financing costs by any means. Faced with a problem of anti-selection within a framework of limited rationality, the international creditor cannot optimize its investment decision. In addition to problems of moral hazard, the creditor would be encouraged to make the debt contract increasingly asymmetrical by introducing incentive mechanisms in its favor.

### 1.1.2. Sovereign debt as a neoclassical contract

Based on a MacNeil's (1978) work, Williamson (1985) establishes a typology of three contracts: The classical contract law, the neoclassical contract law, and the individualized contract.

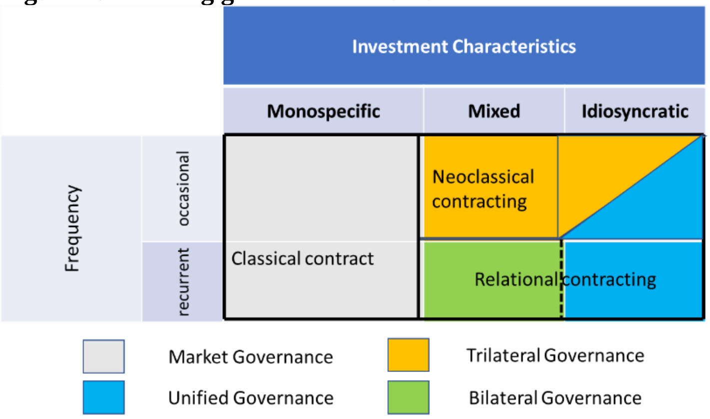
(1) The classical contract law is characterized by its perfectly defined object and by the relationship it establishes an individual transaction carried out via the market. The classical contract law attempts to facilitate exchange by enhancing discreteness and intensifying "presentation." In this type of contract, third party participation is discouraged.

(2) The neoclassical contract law is based on a long-term relationship executed under conditions of uncertainty. This contract is incomplete, with a strong propensity for opportunistic behavior. Third party participation is strongly recommended, in this type of contract.

(3) The relational contracting occurs in case of complex and lasting relations between parties. It is rather close to a relationship of administrative type. Relations are then built more based on standards and rules, than by reference to the original agreement.

In conclusion, the contract of sovereign debt, particularly in the case of developing countries, is rather neoclassical (Figure 1). The contract is not classical, because the relationship is far from being impersonal, nor is it of the administrative type. In the case of an infrequent transaction with a medium to strong specificity of assets, each party seeks to protect itself against any opportunistic behavior from the counterparty. A third-party participation is recommended, in this type of contract. In this context, Williamson (1994) emphasized that the characteristic of neoclassical law of contracts is to admit that the world is complex, that the agreements are incomplete, and that some contracts will never be completed, unless both parties have trust in the arbitrage process. Presumably, it is in this analytical context of the governance structure that the jurisdictional approach (Conférence des Nations-Unies sur le Commerce et le Développement, 2015), which is aimed at developing a binding multilateral, legal, and institutional framework that is universal and applicable to all parties, finds its legitimacy.

**Figure 1:Matching governance structure with commercial transaction**



### 1.1.3. Sovereign debt and agency costs

The agency relationship, which is also called as the principal-agent relation, is complex and reversible insofar as the roles and functions of both parties are not fixed. Each of the two parties may be simultaneously principal and agent. As an example, in the labor contract, the employee makes available to the employer the use of his/her labor force for a wage. Consequently, the employer is considered as the principal and the employee as the agent. At the same time, by transferring to the employee the use of a part of his/her physical and technical capital, the employer becomes an agent and the employee a principal.

The agency theory remains consistent with the rationality assumption and assumes that both counterparts seek to maximize their respective functions and utilities. It also assumes that, through the adequate system of incentives, it is possible to reduce the divergence of interest between the principal and the agent. However, setting up the incentive system in an imperfect information context generates, for both counterparts, monetary and non-monetary costs called agency costs.

According to Jensen and Meckling (1976), agency costs are of three types: (1) Monitoring and incentive expenditures rather incurred by the principal to compel the agent to behave in accordance with the principal's interests; (2) bonding costs supported by the agent to inform the principal that his/her action is in conformity with the contractual commitments (e.g., insurance policy and indemnities); (3) the residual loss, which are opportunity costs measuring the gap between the actual result of the agent's action and the optimal result maximizing the utility function of the principal.

In the case of sovereign debt, the income of the principal (i.e., foreign creditor) consists of the interest received (I). However, the delegation of the management of the property rights to this specific asset to the agent implies to bear monitoring costs (MC) and an opportunity cost called residual loss (RL). Thus, the creditor receives a net income (NIc) equal to the difference between the interests received and the total costs incurred, as in the following equation:

$$NIc = I - (MC + RL) \tag{1}$$

The interest rate is given in the initial agreement, to maximize its net income (NIc), the creditor makes a trade-off between monitoring costs (MC) and residual loss (RL)

$$dNIc = 0 \rightarrow dMC = -dRL \tag{2}$$

In order to reduce its residual loss, the creditor is forced to increase its monitoring and supervisory costs. The optimum is reached when the last additional monetary unit incurred in monitoring costs is exactly equal to the residual loss.

On the other side, the sovereign debtor bears, in addition to the interest charge (I), the bonding costs to signal to the creditor the proper performance of the contract (e.g., report publications and penalties in case of late payments). From its opportunistic behavior, the debtor derives an income equal to the residual loss borne by the creditor. Consequently, its net income (NId) can be written as follows:

$$NId = RL - (I + BC) \tag{3}$$

In order to increase its net income, the debtor is incited to increase the creditor's residual loss, but, at the same time, it is forced to increase its bonding expenditures. The debtor optimum is reached when the last monetary unit incurred involves an equivalent residual gain (or an equivalent residual loss to the creditor).

$$dNId = 0 \rightarrow dBC = dRL \quad (4)$$

In conclusion, according to the agency theory, the relationship with the contract of sovereign debt involves agency costs that both the principal and the agent manage by arbitration. The creditor (principal) seeking to maximize its net income must arbitrate between its monitoring costs and its residual loss. The last monetary unit involved in supervisory costs should cover exactly its residual loss. On the other side, the debtor arbitrates between its bonding costs and the opportunistic gain that it can draw from it. Its optimum is reached when the last monetary unit spent to reassure the creditor yields its equivalent in terms of profit.

The best solution to this arbitration problem lies in market discipline. Indeed, if the axioms of neoclassical theory are rigorously respected, the market would spontaneously ensure the coordination of the interests of the different actors and limit any opportunistic behavior. Therefore, the financial market allows these arbitrations and reduces the problems of the agency by sending signals to the economic agent.

#### 1.1.4. Sovereign debt and the signal theory

The major teaching of the signal theory (Ross, 1977) is that the choice between debt and equity capital is not neutral, and that debt can be used as a mechanism to signal the quality of the enterprise in a context of information asymmetry. The signal theory argues that the value of the enterprise is positively correlated with the level of its indebtedness. Indeed, by increasing risk, the debt improves performance, as managers are forced to maximize the value of the enterprise to limit the bankruptcy risk.

According to the signal theory, the company's debt policy allows to emit several types of signals:

(1) The signal by the involvement degree of the managers: The higher the involvement degree of the manager, the more positive the signal sent to potential creditors.

(2) The signal through the guarantee's requirement: The requirement of a high level of collateral is a negative signal to potential creditors.

(3) The signal through the issuance of bonds: It improves the company's reputation and constitutes a positive signal on the quality of its investments.

(4) The signal by paying a high interest rate: It improves confidence in the company's managers and is interpreted as a signal of good health.

(5) The signal by the debt maturity: Performing companies can afford short-term debt, despite its relatively high cost.

In the context of sovereign debt, the main implications of the financial theory of signals could be easily validated. Thus, stable and democratic political regimes, transparent public policies, and a low level of corruption would be a positive signal to potential creditors. On the other hand, the requirement for additional guarantees would be interpreted as a negative signal. Finally, signals by issuing bonds, by maturity or by the level of interest rate would have the same impact on sovereign debt as on private debt.

#### 1.1.5. Sovereign debt and monitoring function

The monitoring function exhausts its origins in the property right theory (Alchian, 1987; Alchian & Demsetz, 1972, 1973; Coase, 1960). The property right theory considers that any exchange between economic agents is in fact an exchange of property rights over objects. The property right is defined as the socially validated right to choose the uses of any economic asset. The corollary of this theory is that the main function of property rights (mainly private) is to provide the necessary incentives to create, retain, and value assets. The property right is identified by its three attributes, which are: (1) The use or the right to use the asset considered; (2) the *fructus* or the right to derive income from it; (3) the abuse or the naked ownership, that is the right to dispose of the property and to be able to transfer it definitively to a third party.

Alchian and Demsetz (1972) studied the case of the classical capitalist firm and explained its efficiency as an organizational structure by the existence of the monitoring function. Indeed, team production can generate problems of moral hazard insofar as the product is the result of the cooperation of different agents, without it being possible to measure the individual contribution of each one (measure the marginal productivity without bearing additional costs). The existence of an economic agent, called a "monitor" specialized in monitoring the performance of team members, can be an effective solution to problems of moral hazard for team production. However, in order to ensure its monitoring function, the monitor must give a special status, which will be based on a contractual structure and an original property rights structure. The special status of the monitor is based on five rights:

(1) To be the residual creditor or "the residual claimant", namely, to receive the residual from production.

(2) To have the right to observe and control the behavior of resource holders.

(3) To have the exclusive right to be in a contractual relationship with all resource holders.

(4) To have the right to change the composition of the team (i.e., renegotiate the contract with each member).

(5) To have the right to sell the rights (i.e., its special status).

Alchian and Demsetz (1972) concluded that, in the case of the classic capitalist firm, the monitoring function is carried out by the employer-owner, since it combines the five attributes of the monitoring function by its status. In conclusion, the system of property rights, through the incentives it creates, makes the conventional capitalist firm an efficient form of organization.

Jensen and Meckling (1976) considered monitoring to be the set of activities which extends beyond measuring or observing the behavior of the agent. It includes the efforts the principal makes to control the staff member's behavior by means of budgetary restrictions, wage policies (compensation policies) or operating rules.

In some cases of contracts of sovereign debt, the monitoring function is non-existent. The explanation is relatively simple: In the context of high asymmetry information, the monitoring and incentive costs the principal undergoes are so high compared to its residual loss that the principal prefers to relinquish his/her supervisory function. As a result, international creditors continue to lend to countries or regimes that are not credible or democratic, if they are able to repay their debt.

### 1.2.Limitations of measurement tools

At the same time, recurrent sovereign debt crises in both developing and developed economics have demonstrated the limits of the measurement tools of the contractual approach. Analysis by thresholds where sovereign indebtedness is summarized in ratio (i.e., that of debt stock to gross domestic product) seems today to be irrelevant and lacks legitimacy. Admittedly, it is a simple and operational tool that reduces the debt issue into prudential ratio. Nevertheless, its arbitrary character makes it less and less credible (Aglietta, 2011; Chavagneux, 2012; Humbert, 2016).

It must be acknowledged the problem of sovereign debt in developing countries cannot be solved only by defining viability thresholds. Some studies have shown that, on average, developing countries do not have public debt levels significantly higher than those of developed economies (Panizza, Sturzenegger, & Zettelmeyer, 2010). Cases of crises in these countries with moderate levels of public debt lead to the conclusion that the debt structure plays a crucial role.

Debt sustainability is therefore not a fundamentally quantitative issue. The thresholds are important, but the public debt structure by currencies, by interest rates or by maturities has a decisive impact as well as the debt allocation between investment and current expenditures.

However, the analysis of public debt by the structure or through allocation submits the matter to the evaluation on a case-by-case basis and reduces comparability in the international scale. Ultimately, this fact narrows down the scope of the analysis.

Moreover, the economic sustainability approach is based on the analysis of the gap between the economic growth rate and the real interest rate on public debt, which is called “critical gap”. Debt may be a problem only if the interest rate became higher than the growth rate (Aglietta; 2011; Collectif pour l’Audit Citoyen, 2014; Sterdyniak, 2015). Inversely, if the interest rate is below the growth rate, public debt is considered sustainable. The growth rate of the future tax revenues is in these cases, higher than that of the debt services. Ultimately, and as the golden rule of public finances suggests, when the interest rate is equal to the growth rate, future primary surpluses grow at the same pace as the debt service.

Despite its relevance and legitimacy, the analysis of the critical gap is more and more questioned, mainly because its theoretical framework is based on the scrupulous respect of the solvency condition. According to this purely accounting point of view, only the repayment capacity of the debtor is privileged in the financing decision (Hanlon, 2006; Merckaert & Caliari, 2007; Ramasastry, 2007)). Moreover, the social, cultural, political, and ecological impacts of sovereign debt on the populations involved in the repayment process are totally ignored.

On the creditor’s side, the main question the critical gap approach answers whether the economic growth allows or not to ensure the contracted debt service. Meanwhile, on the debtor’s side, the question answered is whether sovereign debt brings to the economy more than its cost. The reasoning on both sides seems rather hasty and relatively too aggregated, since all distribution problems are hidden.

## 2. Sovereign Debt: The Institutional Deadlock and The IMF’s Inertia

Attempts to establish a comprehensive framework of sovereign debt with universal rules to be applied to all actors in the event of crises face serious obstacles. Many divergences remain between the different parties. A first current would like to preserve the contractual approach at any cost, by estimating that any debt should be reimbursed, and in case of crisis a restructuring plan would be considered. The second current argues for a wider variety of solutions, ranging from debt auditing and restructuring to partial or total cancellation as a last resort (Bailly & Toussaint, 2015; Vivien, 2010, 2015).

While the proponents of the market-based vision admit some of the shortcomings of the existing framework, they argue that no progress could be made outside of the contractual approach. On the other hand, many developing countries, under the auspice of the United Nations and with the support of some citizen movements in developed countries, call into question the validity of the existing framework. The latter advocate for outright cancellations of sovereign debt, in some cases.

Nowadays, it should be recognized that alternative movements to the contractual approach have not reached the maturity required to provide effective, sustainable, and operational solutions to the problems of sovereign debt. On the other hand, the liberal current justifying sovereign debt crises with all their magnitude, only by the inadequacies of the legal framework of the contractual approach, seems little credible. The proposals the liberal movement has formulated remain little innovative to: (1) Revive the IMF's proposal on sovereign debt restructuring mechanism rejected in 2003; (2) introduce the rule recommended by the 2012 Treaty creating the European Stability Mechanism, which makes the introduction of collective action clauses mandatory in euro area bond issues; (3) provide restructuring arrangements in the original contract; (4) use international financing as a lever (Destais, 2015a, 2015b; Sgard, 2003).

This institutional stalemate, combined with IMF's inertia, seems to aggravate the problems of sovereign debt mainly in developing countries. So far, developing countries have dealt with their public debt in a fragmented way. No comprehensive solution has been developed to reduce public debt levels in developing countries. Only the heavily indebted poor countries group has benefited from international debt relief measurements. The international community has ignored middle-income developing countries' problem of debt. In addition, the mixed results of these initiatives call into question the soundness of the approaches applied.

Moreover, since its birth, the sovereign debt issue in developing countries was handled in a logic of emergency crisis management. No real preventive approach with the implementation of regulatory measures was developed. The international community's actions in this area have proved limited in scope, given their reactive nature. All that was undertaken so far has been limited to punctual post-crisis measures. Today, it is more than necessary to develop a comprehensive and coherent approach to an effective and efficient management strategy of sovereign debt in developing countries. As the report of the independent expert of the United Nations (Nations Unies, 2016) highlighted that he debt crises are recurrent; it is still necessary to implement an improved mechanism for applying fair, fast, and reliable restructuring and debt relief measures.

At the same time, the author believes that the lack of an international judicial framework to sanction any illegal or illegitimate indebtedness could weaken the international financial system by exposing it to unlimited risks. The IMF's position against the establishment of an international specialized jurisdiction for sovereign debt persists. Hagan, Obstfeld, and Thomsen (2017) explicitly recognized this legal vacuum by pointing out the lack of tribunals empowered to direct the restructuring of sovereign debt. Nevertheless, they argued that only the IMF could intervene in cases of over-indebtedness problems.

The IFIs' position is the opposite of the United-Nations' perspective. Substantial differences remain between the two parties. Firstly, the IMF continues to address sovereign debt issues on a case-by-case basis. The IMF wants to keep its monopoly on the debt distress management process in developing countries. At times, the IMF seems to want to take advantage of the informational rent which it has enjoyed on the issue for more than four decades. Despite the inadequacies of its debt viability framework, the IMF does not propose any relevant alternative to make a transparent and impartial assessment of the state of an economy in the face of an over-indebtedness problem. Hagan et al. (2017) described the IMF's decision-making monopoly in these terms: "The analysis of the debt viability conducted by the

IMF is a central element of its decision-making process, it is always the responsibility of the IMF, and it is impossible to delegate it" (p. 1 ).

This opacity in the IMF's decision-making process makes its position on the issue less and less credible. Moreover, the IMF's ambiguous and sometimes contradictory roles in the management of over-indebtedness crises increase the informational inefficiency of the existing framework. The IMF, as a technical support to the country in difficulty, has an informational advantage, compared to the various stakeholders. By setting itself up as the sole jurisdiction which sanctions in the event of non-compliance with the commitments laid down in its accompanying procedure, the IMF concentrates all the powers of control, supervision, and decision-making. In the end, the monopoly in issuance of signals on the financial markets in the context of sovereign debt crisis management belongs exclusively to the IMF. Ultimately, the decisions of all actors, whether public or private, on the financial markets depend on the nature and the extent on the information the IMF issues. Thus, the latter might become an entry barrier in the financial markets for the middle-income economies.

At the same time, the IMF, which is faithful to its purely accounting approach of sovereign debt viability, is at odds with the United-Nations' efforts in favor an economic, social, and ecological sustainability with respect to human rights. The IMF's inertia regarding the proposals the United Nations' independent expert made in the last years shows a real resistance to change.

The IMF refuses to recognize the creditors' responsibility in an unsustainable sovereign debt process. It continues to consolidate the initial imbalance the contractual approach has introduced, where only the debtor's responsibility is called into question in case of non-compliance with original commitments.

Indeed, the viability analysis framework applied by the IMF (2013) is based on the stabilization on the debt to the gross domestic product ratio, while respecting the initial debt repayment conditions. This stabilization of the level of sovereign debt aims at restoring the confidence of financial markets, allowing the country considered access to market financing. Even, when it is established that sovereign debt is unsustainable, the IMF prefers restructuring as the ultimate solution to the problem. It considers that declaring to be in sovereign default is a particularly destabilizing option for the economy.

The IMF's new proposals for the viability analysis of sovereign debt appears to be below the various actors' expectations and mainly developing countries. Faithfull to its market approach, the IMF only recognizes the contractual framework for reflection. It categorically rejects the institutional and jurisdictional approaches the United-Nations promote. It also refuses acknowledging the shortcomings of the contractual approach. The IMF's major concern would be that of bringing together the economic and financial conditions of a full repayment of the contracted sovereign debt. The myopia of the market approach seems to be reiterated by all the viability analysis frameworks the IMF has developed. The creditor's responsibility in harmful or even impoverishing sovereign debt is evoked in any way.

As to the issue of sovereign debt, the IMF, both judge and party, seems to be deadlocked, nowadays. Regarding the institution that both defines the rules and gives an opinion on their compliance by the different actors, the IMF jeopardizes its own credibility and, ultimately, the stability of the international financial system. By analyzing its role in the management of the over-indebtedness crises, the IMF's approach is far from being preventive or even curative. The IMF's mission in managing sovereign debt crises in developing countries could be summarized in the quarantine of economies that have not followed its recommendations and restructuring policies.

### 3. Sovereign Debt Auditing Between Legal Process and Political Weapon

The idea of auditing sovereign debt grew thanks to the doctrine of odious debt, whose theorization goes back up to Sack's (1927) study. Sack defined odious debt as follows:

*If a despotic power incurs debt not for the needs or the interest of the state, but to strengthen its despotic regime, to repress the people who are fighting it, this debt is odious for the population of the whole State: it is a debt of the regime, a personal debt of the power that contracted it, therefore falls with the fall of this power. (p. 157)*

Consequently, any odious debt should be abandoned for two reasons: (1) It does not benefit the country, from which the present and future generations would bear the burden, but an authoritarian regime; (2) the creditors of this debt assume wholly or partially its odious character, especially when they have made an informed and fully conscious commitment.

Thus, odious loans are a violation of the most universally accepted principles of law, such as free consent to the contract and good faith. Consequently, the pure and simple nullity of any informed loan contract to despots for a purpose hostile to their population could be invoked (Merckaert & Caliari, 2007).

Nowadays, the concept of odious debt is governed by the rule of the three criteria. Thus, a debt can be described as odious if and only if three conditions are met: (1) The debt in question has been incurred by a non-democratic regime, which implies in fine the lack of the population consent; (2) this debt would not have benefited the population to which the burden of its repayment falls; (3) the proof could be provided that the creditors expressed their commitment with knowledge of the debtor's intentions.

The cumulative nature of the three criteria aims to restrict the scope of the doctrine of odious debt, on the one hand, and to strengthen the contractual framework of sovereign debt, on the other hand. Thus, international law tacitly recognizes that, in the case of sovereign debt, the reimbursement should be the rule. Total or partial cancelation of sovereign debt would remain the exception.

The jurisprudence of the rule of the three criteria is more and more recognized to judge the validity of debt (loan) contracts on an international scale. As an example, the United Nations' independent expert (United Nations, 2009) analyzed this framework to examine the effects of debt on human rights and considered that Any assessment of the legitimacy of a debt must consider the activities to be financed, the negotiation of the loan, the contract conditions, and the use of loan funds, as stipulated in the contract. However, in the realm of practices, the rule of the three criteria is far from being anchored. Its application is still limited and subjected to the case-by-case law.

Thus, a debt audit could be defined as a legal mechanism to judge the legitimacy of sovereign debt. In his essay on the sovereign default, Boudet (2015) presented debt audit as a legal process to demonstrate the illegitimacy of a debt. Once the evidence has been provided, the government reserves the right to suspend unilaterally the reimbursement of its debt. Nevertheless, a fundamental distinction remains to be drawn between an audit without legal value initiated by citizen movements and an audit carried out by one of the three branches of power, namely the executive, the legislative, and the judiciary. In the first case, it is both a teaching and mobilizing audit, finding its origins in article 21 of the Universal Declaration of Human Rights, recognizing the right of citizens to take part in public affairs directly or through representatives. In the second case, the audit has a legal force, as it allows to rule on the compliance of the debt contract with international law. In this context, the jurisprudence mentions three types of possible debt audit: (1) An audit by the executive branch (the case of Ecuador in 2007); (2) an audit by the legislative branch (the case of Peru in 2001); (3) an audit by the judicial branch( the case of Argentina in 2002).

The auditing of sovereign debt has been promoted by the current supporting the write-off of the Third World debt, as the most reliable mechanism to legitimize this cancellation (Vivien, 2010, 2015). The members of this current have argued that auditing debt would be a real political weapon that could be used by developing countries negotiating debt reduction. Indeed, in case of failure of the negotiations between creditors and debtor countries, the latter could avail themselves of the audit, to totally or partially cancel their sovereign debt by a unilateral decision.

The idea of auditing debt with a legal force and emanating from the executive branch was initiated by Ecuador in 2007, when an audit committee was formally established. The main task of the commission, which was composed of representatives of the State and of the national and international movements fighting against the debt, was to identify illegitimate internal and external public debts.

The work of the auditing commission of Ecuadorian debt has proved the illegitimacy of the external commercial debt and a part of the multilateral and bilateral debt. Consequently, in 2008, the Ecuadorian government decided unilaterally to suspend the repayment of its commercial debt. In 2009, it decided to partially repay the value of this debt (i.e., only 30-35% of its nominal value).

A less known case is that of Iceland, which refused to repay the debt caused by the bankruptcy of the private banks in 2008. Three years later, an arbitration tribunal ruling in this conflict with the United Kingdom and the Netherlands took a decision in favor of Iceland (Toussaint, 2016). The use of auditing in this case proved the illegitimacy of the debt private banks accumulated during the crisis.

A few years ago, the candidate countries to auditing public debt were exclusively developing countries. Nowadays, more and more developed countries are joining the movement for auditing debt, mainly under the citizen initiative impetus. Moreover, because of the 2010-2011 sovereign debt crisis, an increasing number of European Union countries have felt concerned by the sovereign debt problem. Initiatives for auditing sovereign debt have emerged in Greece, but also in Spain, Portugal, Belgium, and France.

Nevertheless, most of the auditing cases in this movement remain without legal value whatsoever. For example, in 2014, an audit was initiated in France by a collective for a citizens' audit of the public debt. The auditing report concluded that the French public debt is not only in a large part illegitimate, but also widely unsustainable. Indeed, more than half (59%) of the French public debt would be explained by tax gifts and excessive interest rates (Collectif pour l'Audit Citoyen, 2014).

In 2015, the RAID[4] association, supported by some deputies and opposition parties, initiated a campaign[5] for auditing Tunisian public debt. In 2016, the movement led to the tabling

[4] RAID-ATTAC Cadtm Tunisia has been an active anti-globalization association in Tunisia since 2011.
[5] The title of the campaign was *Right to Know on the Debt of the Dictatorship: Auditing Debt, Giving a Chance to Tunisia.*

of a bill to create a truth commission on Tunisian public debt, backed by more than 70 members of parliament[6].

## 4. The United Nations' Role in Giving Credibility to Auditing Sovereign Debt

The United Nations have played a key role in giving credibility to auditing sovereign debt. Indeed, this international organization was in favor of rationalizing sovereign debt by the audit. Thus, in 2009 the independent expert the United Nations appointed to examine the effects of debt on human rights reported that the audit provides a valuable analysis tool to determine the nature of the debt of a country. However, beyond its direct objective, namely to establish with certainty the original conditions in which the loan contract has been established, the debt auditing would be a means of assessing (1) the social and ecological consequences of the debt; (2) the development conditions of the borrowing country; and (3) in terms of respect for human rights.

In addition, the independent expert's report (United Nations, 2009) went further in the direction of consolidating auditing practices for sovereign debt by also encouraging creditors conduct audits of their loan portfolios. In the latter case, the objective was twofold: First, to examine the validity of the developing countries' claims of illegitimate debts; secondly, to ensure that the existing loans contribute to the achievement of development goals with respect for human rights.

The United Nations' contribution in this field is significant at two different levels: (1) Two types of audits are admitted, namely an ex-post audit and a concomitant audit; (2) the audit is not the privilege of either party at the expense of the other; indeed, not only debtor countries could conduct public debt auditing, but also their creditors are encouraged to audit their respective loan portfolios. Auditing debt could thus become a political neutral rule of the international indebtedness game.

The debt audit so claimed by developing countries and rejected by their creditors is an ex-post audit, which is a crisis audit aimed to determine a posteriori if the creditors' commitment is made in full knowledge of the illegitimate, illegal, odious or the unsustainable character of the debt contracted. In other words, it is an audit with the main aim of legitimizing a partial or total cancellation of a sovereign debt by proving its illegitimacy. In this context, the audit ex post appears as a legal mechanism to bring the burden of proof that the debt cannot be repaid, given the original conditions of its conclusion.

However, the concomitant audit in accordance with the United Nations' doctrine would be an assessment tool, whose purpose is to make the process of sovereign debt more transparent. Allowing creditors access to information related to economic, social, and ecological consequences of the debt incurred could help to limit the problems of moral hazard. In enhancing transparency, the concomitant audit could strengthen market discipline.

In this regard, importantly, in 2017, at the end of his mission in Tunisia[7], the United Nations' independent expert on the effect of foreign debt[8] argued that better control of lending and borrowing operations, transparency, and public participation are crucial to ensure that

[6] The bill was filed on June 14, 2016, at the order office of the Assembly of People's Representative.

[7] From 20 to 28 February 2017.

[8] The independent expert on the effects of foreign debt and other related international financial obligations of states on the full enjoyment of all human tights, particularly economic, social, and cultural rights.

public resources are allocated to the realization of human rights and sustainable development goals.

The United Nations' doctrine also encourages developing countries' creditors to audit their loan portfolio. Recognizing the right of both debtors and creditors to use a debt audit, it could be beneficial to depoliticize the issue. By introducing the audit as a rule in the international indebtedness game, both known and accepted by players, could contribute to streamlining the process of sovereign debt. Auditing debt could now help creditors in their investment choices to penalize the less credible debtors.

The United Nations' independent expert is quite clear concerning debt auditing issues. In the case of Tunisia, he argued that:

*there must be a responsibility for the serious financial crimes under Ben Ali, as well as the intermediaries who facilitated the flows of illicit funds. The role of foreign lenders and donors who have financially supported the regime of Ben Ali, should be examined*[9]. (United Nations (2017), p.1)

## 5. Sovereign Debt Auditing and Market Discipline

Beyond its juridical role as a legal mechanism to demonstrate the illegitimacy of sovereign debt, the audit could be the missing piece to the puzzle of the contractual approach.

In corporate finance, auditing is at the heart of the agency's relationship. The use of an external auditor is a mechanism for resolving conflicts not only between managers and shareholders, but also between managers and all third parties. The audit report is an information and control tool to reduce information asymmetries between the company's managers and third parties. The author argues that the introduction of the audit in the contract of sovereign debt would be an optimal solution to reduce information asymmetries between contracting parties. International creditors could thus solve the problems of adverse selection and moral hazard of which they may be victims. By eliminating these problems due to the imperfection of the contracts of sovereign debt, the audit could promote optimal allocation of resources. In a context of limited rationality and in the hypothesis of opportunistic behavior of economic agents, the audit would be a relatively efficient incentive mechanism for responsible and sustainable sovereign debt.

Furthermore, the signal theory (Ackerlof, 1974; Ross, 1977; Spence, 1974) argues that a signal must be stripped of ambiguity and transmitted in the right time (Bertin, Jaussaud, & Kanie, 2002). The audit mission will be carried out by a specialized independent auditor with the required technical expertise. In fact, economic theory considers that the auditor is in an agency relationship with third parties who have given him/her the mandate to control and supervise the work of managers. Therefore, the auditor could be a potentially opportunistic agent insofar his/her audit effort is imperfectly observable. In order to encourage the auditor to make a maximum effort, incentive mechanisms such as the regulatory framework, professional standards, and ethical codes, are put in place. At the same time, and in order to optimize the auditor's effort and to make the signals he/she emits credible, any false signal should be penalized. Thus, the establishment of a mechanism for auditing sovereign debts, particularly in the case of developing countries, requires the definition of a legal framework and international standards.

The recognition of the illegitimacy character of certain sovereign debt through an audit could solve the problem of moral hazard and strengthen market discipline. Indeed, the existing

[9] Tunisia: Human rights should forge economic policies, according to the United Nations' expert. UN News Center, February 28, 2017.

framework of sovereign debt does nothing to limit the moral hazard behavior. It must be admitted that, today, lenders, mainly IFIs and developed countries, are aware that they could lend to little credible regimes without any sanctions.

Considering the problem of moral hazard in the borrower-lender relationship, cancelling illegitimate debt could become the norm in contracts of sovereign debt. The introduction of this rule should impose some discipline on borrowers' countries, on one hand, and prevent the contraction of new illegitimate or odious loans in the future, on the other.

The contracts of sovereign debt are incomplete by nature and are often concluded within a framework of information asymmetry between the contracting parties. Baudry & Chassagnon, (2014) argue that the contracts incompleteness is exogenous, since it is almost impossible to draft an ex-post executable contract that can anticipate and integrate future contingencies.

The incompleteness of contracts can encourage opportunistic behavior, which must be protected by the inclusion of certain clauses. Opportunistic behavior can manifest itself during the negotiation of the contract, which poses a problem of adverse selection. Countries wishing to take on debt are more aware of their ability to repay than their potential creditors. The latter will be forced to incur significant costs to overcome this problem of information asymmetry. For example, international creditors can only distinguish between credible and non-credible economies (i.e., sometimes political regimes) at relatively high information costs. The opportunism of the economic agents can also be observed during the execution of the contract. This second form of opportunism results from a problem of moral hazard. Both the debtor country and the international creditor may not behave in accordance with their respective initial commitments, when they know full well that the costs of monitoring and controlling their activities are relatively high. As Koenig, (1993) argues protection against opportunism can be ensured by (1) a very high degree of substitution between contracts and (2) by contractual clauses;

Contractual clauses to limit the opportunistic behavior of economic agents can be of four types:

(1) Pure and simple sanctions for the party handling the information to its advantage or engaging in behavior that does not comply with its initial commitments. Sanctions can go as far as breaking the contract. However, sanctions must be based on the monitoring mechanism of the contract execution. Therefore, any debt to developing countries can be cancelled, if the project for which it was originally intended has not been maintained or if the executive power in place does not benefit the local population of its fruits in a fair, accountable, and transparent way. However, the relatively high cost of setting up a monitoring mechanism or even an audit function explains the international creditors' reluctance to do so. If the monitoring cost exceeds the residual loss of the latter in the bankruptcy cases, creditors have no interest in opting for this clause.

(2) Incentives for transparency and compliance with mutual monetary and non-monetary commitments. Such measures may replace sanctions, as they may complete them. In the specific case of sovereign debt, they are preferential measures or a bonus/malus system for countries that adopt an efficient and transparent behavior respecting the three pillars of sustainable debt, namely economically viable, socially equitable, and ecologically bearable.

(3) Arbitration procedures that may reduce differences in interpretation or perception of the facts by the contracting parties. Thus, the United Nations' proposition for an

international jurisdiction over sovereign debt is perfectly justified as a mechanism for reducing the incompleteness of the contracts of sovereign debt.

(4) Renegotiation procedures allowing the party affected by the information asymmetry to redefine clauses of the original contract.

In this context, Hanlon (2006, 2007) argued that, in the case of illegitimate loans, are the lenders, rather than the borrowers, responsible. The process of debt relief of the Third World countries was initially designed around borrowers: Sovereign debt would be partially or completely canceled, if the debtor country is too poor to pay. As a result, the debate should be refocused on lenders[10]; in other words, an illegitimate debt should not be repaid, regardless of the quality of the borrower.

Meanwhile, Jayachandran and Kremer (2006) believe that, in order to solve the odious debt problem, a transformation of the institutional and legal framework is needed to encourage potential lenders not to grant illegitimate loans. They argued that the efficiency gains due to the prevention of odious debt would be significantly higher than those resulting from the resolution of the problem of debt overhang, mainly in the case of the heavily indebted poor countries. Thus, the United Nations Security Council's unanimous declaration that any future debt a dictatorial regime would incur is considered illegitimate and therefore not transferable to the successor regime could potentially eliminate equilibrium with odious debt. The trade sanctions decided ex post against dictatorial regimes often remain ineffective to the extent that third parties are encouraged to not comply with them. However, financial sanctions limiting the ability to borrow of these regimes can be more effective, especially in the long-term, since they limit odious debt accumulations.

The implementation of an effective and efficient market discipline is subject to conditions such as strengthening the constraint of information disclosures, but also in terms of incentives (Aglietta & Rigot, 2009). Consequently, the author argues that auditing debt, both ex post and concomitant, could consolidate transparency in developing countries' process of sovereign debt and improve the disclosure requirement of relevant, reliable, and close to reality information.

Meanwhile, the author believes that the integration of the threat of the cancellation of all or part of an illegitimate debt into contracts of sovereign debt could strengthen incentives for creditors to exercise their role as principal. Knowing that excessive risk-taking by lending to little credible regimes acting against the interests of their populations would be sanctioned, creditors would direct funding towards the most economically, socially, politically, and ecologically sustainable economies.

Finally, the author argues that strengthening the contractual framework for sovereign debt would be a positive-sum game, where all parties come out winners. Indeed, market discipline could be enhanced through an explicit recognition of cases of illegitimate debt, on one hand, and through the introduction of debt audit as a mechanism of transparency and good governance, on the other hand. International creditors are thus encouraged to direct their funds to the most reliable economies. Consequently, they reduce their counterparty's risk to which they are exposed individually, but also ensure greater stability of the international financial

[10] This was the case of the United States in their campaign for the cancellation of Iraq's debt by invoking the lenders' responsibility in the loans given to the regime of Saddam Hussein.

system as a whole. Meanwhile, developing countries are forced, at the same time, to favor indebtedness generating wealth and well-being.

## Conclusion

In this paper, the author argues that the international community would gain to depoliticize the debate on sovereign debt of developing countries. The institutionalization of the audit as a clause in debt contracts could create a streamlined mechanism for sovereign debt, limiting the problems of *moral hazard* and strengthening market discipline. The author believes that the reluctance of the IMF to the new United Nations' proposals in this field is not justified. The IMF's monopoly in managing and supervising sovereign debt crisis in developing countries is economically irrelevant. It could in fine endanger the stability of the international financial system.

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