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Is audit the solution to the sovereign debt dilemma?

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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 market approach by contrasting the International Monetary Fund inertia to the United Nations' determinism in favor of responsible and sustainable sovereign debt. Secondly, based on the agency theory, 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 rejection of sovereign debt auditing would not allow an optimal equilibrium of the international financial system. In conclusion, the author supports the view that the international community would benefit from depoliticizing the debate on developing countries' public debt. The audit's institutionalization as a clause in debt contracts could create a mechanism for rationalizing sovereign indebtedness. Therefore, auditing may solve the sovereign debt dilemma by limiting adverse selection and moral hazard problems and strengthening market discipline.

Keywords: sovereign debt, audit, market discipline, agency theory, transaction costs.

Introduction

Sovereign debt auditing has become a topical issue in the economic and financial literature with the rise of citizen movements requiring greater transparency in public affairs management. More recently, and in the context of the economic and financial crisis linked to the COVID-19, the issue of best practices in managing public funds has re-emerged. Indeed, in some cases, international financial institutions (IFIs) had provided emergency funds irrespective of the debtors' quality. An audit could have been an appropriate instrument to assess the funding needs and ensure optimal resource utilization.

While many scholars were interested in sovereign default (Scholl, 2017; Roos, 2019; Andreasen, Sandleris & Van der Ghote, 2019 and Abbas, Pienkowski, & Rogoff, 2019), this paper focuses on auditing as a solution to the sovereign debt dilemma. Two opposing views had emerged in this field. IFIs and some developed countries led the first one, reluctant to debt auditing, the second dominating by citizen movements, is quite favorable.

In this paper, the author explores auditing sovereign debt, which was for a long time rejected by the proponents of the contractual approach of the debt, including 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 benefit the market approach. Indeed, debt auditing could close the contractual approach's main loophole, 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 sovereign debt's process.

However, by engaging the debtor countries' responsibilities and their creditors on an equal footing, the debt auditing could constitute a mechanism for encouraging respect for mutual commitments.

Consequently, the author supports the view 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 informed about their illegal, illegitimate, odious, or unsustainable character (Sterdyniak, 2015), debt auditing could incite creditors to lend only to credible governments (Blinder, 2000 and Blanchard & Cottarelli, 2010). Debt auditing could thus become the incentive mechanism for responsible and sustainable debt in emerging and developing countries.

The author also argues that concurrent debt auditing could increase the contracting parties' accountability of their initial commitments. By reducing information asymmetries and making the information flows more fluid, debt auditing could ultimately strengthen market discipline.

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

The paper draws on the new neoclassical orthodoxy of property rights and agency relationships. It addresses the three critical 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 contracts' execution; (3) the identification of the resulting transaction costs.

The paper is organized into four sections: the first section discusses the legal, political, and institutional dimensions of sovereign debt audit. The second analyzes the debt contract according to the new neoclassical orthodoxy. The third section establishes the role of audit in strengthening market discipline. The last section discusses the paper's main implications.

Sovereign Debt Auditing: A three-dimensional issue

Sovereign Debt Auditing as a Legal Process

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 a 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, mostly 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 straightforward nullity of any informed loan contract to despots for a purpose hostile to their population could be invoked (Merckaert & Caliari, 2007).

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

Nowadays, the concept of odious debt is governed by the rule of the three criteria. Thus, 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 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 the reimbursement should be the rule in the case of sovereign debt. Total or partial cancelation of sovereign debt would remain the exception.

The jurisprudence of the three criteria rule 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 debt's effects on human rights and considered that any assessment of the legitimacy of 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 three criteria rule is far from being anchored. Its application is still limited and subjected to the case-by-case law.

Jayachandran and Kremer (2006) suggest that 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 debt overhang, mainly in the case of the heavily indebted poor countries. Thus, the United Nations Security Council's unanimous declaration that any future loan to a dictatorial regime 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 oppressive 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 these regimes can be more effective, especially in the long-term, since they restrict odious debt accumulations.

Thus, a debt audit could be defined as a legal mechanism to judge the sovereign debt's legitimacy. In his essay on the sovereign default, Boudet (2015) presented a debt audit as a legal process to demonstrate its illegitimacy. Once the evidence has been provided, the government reserves the right to suspend the debt's reimbursement unilaterally. 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: 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 citizens' right to participate in public affairs directly or through representatives. In the second case, the audit has a legal force, as it allows for ruling 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 2007-2008); (2) an audit by the legislative branch (the case Brazil in 2009-2010); (3) an audit by the judicial branch (the case of Argentina between 1982-2000). Table 1 makes a comparison between the different types of debt auditing.

Table 1: Comparison of the different types of audit

		Description	Examples	Advantages	Limits
Official audit	Government audit	The audit is instituted and conducted by the executive branch (government or official public entities)	Brazil (1930) Ecuador (2007-2008) Norway (2013)	A binding audit with legal force. An audit with a direct financial and economic impact. The most comprehensive and complete form of an audit. An audit that often results in concrete decisions.	The scope of the audit depends on the government's willingness to complete the transaction.
	Parliamentary audit	The audit is instituted and conducted by parliamentarians as part of the exercise of their official duties.	The case of the Independent Parliamentary Commission on Public Debt in Brazil between 2009-2010	The audit fits perfectly within the remit of the legislative branch.	The reliability of the audit will depend on the anchoring of a democratic culture in the country considered.
	Judicial audit	The audit is in the form of an investigation by the judiciary branch.	The case of Argentina (trial between 1982-2000)	This is an audit with binding legal force.	The procedure can be long and complicated and limited in scope.
Citizen audit		Audit is initiated and conducted by citizen movements	Brazil (2000) Mali (2007) Ireland (2011) Portugal (2011) Spain (2011) Belgium (2013) France (2014)	An educator audit. A unifying audit of the principles of good governance in the public domain. A preliminary phase and, in some cases, an obligatory passage for an official audit.	An audit with no legal value that is more akin to an awareness campaign An audit with no concrete results and financial consequences.

Sovereign Debt Auditing as a Political Weapon

The auditing of sovereign debt has been promoted by the current support for the debt write-off of Third World countries, as the most reliable mechanism to legitimize this cancellation (Vivien, 2010, 2015). The members of this current support have argued that auditing debt would be a real political weapon used by developing countries in 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 cancel their sovereign debt totally or partially 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 commission's main task, composed of representatives of the State and 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 Ireland, which refused to repay the debt caused by the private banks' bankruptcy in 2008. Three years later, an arbitration tribunal ruling in this conflict with the United Kingdom and the Netherlands decided in favor of Ireland (Toussaint, 2016). In this case, auditing proved the illegitimacy of the private debt banks accumulated during the crisis.

A few years ago, the candidate countries to auditing public debt were exclusively developing countries. More and more developed countries are joining the auditing debt movement, 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, 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 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, some deputies and opposition parties supported the RAID[ii] association and initiated a campaign for auditing Tunisian public debt. In 2016, the movement led to a bill's tabling to create a truth commission on Tunisian public debt, backed by more than 70 members[iii].

Figure 1 traces the chronology of the sovereign debt auditing around the world. The different experiences show that the process is far from being uniform. Every experience has its characteristics and constraints. Nevertheless, the case of Ecuador remains the most successful example in this regard. The reduction of Ecuador's public debt from private international banks by 70% of its value has given audit credibility. The Latin American experience (Argentina, Brazil, and Ecuador) has paved the way for debt auditing in Europe and Africa. Nevertheless, the experiences of the 2010s that focused more on citizen auditing have led to a considerable large-scale awareness of the challenges and issues of sovereign debt auditing.

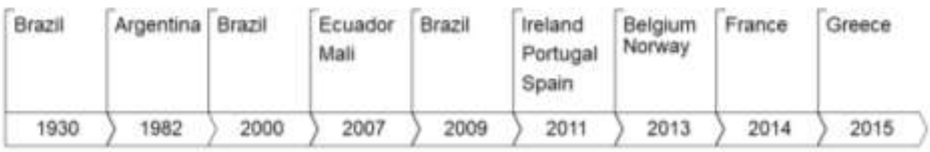

Figure 1: Timeline of the main sovereign debt auditing experiences in the world

Sovereign Debt Auditing as an Institutional Process

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 debt's effects on human rights reported that the audit provides a valuable analysis tool to determine the nature of a country's debt. However, beyond its immediate 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.

The independent expert's report (United Nations, 2009) went further in consolidating auditing practices for sovereign debt by encouraging creditors to conduct 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 neutral political rule of the international indebtedness game.

The debt audit so claimed by developing countries and rejected by their creditors is an ex-post audit. 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 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, following the United Nations' doctrine, the concomitant audit 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 limit moral hazard problems. In enhancing transparency, the concomitant audit could strengthen market discipline.

In this regard, in 2017, at the end of his mission in Tunisia[iv], the United Nations' independent expert on the foreign debt[v] effects argued that better control of lending and borrowing operations, transparency, and public participation are crucial to ensure that 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 portfolios. Recognizing both debtors and creditors' right to use a debt audit 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, it could be streamlining the process of sovereign debt. Auditing debt could now help creditors in their investment choices to penalize the less credible debtors.

A debtor is considered credible if his conduct is consistent with the original commitments under the sovereign debt contract. Indeed, Blinder (2000) supported that a policy is deemed credible if people believe that the policymaker will realize the announced policy. At the same time, Blanchard & Cottarelli (2010) related fiscal credibility to public debt sustainability expectations.

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*[vi]. (United Nations (2017), p.1)

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 of economic, social, and ecological sustainability with respect to human rights. The IMF's inertia regarding the United Nations' independent expert's proposals in the last years shows a real resistance to change.

The IMF refuses to recognize the creditors' responsibility in an unsustainable sovereign debt process (IMF, 2013 & 2018). 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 IMF's viability analysis framework (2013, 2018) is based on stabilizing 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 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 destabilizing option for the economy, (Roos, 2019).

The IMF's new proposals for the viability analysis of sovereign debt appear 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 to acknowledge the shortcomings of the contractual approach. The IMF's primary concern would be bringing together the contracted sovereign debt's economic and financial conditions' full repayment. 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.

The sovereign Debt Contracts in the New Neoclassical Orthodoxy

In the last two decades, 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 for 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.

Despite 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 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[vii].

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 care instead of optimal repayment conditions, given the borrower's risk level. 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 contract.

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: property rights (Alchian & Demsetz, 1973; Coase, 1960) and agency theory (Jensen & Meckling, 1976). Although it complements the property approach, the agency theory is considered the dominant analytical framework in the recent neoclassical developments. Some authors view agency theory as the general reformulation of the property rights theory (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 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, IFIs, 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 of 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) 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 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. To reduce these problems, the contracts of sovereign debt should provide incentives and monitoring. Without these mechanisms, the contract of sovereign debt cannot allow debt to allocate resource efficiency.

Adverse selection and moral hazard problems in contracts of sovereign debt

Based on Coase's (1937) firm theory's founding paper, 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 agents' behavior. The implication of the limited rationality principle is the incompleteness of the contract.

Simultaneously, the incompleteness of the contract will induce an opportunistic behavior of economic agents. Opportunistic behavior is any behavior an economic agent adopts to favor his/her 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, before the contractual relationship between the two parties is established, resulting from information asymmetry. Ex-ante opportunism refers to the adverse selection problem as defined by 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 moral hazard due to the contract's incompleteness, the limited rationality, and the assets specificities.

An examination of the contractual relationship between the sovereign debtor and its international creditor highlights the contracts' incompleteness, thus opening the door to opportunistic behavior on the part of both party's ex-ante and ex-post. Therefore, the sovereign debtor would be tempted to cheat regarding its ability to honor its financial commitments, the soundness of its macroeconomic fundamentals, and the projects' profitability 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 anti-selection within a limited rationality framework, the international creditor cannot optimize its investment decision. In addition to moral hazard problems, the creditor would be encouraged to make the debt contract increasingly asymmetrical by introducing incentive mechanisms in its favor.

Sovereign debt as a neoclassical contract

Based on a MacNeil's (1978) work, Williamson (1985) established 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 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 relatively 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 developing countries, is rather neoclassical. 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. 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.

Sovereign debt and agency costs

The agency relationship, which is also referred to as the principal-agent relation, is complex and reversible as both parties' roles and functions are not fixed. Each of the two parties may be simultaneously principal and agent. For 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. Simultaneously, 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 it is possible to reduce the divergence of interest between the principal and the agent through an adequate incentive system. 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 instead incurred by the principal to compel the agent to behave following the principal's interests; (2) bonding costs supported by the agent to inform the principal that his/her action conforms 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 property rights management's delegation 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:

$$NIc = I - (MC + RL) \qquad (1)$$

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)

$$dNIc = 0 \rightarrow dMC = -dRL \qquad (2)$$

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 precisely 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 contract's proper performance (e.g., report publications and penalties in case of late payments). The debtor derives an income equal to the residual loss borne by the creditor from its opportunistic behavior. Consequently, its net income (NId) can be written as follows:

$$NId = RL - (I + BC) \qquad (3)$$

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).

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

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 residual loss. The last monetary unit involved in supervisory costs should precisely cover 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 neoclassical theory's axioms are rigorously respected, the market would spontaneously ensure the coordination of the different actors' interests and limit any opportunistic behavior. Therefore, the financial market allows these arbitrations and reduces the agency's problems by sending signals to the economic agent.

Sovereign debt contract and monitoring function

The monitoring function was developed as part of the property rights theory (Alchian, 1987; Alchian & Demsetz, 1972, 1973; Coase, 1960). The property rights theory considers that any exchange between economic agents is 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. This theory's corollary is that the primary 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 classical capitalist firm's case and explained its efficiency as an organizational structure by the monitoring function's existence. Indeed, team production can generate moral hazard problems insofar as the product results from the cooperation of different agents, without measuring 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, 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 team's composition (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 the employer-owner carries out the monitoring function in the classic capitalist firm's case since it combines the five attributes of the monitoring function by its status. In conclusion, through the incentives it creates, the property rights' system makes the conventional capitalist firm an efficient organization.

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

In some cases of sovereign debt's contracts, the monitoring function is non-existent. The explanation is relatively simple: In the context of high information asymmetry, the monitoring and incentive costs undergoes so high compared to the 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 can repay their debt.

The Sovereign Debt Auditing, the Missing Piece in the Contractual Approach Puzzle

The argument of the Incompleteness of Sovereign Debts Contracts

The contracts of sovereign debt are incomplete by nature and are often concluded within 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 avoided by including specific clauses. Opportunistic behavior can manifest itself during the contract negotiation, 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 high 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 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 straightforward 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 canceled if the project for which it was initially 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 latter's residual loss 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 international jurisdiction over sovereign debt is entirely justified as a mechanism for reducing the contracts of sovereign debt's incompleteness.

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

The argument of solving anti-selection and moral hazard problems

The recognition of some sovereign debt's illegitimacy character through an audit could solve moral hazard and strengthen market discipline. Indeed, the existing framework of sovereign debt does nothing to limit 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, canceling illegitimate debt could become the norm in contracts of sovereign debt. The introduction of this rule should impose some discipline on borrowers' countries, on the one hand, and prevent the contraction of new illegitimate or odious loans in the future, on the other.

The argument of the audit reliability in the private sector

In corporate finance, auditing is at the heart of the agency's relationship. An external auditor's use 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 sovereign debt's contract would be an optimal solution to reduce information asymmetries between contracting parties. International creditors could thus solve the problems of adverse selection and the moral hazard of which they may be victims. The audit could promote optimal resource allocation by eliminating these problems due to sovereign debt contracts' imperfection. In a context of limited rationality and the hypothesis of economic agents' opportunistic behavior, 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 at the right time (Bertin, Jaussaud, & Kanie, 2002). The audit mission will be carried out by a specialized independent auditor with the required technical expertise. The 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 managers' work. Therefore, the auditor could be a potentially opportunistic agent insofar his/her audit effort is imperfectly observable. 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. Simultaneously, and to optimize the auditor's effort and make the signals he/she emits credible, any false signal should be penalized. Thus, establishing a mechanism for auditing sovereign debts, particularly in developing countries, requires the definition of a legal framework and international standards.

Discussion

The Third World countries' debt relief process was initially designed around borrowers: Sovereign debt would be partially or entirely canceled if the debtor country is too poor to pay. As a result, the debate should be refocused on lenders[viii]; in other words, an illegitimate debt should not be repaid, regardless of the borrower's quality.

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

Meanwhile, the author believes that integrating the cancellation's threat of all or part of an illegitimate debt into sovereign debt's contract could strengthen creditors' incentives to exercise their role as principal. Knowing that excessive risk-taking by lending to little credible regimes acting against their populations' interests 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 explicit recognition of illegitimate debt cases, on the 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 and ensure greater international financial stability. 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 developing countries' sovereign debt. The audit's institutionalization as a clause in debt contracts could create a streamlined mechanism for sovereign debt, limiting moral hazard problems, and strengthening market discipline. The author believes that the IMF's reluctance to the new United Nations' proposals in this field is not justified. The IMF's monopoly in managing and supervising the sovereign debt crisis in developing countries is economically irrelevant. It can potentially endanger the stability of the international financial system.

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[i] 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.
[ii] The title of the campaign was *Right to Know on the Debt of the Dictatorship: Auditing Debt, Giving a Chance to Tunisia*.
[iii] The bill was filed on June 14, 2016, at the order office of the Assembly of People's Representative.
[iv] From 20 to 28 February 2017.
[v] 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.
[vi] Tunisia: Human rights should forge economic policies, according to the United Nations' expert. UN News Center, February 28, 2017.
[vii] 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.
[viii] 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.