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"Odious Debt" as a Principal-Agent Problem

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In principle, governments contract debt on behalf of the population in order to provide public goods. However, public debt is sometimes used for private benefit, including for the purpose of maintaining a government's hold on power by repressing the population. The concept of "odious debts" is therefore closely related to a principal-agent problem: the agents contracting debt – the governments – do not use it for the benefit of the principals – the population – who are ultimately responsible for repaying it.

Is cancellation of odious debts an answer to the problem, as advocated by a number of Civil Society Organizations on the argument that creditors should bear responsibility for aligning the interests of governments and their populations? Should lenders commit to an odious debt framework, designed to ensure that loan proceeds are used for the benefit of the population, with the possibility that failure to do so might mean that lenders could lose the right to enforce their claim? Specific proposals have been made by Civil Society Organizations and others along these lines, among them the undertaking of debt audits, and repudiation of those debts found to be odious (the "ex-post" approach); the imposition of sanctions, whereby loans to regimes declared odious would not be enforced (the "loan-sanction" approach); and an approach whereby creditors would need to prove that loan proceeds are adequately used to ensure their claims are enforceable.

The paper analyzes these policy proposals using a game-theoretical framework that explicitly models the principal-agent problem between governments and populations. Although an extensive literature has debated the odious debt doctrine few studies have considered the problem from the point of view of economic theory, and those that have do not explicitly analyze the impact of an odious debt framework on the political agency problem ultimately at the heart of the debate. In other words, does implementing an odious debt framework indeed help align the interests of governments and populations, thereby increasing the population's welfare?

The study models the relationship between governments and their population as a principal-agent problem where the lack of information about a government's actions leads to moral hazard, and the primary incentive for government executives is the possibility that they can be replaced – through elections in a democratic environment, or through an overthrow of the current leadership. The model is modified to include two features relevant to the odious debt debate: first, governments finance their activities partly by borrowing from foreign creditors; and second, governments may seek to remain in power by providing public goods to the population, or by spending resources on repression.

The precise nature of the enforcement mechanisms available to creditors of sovereign nations, as well as the empirical evidence for the effectiveness of different mechanisms, have been the subject of an extensive literature. Given that the main focus of the paper is to understand the impact of an odious debt framework on the incentives of governments, I simply assume that a punishment is available at no cost to creditors. I then make the best-case assumption that holders of debts that are declared odious (whether ex-ante or ex-post) cannot avail themselves of such a punishment.

The baseline model highlights the trade-off between the willingness of governments to forego repression and engage in public investments and both political stability and the returns on public investments. Reflecting the fact that governments, regardless of their types, seem to repay their debts under normal circumstances, in the baseline all regimes pay similar interest rates, but populations under odious regimes are worse off.

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The impact of any of the lending frameworks on the welfare of the population is ambiguous. If creditors need to prove that loan proceeds are adequately used to ensure their claims are enforceable, the welfare of populations under odious regimes would increase, under appropriate conditions, but these benefits are limited by the fact that these same governments may divert domestic budget resources for private consumption or repression. The impact of the "loan sanctions" framework on the welfare of the population living under odious regimes is attenuated by the diversion of resources from the domestic budget towards repression. Two outcomes are possible: governments find it more advantageous to give up repression and be eligible for loans, improving welfare, or budget resources are diverted, lowering investment and welfare. The "ex-post" approach increases borrowing costs of all regimes, and its effects on welfare depend on how correlated public signals of "odiousness" are with actual repression. When lenders can perfectly identify odious regimes, this approach converges to the "loan sanctions" framework; when the lender's uncertainty about future "odiousness" is high, however, the increased costs of delivering public goods make repression relatively more attractive to otherwise non-odious regimes.

There are no easy policy conclusions – the results of the model are mostly ambiguous, particularly in view of the potential for diversion of domestic resources towards repression. But framing the problem as one of political agency does highlight the importance of promoting effective mechanisms for tracking expenditure and increasing budget transparency as a means of ensuring that not only the proceeds of loans, but all public resources, are used in the interest of the population rather than for the private gain of politicians in government.