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The Economics of Odious Debt
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Aligning the incentives of those responsible for negotiating and contracting loans and those that ultimately bear the burden of repayment is difficult in the context of sovereign borrowing. This agency problem between governments and their population is at the heart of the debate over the cancellation of "odious" debts. The proponents of odious debt policies argue that the lack of incentives for governments to secure loan proceeds for the welfare of their people should be corrected by forcing lenders to ensure that loans are only made to governments for purposes that are aligned with the interests of the population.

The paper identifies four different policy approaches to odious debt (see Box). The odious regimes framework argues that no debts incurred by a regime deemed odious should be enforceable. Under an ex-post version of this framework, successor regimes can argue (through litigation) that the predecessor regime was odious – and therefore that debt contracted by the predecessor need not be honored. In practical terms this would imply that successful litigation would prevent courts from attaching assets to enforce the repayment of a debt contracted by the odious regime. Under an ex-ante version of the odious regimes framework, an international body would declare certain regimes odious and agree that courts in member countries would not enforce debt contracts entered with such odious regimes.

The odious loans framework argues that those loans that were used against the interest of the population should be cancelled or declared unenforceable. Under the ex-post version of this framework, old loans are audited, and those deemed illegitimate (regardless of the regime that contracted them) are repudiated. Under the ex-ante version of this framework creditors must undertake sufficient due diligence to certify that a loan is being used for legitimate purposes, in which case that loan could not later be deemed odious.

Odious Debt frameworks:

Frameworks	Ex-ante	Ex-post
Debts of odious regimes should not be enforceable	An international body declares certain regimes odious, with an agreement that courts of member countries will not enforce debt contracts with them.	Successor regimes argue, through litigation, that the debts of a predecessor regime should not be honored.
Odious loans should be cancelled or declared unenforceable	Creditors must make due diligence to ensure a loan is for legitimate purposes.	Disbursed loans are audited and those deemed odious are repudiated, regardless of who contracted them.

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The paper analyzes how the odious regime and odious loan frameworks would affect the political, legal, and market costs of debt repudiation for commercial as well as official debt, and the implications for borrowing costs. The main findings of the paper are that odious policies are unlikely to be costless. Under the odious regime frameworks, borrowing costs to all regimes would increase: under the ex-post version, creditors would have to factor in the probability that the regime would be declared odious, which would increase the pre-default borrowing costs to non-odious regimes; under the ex-ante version the incentive of an odious regime to default on its debt would be independent of whether this debt is considered odious or not. This could imply that the legitimate successor regime would inherit a stock of legitimate arrears, which could potentially lead to an increase in the costs of new financing.

The ex-post version of the odious loan framework is similar in practice to what many Civil Society Organizations have been advocating: namely that countries should have audits of their debts and repudiate those loans that have been deemed odious, regardless of the type of regime that contracted the debt. In addition to the legal and administrative costs related to the audit, the uncertainty created by the audit is likely to raise borrowing costs.

The ex-ante version of the odious loans framework shares some aspects with the "responsible lending" approach, requiring greater due diligence to ensure loans meet pre-determined standards. Unlike the ex-post version of the odious loan framework, the ex ante version – if properly designed – does not bias lending away from high-risk, high-return projects. But these benefits are not costless: the increased requirements for due diligence will entail costs, which will largely be borne by all borrowers, including those with adequate control systems.

The benefits of even a well-designed ex-ante odious loans approach must be weighed against potential costs: if odious regimes cannot borrow, they may use domestic revenues or exploit natural resources more intensively. A loan-by-loan approach is only effective to the extent that a large volume of financial flows going through the government consists of external loans, which is not the case in many countries. Moreover, such a loan-by-loan approach would reverse the tendency for official creditors to build and use domestic budget monitoring systems – that is, to build the capacity for the country's own population to monitor the expenditure of state resources.