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**“ODIOUS DEBTS: A LESSON FOR A BETTER MANAGEMENT, TRANSPARENCY AND  
AUDITING OF PUBLIC DEBT”**

Public debt is deeply linked to countries' development, governmental performance as a whole, growth of financial institutions and opening to international markets.

In the last decades, debt has been related to instability, devaluation, capital flights, speculation and international crisis infection phenomena. Besides its fiscal, financial and economical function, debt has direct implications in the society's relationships, and is nowadays increasingly present within democratic nations.

Public debt –specially the external one— is unquestionably a crucial concern for the correct functioning of democracies within countries, given its deep implications on distributive issues and economical stability.

From a universal point of view, the management, problematic and nullity of public debt are relatively contemporary issues, mainly subject to analysis by its ruling body: International Law. A debt act legally exercised by a certain government, produces consequences which should be assumed by subsequent governments. According to this rule, the State is responsibly obliged by the legal acts agreed by previous governments.

According to International Law, there is a Debt Transference Principle by means of which a legal government act should be recognized, regardless of its origin (not considering if this act was signed by a dictatorship or by a democratic government). These acts will always be considered as acts of the State, executed by those organisms acting on the State's behalf. According to this principle, as well as to the Continuity of the State principle (a correlative principle to the permanent existence of the entity of the Generally Accepted Accounting Standards), debts from the previous government should be recognized by the succeeding one.

Nevertheless, another perspective based on the transnational experience holds that contracted public debts can and should be valued by the succeeding government, or should be evaluated during the corresponding succeeding processes. This way, debts acquired by an usurping government or contracted to serve illicit purposes, can be disclaimed by the government taking power and, therefore, remain not obliged to the corresponding reimbursement.

International legal practice establishes that all acts by which an illegitimate government contracted obligations on behalf of the State, can be considered nullified acts. In this case, debt contracted by this regime would not be considered obligatory for a nation and would consequently disappear with the fall of such regime.

These same considerations apply for creditors. In 1847, the Court of Paris issued a sentence that leaves no room for questioning. Firstly, it establishes that all creditors grant loans to usurping governments at their own risk and under their full responsibility. In order to claim payments, creditors must prove that debts were contracted by a legitimate government and for a legal purpose, at all times abiding the internal order of the State. In second place, the sentence establishes that it can be assumed that creditors granting loans to these kind of governments act in a dolus and fraudulent manner, and can therefore be subject even to criminal charges.

The international legal doctrine that supports the argumentation regarding irregular debt contraction was developed by Alexander Nahum Sack in 1927, a fourth of a century after the Hispanic-American War. Sack was a ministerial precursor of the Russian czarism and, after the Russian Revolution, a Law professor in Paris.

Sack never ceased to acknowledge that obligations contracted as public debt should remain intact, since they represent obligations for the State according to a territorial component, rather than as a specific governmental structure. He based his argument not only on a strict principle of natural justice, but also on the international trade demands, stating that chaos could take control in the relations among nations without rigorous rules.

The true essence of Sack's doctrine takes into account that, in view of the colonial territories' independence, the States and Colonies experienced a change in power, Monarchies were replaced by Republics, and military rules by civil ones; constant fluctuations were experienced in the European frontiers and new ideologies emerged.

Sack observed that debts contracted not for the benefit of the State's interests should not be tied to inflexible rules, since this kind of legal acts were rejected by society and therefore considered as "Odious Debts". Thus, he argues that if a despotic power has incurred in debt as a result not of the national needs or interest, but to reinforce the regimen or repress oppositional citizens, such debt would be rejected by all the State's society.

The odious debt doctrine is subject to an abusive interpretation, with the risk of favoring merely particular interests. To avoid an eventual misinterpretation of the odious debt doctrine, Sack proposed new governments to prove that their debts would be contracted in benefit of the public interest, and that the corresponding creditors should be well informed about it.

In order to claim reimbursement of granted loans, creditors must prove, by means of auditing tasks, that granted borrowings were used in benefit of the State. Failure in proving this before an international court would result in a non-compulsory debt.

For the last 40 years, the wealth in the world has multiplied itself eight times; yet, 25% of the global population lives with less than USD \$1 per day, and 50% lives with twice of such an undersized figure.

This problem has been faced via financing and borrowing. Yet, a hard-to-break vicious circle is implied in this solution, since developed nations demand from developing countries debt payment in exchange for new capital flows to overcome poverty.

There are three convergent ways to mend the damage produced by this situation in undeveloped economies. The first one is to implement the model adopted by the United States of America in 1898, in the Conference of Paris, when this country --acting as the new "defender" of the Caribbean island-- established that the Cuban debt contracted with Spain was not to be recognized. An argument was made, stating that such debt was contracted by the occupation of Iberia's strength. With this measure, the concept of "Odious Debt" felt present, and has almost fallen into oblivion nowadays.

In legal terms, there are background cases in which public debts contracted by despotic governments were nullified, like the beginning of the great progression of Latin-American public debt scenario, occurred during the 70's.

The second, less-radical measure, is to negotiate with creditors a new schedule for the debt's reimbursement. Considering there is no question about its authenticity, the debt would be paid but not under the creditor's conditions, but within the debtor's possibilities, taking into consideration thereby that enough resources are left to promote the country's internal development and growth.

The third way to avoid "odious" debt reimbursement is "payment cessation", which means to simply stop paying any obligation whatsoever regarding the debt. This alternative is not accepted, not only by the loyal representatives of the legal framework, but also by large population segments which realize that such measure can provoke domestic international capitals to abandon their country.

In Mexico, moratoria, payment deferrals and debt restructuring have been a constant in the country's History. The first moratorium took place in 1828, just four years before the establishment of the Republic. During the first century of independency, the government was unable to reimburse external debt payments due to foreign invasions, disclaimed debts contracted by previous administrations and the revolutionary war.

On the other hand, it is also true that all along the Mexican history, debts have been contracted due to the oil and railroad nationalizations. The last episode of public debt significant increase in Mexico took place between 1994 and 1995, as a result of the banking system rescue. In this case, serious questions were raised regarding the transparency and adequacy of such debt contraction.

In view of its significant risks and implications, contracting external or internal debt should be based on a country-development-financing strategy. A sustainability basis is required, as well as reasonable cost levels in order to pay for the fiscal deficit, as well as for the current account within the payment balance.

The lack of a viability and risk analysis when contracting entitled, contingent or implicit debt, leads to the perception of a threat to growth, in light of the significant fiscal burden that its eventual payment represents.

A well-balanced examination of associated costs and benefits should take into consideration the magnitude of the debt's amount, its financial requirements for appropriate compensation, its management efficiency, and the expected outcomes of its administration.

Within this context, Supreme Audit Institutions play a crucial role, since they are the revising institutions that foster, before the responsible managers, adoption of best practices in public debt administration.

Therefore, it is a priority to promote an efficient and professional public debt management, in order to decrease financial costs and risks implied.

It is essential to carry out, under different scenarios, an accurate evaluation of the fiscal sustainability for debt payment, as well as to incorporate contingent and implicit liabilities that in time may affect its structure.

With the intention of reducing financial crisis risks, a wide dissemination of information on public debt should be encouraged, as well as banking system regulatory mechanisms and an efficient transparency and accountability scenario, in order to allow for a more objective and reliable assessment and analysis regarding the debt's fiscal vulnerability.

The advantages of transparency in debt management can be grouped into four categories: 1) it is beneficial to the efficiency of the private sector; 2) it reduces costs and probable financial risks; 3) it promotes confidence, thus avoiding external crisis widespread; and, 4) it supports and encourages democracy.

Despite the significant potential benefits offered by debt's information disclosure, institutional transparency in middle-income countries has been unable to prevent crisis caused by infection or speculation.

In order to play an efficient role, transparency must be global and should include all of the international financial system actors. It also requires including a sufficient amount of information for the heads and officers of the central banks in developing countries, regarding international and coverage funds.

The classification of financial information in Mexico has experienced major changes. During the 70's and 80's, governmental creditors and public debt conditions were not disclosed. In the middle 90's, information regarding the international reserves of Banco de Mexico (the Mexican Central Bank) were disseminated only twice a year. Currently, in our country some information is still classified, even though it is limited, exceptional and justified.

Transparency is a technical and costly task, which requires the development of regulations, institutions, practices, systems, education, as well as social and cultural feedback. Transparency generates responsibilities to public officers and is therefore not always welcomed. Public officers tend to carry out their tasks as a technical function instead of as a political or social one. They would like to be judged by their results instead of by the decisions they make. Certainly, transparency brings complexity to the public sphere.

Through the revision of public debt's theory and function, it becomes evident that public debt is the result of the economical system performance and the implementation of public policies. Public debt transparency should be seen as a whole and include the following information areas:

- Use and purpose of the debt.
- Public policies related to debt management and its exercise.
- Form and frequency of debt payment.
- Negotiations with creditors.
- Assets and liabilities balance.
- Composition and operations of the stock, banking and commercial debt.
- Indirect and contingent debt.
- Solvency or capital requirements to face risks.
- Obligations resulting from unfunded constitutional or legal rights (implicit liabilities).
- Social Pact: regulatory government and counterpart.
- Fiscal sustainability of the internal and external debt.
- Adopted prudential criteria.

The debate regarding a new international financial system structure comes, in part, as a consequence of the global debt crisis, the frequent banking crisis and its widespread effects. These changes would help shaping a new face to capital accounts opening, and would support more creative ways of insertion within the global economy.

On the other hand, public debt auditing should assess compliance with the legal and regulatory dispositions, the effects in the economy and its impact on the government's action range. Among the main issues to be revised, the following should be highlighted:

1. Legal and regulatory public debt framework
2. Debt purpose and its income-yield capacity in social-economic terms
3. Debt's administrative cost and payment
4. "Commitment" costs per commission fee
5. Public debt management
6. Public debt fiscal sustainability
7. Liabilities and contingent or implicit obligations
8. Quality and opportunity of accountability

Supreme Audit Institutions must report to the Parliaments or Houses the outcomes of the analysis and assessment performed on all the aforementioned issues, including, if that is the case, the magnitude of the fiscal risks that could compromise the financial, economic and political stability.

The role of the International Organization of Supreme Audit Institutions (INTOSAI) stands out within the assessment and auditing tasks of the public debt general scheme. The exchange of experience between the 188 members of the Organization and the subsequent technical progress attained, guarantee the passage of public auditing into new horizons.

INTOSAI supports its members by providing them information and experience on the challenges faced by the world today, in the auditing and performance audits spheres.

Additionally, the Organization comprises the Initiative for INTOSAI Development (IDI), a training-providing body, as well as the Public Debt Committee, responsible for carrying out studies and research on this subject.

Since the year 1991, the Public Debt Committee was established by INTOSAI. It currently includes Supreme Audit Institutions from 16 country-members, as well as from 5 country-observers.

Research and analysis papers on public debt have been undertaken and are available in the Committee's Website ([www.intosaipdc.org.mx](http://www.intosaipdc.org.mx)), including the following themes:

- Guidance on Definition and Disclosure of Public Debt;
- Guidance for Planning and Conducting an Audit of Internal Controls of Public Debt;
- Guidance on the Reporting of Public Debt;
- Public Debt Management and Fiscal Vulnerability;
- Fiscal Exposures: Implications for Debt Management and the Role for SAIs;
- Performance Audit on Public Debt and Terms of Reference;
- Substantive Procedural Guide for Auditing Public Debt; and finally,
- General Policies and Best Practice in Public Debt Management.

Given the importance of auditing public debt, its management, accountability and audit was chosen as material for the XIX INTOSAI Congress, held in Mexico City from November 5 to 10. During this event, the Superior Audit Office of Mexico was appointed Chair of the Organization for the period 2007 to 2010.

Until now, audits on public debt management have been limited to verify the compliance with the legal and regulatory dispositions, accounting records and payments revision, balance conciliation, and assessment of internal control mechanisms. However, these revisions have turned out to be insufficient, due to the following:

- Inadequate disclosure of the debt's structure, in terms of contracting, evolution, sources and financing;
- Scarce and unreliable information regarding amortization and interests payment;
- Discretionary decisions regarding debt purposes (expenditure or investment);
- Insufficient regulation and lack of supervision and control, regarding financial institutions;
- Lack of transparency and accountability on public debt, and finally,
- Limited control and auditing, and an historical or short-term approach.

For all the abovementioned, the mission of Supreme Audit Institutions should include overseeing and assessing the correct and honest allocation of public debt resources. The essence of the debate resides in encouraging a culture of transparency and accountability on this issue, and to promote among governments a responsible and committed attitude regarding the future generations.

Ladies and gentleman, thank you very much for your attention.

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## SOVEREIGN PUBLIC DEBT INDICATORS

### a) Total Public Debt Indicators

- i. Total Public Debt and Debt Service / GDP,
- ii. Budgetary Deficit and Financial Cost / GDP,
- iii. Total Public Debt Service / Export Income,
- iv. Average Maturity and Duration.

### b) External Public Debt Indicators

- i. External Public Debt and its Service / GDP
- ii. External Public Debt Service / External Public Debt
- iii. Short-term External Public Debt / Total Exports, or External Public Debt and Service / Total Exports
- iv. Short-term External Public Debt / Foreign Exchange Reserves and Exports
- v. Capital Account of the Balance of Payments / Current Account

### c) Domestic Public Debt Indicators

- i. Domestic Public Debt and Short-term Debt / Ordinary Revenue
- ii. Service of Domestic Public Debt / Ordinary Revenue
- iii. Interest on Domestic Public Debt / Ordinary Revenue
- iv. Interest on Domestic Public Debt / Net Expenditure

## CONTINGENT PUBLIC DEBT INDICATORS

- i. Total Amount of Contingent Liabilities / GDP
- ii. Total Amount of Contingent Liabilities / Total Amount of Direct Debt
- iii. Total Amount of Contingent Liabilities / Public Sector Total Net Expenditure
- iv. Public Sector Ordinary Revenue (1, 5 and 10 years)
- v. Estimated Payment of the Financial Costs of the Contingent Liabilities / Estimated Payment of the Financial Costs of the Direct Public Debt (1, 5 and 10 years)
- vi. Estimated Payment of the Financial Costs of the Contingent Liabilities / Public Sector Total Net Expenditure (1, 5 and 10 years)
- vii. Estimated Payment of the Financial Costs of the Contingent Liabilities / Expected Public Sector Ordinary Revenue (1, 5 and 10 years)