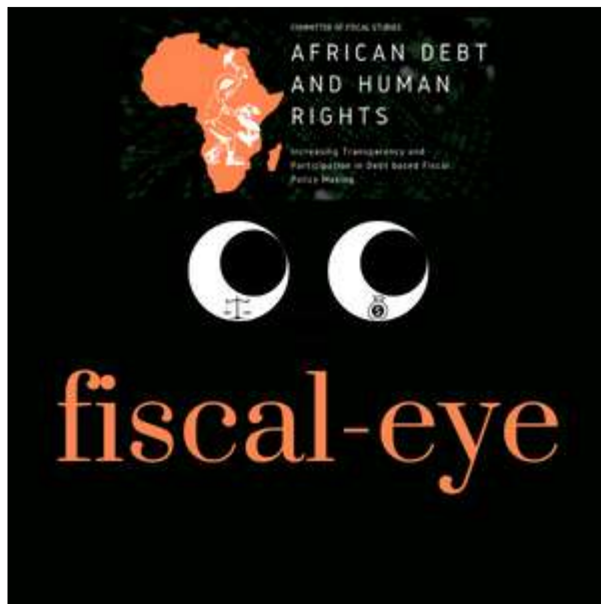

Is Africa's fiscal space undermined by debt related illicit financial flows?
Lyla Latif

When I think of the African fiscal space, I like to focus on the extent to which African governments can generate revenue to meet their financing needs. Usually, every government is exposed to revenue shortfall which undermines their efforts and planning towards securing a sustainable socio-economic environment which is buttressed by efficient political frameworks and strong financial sectors.

Why African Governments Borrow?

To guard against fiscal limitations, governments borrow. However, (1) Unchecked borrowing, (2) borrowing utilised for non-economic activities that do not result in returns but are instead diverted towards private use, (3) borrowing that results in the creditor looking at a debtor state as a pathway towards monetising the debt and earning more out of what is loaned goes against the very idea of fiscal activism.

A government borrows so that it has enough to run the state and its society – debt then has the effect of supporting the African fiscal base, but debt can also undermine the fiscal space by eroding it. This happens when debt creates an enabling environment for illicit financial flows (IFFs) to thrive or sneak into a country's legal system. Laws and political institutions and how they relate to debt is critical in understanding and protecting the African fiscal base.

Having these thoughts in mind, I wrote this briefing on Africa's fiscal space undermined by debt related illicit financial flows. It is an important topic because the current collective African debt stands at 726billion US dollars – this is according to the World Bank and the African Development Bank.

The Problem of the Colonial Past

Much of the African debt has been aggravated by historical injustices in the form of colonial and odious debts, emergence of vulture funds, lack of thin capitalisation rules, debt to equity swaps, lack of fiscal transparency and accountability for resource backed loans all which culminates into an environment that fosters opportunities for illicit finance or untaxed gains made from manipulating the debt and the legal framework within which it operates.

Colonialism and apartheid undermined the fiscal policy of a state in so far as it would result in the economic improvement of the natives – now that's my view. The tax structures of the African countries, colonial in their origin, were responsive to colonial markets because the intention was to scramble for African wealth. Fiscal policy during colonialism was targeted towards revenue extraction and exporting such revenue abroad – debt therefore, understood in the post-colonial

context, is also actually about revenue extraction from the debtor state – think of this in terms of the high interest rates and management fees that come with it and the secrecy around resource backed loans – which when there is a default, entitles the creditor to seize the debtor state's assets.

This post-colonial vision on monetising debt, in my humble view, was introduced through the Washington Consensus – a political arrangement that looked to support fiscal regimes with revenue in turn of the borrowing state acceding to some conditions. Then we have the debt phenomenon aggravated by post-colonial fiscal policy. Successive African governments have been bound to IMF led structural adjustment programs that demand for a favourable liberal environment which is a catalyst for IFFs if unregulated- of course the very idea behind liberal markets is privatisation and privatisation is all about deregulation – a distinct red flag!

Arguably, vulture funds exist because of this liberal market, that also permits neglect in introducing thin capitalisation rules and promoting debt to equity swaps.

The Evolution of Debt + Consequences

Now that's the context against which the African debt has evolved standing at 726 billion US dollars out of which the World Bank 2019 statistics reveal that the SADC region, for example, owes 123.71billions US dollars. What are the consequences of this debt on the SADC region? Zimbabwe, Angola and Zambia are failing to meet their SDGs – these countries are spending more towards financing the debt than they are towards securing economic well-being and livelihoods. Angola and Mozambique are on the path towards debt distress. Zimbabwe already is in debt distress and about 7.9million Zimbabweans are in extreme poverty. Zambia is spending 4 times more on debt payments than its budget for education, health, water and sanitation.

East African countries as well spend more on debt than on social spending. Doesn't this make their fiscal space fragile when it comes to guaranteeing socio-economic rights and the progressive realisation of human rights? Isn't their revenue base further eroded by debt related IFFs, if any? To start with a few statistic – IFFs from the SADC region are estimated at 542.4billion US dollars. Of course, accumulated over the years. Any fiscal regime in which IFFs thrive – expose the fiscal space to vulnerabilities.

These vulnerabilities are legally constructed. A country has legal systems and institutions in place -to negotiate the debt, the tax arrangements and repayment terms, there are monitoring institutions in place that should guarantee fiscal transparency and accountability, put in checks and balances in how the debt is utilised, and how financial flows are regulated. There are oversight bodies that see to laws and regulations being implemented yet amidst it all, like a shadow, illicit finance traverses through all these systems, institutions, and bodies. The law gives illusions of legitimacy to debt when debt itself fosters IFFs.

Consider how much SADC countries owe in debt versus how much they lose through IFF – it is 123 billion US dollars versus 542 billion US dollars. How does this happen? How can we identify debt related IFFs?

Debt related IFFs

We have the element of **corruption** in the use of debt sourced funds- Tuna Bonds scandals in Mozambique and various governments looting covid funds and redirecting those funds towards private enterprise are a few examples of how debt was transformed for illicit gain.

Vulture Funds pose a threat as debt related IFFs. This is a company usually an investment fund set up by commercial creditors that seek to make profit by buying up bad debt at a cheap price then attempting to recover the full amount often by suing through the courts. These funds are companies which buy the debt of poor nations cheaply when it is about to be written off and then sue for the full value of the debt plus interest which is sometimes 10 times more than what they paid for it.

The full profits they make on debt that they purchased cheaply along with interest and on the principle amount is usually routed through a web of transnational companies registered in either secrecy or law or no tax offshore jurisdictions making it difficult for revenue authorities to tax the profit and interests earned. Such tax evasion practises are characteristic of vulture funds.

Now these funds target poor country governments. Many of these vulture funds are based in tax havens hence tend to be quite secretive. There is limited or no information on who owns them. When an impoverished country has an outstanding debt or to a private creditor that has not been written down or restructured there is a chance that a financial organisation will seek to buy that debt at reduced prices and seek repayment of the original amount or more.

The debtor government is then threatened with legal action and when they lose the court rules that the debtor government pay the original debt, interest and fees accrued since the debt has been in arrears as well as the legal costs. Firms called this capitalising but in reality, this vulture activity is to be seen as a form of IFF because they have the effect of paralysing the economies of indebted nations.

We have Angola, Mozambique, Tanzania and Zambia that have been subjected to vulture action. Now vulture activity is immoral, but it is not strictly speaking illegal and the profits made on suing for distressed debts cannot be deemed as illicit earnings. This is where the problem is, and such thinking makes the African fiscal space vulnerable to vulture activities.

For example, in one recent case against Zambia, a vulture fund bought the Zambian debt at $3 million and sued Zambia for 55million - it was awarded 15.5 million U.S. dollars. in essence this fund made a profit of 12.5 million none of these extra earnings on the recovered debt was subjected to withholding tax by the Zambian government on the interest earned.

Vulture funds that purchase debt are nested in tax havens. They can also be shell companies which makes it impossible to quantify how much debt around the world they actually hold. Since they are subject to a private contract when they buy the debt or when the debt is sold - it is subject to a private contract, thus the discount rate at which the distressed debt is purchased is also not

publicly known -so when the company sues for full recovery it actually makes a profit such as in the Zambian case.

Because of privity of contract the domestic revenue authority is not aware of the purchase price of the debt also because the contract is negotiated through a cluster of companies spread out in various jurisdictions – this means that the full recovery of the debt at a later stage if it results in a profit remains outside the tax bracket as it will be deemed as a recovery of an expense. This is a classic modus operandi for IFFs. I think the point is clear that the activities of vulture funds clearly undermine African debt repayment approaches and relief interventions.

Debt to Equity swaps are another form of debt related IFFs– these swaps can be used to launder illicit proceeds by converting the debt owed by a state-owned enterprise as part of a joint venture agreement (JVA) into equity for the creditor who uses the opportunity to invest more in equity shares using laundered proceeds, or utilising the JVA to move money in the form of repayments for legal claims such as IP, management fees, consultancies offshore.

Thin capitalisation rules (TCR)– in so far as TCR are concerned these exist to prevent international debt shifting and may be a concern in facilitating debt related IFFs. Think of this as a private creditor issuing debt to a state and making excessive interest deductions to avoid paying tax in its own jurisdiction – yet earning more in interest from the debtor state. It is important to set out a debt-to-equity ratio – high debt to equity ratios would mean that a private creditor would be able to claim higher tax deductions if interest on debt is taxed by the debtor state by moving debt repayments offshore to its subsidiary incorporated in a low or no tax jurisdiction.

Solutions?

So, what do we do? How do we curb against such debt related IFFs? I want to offer two recommendations on curbing the vulture fund menace and abuse of debt-to-equity swaps.

1. Curbing vulture funds– it would be ideal for the World Bank to buy back outstanding private and commercial debts from African countries so that at risk debts are taken out of the public domain. Laws on sovereign immunity against vulture activities must be implemented and profiteering from vulture acts must be declared illegal.

2. For debt-to-equity swaps – African countries should implement safe habour rules and there should be restrictions placed on private creditors against selling or re-assigning sovereign debts without explicit approval of the indebted state.

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