Nairobi International Financial Centre or Nairobi Tax Haven?

A review of the Nairobi International Financial Centre Bill

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EATGN
East Africa Tax & Governance Network

TAX JUSTICE NETWORK AFRICA

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EAC	East African Community
EMPEA	Emerging Markets Private Equity Association
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FSD-Africa	Financial Sector Deepening
FY	Financial Year
GDP	Gross Domestic Product
GFCI	Global Financial Centres Index
GP	General Partner
ICIJ	International Consortium of Investigative Journalists
IFC	International Financial Centre
IMF	International Monetary Fund
KRA	Kenya Revenue Authority
NIFC	Nairobi International Financial Centre
NYS	National Youth Service
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OFC	Offshore Financial Centre
PAYE	Pay As You Earn
QFC	Qatar Financial Centre
QIFC	Qatar International Financial Centre
SDG	Sustainable Development Goals
VAT	Value Added Tax

Introduction

Financing the global development strategy, the sustainable development goals (SDG), is estimated to cost between USD 3.5 trillion to 5 trillion annually (Deen, 2015). The figures are staggering but so are the envisioned outcomes of the fifteen year plan that rides into 2030 along seventeen distinct goals. These are aimed at reducing extreme poverty while ensuring equality among the world's populations, having both national and global implications. This calls for state level responsibility by means of sustainably raising sufficient resources to cover the costs of realisation as well as global collaboration and partnership. Domestic resource mobilization has been identified as the only real key to sustained economic growth, development and transformation in all economies (Eric & Desire, 2010)

Budget deficits, increasing debt levels and the ongoing international economic downturn means that governments, especially in developing countries, need to expand their domestic resource base to finance the gaps and provide alternative funding. More specifically, the need for sustainable development has meant that domestic resource mobilization moves to the centre of the global development discourse and forms the crux of government business. In a bid to bridge these gaps, many countries especially in the global south, have resorted to increasing foreign direct investment (FDI). The particular focus in this regard, is the creation of an environment with the requisite conditions to attract FDI. This has given impetus towards establishing robust financial services sector, believed to be core in driving economic development.

Kenya's budget continues to increase concomitantly to revenue generation and collection, an indication of robust economic activity (Government of Kenya, 2016). The FY2016/2017 presented Kenya's biggest budget yet. However, there are concerns about the budget deficit and increased debt forecast of 6.9% of GDP which has led to the debt ceiling being raised by government to permit subsequent increased borrowing. This is among the reasons informing the setting up of an International Financial Centre (IFC) in Nairobi, a process which begun as early as 2008.

In the Financial Year (FY) 2016/2017 the Cabinet Secretary in charge of Treasury committed to bringing to the floor of Parliament the Nairobi International Financial Centre Bill (Government of Kenya, 2016). The Bill is supposed to create a legal framework that will establish Nairobi as the Financial Hub for the East and Central African region. It is worth noting, however, that financial centres do not operate in isolation and therefore require relative political stability, robust investments in infrastructure, predictable and fair tax systems, or efficient dispute resolution mechanisms, all of which are necessary components of this ecosystem.

This paper interrogates the provision of the Draft Nairobi International Financial Centre Bill 2016 (the "Bill") in regards to its ability to confer the proposed benefits of an IFC while mitigating the inherent risks that arise specifically as relates to domestic resource mobilisation. It reviews the background and motivations that led to the drafting of the Bill while providing a critique on key provisions of the Bill. It also analyses by way of case study, the defunct international financial centre in Ghana to glean lessons that would be relevant in the Kenyan context.

Background

Nairobi International Financial Centre or Nairobi Tax Haven?
The Panama leaks[1] recently exposed the role of tax havens in facilitating illicit financial flows. Tax havens by their nature of operations are characterised by certain factors including:

(i) laws and regulations that can be used to evade or avoid tax or regulations of other jurisdictions
(ii) grant fiscal advantage to non – resident entities without requiring substantial economic activity be carried out within the jurisdiction
(iii) provide significantly lower effective level of taxation including zero taxation

The Panama Leaks exemplified the machination of the global offshore financial system and how individual and corporate entities employed similar measures to "ease" the burden of doing business (International Consortium of Investigative Journalists, 2016). A key defence offered by entities involved was that their activities were completely within the prescriptions of the law. The Panama papers have stood out from all the other leaks given the sheer quantity of data that has been released, the people involved and the secrecy that shrouded the operations of Mossack Fonseca, the law firm implicated in the Panama Leaks. It has been described as the largest tax and money laundering scandal of the world. According to the Economist (S.N., 2016), in the wake of the Panama papers, the global industry of service providers, which sells financial secrecy to those who can afford it, have in some cases done more than just feast on poorly designed tax policies.

The Nairobi International Financial Centre (NIFC) is set to be established through an Act of parliament therefore entrenching it within the laws of Kenya. Kenya therefore proposes to establish an un-encumbered environment through which investment can be channelled by creating an International Financial Centre. Interestingly, similar reasons were proffered as justification for setting up the Cayman Enterprise City (Cahill, 2016); a well-established tax haven. The International Financial Centre which will be based in Nairobi, seeks to provide favourable conditions for operations; meaning that the terms offered will either be similar to or better than established international financial centres.

The African Union High Level Panel Report on Illicit Financial Flows identified commercial activities as accounting for the largest stake in the loss of financial resources from the African continent through tax avoidance and evasion practices (African Union/Economic Commission for Africa, 2015). These commercial activities are underwritten by a complicated financial system that creates an enabling environment for the circumvention of the public purse, mainly facilitated by international financial centres. In its conception and by admission, the Nairobi International Financial Centre (NIFC) seeks to be a conduit and entry point for finance to Eastern and Central Africa. Reasonably therefore, any establishment aimed at enhancing or facilitating the ease of doing business (commercial activities) while seeking special exemptions such as secrecy and incentives, should of necessity come under rigorous scrutiny. This is important because of the inherent risk of perpetuating illicit financial flows, undermining domestic resource mobilisation and abusing state power by destroying state institutions' integrity.

International Financial Centres' State of Affairs

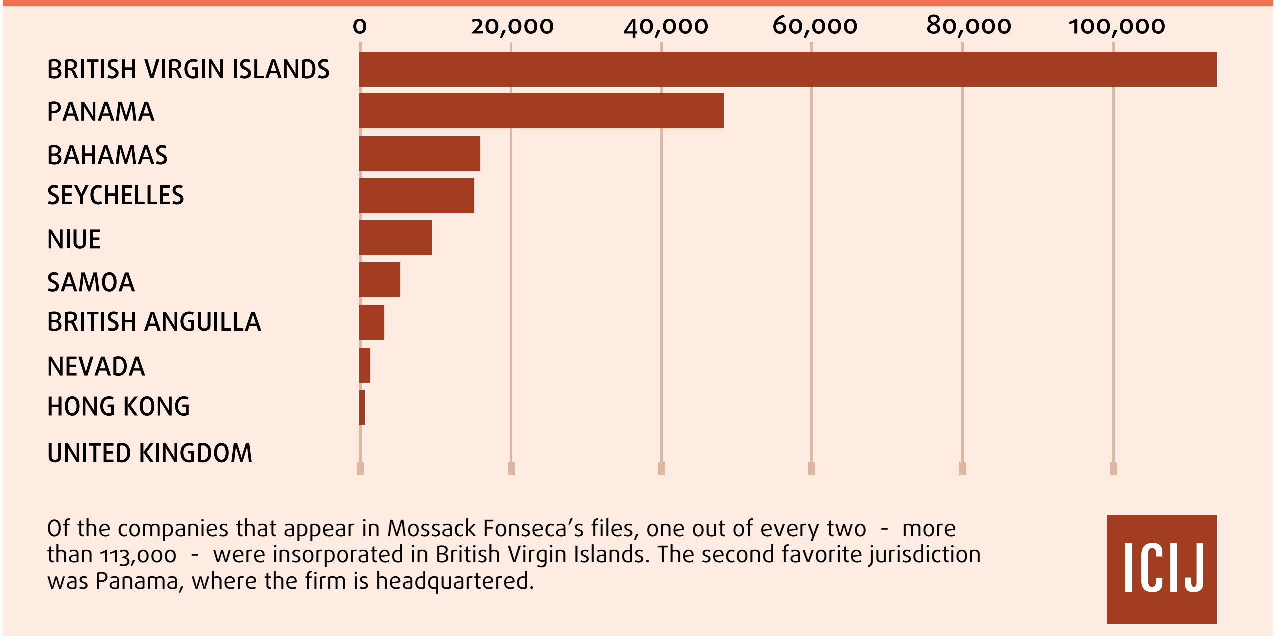
The International Monetary Fund (IMF) describes an IFC as a centre (usually a city) where the bulk of financial sector activity is offshore, the transactions are initiated elsewhere and the majority of the institutions involved are controlled by non-residents (IMF 2000). Characteristic features of an IFC include: relatively large numbers of financial institutions engaged primarily in business with non-residents; financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and more popularly, centres which provide some or all of the following services: low or zero taxation; moderate or light financial regulation, banking secrecy and anonymity. At the epicentre of this thinking is the need to maximise shareholder value while cutting through red tape that is often considered a hindrance to doing business. In perspective, for an IFC to be successful in attracting foreign direct investment (core business), it would have to meet these basic requirements and perhaps even supersede them. However, International Financial Centres are faced with competing interests both internal and external to the jurisdiction. First, how to leverage on the global financial system to attract FDI by offering the best possible set of incentives. Second, how to balance off these incentives against domestic objectives which inform the original purpose of establishing an IFC.

[1] Leak of 11.5million documents from the Panamanian law firm and corporate service provider Mossack Fonseca

Richard Brooks argues that competition among low tax jurisdiction is actually becoming stiffer, leading to a global race to the bottom that depletes contributions of major corporations and leaves citizens to pick up the tub (Brooks, 2014). Tax incentives tend to be a key feature of international financial centres. Tax Justice Network – Africa and ActionAid International, in 2012 (TJN-A & AAI, 2012) and 2016 (ActionAid International and Tax Justice Network-Africa, 2016), while examining the tax incentives regimes in the East African Community (EAC), noted an inherent risk in the tax incentives regimes offered by member states. The prescription of tax laws provided discretionary powers to individual state officials to issue incentives thereby creating an opportunity for "sweetheart" deals. This exposed the incentive regimes to abuse, both by the issuing authority who are susceptible to compromise and the recipients who enjoy undue advantage over indigenous firms. In addition, the case of East Africa demonstrated that incentives offered mainly in the form of tax breaks, were not granted based on a cost benefit analysis that would estimate the potential revenue impact. As a result of this regime, it is estimated that between USD 1.5 Billion and USD 2 Billion is lost annually in the region (ActionAid International and Tax Justice Network-Africa, 2016).

Tax justice campaigners argue that tax concessions are requisite to the incentives structure of any IFC because of the unhealthy tax competition and de-regulated environment in which they exist. The Tax Justice Network defines IFCs as commercial communities hosted by tax havens (Waris, 2014). Accordingly, IFCs are entities that exploit domestic legislation and enjoy opacity in the manner in which they conduct business for the benefit of foreign residents and to a certain extent a select elite. The Panama Leaks demonstrated that the favourite destinations to set up companies were indeed tax havens (International Consortium of Investigative Journalists, 2016).

Figure 1: **The 10 most popular tax havens in the Panama Papers**



Source: International Consortium of Journalists[2]- Explore the Panama Papers Key Figures

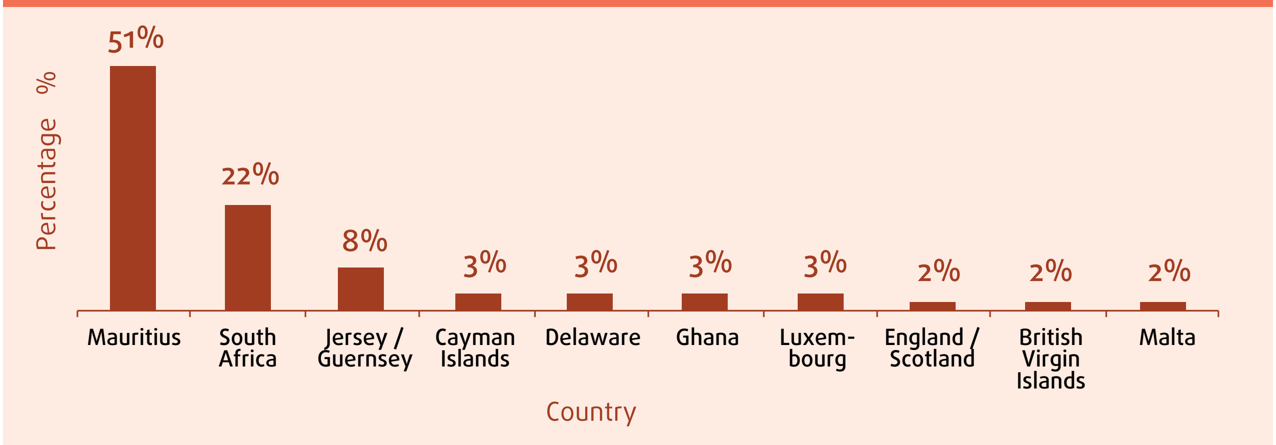
The Panama Leaks strongly indicts tax havens as avenues used to avert tax liabilities. This is a particularly important consideration for any jurisdiction to contend with, especially where tax revenue accounts for a significant proportion of the national budget. For Kenya in its FY2016/2017 budget, it is anticipated that total tax revenue will account for 66.25% of the total budget (Mwanyumba, 2016), the highest in the region by comparison, both in terms of actual value and percentage of budget to tax revenue. This is no doubt a major consideration, especially when tax incentives are salient to the success of an IFC in Kenya, while on the other hand a significant proportion of the budget heavily relies on tax revenue. The challenge especially for Kenya is the fact that as the dominant economy within the East Africa Community (EAC) (Goldman, 2016), decisions it takes have a ripple

[2]https://panamapapers.icij.org/graphs/

effect among member states. Kenya has been often described as the gateway to East Africa and it seems that Nairobi is keen on ensuring that the NIFC becomes the financial gateway. This is indeed an important proposition especially when considering the potential effects on tax revenue the NIFC could have for Kenya, other EAC member states and beyond considering the NIFC may come with tax incentives and exemption that may not other countries in EAC. This may lead to diversion of investments from other EAC members to Kenya with a view taking advantage of the incentives that may come with establishment of NIFC.

It is relevant to juxtapose Kenya against Mauritius, given its acclaim as an international financial centre. Mauritius has fastidiously promoted itself as a financial hub and encouraged several companies to register within its jurisdiction and conduct business on the African mainland which end up shifting profits to Mauritius to take advantage of the low tax rates. This has mainly been possible because of the low tax regime and the labyrinth of double taxation agreements Mauritius has entered with other states. It is now standard practice for Africa's private equity industry to channel funds through offshore jurisdictions. According to Financial Services Deepening – Africa (FSD-Africa) and Emerging Markets Private Equity Association (EMPEA) nearly 75% of respondents to their study indicated that offshore jurisdictions were their preferred conduit for private equity funds to Africa (FSDA and EMPEA, 2015). Mauritius was their favourite destination, followed by South Africa as on-shore jurisdiction. According to the same report, other jurisdictions which are being touted as possible on-shore financial centres include: Kenya, Botswana, Tunisia and Nigeria, with strategic geo-political importance. Consequently, this means that multi-national companies and private equity funds with operations in main land Africa are motivated to shift their profits or report their profits in Mauritius.

Figure 2: **Nearly 75% of Respondents utilise an Offshore location for their current fund domicile - % of Respondents**



Source: FSDA and EMPEA, "Conduits for Capital; Onshore Financial Centres and Their Relevance to African Private Equity" (2015), page 20

The NIFC has the specific onus of catalysing Kenya's Vision 2030, the country's development blueprint, with the aim of achieving middle income status. More specifically, through the NIFC, Kenya is seeking to create employment; provide financing for flagship projects planned by the government; tap into new investments coming into Africa; encourage investment groups, stockbrokers, pension funds, banks and insurance companies to set up offices at the NIFC and improve competition in domestic financial services.

Anchoring the NIFC within Kenya's development vision 2030 blueprint means that complimentary processes need to accompany financial reforms. The question is, are there commensurate investments in supplementary sectors as proposed within the social pillar, economic pillar and political pillar of Vision 2030? Recommendations of the Addis Ababa Action Agenda (United Nations, 2015), the final document of the Third International Conference on Financing for Development, speaks to the role of domestic resource mobilisation as a key component of financing the sustainable development goals. The risk of the NIFC in undermining domestic resource mobilisation capabilities especially with regards to the incentive structure envisioned, is a legitimate concern for Kenya especially upholding the Addis Ababa Agenda commitment of financing development through domestic resource mobilisation.

Methodology

The research was primarily qualitative, as it focused on the review of the Nairobi International Financial Centre Bill 2016 and its likely effects in regards to domestic resource mobilisation for Kenya and the region. It also examined secondary data on international financial centres and tax havens, and the role they play in foreign direct investment. Lastly, the research employed purposive sampling from experts in; academia, civil society and the corporate sector to give insight into Tax Justice, International Financial Centres (IFC) and Financing for Development through a peer review exercise. The objective of the Peer Review was to engage with experts to interrogate the provisions of the NIFC Bill through: sharing of an in-depth critique on the theoretical framework of IFCs in general and the NIFC in particular, reviewing and deliberating over the legal provisions of the NIFC Bill and its implications, and, offering pertinent contextual insight from a professional perspective on the NIFC. The Peer Review's purpose was to enrich the detail of the final report and create a resource base among the experts.

Analysis and Findings:
What does "the Bill" say?

The key arguments that have been put across when establishing IFCs in most jurisdictions are among others, fostering economic growth, creating employment and increasing attraction of foreign direct investment. Similar sentiments have been echoed by the Government of Kenya where the establishment of the NIFC has been concerned. According to the Cabinet Secretary for the National Treasury, Mr. Henry Rotich, Vision 2030 envisages the Nairobi International Financial Centre as a catalyst for Kenya to gain a stronger presence in Sub-Saharan Africa's growing financial services market. He further reiterated that development of the Centre is expected to create employment, raise financing for flagship projects and tap into new investments coming to Africa (Rotich, 2016)

This section of the study provides an in-depth analytical review of the NIFC by focusing on the legal provisions on which it will be established, as well as its implication on domestic resource mobilisation of which tax is a key component. It will also look at a case study of the Ghana International Financial Centre to allow readers draw comparison.

The Provisions of the Draft Bill and Framework for Analysis

The study looked through the provisions of the Bill with a view of understanding said provisions and putting them in context in relation to other existing regulations and regulatory institutions that would be engaged in the activities of the international financial centre. Specifically the legal analysis focused on how the following issues have been articulated in the Bill.

(a) Tax provisions and benefits under the Bill
(b) Secrecy provisions
(c) Regulator's independence;
(d) Regulator's accountability
(e) Availability of information;
(f) Money laundering regulations;
(g) Dispute resolution provisions.

Tax Provisions and Benefits

One of the arguments fronted in the establishment of IFCs is that they should be tax neutral jurisdictions (Gray, 2012) as such, a defining characteristic of an IFC is its "tax haven" properties. Although the term "tax haven" has not been accorded a commonly adopted definition, it can be described as a jurisdiction with laws and other measures that can be used to evade or avoid the tax or regulations of other jurisdictions. This often arises as a result of the tax compromises that are made with a view of making the centre competitive and appealing for firms to join. Such compromises include extending special tax incentives and exemptions to the firms intending to establish operations in the centre.

Box 1: A definition of tax incentives

A **tax incentive** can be defined as a deduction, exclusion or exemption from a tax liability offered as an enticement to engage in a specified activity such as investment in capital goods for a specified period (Business Dictionary, 2016). For instance, a review of the Qatar International Financial Centre (QFC) (Qatar Financial Centre, n.d.) identifies the following tax incentives granted to firms as:

- Extensive tax exemptions for qualifying activities, dividends and capital gains
- No withholding tax on payments out of Qatar
- Extensive Double Tax Treaty network
- No personal income tax, wealth tax, VAT
- Advance ruling service providing QFC licensed firms with a high degree of certainty

According to Section 36 (2) of the Bill, the Cabinet Secretary may make regulations among others relating to:

(a) Designation of qualified activities to be conducted by NIFC firms
(b) Determination of any benefits, exemptions and incentives available to NIFC firms

As yet, the regulations have not been published. Therefore, the exemptions available and the criteria by which those exemptions are issued cannot be ascertained. The failure to publish the Regulations alongside the Bill raises the questions as to the transparency of the criteria used to determine the granting of tax incentives.

The Bill also gives the Cabinet Secretary the power to grant tax incentives. The reasoning behind such incentives is that they attract foreign direct investment and encourage private sector participation in what would hitherto be high-risk government projects. As currently constituted, the Cabinet Secretary in charge of finance shall be a member of the Nairobi International Financial Centre Authority and therefore will have power to grant tax incentives across all tax classes as he/she may deem fit. The issue of such tax incentives in Kenya, which has a fragile and inadequate financial infrastructure begs the question of the overall benefit. Further public access to information is not guaranteed under the present proposed legislation, preventing the public and other interested parties to undertake a cost benefit analysis of the impact of such incentives.

However, gleaning from the incentives offered by the Qatar Financial Centre[3] on which the NIFC is modelled, it can be expected that aggressive tax incentives - including no withholding taxes, highly slashed/no corporate tax rates and no tax on capital gains among others - will be extended. Equally, according to the Cabinet Secretary's speech, a number of African countries including Ethiopia, Botswana and Rwanda have strategies to position themselves as leading international financial centres and as such tax incentives extended will provide a competitive advantage. If the Nairobi International Financial Centre is going to be competitive, benchmarking on other IFCs may give a taste on the nature of the incentives and exemptions that would be proffered to NIFC firms. Indicatively, the NIFC will in many ways operate like a corporate tax haven.

The Constitution of Kenya 2010 gives the power to the national government to impose tax. Article 210 provides that no tax or licensing fee may be imposed, waived or varied except as provided by legislation. Where the legislation permits such waiver a public record of each waiver shall be maintained and the reason for it shall be reported to the Auditor General. The vagueness in the bill on what incentives are enlisted and how they will be administered raises question on if the process will be done in line with the constitution.

[2]http://www.qfc.qa/en/Setup/Pages/default.aspx

Arbitrary application process to access NIFC privileges

The procedure to be certified as a firm eligible to operate within the NIFC is provided for in the Bill. The application shall be to the Authority in the prescribed manner and at the Authority's discretion, it will either grant or decline the issue of an NIFC firm certificate. The constitution of the Authority (discussed below) together with the criteria for assessment and the lack of public participation in the granting of certification is indicative that the licensing of NIFC firms is open to abuse. Rent seeking by the gatekeepers of the certification opens the process to massive corruption, nepotism and cronyism. Additionally, certified entities are required to pay an annual license fee to the authority to maintain their certification. To the extent that the authority is dependent on fees paid by these firms, it is subject to regulatory arbitrage through lenience or turning a blind eye to corporate indiscretions.

Loophole for secrecy of NIFC Firms and Publication of Register of Firms

Section 36 of the Bill provides that the Minister may prescribe information required of NIFC firms. This blanket provision allows for secrecy of the legal entities operating within the NIFC. There is no requirement under the proposed Bill that the legal and beneficial ownership of the NIFC firms be identifiable prior to certification. Indeed it would be expected that for the NIFC to be competitive to other well-established jurisdictions, secrecy would be of strategic importance.

The Bill provides that the Authority shall keep a public register of NIFC firms together with any other information related to the firm, which the Authority considers appropriate. The wording of the clause is ambiguous as it does not clearly provide what kind of information will be contained in the public register considering the growing debate for the need of beneficial ownership.

The Bill provides that a person shall make an application to be an NIFC firm. The definition of a person provided under the Bill includes company, association or other body of persons whether incorporated or unincorporated. The scope of the definition is wide enough to include companies, trusts, partnerships and individuals. There is no residency requirement under the Bill and therefore firms can take advantage of multiple jurisdictional organisation to exploit secrecy provisions in the formation of their entities.

Qualified Activities under the NIFC and Unfair Competition

Upon a detailed review of the Bill, it was found that no section provides a list of qualified activities that firms in NIFC will be allowed to operate in. However, the Bill provides that NIFC firms may carry out any business activity, which the Cabinet Secretary designates by publishing in the Kenya Gazette as a qualified activity. Failure to include a list of the approved activities in the Bill can be construed as an attempt to bypass Parliamentary interrogation into the nature of activities that will be authorized by NIFC firms at the legislation stage.

By their nature some of the activities may be predatory to local industry and expose local firms to unfair competition in respect to the incentives and benefits that are offered to NIFC firms. A proper wording of the Bill would have set out the qualified activities that are open to NIFC firms so that they are debated and ratified prior to the law coming into force. It is no doubt that many of the firms who would seek to utilise the NIFC will be multinationals, which are well positioned to take advantage of the "favourable" business environment that will be advanced by setting up the NIFC while the domestic firms will be subject to the normal business environment.

Independence of the Proposed Regulator

Section 5 of the Bill provides for the establishment of an authority known as the Nairobi IFC Authority (the "Authority"). The objectives of the authority are to:

a) establish and maintain an efficient operating framework in order to attract and retain NIFC firms;
b) develop and recommend strategies and incentive structures in collaboration with relevant agencies in order to attract firms to be NIFC firms; and
c) review and recommend, in collaboration with the relevant regulatory authorities developments to the legal and regulatory framework in order to develop Kenya as an internationally competitive financial centre.

The regulator under the proposed NIFC legislation shall operate in a complex environment considering that there already exists various actors, including public authorities and private sector players. The regulator must balance competing wants and needs from different actors.

The Bill further provides for a board of the authority, which shall comprise of six members including:

(a) a Chairperson appointed by the President;
(b) Cabinet Secretary responsible for finance;
(c) Cabinet Secretary responsible for international trade;
(d) the Attorney General;
(e) Four other persons with relevant experience in international financial services.

A cursory view of the appointees to the Authority reveals shortfalls in the ability of the Authority to be independent. The Chairperson, the Cabinet Secretary, Attorney General and the four other persons are all presidential appointees. This implies a high likelihood of compromise on independence of decisions given the undue influence of the appointing authority.

Another aspect of the regulator's independence is tied to financial autonomy. Financially the Authority has multiple sources of funding for its budget. These are provided for in Section 20 of the Bill and include budgetary allocations from central government as well as fees levied on industry players. To this end the Authority will have some independence in funding itself. Conversely, the regulator also relies on fees from certified firms; the ability of such firm to engage in regulatory arbitrage by threatening to move their activities to other financial centres with better incentives may compromise the impartiality of the regulator to be effective.

Accountability of the Proposed Regulator

The question of accountability relates to whom the regulator is accountable by law, it is complimentary to independence. Independent regulators are reined in through accountability to ensure that some overall control, which in accordance with the constitution of Kenya, is vested in the people. Accountability manifests as the requirement for the agency to publish performance information or engages in public consultations and hearings. The Bill provides for a Steering Council to act as the accountability organ.

The Steering Council consists of:

(a) President as the chairperson;
(b) Deputy President as the deputy chairperson;
(c) Cabinet Secretary responsible for matters relating to finance;
(d) Governor of the Central Bank of Kenya;
(e) Chief Executive Officer of the Capital Markets Authority;
(f) Chief Executive Officer of the Insurance Regulatory Authority;
(g) Chief Executive Officer of the Retirement Benefits Authority; and
(h) Chairperson of the Authority.

The Steering Council is responsible for reviewing the progress of the Centre and giving directions. Once again we see that the Authority is heavily subjected to the Executive. The heavy presence of the Executive as the appointing, constituting and oversight authority means that the NIFC could be subject to the short term whims of the government of the day, which may be at odds with the best interests of the citizenry. A glaring omission from this oversight authority is the Commissioner of the Kenya Revenue Authority (KRA) especially because of the envisioned incentives regime of the NIFC and its potential impact on domestic resource mobilisation.

Tax and Economic Implications

A key consideration for any government when making any economic decision is the ultimate effect of policy action on economic growth for the country and its ability to resource its obligations based on the social contract. One of the reasons given for establishing the NIFC is to promote economic growth of the financial services sector, culminating into an annual GDP growth of 10% necessary for the realisation of Vision 2030 (Republic of Kenya, 2007). In line with Paragraph 22 of the Addis Ababa Action Agenda, tax revenue is considered a key component of domestic revenue mobilisation and crucial towards the attainment of sustainable economic growth. This was part of the resolutions passed at the 3rd Financing for Development Conference out of which the Addis Ababa Action Agenda was developed.

Upon review of a number of existing IFCs one of the key characteristic traits which are geared towards making the centres competitive and attractive is the tax exemption and incentives extended. According to the Global Financial Centres Index (GFCI) Report released in March 2015, taxation is a key area of competitiveness after business environment in determining location of operations/businesses (Mark & Michael, 2015)

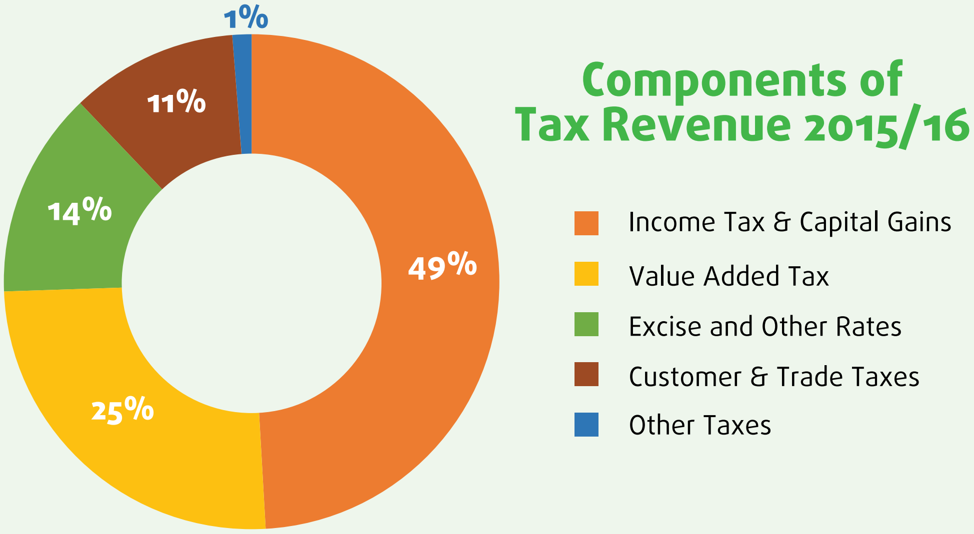
Figure 3: **Areas of Business Competitiveness by Rank**	
Business Environment	201
Taxation	164
Human Capital	146
Reputation	116
Infrastructure	106
Financial Sector Development	100

Source: GFCI 17 Report March 2015 pg. 10

Further, the STEP Report (2009) describes IFCs as countries and territories with low tax rates and other features that make them attractive investment locations. Based on the forgoing observation and findings, it is no doubt that even without the government issuing draft tax regulations, to this extent, for the NIFC to compete with the existing IFCs, it remains eminent that massive and unnecessary tax exemption and tax incentives will be extended. The implication of which is that government will forego huge amounts of tax revenue. This raises a concern for a country like Kenya which relies on corporate tax and personal taxes to finance its budget.

According to Hines and Summers (2009) countries with small populations, and those that are most open to international trade, rely much less on corporate and personal income taxes as compared to larger and more economically closed countries. Small countries often rely on expenditure-type/consumption based taxes to fund their governments. Based on World Bank's classification of small states Kenya is listed among the marked small states which be considered fully open to international trade. This implies that there is a big risk of crowding out domestic investments by establishing the NIFC and an equally big risk of losing huge tax revenues in form of income tax with the anticipated tax exemptions and incentives. The graph below shows the proportion of income tax to the total tax collected in the financial year 2015/16.

Figure 4: **Components of Tax Revenue- proportion of income tax to total tax revenue FY2015/2016**

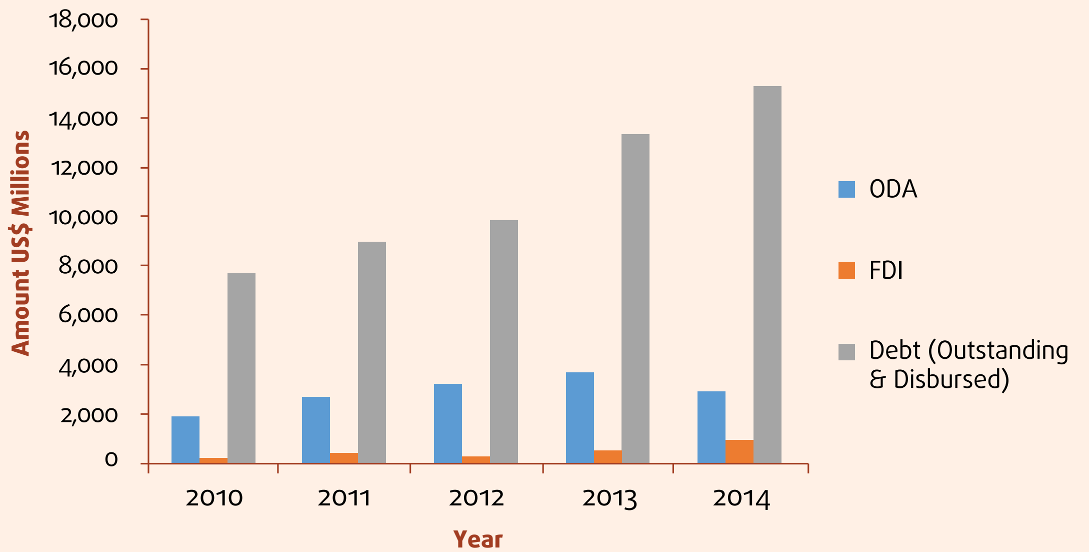


Source: Economic Survey 2016, Pg. 105

From the graph it is evident that Kenya relies on income tax to finance most of its budget i.e. income tax and capital gains tax forms 49% of the tax revenue. Establishment of the NIFC implies a huge compromise of income tax and consequently increased budgetary deficits. Widening tax deficits will force the government to review other taxes including increasing the rate of Value Added Tax (VAT). VAT is a regressive tax which confers a huge tax burden on the majority poor and subsequently increases levels of inequality in a country. This is against the provisions of Paragraph 22 of the Addis Ababa Action Agenda champions for enhancing revenue administration through modernized, progressive tax systems, improved tax policy and more efficient tax collection.

International tax competition is another major setback that is likely to arise following the setup of the NIFC. Admittedly, Kenya is a developing country and like most developing countries it relies on taxes to fund its operations. Positioning Kenya as a gateway to sub-Saharan Africa by offering low tax rates risks negative tax competition among and between other Sub-Saharan countries with a view of retaining their current tax payers who are prone to move to the NIFC. The consequences of tax competition are detrimental to the Addis Ababa Action Agenda and subsequently to the attainment of the Sustainable Development Goals (SDGs), considering the dwindling of Official Development Assistance (ODA), increasing international debts and other foreign assistance. The figure below details the trend of Kenya's ODA, foreign direct investments (FDI) and international debt.

Figure 5: **Trends of Kenya's ODA, FDI and Debt**



Source: World Bank & Development Initiatives,

From the graph above it is evident that the outstanding and disbursed debt has sharply increased over the years, with ODA and FDI showing mixed trends. It is evident that ODA is unreliable and that even with the existing tax incentives and concessions, FDI trends have not been impressive and as such set up of NIFC with tax incentives and concessions that come by it may not make any significant difference.

Financial Secrecy and Transparency

According to Sidsel (2016) offshore financial centres are masters of opacity; thus there are strict laws in place that forbid any form of disclosure or investigation. As highlighted in the legal analysis, the Bill is prone to position Kenya as a secrecy jurisdiction. Not only do International Financial Centres attract their global clientele with low or no tax but also with secrecy, which provides an escape from national laws and regulations (Sidsel, 2016).

Recent international events have seen an increase in data leaks such as the Wikileaks (2010), Lux Leaks (2014), Panama Leaks (2016). The various leaks have exposed tax-avoidance and evasion practices by multinationals, complicity between banks and individuals to maintain undeclared accounts, money laundering from proceeds of criminal and corrupt activities. One of the common and key features of the leaks was that most of the data was held in secret over a period of time. Secondly, it is no coincidence that the data relates to transactions carried out/associated to offshore financial centres. Offshore finance centres are shrouded in layers of secrecy evident by the nature of how the data came to the public domain; through leaks described as theft and violation of confidentiality in tax havens (Sidsel, 2016). The NIFC may not be different from the already existing IFCs as regards the level of secrecy, as highlighted in Section 36 of the Bill, and as such it raises worries on what is being propagated.

Based on the forgoing, it is a concern that the NIFC may not be far from being one of the platforms that may be used by the likes of Mossack Fonseca to perpetrate illicit transactions. Furthermore, the NIFC potentially forestalls the increasingly welcomed debate on disclosure of beneficial ownership and exchange of information.

Box 2: **A Case Study of Ghana**

In October 2008, the Bank of Ghana published an article **"Offshore Banking and the Prospects for the Ghanaian Economy"** (Bank of Ghana, 2008). In the paper the Bank outlined the reasons for the establishment of an Offshore Financial Centre (OFC). Many of the reasons put forth are similar to the ones cited by the Cabinet Secretary to the National Treasury in Kenya. The OFC at the time was viewed as a key aspect for the development of the Ghanaian financial sector which would lead to growth in jobs, knowledge transfer and lower the cost of credit. This was heralded as a frontier for economic growth and a key attraction for foreign direct investment, positioning Ghana as a gateway between the larger West Africa and the global economy.

The structure adopted by Ghana was such that both domestic and international entities will qualify to operate in the International Financial Centre, i.e. a hybrid model. To operationalize the IFC, amendments to the Banking Act were done to allow for offshore banks, ergo the opening of offshore bank accounts in Ghana. Barclays Bank of Ghana was granted the first and only license for offshore banking in September 2007.

Soon after operationalization of the OFC, Ghana was plunged into the fore as a possible tax haven and a conduit for illicit financial flows. In 2010, an investigation found that proceeds of corruption had been traced to accounts in Ghana (Emmanuel, 2016). With this development it was no doubt that the IFC had been used as a platform to facilitate and lodge proceeds of crime and corruption. Increasingly Ghana came into the spotlight on its role as a tax haven with international organizations like the OECD strongly condemning the move and warning Ghana to be aware of the risks of becoming a tax haven (Emmanuel, 2016). According to its February 2012 public statement, the Financial Action Task Force (FATF) blacklisted Ghana by classifying it as a jurisdiction at high risk of money laundering and financing of terrorism (FATF, 2012).

In 2011, the Bank of Ghana under the yoke of international pressure, revoked the offshore license for Ghana citing reputational risk of being labelled a money laundering jurisdiction. Ghana is currently ranked 48 out of 92 by the Tax Justice Network, with a secrecy score of 67% (Tax Justice Network, 2015), indicating a high propensity for illicit financial flows.

It is noteworthy that the proposed NIFC is no different from what was set up in Ghana a decade ago. The implication for Kenya in establishing a perceived avenue/platform for financial crimes is risking reputational damage. On the other hand, according to the FATF periodical updates Kenya has failed to put in place measures which are key as regards financial transparency. This incompliance with international best practice on financial transparency requirements will send warning signals to other countries when it comes to the implementation of the NIFC, since it gives way for money laundering and financing for terrorism.

The unfolding events in Ghana (see box) provide a predictive model for the outcomes of the establishment of an IFC in Kenya. The motivations for establishment are similar: to attract FDI and spur economic development through a robust financial services sector. Geopolitical factors are mirrored in Kenya, as Ghana was also considered a hub and gateway into West Africa with a sound economy and fairly predictable economic climate. From a regulatory perspective, Ghana commenced with the enactment of the substantive legislation but never proceeded to provide for the regulations. The NIFC Bill seems to be taking shape along the same lines with vague provisions in the Bill coupled with no indication on the nature of regulations, which is fertile ground for abuse.

Similarly Kenya like Ghana is struggling with compliance of Anti-Money Laundering and Counter Terrorism Financing provisions (Irungu, 2012). The NIFC operations will be of an international nature, as such Kenya will be subject to scrutiny in regard to international best practice. Further, despite having been in place for just about four years, the Ghanaian IFC was shelved with little evidence that the objectives of spurring economic growth were palpable or that there were major indicators of positive growth in FDI. The uprising and failure of Ghana's IFC is a clear demonstration and a strong warning that Kenya should stand well informed to review the challenges both ethical and practical awaiting them with the set-up of the NIFC. This can be summed up that Kenya is not ready in setting up and operating an IFC.

Conclusion

In line with the above analytical findings the following conclusions were made:

1. From the legal analysis it is evident that the Bill presents pressing concerns. The nature of its ambiguous drafting, with key substantive provisions left out, and to be subsequently captured in regulations prescribed by the Cabinet Secretary begs several questions.

    - In the first instance, the real structure of the NIFC cannot be ascertained from the current draft. Whether or not this was by design it is clear that it provides no basis for an informed debate neither at the parliamentary nor stakeholder level.

    - Secondly, the undue influence of the executive in setting the agenda for the NIFC and instituting itself as a regulator has left little room for public participation and independent oversight. Civic education around the impact of an IFC in Kenya has not been undertaken and even for informed stakeholders, the availability of information around the thinking and progress has been limited.

    - Thirdly, the complexity of the provisions of this legislation may be a hindrance to an informed parliamentary debate, which could see the Bill pass without articulating the pertinent issues through the reading stages and eventual enactment of the law.

2. The establishment of the NIFC may undermine the achievement of other crucial goals, particularly tax collection and domestic revenue generation (Waris, 2014) which are key to economic growth. This presents obvious concerns as regards the commitment to the Addis Ababa Action Agenda which champions the use of domestic resources in attaining sustainable development. The tax incentives that ought to be extended in order to make the NIFC competitive, coupled with the secrecy provisions, are subject to cultivating a window for insurmountable negative externalities, including the attraction of illicit capital and increased instances of tax evasion. These undermine the tax collection agenda with direct implications on the government's ability to provide essential services to its citizens as prescribed in both national and international instruments.

3. Setting up the NIFC will be a propagation of commercial related forms of Illicit Financial Flows (IFFs). From the above it is eminent that Kenya's institutions have not displayed the rigour to withstand abuse and manipulation that will arise as a result of setting up the NIFC. In fact, Kenya has been on the FATF watch list for terrorism financing (Irungu, 2012) and "grand" corruption scandals implicating the highest echelons of power (Ongiri, 2016). The likelihood of the NIFC serving as a haven for illicit funds and a source for terrorism financing cannot be overlooked. This also bears reputational risk for Kenya both regionally and globally and could have far reaching implications for Kenya, including on its credit ratings. This was evident in the case of Ghana, upon positioning itself as a West African financial hub, taking advantage of its emergence as an oil producer which became a key point of international ridicule. The OECD was quick to warn that Ghana should be aware of the risks of becoming a tax haven with the establishment of offshore banking within its jurisdiction especially with regard to fuelling corruption and crime in West Africa (Emmanuel, 2016).

Recommendations

1. It is of considered view that the intention of establishing the NIFC in its present form should be abandoned completely. This is based on the challenges in its planned constitution, proposed operational framework and potential effect to undermine tax revenue. The former President of the OECD, Jeffery Owens, puts it best by assessing that "the last thing Africa needs is a tax haven in the centre of the African continent." (Emmanuel, 2016)

2. Kenya needs to take the lesson from Ghana. Ghana's IFC did not last 5 years before it was shelved. The justifications fronted for the establishment of an IFC in Ghana - mainly to act as a catalyst for FDI and overall economic growth - did not materialize. Instead weak internal regulation in the face of shrewd global players had Ghana blacklisted and ridiculed internationally. Even after shelving the IFC, Ghana is still suffering the aftershocks of its catastrophic venture. Kenya is no different in its thinking and approach to establishing an IFC, in fact many of the conditions prevalent in Ghana are well and alive in Kenya.

3. Kenya should review the challenges that come with compromised financial integrity and a lax regulatory environment. Reforms within the financial sector are crucial should Kenya pursue its ambition to establish an International Financial Centre. Reforms should include increased transparency of the operations of firms, a public registry of listed firms, disclosure of beneficial ownership information and enforcement of the law in the event of violation.

4. The heavy hand of the Executive in the operations of the NIFC need to be checked. The Executive cannot be the appointing, constituting and oversight authority for the NIFC because this would lead to an undue influence over its operations. Presently, the NIFC is subject to the short term whims of the government of the day. Public participation and oversight is therefore crucial.

5. There are other interventions that the country may undertake to spur economic growth and attract foreign direct investments besides establishing the NIFC. Investments in improving the ease of doing business, e.g. licensing procedures, infrastructure and human capital are just as crucial as investments in the financial services sector. Huge incentives and concessions have in the past only led countries to lose huge amounts of revenues (ActionAid International and Tax Justice Network-Africa, 2016).

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