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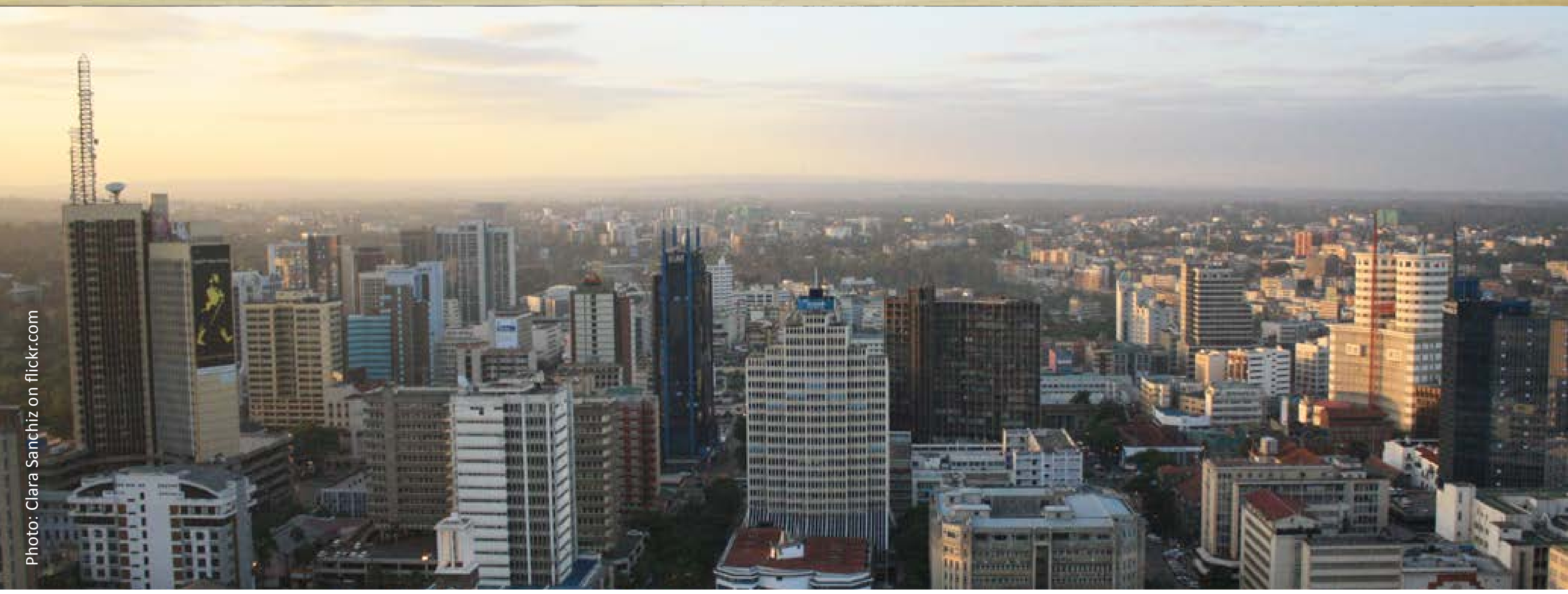
The Creation of International Financial Centres in Africa: The Case of Kenya



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International financial centres (IFCs) are jurisdictions whose laws and institutions provide optimal conditions for the financial services industry. While some of the activities they encourage may have positive effects on a country's economy, IFCs also facilitate money laundering, tax evasion, tax avoidance, and other practices generally considered harmful. These effects have been recognised at least since 1998, when the Organisation for Economic Co-operation and Development (OECD) established an international framework to counter harmful tax competition.

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In 2000 the OECD released a list of uncooperative tax havens, with updates in subsequent years. This led, in 2009, to the release of another OECD "watch list" of jurisdictions based on their level of financial transparency. The Financial Action Task Force also began releasing an annual list of countries at high risk for money laundering and tax evasion. Recently, the global push against tax havens has gained momentum. In recent years the G20 has put increasing pressure on traditional tax havens, and G20 countries such as the United States and the United Kingdom, which are also major destinations for illicit financial flows (IFFs), have pledged to increase financial transparency and oversight of corporations.

Despite this international push for financial transparency, over the past 15 years some African countries have taken steps to establish IFCs. They have established corporate structures that allow the real owners of companies to hide their identities and have granted tax exemptions, either broadly or through agreements with individual companies. By 2000, there were IFCs in South Africa, Mauritius, Seychelles, Djibouti, and Algeria. Botswana set up an IFC in 2003; Ghana tried in 2010 but failed due to opposition from civil society and the public. Kenya started considering this option in 2009 and is currently in the process of creating an IFC in Nairobi.

For an aid-recipient country like Kenya, the establishment of an IFC is problematic. Some features of IFCs can undermine the achievement of crucial goals – particularly tax collection, domestic revenue generation, and financial integrity and transparency – that donors pursue when they assist developing countries. This raises the question of how donors should respond to plans for the creation of an IFC in an aid-recipient country.

IFCs and tax havens

The term "international financial centre" is often used interchangeably with "tax haven" or "secrecy jurisdiction," although the latter terms have more negative connotations. Scholars generally label as "tax havens" those territories that offer favourable tax regimes and bank secrecy laws designed to attract foreign investors (Hines 2004). The OECD (1998) states that a tax haven has no or nominal tax rates, along with other features such as lack of effective exchange of tax information with other countries and/or lack of transparency in the tax system.

An IFC is usually found within a tax haven, usually in a city. The Tax Justice Network defines IFCs as the commercial communities hosted by tax havens, which exploit the legislation and corporate secrecy offered by the tax haven to the benefit of foreign residents (TJN UK 2008, 3–4). In an IFC, the clustering of financial intermediaries and service providers – bankers, lawyers, accountants – in one location allows for easier coordination of financial transactions and settlement of payments. This reduces transactional costs and creates economies of scale, benefitting investors and other financial sector stakeholders (Kaminsky 2009).

IFCs typically share several characteristics: the presence of foreign investment opportunities, low or no foreign corporate taxes, connection with other financial centres, and a sophisticated regulatory and legislative framework. They usually also offer a high concentration and diversification of banking activities such as credit for import, currency and foreign exchange trading, cross-border funds transfer, foreign borrowing and lending, and foreign investment and wealth management. Different types of IFCs provide different sets of services.

Examples of IFCs in Europe include London, Luxembourg, and Zurich; in North America, New York and Toronto; in Asia, Tokyo, Singapore, and Hong Kong; in the Middle East, Dubai; in South America, São Paulo; and in Africa, Johannesburg. In 2014 the top four global financial centres were New York, London, Hong Kong, and Singapore (Z/Yen Group 2014).

There can be legitimate and illegitimate reasons for using IFCs. Foreign investors may deposit or invest their savings in an IFC to escape economic and fiscal instability in their home countries, and to take advantage of the financial and wealth management services offered by IFCs. On the other hand, IFCs also attract individuals seeking to launder illicit funds, such as those generated by tax evasion, drug trafficking, or corruption; these individuals are usually attracted by the possibility of hiding their identity. Still other corporations and individuals use the tax incentives and exemptions granted by the governments that host IFCs as a way to avoid taxes.

A key question is whether a country can set up an IFC that attracts foreign investment without engaging in harmful tax practices or providing secrecy. A review of existing cases suggests that this is difficult to accomplish.

Types of IFCs

IFCs can be categorised in at least three ways. The first typology divides them into offshore, hybrid, and integrated. Offshore centres do not allow for interaction between foreign and domestic investment and savings markets (e.g., Dubai). Hybrid centres allow for specific and conditional access of domestic investors to the international market (e.g., Qatar). Integrated centres allow for full access of international investors to domestic markets, with preferential treatment (e.g., London).

The second typology divides IFCs into global centres that serve clients from all over the world (e.g., London); regional centres that serve regional markets (e.g., Dubai, Hong Kong); and ordinary IFCs that cater mainly to the needs of their national economies (e.g., Paris, Frankfurt, Tokyo, Sydney).

The third typology is based on the services and conditions the IFC provides. In general, IFCs offering lower taxes and higher levels of secrecy are more likely to be used for illicit or illegal purposes, such as tax evasion or money laundering. The Financial Secrecy Index, compiled by the Tax Justice Network, offers a snapshot of how different IFCs perform in this respect. From this perspective, IFCs can be divided into transaction-oriented and deposit-oriented categories. Transaction-oriented IFCs usually attract legitimate businesses that are looking for high-quality financial services. Deposit-oriented IFCs seek to increase domestic resources for national or regional development, and it is these centres that tend to attract the largest share of illicit flows.

Advantages and disadvantages of IFCs

Traditionally, countries that set up IFCs are driven by a desire to attract capital. A country's ability to borrow is usually limited by its domestic economic activity and the size of its financial market, which can be a severe constraint for developing countries. Because IFCs attract foreign investment and host large international lenders, they raise a country's natural borrowing limit, allowing financing for larger projects.[1] IFCs that are set up with this objective in mind usually aim to attract savings rather than trading capital.

Countries also offer low tax rates as well as tax incentives and exemptions in the belief that this attracts investment and generates more economic activity and higher growth rates. This premise is, however, debatable. Especially in developing countries, companies are attracted by stable governments more than by low taxes; low taxes tend to generate short-term investment that evaporates when tax rates increase. Low tax rates also mean low domestic revenue generation, and therefore more dependency on indirect taxes (which place a disproportionate burden on the poor) and on foreign aid. IFCs can "ring-fence" tax exemptions and incentives by limiting them to businesses with no substantial presence inside the country, thus eliminating the tax loss to the country. Even in these cases, though, the harmful effects for the tax systems of other countries remain.

Another common argument in favour of IFCs is that they offer a cushion against economic downturns by providing a reserve of liquidity and investment. In essence, this mechanism relies on IFCs using financial resources from surrounding countries to fuel domestic investment. This approach can have the perverse effect of deepening the crisis in neighbouring countries whose resources are invested in an IFC.

Recent research suggests that IFCs also have the potential to undermine democracy and institutions. Within IFC countries, corporations and other financial actors may gain excessive influence, enabling them to manipulate regulation and policy-making in their favour. Over time, the country's policies may come to disproportionately benefit powerful economic interests, both legitimate and illegitimate, eroding people's trust in democratic institutions (Shaxson and Christensen 2013).

Finally, IFCs increase the risk of capital outflows and tax evasion in other countries. It is widely known that IFCs are magnets for companies and individuals from around the world seeking to avoid taxes. This has resulted in a global push to include IFCs in tax information exchange agreements.[2] Secrecy can reduce the ability of governments to hold their domestic companies to account when these companies exploit corporate structures offered by IFCs to hide corporate ownership and control. This problem is particularly acute for developing countries, which are already struggling to develop their tax bases.

The Nairobi International Financial Centre

Kenya's Vision 2030 is a national development blueprint launched in 2008. It identifies financial services as one of the sectors to be developed in order to achieve the target 10 percent annual growth rate. The objective is to create a competitive financial sector that can attract foreign investment, provide large-scale financing for Kenya's investment needs, and contribute to making Kenya into a regional financial services centre. The Ministry of Finance sees the Nairobi International Financial Centre (NIFC) as the flagship project in the financial sector, one that will also help finance all other components of the Vision 2030 development plan.[3]

In June 2013, the Kenyan Cabinet approved the establishment of the NIFC in order to "connect Kenya to international financial markets by providing for international banks to operate in Kenya."[4] The Cabinet directed that the centre be set up by December 2013. Banking, insurance and reinsurance, capital insurance, and the stock market were identified as priority areas to be developed.[5]

In terms of other incentives for setting up the NIFC, questions have been raised regarding possible lobbying by specific domestic or foreign investors. The media have reported on the role of the City of London Corporation in supporting the NIFC, but the extent and effectiveness of this and other lobbying efforts are unclear (Oyuke 2013).

While Vision 2030 pointed to Mauritius and the Seychelles as potential models for the Kenyan IFC, the technical committee of the Kenyan Treasury in charge of drafting the plan also visited Dubai, Qatar, South Africa, Malaysia, and the UK. In the end, a decision was made to follow the hybrid model, the same used in Qatar, which allows selected local investors to access the IFC on a par with foreign investors.

As of August 2014, Kenya is more than eight months behind schedule in creating the NIFC. No legal or regulatory framework has been designed, and no government agency has been assigned the task of overseeing the IFC. No specialised courts, dispute resolution system, or corporate and securities registry have been established.

One of the main obstacles is that Kenyan law does not allow for a separate authority to be set up with broad powers and independence. Another challenge is related to the establishment of an ad hoc dispute resolution system for IFC-based companies. Kenya's chief justice announced the creation of the Nairobi Centre for International Arbitration, possibly to pre-empt creation of a separate authority under the IFC. This suggests that the Kenyan judiciary recognises the need to maintain oversight over the IFC and set limits on its independence.

Other aspects of regulation also remain to be defined. Kenya is a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes, and thus its tax regime is subject to peer review; this may constrain its ability to offer tax secrecy arrangements, although its impact on Kenya has so far been limited. A more effective mechanism to prevent the misuse of IFCs is the one contemplated under Financial Action Task Force (FATF) rules, which requires governments establishing an IFC to sign a memorandum of understanding (MOU) that commits them to counter money laundering and financing of terrorism. This MOU must be signed by the Central Bank of Kenya, Kenya Revenue Authority, Capital Markets Authority, National Intelligence Service, Retirement Benefits Authority, and Office of the Attorney General.[6] The NIFC will have to comply with the MOU and with FATF regulations, and as a result it will be monitored by the Financial Reporting Centre, Kenya's financial intelligence unit. As of mid-2014, there is no indication that this MOU is in place, which leaves a potentially large gap in oversight.

Under the new Kenyan constitution, involvement of civil society is required in the process of establishing an IFC. So far, however, local civil society organisations, including those working on tax issues, have been involved only marginally. The East Africa Tax and Governance Network has raised some concerns with the government and is advocating against the NIFC.[7]

While tax benefits and secrecy allow IFCs to attract foreign investors, they also attract illicit capital and can produce numerous negative externalities, as noted above. It is envisioned that the NIFC may grant tax incentives, including a maximum 10-year tax holiday, along with VAT and customs exemptions.[8] These provisions are not as generous as those of Qatar and some other IFCs; this raises questions regarding the NIFC's ability to attract investors, but also mitigates concerns that the NIFC may attract those seeking tax evasion and avoidance. It is still unclear what level of secrecy the NIFC will afford to foreign and domestic investors. This is a crucial aspect that remains to be defined and that could determine what types of capital the NIFC will attract.

Three main scenarios can be outlined. If Nairobi merely replicates conditions that are already available in other IFCs (e.g., Mauritius), this will likely not affect the volume of IFFs flowing into and out of the region and country. If Kenya undercuts these other jurisdictions by offering more advantageous conditions, this may result in increased tax competition between IFCs in the region. Finally, if Kenya manages to create an IFC that provides a gateway for investment into African countries, but without the harmful tax aspects and with no secrecy provisions, this has the potential to benefit other African countries, provided that businesses can be persuaded to channel their investments through it. In this last case, Kenya could become a forerunner of a new model of IFCs that could survive the current efforts to do away with secrecy jurisdictions.

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Conclusions and considerations for donors

For developing countries like Kenya, an IFC can be a tool to spur economic growth and strengthen the financial sector, which is a precondition for developing other areas. On the other hand, some features of IFCs can undermine the achievement of crucial goals, particularly tax collection, domestic revenue generation, and financial integrity and transparency. This presents obvious concerns to donors interested in reducing aid dependency, strengthening institutions, and reducing corruption in partner countries.

How should donors relate to countries like Kenya that are in the process of establishing an IFC? Donor countries are in a delicate position: most of them host financial centres, and some are major destinations for IFFs. But they can still play a positive role in helping countries realise the positive effects of IFCs while reducing the risks and negative externalities.

The crucial area where donors can make a contribution is in shaping the overall framework for taxation, regulation, and oversight, which in Kenya's case remains largely to be determined. Donors should continue supporting and strengthening tax authorities so that these agencies can be more assertive and competent in their interaction with other government agencies regarding taxation in the framework of IFCs (Hearson 2014).

Regarding regulation of financial transparency and integrity, the question of donors' involvement is even more delicate, as this area falls within the sphere of state sovereignty. While there may be little that donor countries can do directly in developing countries, they can positively influence the global debate by implementing measures in their own countries that reduce secrecy. For instance, if more donor countries were to start collecting and publishing information on beneficial ownership, it could become politically difficult for developing countries to justify steps in the opposite direction. The current trend towards more corporate transparency, for instance in the United States and United Kingdom, where beneficial ownership transparency is high on the policy agenda, is encouraging.

Finally, civil society participation in debates surrounding the establishment of IFCs is crucial to ensure that these centres benefit the entire population, not just powerful interests and lobbies. In Kenya the participation of civil society has been limited, and this has resulted in a weak public debate around the NIFC. Here too, donors have a role to play, for instance by directly funding or supporting civil society organisations, particularly local ones, and journalists that focus on issues of financial transparency and taxation.

Notes

[1] In interviews with the author, Nigerian and Kenyan central bank officials indicated that this was a main motivating factor with respect to setting up IFCs in their countries.

[2] Johannesen and Zucman (2014, 2). At the summit held in April 2009, G20 countries urged tax havens to sign at least 12 treaties under the threat of economic sanctions. By the end of that year, tax havens had signed more than 300 treaties.

[3] For more information on the Nairobi IFC, see the project's page on the Vision 2030 website, www.vision2030.go.ke/index.php/pillars/project/Economic/104. Also see Kenya Vision 2030 (Office of the Prime Minister 2012).

[4] Cabinet Brief, 27 June 2013, State House, Nairobi, http://www.statehousekenya.go.ke/cabinet_briefs/june2013/2013270602.htm.

[5] Author's interview with Kenyan National Treasury official.

[6] Author's interview with a Kenyan National Treasury Official.

[7] Author's interview with a member of civil society working on issues of economic justice in Kenya.

[8] Author's interview with a Kenyan National Treasury Official.

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