The International European Model United Nations 2018

United Nations General Assembly

Topic A: Illicit Financial Flows

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Welcome Letter

Dear Delegates, you are tasked with a challenging dilemma that has the capability to affect people worldwide and yet is rarely discussed. Man-made famine is a grave situation that is currently affecting millions of people. It is currently one of the largest humanitarian crisis the world is facing.

With that being said, there is no need to worry. Whether you are a first timer in MUN or a veteran looking for more challenge, this topic is suited for you. The topic involves political, environmental and developmental issues. It is a broad and engaging spectrum that we hope you will have a fun time with. Man-made famine is the result of various circumstances and yet it is rarely talked about. Therefore, we are expecting you talk about the things the world does not want to talk about. Hopefully, it is not all talk and there are actions involved.

We are looking forward to having you in the council. We as chairs only wants what is best for you. We want you to have a fun and engaging debate where you will get something out of it that you can take home with you.

If you have any question regarding the topic, please don’t hesitate to ask us.

Yours Truly,

Chairs

Rizqi Imaduddin Joviana Henza

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Introduction

> *"My viewpoint is entirely my own, as was my decision to share the documents with Süddeutsche Zeitung and the International Consortium of Investigative Journalists (ICIJ), not for any specific political purpose, but simply because I understood enough about their contents to realize the scale of the injustices they described."*

- John Doe's Manifesto about the Panama Papers[1]

The World Bank defines illicit financial flows (IFFs) as "money that is illegally earned, transferred or used, that crosses borders." Through this broad definition, it includes a variety of illicit money transfers. Money that is *illegally earned* corresponds to funds acquired through criminal activity, and relates to the policy field of organized crime. Money that is *illegally used* is money smuggled for criminal or terrorist purposes, and relates to security policy. Money which is *illegally transferred* primarily identifies transfers related to corruption and tax evasion.[2] This latter aspect shall be the focus of this meeting of the General Assembly, in particular the tax evasion behavior of large corporations.

In recent years, multiple leaks have brought illicit financial flows to public attention – the LuxLeaks, the Offshore Papers, Panama Papers, and in 2017 the Paradise Papers, to name an illustrious few. They have implicated various global leaders, including the serving Icelandic Prime Minister and the King of Saudi-Arabia.[3]A general account of the scale of illicit transfers is nonetheless difficult. A 2011 report estimated that tax evasion in all its forms cost governments 3.1 trillion US$ every year – which corresponds to more than 5% of global GDP.[4] A large amount of this money is outflowing from developing countries – the Global Financial Integrity Initiative estimated this to be 1.1 trillion US$ in 2013.[5]

As such, illicit financial flows present a central challenge to the development of the Global South. Past actions have not been sufficient in facing the continuing investigative revelations

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[1] John Doe, "John Doe's Manifesto," *Süddeutsche Zeitung* (website), http://panamapapers.sueddeutsche.de/articles/572c897a5632a39742ed34ef/.
[2] World Bank, "Illicit Financial Flows (IFFs)," *World Bank* (website), July 7, 2017, http://www.worldbank.org/en/topic/financialsector/brief/illicit-financial-flows-iffs.
[3] Adam Lusher, "Panama Papers: 12 world leaders linked to offshore dealings - and the full allegations against them," *The Independent* (website), April 5, 2016, http://www.independent.co.uk/news/world/politics/panama-papers-assad-putin-poroshenko-mubarak-al-saud-pm-iceland-sigmundur-davio-gunnlaugsson-a6967411.html.
[4] Julia Werdinger, "Tax Evasion Costs Governments $3.1 Trillion Annually, Report Says," *The New York Times* (website), November 28, 2011, http://www.nytimes.com/2011/11/26/business/global/26iht-tax26.html.
[5] Global Financial Integrity, "Illicit Financial Flows," *Global Financial Integrity* (website), http://www.gfintegrity.org/issue/illicit-financial-flows/.

and . The United Nations General Assembly should therefore take a stance on past programs, and develop inroads for further cooperation in tackling the problem.

History

Historically, the imposition of national capital controls has held illicit financial flows limited. Capital controls, which mean that countries regulate the monetary flows in and out of their countries prior to War II.[6] With capital controls, international illicit flows are potentially limited to the physical transfer of cash over national borders. Naturally, there was tax avoidance in this period, but it took rather a domestic form and remained smaller in scope.

Three developments have intensified the role of international tax avoidance and illicit flows since the times of capital control. Firstly, the waves of independencies from the 1960s onwards established newly sovereign countries. These countries' economies, however, were often still dependent on capital from their former metropoles. To track the profits from these investments, however, many of these countries lacked the administrative and legislative structure.

Secondly, capital controls were continuously weakened from the 1960s onwards. The Washington Consensus emerged in the late 1970s, and neoliberal policies were introduced widely around the globe.[7] The Washington Consensus is a policy agreement that focuses on trade and investment liberalization, privatization, and deregulation; and has been applied multiple times both in the Global North and the Global South. This weakened domestic tax authorities, as capital control was increasingly revoked in favor of free-market policies.[8] It is important here to clarify that freedom of capital movement does not equal tax avoidance, but that it facilitates the masking and distorting of international financial flows.

Lastly, and partly resulting from these liberal policies, international financial flows have accelerated. Particularly Transnational Corporations (TNCs) have been able to use this to their advantage, switching profits quickly between tax jurisdictions. The influence and capacity to do so has expanded over the years. TNCs now account for roughly 80% of international trade.[9] These trades often occur between two sister companies under the same umbrella company,

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[6] Dani Rodrik, "Greek Lessons for the World Economy," *Project Syndicate* (website), May 11, 2010, https://www.project-syndicate.org/commentary/greek-lessons-for-the-world-economy?barrier=accessreg.

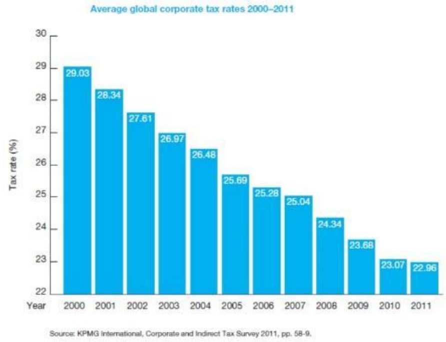
[7] Atish R.Ghosh and Mahvash S. Qureshi, "What's in a Name? That Which We Call Capital Controls," IMF Working Paper 16/25, *International Monetary Fund* (website), February 2016, https://www.imf.org/external/pubs/ft/wp/2016/wp1625.pdf, 1, 22.

[8] Thomas Pugel, *International Economics*, 16th ed.,(New York: McGraw Hill Education (2016), 421ff.

[9] United Nations Conference on Trade and Development Press Corps, "80% of trade takes place in 'value chains' linked to transnational corporations, UNCTAD report says," UNCTAD/PRESS/PR/2013/001, February 27, 2013, *UNCTAD* (website), http://unctad.org/en/pages/PressRelease.aspx?OriginalVersionID=113.

which alone accounts for more than half of global trade.[10] This has resulted in countries competing over tax revenues by offering lower tax rates, as Figure 1 shows. This race to the bottom only exacerbate the difficulty for developing countries to finance their development.

All three of these developments together – the difficult infancy conditions for newly independent countries, the weakening of capital controls, and the rise of Transnational Corporations, have contributed to higher levels of tax evasion. Countries in the global South, which are those with most need for tax revenues, are particularly harsh hit by this spike in tax evasion.



Discussion of the Problem

The relationship between international tax evasion and Less Developed Countries

Tax evasion is undoubtedly an issue both for the global North and the global South. In absolute terms, for instance, the United States are the largest loser of governmental income due to tax evasion, losing over 300 billion US$ every year, accompanied by Brazil, European States, Russia and China in the group of the biggest losers.[11] The relationship to development becomes clearer, however, if one looks at the losses countries have to incur relative to their GDP. For the U.S., for instance, this number drops to below 1.2% of GDP.[12]

Developing countries, who are the hungriest for tax revenue, lose higher amounts of their legitimate taxes. This is due in part to the large informal economy in many developing nations, and the continuing difficulties in collecting taxes in rural and less developed areas.[13] Developing countries thus seek to attract Foreign Direct Investment (FDI), which ideally offers tax revenues that are collectable. What journalism and research have shown over the last years, however, is that much of this FDI is operated through offshore firms, which are letter-box companies that reside in jurisdictions with particularly lax tax legislation.[14] Since 2011, this

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[10] Share the World's Resources, "Financing the global sharing economy, part three (4): stop tax avoidance," *Share The World's Resources* (website), October 1, 2012, http://www.sharing.org/information-centre/reports/financing-global-sharing-economy-part-three-4-stop-tax-avoidance.

[11] The Tax Justice Network "The Cost of Tax Abuse – A briefing paper on the cost of tax evasion worldwide," November 2011, *The Tax Justice Network* (website), https://www.taxjustice.net/wp-content/uploads/2014/04/Cost-of-Tax-Abuse-TJN-2011.pdf, 4.

[12] Joe Myers, "Which countries are worst affected by tax avoidance?," *World Economic Forum* (website), April 12, 2018, https://www.weforum.org/agenda/2017/04/which-countries-are-worst-affected-by-tax-avoidance/.

[13] The Tax Justice Network, "The Cost of Tax Abuse," *op. cit.*

[14] Max Bearak, "How global tax evasion keeps poor countries poor," *The Washington Post* (website), April 8, 2016, https://www.washingtonpost.com/news/worldviews/wp/2016/04/08/how-global-tax-evasion-keeps-poor-countries-poor/?utm_term=.148c48f426ba.

number has exceeded 1.1 trillion US$ per annum.[15] This number has risen dramatically, as numbers of the Global Financial Integrity project show (Figure 2, 3,).

Illicit Financial Flows to GDP[18]
(in percent of GDP)

Region	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Average
Sub-Saharan Africa	5.4	7.3	6.9	8.0	7.1	8.1	6.1	5.2	4.4	4.7	6.1
Asia	5.0	4.7	4.3	3.9	3.8	3.4	4.0	3.2	3.6	3.5	3.8
Developing Europe	6.2	5.5	5.2	5.8	5.8	6.4	6.0	6.8	5.5	5.4	5.9
MENA+AP	2.4	2.0	1.9	2.7	3.1	2.2	1.9	2.5	2.0	2.1	2.3
Western Hemisphere	5.4	4.8	3.5	3.6	3.6	3.1	3.4	3.3	3.5	3.6	3.6
All Developing Countries	5.0	4.7	4.1	4.3	4.2	4.0	4.0	3.8	3.7	3.7	4.0

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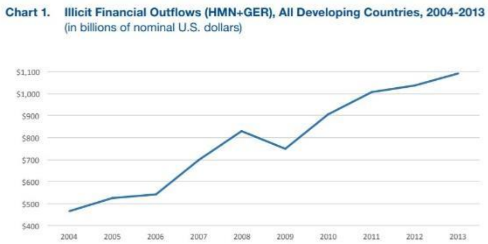
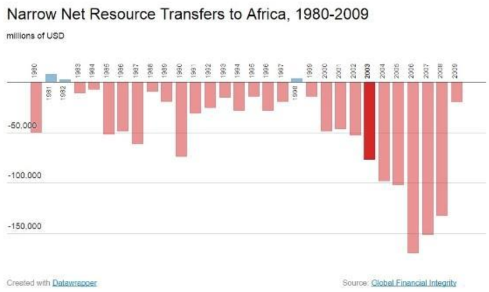
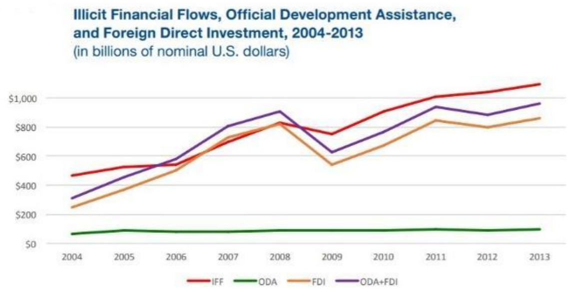
To exemplify the strain this puts on developing countries' ability to fund their own development, the comparison with global development aid is striking. In 2016, global development aid billed at 142.6 billion US$, according to the Organization for Economic Cooperation and Development (OECD) – which represents little more than a tenth of the yearly outflows from developing countries.[16] In the case of Sub-Saharan Africa, even accounting for Foreign Direct Investment and other licit flows of money, the net flow is negative – meaning that money is flowing out of Sub-Saharan Africa, making development more difficult to attain.[17] This holds true for developing nations in general, as well (Figures 4, 5).[18]







http://www.gfintegrity.org/wp-content/uploads/2015/12/IFF-Update_2015-Final-1.pdf

[15] Global Financial Integrity, "Illicit Financial Flows," *op. cit.*

[16] Organization of Economic Cooperation and Development, "Development aid rises again in 2016 but flows to poorest countries dip," April 11, 2017, *OECD* (website), http://www.oecd.org/dac/development-aid-rises-again-in-2016-but-flows-to-poorest-countries-dip.htm.

[17] Global Financial Integrity, "Illicit Financial Flows," *op. cit.*

[18] Dev Kar and Joseph Spanjers, "Illicit Financial Flows from Developing Countries: 2004-2013," *Global Financial Integrity*, December 2015, http://www.gfintegrity.org/wp-content/uploads/2015/12/IFF-Update_2015-Final-1.pdf.

Methods of international tax evasion

One of the striking revelations of the Panama Papers was to what extent these tax evasion practices were within the boundaries of the law. The tax outflows from developing countries, however, occur through both legal and illegal practices – with the line between them often quite blurry. One central practice for capital flight is misinvoicing. Through stating falsified sums on a customs invoice for a trade between two companies, profits are shifted from one tax jurisdiction to another.[19] By underreporting an export invoice, for example, a company can directly evade taxes and customs and shift profit outside. Import over-invoicing, on the other hand, exaggerates the prices of material bought from another country, allowing to shift profits there. Both these methods are relatively equally used for capital flight from the global South (Figure 7).[20] In developing countries where capital controls of some sort are imposed, misinvoicing is often used to circumvent these.[21]

The precise share of misinvoicing in capital flight from the global South is debated. A report of *Christian Aid* estimated that developing nations lose 1.6 billion US$ of direct tax revenue.[22] The *Global Financial Integrity* think tank (GFI), with a broader methodology, estimates misinvoicing to account for over 80% of illicit capital flight from the global South, over 800 billion US$.[23] The incentives for companies to falsify invoices is even higher when the trade occurs between two branches of one larger corporation. The Panama Papers revealed, for instance, that *Apple* moved profits to its own branch on the Channel island Jersey.[24]

The second large practice of capital flight is the trafficking of the money unrecorded. This can either be done physically (which represents only a relatively small amount); or through shell companies in offshore financial centers. According to the numbers of the GFI, which measures these outflows in errors and omissions in a country's balance of payment, this means of capital

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[19] Volker Nitsch, "Trade Misinvoicing in Developing Countries," *Center for Global Development*, 2017, https://www.cgdev.org/sites/default/files/trade-misinvoicing-developing-countries.pdf, 4.
[20] Dev Kar and Joseph Spanjers, "Illicit Financial Flows from Developing Countries," *op. cit.*, 10.
[21] Global Financial Integrity, "Trade Misinvoicing," *Global Financial Integrity* (website), http://www.gfintegrity.org/issue/trade-misinvoicing/.
[22] Jomo Kwame Sundaram (ed.), *Reforming the International Financial System for Development*, New York: Columbia University Press, 2011, 253.
[23] Dev Kar and Joseph Spanjers, "Illicit Financial Flows from Developing Countries," *op. cit.*, 10.
[24] Nick Hopkins and Simon Bowers, "Apple secretly moved parts of empire to Jersey after row over tax affairs," *The Guardian* (website), November 6, 2017, https://www.theguardian.com/news/2017/nov/06/apple-secretly-moved-jersey-ireland-tax-row-paradise-papers.

outflow has greatly increased over the last years, accounting for almost 20% of capital outflows in 2013 (Figure 6).[25]

http://www.gfintegrity.org/wp-content/uploads/2015/12/IFF-Update_2015-Final-1.pdf

Components of Illicit Financial Outflows
(in percent of total illicit financial outflows)

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Average
Import Over-Invoicing	27.2	26.3	27.4	26.7	26.2	24.8	28.6	34.6	38.1	42.6	31.5
Export Under-Invoicing	65.9	59.3	61.3	59.6	58.2	53.9	49.5	51.5	42.9	37.9	52.0
Hot Money Narrow	6.9	14.4	11.3	13.8	15.6	21.3	21.9	13.9	18.9	19.4	16.6

The role of offshore financial centers (OFCs)

Offshore financing has played an increasingly important role in international financing. In its most basic form, the IMF defines it as "the provision of financial services by banks and other agents to non-residents". Offshore financial centers, then, are Territories or States in which offshore finance represents a large chunk of general financial sector activity, that is, where most of financial services is offered to non-residents.[26] The boundaries are not clear cut, and what qualifies as an OFC depends on the definition.

The most important OFCs for capital flight from the global South are those offering banking secrecy for the customers of their financial services. This secrecy can be used to let money from the global South "disappear". Almost half of all capital flight from the global South is ultimately directed towards such offshore financial centers with strict banking secrecy.[27] 32 of the 52 offshore financial centers identified by the IMF are island nations or territories, which potentially depend on the income from providing tax secrecy. Another particularity is

[25] Dev Kar and Joseph Spanjers, "Illicit Financial Flows from Developing Countries," *op. cit.*, 10.
[26] International Monetary Fund, "Offshore Financial CentersIMF Background Paper," *International Monetary Fund* (website), June 23, 2000, https://www.imf.org/external/np/mae/oshore/2000/eng/back.htm#II.
[27] Global Financial Integrity, "Illicit Financial Flows," *op. cit.*

represented by the large number of non-sovereign territories, which represent 16 of the 52 countries (11 under British sovereignty, 3 under Dutch sovereignty, and two under Chinese sovereignty).[28] They are joined *inter alia* by Panama, Switzerland, Ireland and Luxemburg, most prominently.

What unifies these countries is that they have a very low corporate tax rate and to not cooperate with other countries in the exchange of financial information. The financial secrecy index (see figure on the right) gives a good account of countries' participation in international information exchange.[29] Despite international attempts at curbing illicit flows to OFCs, the size of the offshore market has enjoyed relatively stable growth over the last decade. Between 1982 and 2003, they grew 2,8% per year on average – twice as much as total global GDP, which grew by only 1,2% on average.[30] In 2010 for instance, the Tax Justice Network estimates, between 21 and 31 trillion US$, or between 9% and 13% of global household wealth, were held in tax havens.[31] Another study found that offshore wealth had increased by 35% between 2007 and 2015.[32]

1	Bermuda
2	Cayman Islands
3	Netherlands
4	Switzerland
5	Singapore
6	Ireland
7	Luxembourg
8	Curaçao
9	Hong Kong
10	Cyprus
11	Bahamas
12	Jersey
13	Barbados
14	Mauritius
15	British Virgin Islands

This is intrinsically linked to Transnational Corporations: 90% of the 200 biggest corporations worldwide are present in tax havens.[33] A report by Oxfam on the issue identified those tax havens that "facilitate the most extreme forms of corporate tax avoidance" (Figure 7).[34] Notwithstanding these clear cut-examples, illicit capital flight from the developing world also ends up in the developed world more than four out of ten times. Offshore financing has increased in spite of international attempts at countering illicit financial practices over the last decades. The next section will review these efforts.

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[28] International Monetary Fund, "Offshore Financial Centers (OFCs): IMF Staff Assessment," November 20, 2014, *International Monetary Fund* (website), http://www.imf.org/external/NP/ofca/OFCA.aspx#P.
[29] Financial Secrecy Index, "2015 Results," *Financial Secrecy Index* (website), http://www.financialsecrecyindex.com/introduction/fsi-2015-results.
[30] Joanne Ramos, "Places in the sun," *The Economist* (website), February 22, 2007, http://www.economist.com/node/8695139.
[31] International Centre for Tax and Development, "Tax avoidance and evasion by high net worth individuals," *International Centre for Tax and Development* (website), http://www.ictd.ac/tax-avoidance-and-evasion-by-high-net-worth-individuals.
[32] E.K. Hudson, "Rich people from these countries hide the most money offshore," *The Real Deal* (website), September 16, 2007, https://therealdeal.com/2017/09/16/rich-people-from-these-countries-hide-the-most-money-offshore/.
[33] Oxfam International, "Paradise Papers: the hidden costs of tax dodging," *Oxfam International* (website), https://www.oxfam.org/en/even-it/paradise-papers-hidden-costs-tax-dodging.
[34] Oxfam Policy Paper, "Tax Battles – The dangerous global Race to the Bottom on Corporate Tax," December 12, 2016, *Oxfam International* (website), https://www.oxfam.org.au/wp-content/uploads/2016/12/bp-race-to-bottom-corporate-tax-121216-en-EMBARGO.pdf.

Past international efforts

One of the central issues in detecting tax avoidance is transparency. Practices of misinvoicing, for example, can be detected by mirroring and comparing the invoices of the importing and the exporting country.[35] Another tactic to identify misinvoicing is to look for abnormal prices – real examples are a ballpoint pen from Trinidad worth 8,500 US$ a piece, or apple juice from Israel worth over 4000 US$ a liter.[36] Such exaggerated mispricing, however, is rather the exception to the rule, and detecting mispricing can be a challenging task.[37]

Many countries have therefore entered into tax cooperation agreements on a bilateral basis. Over 500 such agreements have been made between States and territories since 2000.[38] These bilateral agreements, however, often exclude developing countries, which benefit little from the information sharing between tax havens and developed economies. A more comprehensive approach is therefore needed. The OECD and the UN have both put forward such a multilateral approach to address the problem.

OECD: Convention on Mutual Administrative Assistance in Tax Matters

The OECD drafted the Convention on Mutual Administrative Assistance in Tax Matters already in 1988 with the Council of Europe. It was amended after the G20 proposed a renewal in 2010, and opened for all countries to participate. It serves as a multilateral basis for cooperation between multiple tax jurisdictions and applies to income and corporative taxes.[39] As of November 2017, 115 countries participate in the Convention, including the non-sovereign tax havens by extension of the participation of the United Kingdom and the Netherlands, respectively.[40] It is the most comprehensive effort in the international community, and seeks to facilitate the exchange of relevant information to combat tax evasion. The States party to the convention commit to exchanging this information, but are not legally bound to do so.

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[35] Volker Nitsch, "Trade Misinvoicing in Developing Countries," *op. cit.*, 4-5.
[36] Share the World's Resources, "Financing the global sharing economy, part three (4): stop tax avoidance," *op. cit.*
[37] Volker Nitsch, "Trade Misinvoicing in Developing Countries," *op. cit.*
[38] Only Wikipedia provides a comprehensive, accessible list at https://en.wikipedia.org/wiki/Tax_information_exchange_agreement.
[39] OECD, "The Multilateral Convention on Mutual Administrative Assistance in Tax Matters," *OECD* (website), August 25, 2016, http://www.oecd.org/ctp/exchange-of-tax-information/ENG_Convention_Flyer.pdf.
[40] OECD, "JURISDICTIONS PARTICIPATING IN THE CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS," *OECD* (website), November 10, 2017, http://www.oecd.org/tax/exchange-of-tax-information/Status_of_convention.pdf.

United Nations: Committee of Experts on International Cooperation in Tax Matters

Within the United Nations system, the Committee of Experts on International Cooperation in Tax Matters was established by ECOSOC Res.2004/69. The Committee has drafted the United Nations Model Double Taxation Convention, which is however unbinding, and not an official recommendation by the United Nations.[41] It rather serves as a guideline for countries to incorporate into their bilateral treaty negotiations. In the Model Convention, specific rules for the taxation of goods, capital, and services are provided to ensure that individuals do not have to pay taxes twice. Additionally, information exchange is encouraged to facilitate the detection of the misuse of its provisions, for which developing countries are more prone due to their potentially lacking enforcement and implementation mechanisms.

Conclusion

The international efforts already undertaken mark a first step. Developing countries, however, are in an asymmetric relationship to many large corporations. After all, only 39 of the 100 currently biggest economies are States, while 69 are Transnational Corporations.[42] This gives corporations an incredible bargaining power, and makes it particularly difficult for developing States to stand up to them, as they often depend on their Foreign Direct Investment. Better bilateral agreements are of help in this regard, but maintain one central weakness with regards to the private sector: The movability of capital. If one country seeks to collect its taxes stricter, the production location can be switched to a neighboring country.

The General Assembly should therefore assess in how far the existing steps are sufficient, and whether the UNGA should call upon all States to cooperate in those efforts. Furthermore, the General Assembly should develop broad terms in which these existing programs can be developed further, or whether there should be an additional UN body to facilitate the detection of tax evasion.

[41] United Nations, "United Nations Model Double Taxation Convention between Developed and Developing Countries (Update)," New York, 2011, *United Nations* (website), http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf, 9.

[42] Duncan Green, "The world's top 100 economies: 31 countries; 69 corporations," *World Bank Blog* (website), September 20, 2016, https://blogs.worldbank.org/publicsphere/world-s-top-100-economies-31-countries-69-corporations.

QARMAs

- Should the UNGA encourage all States to participate in the OECD Convention on Mutual Administrative Assistance in Tax Matters?
- Should the UNGA call upon tax havens to disclose their clients?
- How can the international community further strengthen developing countries in their tax collection efforts?
- How could international community ensure to hold those Transnational Corporations that drain their profits from developing countries accountable?
- What role can the UN Committee of Experts on International Cooperation in Tax Matters play in this regard?

Further reading

- Dev Kar and Joseph Spanjers, "Illicit Financial Flows from Developing Countries: 2004-2013," *Global Financial Integrity*, December 2015, http://www.gfintegrity.org/wp-content/uploads/2015/12/IFF-Update_2015-Final-1.pdf.
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