

# HOW WE GOT HERE

## A HISTORICAL PERSPECTIVE ON TAX FRAUD AND TAX EVASION

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**GUE/NGL**  
European United Left • Nordic Green Left

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**How we got here: a historical perspective  
on tax fraud and tax evasion**

Report for the European United Left/Nordic Green Left  
(GUE/NGL) in the European Parliament



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## KEY TAKEAWAYS

Fraud and tax evasion rest primarily on a legal framework built over decades by our governments. In this pamphlet:

- It looks into the financial liberalisation which began in the 1980s;
- It examines the emergence of multinationals and their business model evolution;
- It underlines the crucial role played by tax havens in aggressive fiscal planning.

# HOW WE GOT HERE

## A HISTORICAL PERSPECTIVE ON TAX FRAUD AND TAX EVASION

Tax fraud and tax evasion require specific conditions to flourish. Such conditions do not arise overnight. To understand how we got here, we have to look into the past to see how the liberalisation of capital flows and international financial markets that began in the 1980s set the stage for so-called aggressive tax planning, tax competitiveness and tax evasion and/or avoidance by large transnational companies.

# FINANCIAL GLOBALISATION AND DEREGULATION

The last decades of the 20th century and the first few years of the 21st century were characterised by significant changes in international financial relations. Growing financial flows, the opening up of markets, and new and increasingly sophisticated financial instruments bear witness to the phenomenon. The mobility of capital on an international and unprecedented degree inspired the phrase 'financial globalisation' which enshrines the idea of a globalised financial market on an international scale.

The current financial globalisation is not only characterised by the use of sophisticated financial instruments and their circulation worldwide, but also by the gradual decoupling between financial flows and production. We live in an age when the financial sector is becoming increasingly detached from the productive sectors, allowing for speculation. This phenomenon is at the root of the financial crises that have repeatedly shaken our societies. Those crises have resulted precisely from the autonomy of the financial sector vis-à-vis the real economy. Financial operations are in themselves sources of profit, if not the main source of profits. But such profits are not connected to any economic activity. They lack a supporting substrate and will only last until the corresponding speculative bubble bursts - a mechanism that readjusts financial flows to the productive and commercial realities. Figure 1 below is based on World Bank data and shows how market capitalisation grew exponentially in the 1980s and 1990s.

Neoliberalism, as an economic doctrine, arose among US academics who were inspired by the ideas of Austrian economist Friedrich Hayek, under the leadership of Milton Friedman, the true mentor of the Chicago School's monetarist theory. From the 1980s onwards, neoliberalism became the cornerstone of Ronald Reagan and Margaret Thatcher's policies in the US and the UK, and was gradually adopted throughout the world.

**GLOBAL STOCK MARKET CAPITALISATION INDEX (% PIB)**

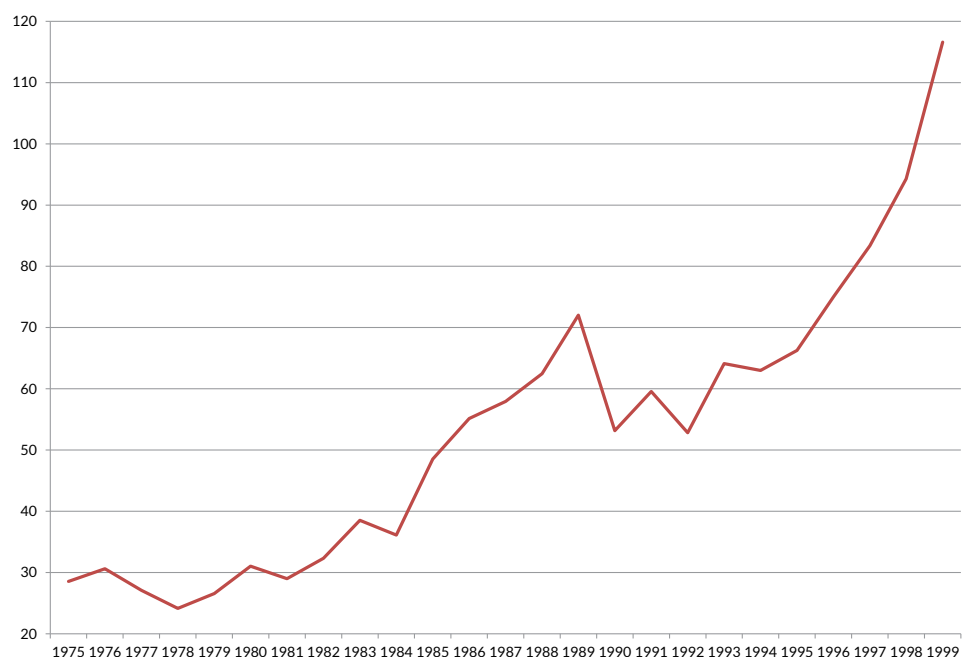
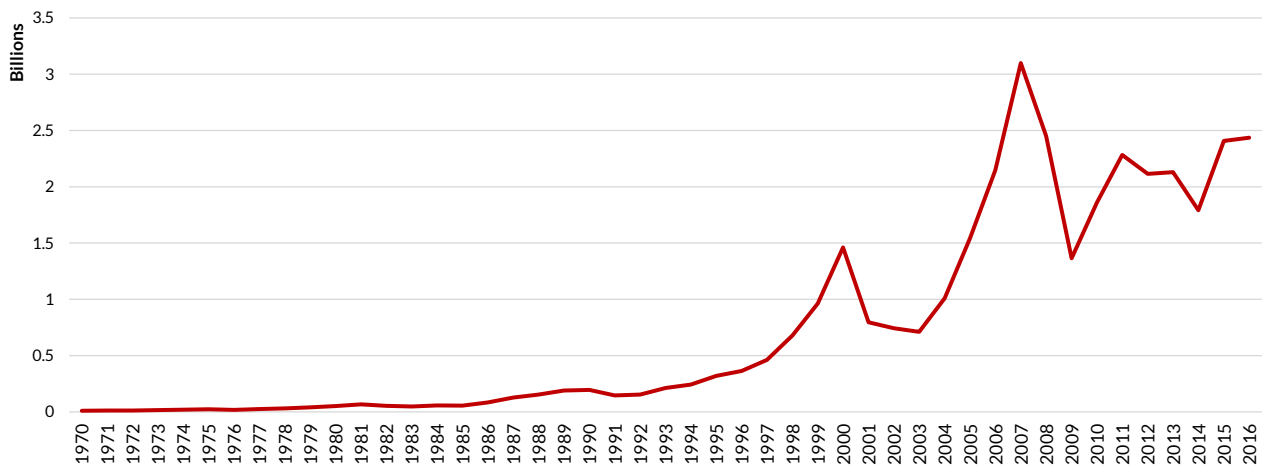


Figure 1

Source: Fédération Mondiale des Bases de Données des échanges

### FOREIGN DIRECT INVESTMENT, NET INFLOWS (BOP, CURRENT US\$)



In the 1970s, the process of financial liberalisation and deregulation gathered speed. In 1971, the US administration unilaterally cancelled the international convertibility of US dollars into gold. In 1974, that same administration loosened controls on capital flows. From then on, policies inspired by the ten commandments of the Washington Consensus have prevailed (see page 7). Regulation Q, which applied controls to interest rates, was repealed. The Glass-Steagall Act of 1933, which separated commercial from investment banking, was also repealed. And whilst huge empires were created to house vast and diversified sets of financial products and activities, the regulatory power was left without the means to deal with the creation and commercialisation of increasingly complex and opaque products. So-called derivatives are a good example of this financial alchemy. Derivatives are financial products whose value derives from an underlying asset. Since the 1990s, there has been a boom in the provision of such products, in particular the infamous Credit Default Swaps (CDSs). Their extensive use, and the volatility and essentially speculative nature of this segment of the securities market, led to a series of warnings and appeals to greater regulation and supervision. The ‘answer’ came in 2000 with the adoption of the Commodity Futures Modernization Act which exempted derivatives from any supervision. The arguments put forward by Alan Greenspan, Chairman of the US Federal Reserve, and by Robert Rubin, US Secretary of the Treasury, went in the same direction: nothing should hold up innovation in such a lucrative business.

Figure 2

Source: World Bank based on International Monetary Fund, Balance of Payments database, supplemented by data from the United Nations Conference on Trade and Development and official national sources.

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## THE WASHINGTON CONSENSUS

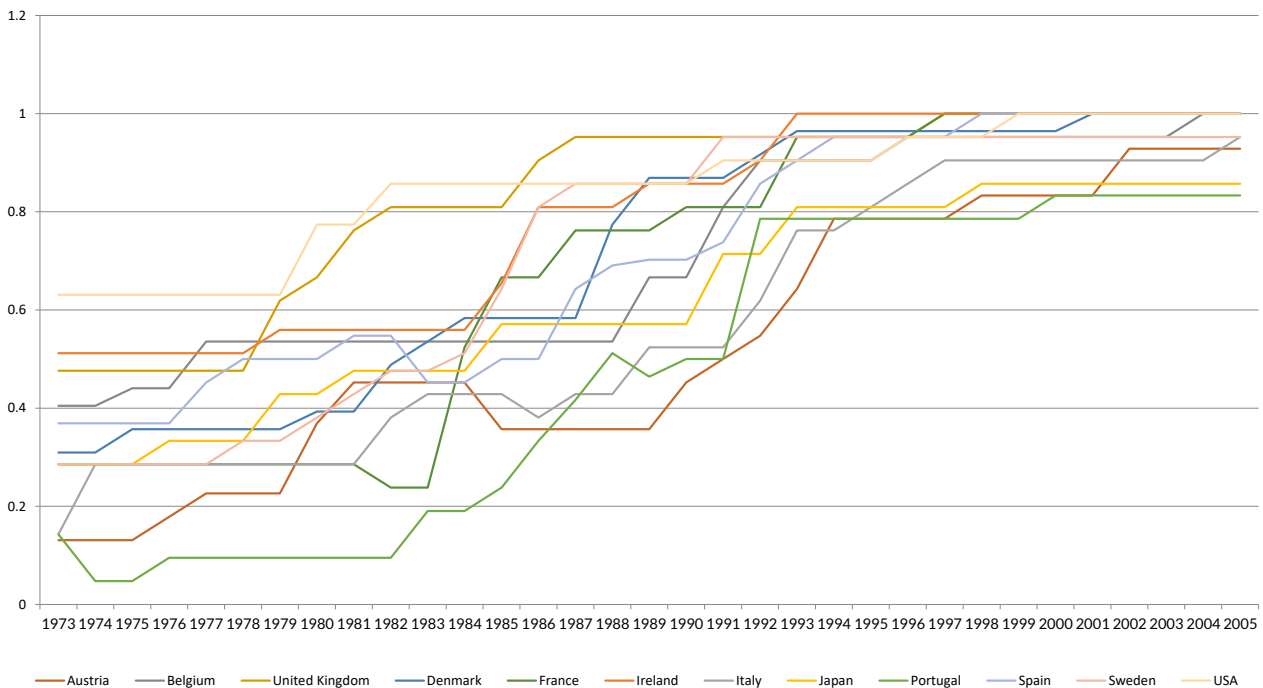
The Washington Consensus represents a set of policy prescriptions inspired by the Chicago School that were applied in highly-indebted countries (particularly in Latin America) by the World Bank and the International Monetary Fund - two Washington-based institutions. The economist John Williamson summarised the prescriptions in an article published in 1989, where he listed 10 fundamental proposals that are presently considered the ten commandments of neoliberalism (Williamson, 2000).

1. Fiscal discipline;
  2. Redirection of public spending towards sectors that will stimulate economic growth and reduce social inequalities;
  3. Tax reform, broadening the tax base;
  4. Liberalisation of interest rates;
  5. A single competitive exchange rate;
  6. Liberalisation of international trade;
  7. Removal of barriers to foreign investment;
  8. Privatisation of public monopolies;
  9. Deregulation of markets;
  10. Protection for private property, including intellectual property rights.
- 

On this side of the Atlantic, the neoliberal shift was initiated by Margaret Thatcher, the British Prime Minister between 1979-1990. Whilst cutting public expenditure and restricting wage growth, she reduced taxes for high earners. Regarding the economy and financial system, her government suspended foreign exchange controls and fully liberalised the banking and financial sectors, thus breathing new life into the City of London. To maintain their competitiveness, other European financial markets had to follow suit.

To assess the progress of financial deregulation in different countries, the International Monetary Fund (IMF) devised an Index of Financial Liberalisation (Abiad, Detragiache, & Tressel, 2008). The index represents the sum total of seven different indices measured on a scale from zero (regulated) to 3 (unregulated). The seven indices assess credit controls, control over interest rates, barriers to entry, banking supervision, privatisation, foreign exchange controls and regulations concerning financial markets. Figure 3 (page 8) illustrates how financial liberalisation advanced in major European countries during the final decades of the 20th century.

## FINANCE LIBERALISATION INDEX, 1973 - 2005



The process of financial liberalisation is also clearly inscribed in the evolution of the European Union. Indeed, the free movement of capital is at the core of the Single Market. According to EU Treaties, it is one of the four fundamental freedoms - the free movement of goods, people, services and capital. The Treaty of Rome already provided for the free movement of capital, albeit subject to the necessary restrictions to ensure the smooth functioning of the common market. Thus, financial operations between member states were often subject to prior approval until 1990.

Although a 1988 Directive on the liberalisation of capitals provided for their free movement from 1990, it was in 1994 with the Maastricht Treaty coming into force that established the Economic and Monetary Union which placed the freedom of movement of capital on par with the other three freedoms. According to Article 63 of the Treaty on the Functioning of the European Union, "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited".

Figure 3

Source: "A New Database of Financial Reforms," IMF Working Paper WP/08/266, December 2008

**Whilst cutting public expenditure and restricting wage growth, Margaret Thatcher reduced taxes for high earners**



# TAX HAVENS

In the process of financial globalisation described in the previous chapter, tax havens play a central role. Considering their growing importance in recent decades, one could argue that they represent a fundamental pillar in economic and financial globalisation. According to the United Nations Conference on Trade and Development (UNCTAD), about half of all the investments made by multinational companies originate in tax havens. To quote an example that merely hints at the true scale of the phenomenon, the Channel Islands (Jersey and Guernsey) have invested more in China than Japan or the USA whilst Mauritius was India's largest foreign investor. As reported by ATTAC Switzerland, there are currently more than 700 tax havens around the world concentrated in three geographical areas: the Caribbean, western Europe and South Asia. All of them are linked to and are highly dependent on the major industrial and banking powers that dominate the world's economy: the USA, western Europe and Japan. Tax havens have grown exponentially over the last three decades and have become the core of the world's financial system.

The history of tax havens goes all the way back to the Classical Age some 4,000 years ago, when Greek traders tried to do business outside ports to avoid existing port levies and taxes.<sup>1</sup>

***One could argue that tax havens represent a fundamental pillar in economic and financial globalisation***

In the Middle Ages, duty-free fairs were established with the aim of promoting commercial exchanges and specific commercial land routes. But the first modern-day tax havens date from 1880, when the US state of New Jersey followed by Delaware decided to apply reduced taxes to businesses willing to establish their headquarters in their territories. It was the first instance when a sovereign government applied a tax exemption to the whole of its territory. In the 1920s, the practice became more widespread and other territories such as the Bahamas and Switzerland also began applying it. The Swiss law on bank secrecy that criminalised the disclosure of banking data came into force in 1930 and was further strengthened in 1934. Between 1920 and 1938, offshore fortunes, i.e. those of non-residents in Switzerland,

jumped from 10 billion to 125 billion Swiss Francs! In its extensive research, the Volcker Commission touched upon bank secrecy rules and identified 2.2 million accounts that were opened by foreigners in Swiss banks between 1933 and 1945.<sup>2</sup>

However, it was mainly after World War Two that a number of territories began specialising in favourable tax treatments to huge fortunes and strict banking secrecy rules. Starting in the 1960s, and later with the emergence of petrodollars, the major financial markets themselves actively promoted the establishment of tax havens which gradually emerged as a fundamental link in international financial practices. With globalisation and the free movement of capital, as well as a series of legal innovations, companies gradually changed

<sup>1</sup> For a history of tax havens and how they emerged in the modern world, see Zucman, 2015: "The Hidden Wealth of Nations".

<sup>2</sup> In 1995, as the 50th anniversary of the end of World War Two was being marked, several Israeli newspapers raised the issue of funds deposited in Swiss banks by Jewish persons who had died during the Holocaust. It was estimated at the time that those funds were worth more than 50 million Swiss Francs. To investigate the matter, an Independent Committee of Eminent Persons (ICEP) was established. It was headed by Paul Volcker, former Chairman of the US Federal Reserve and became known as the 'Volcker Commission'.

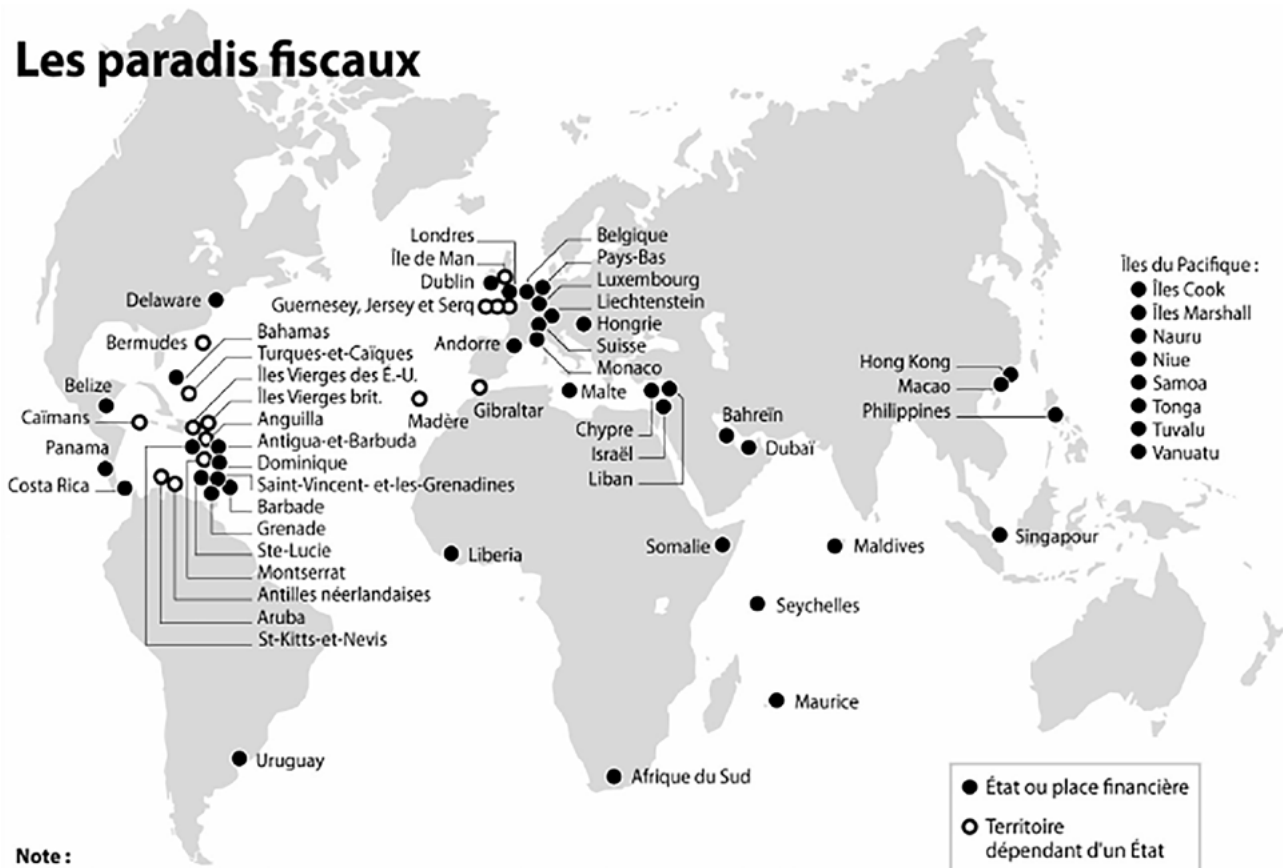
their structure by breaking themselves up into in a constellation of legal entities, producing goods in one place, opening their bank accounts in another and paying their taxes there, or even, in a different location.

There are numerous tax haven lists - all compiled according to different methodologies. However, they all share OECD's known criteria for defining a tax haven (low or non-existent rates of taxation, an opaque tax system and no exchange of tax information with other jurisdictions). Figure 4 was collated by Christian Chavagneux and Ronen P. Palan (Chavagneux & Palan, 2006). It gathered information from three black lists of tax havens (countries or territories) compiled by the OECD. Other maps and lists have also been compiled and are designed just as meticulously. The example shown below does not provide a definitive answer to the issue but it has the advantage of being transparent in the criteria used to produce it and of showing the geographical scale of the phenomenon.

Figure 4

Sources: Christian CHAVAGNEUX et Ronen PALAN, *Les Paradis fiscaux*, Paris, La Découverte, 2006 et *Plateforme paradis fiscaux et judiciaires*. Carte Antoine Dulin et Atelier de Cartographie de Sciences Po, Mars 2007

## Les paradis fiscaux



### Note :

Les paradis fiscaux représentés sont notamment issus des 3 listes noires de pays ou territoires émanant :

1. de l'OCDE (47 identifiés en 1999 et finalement 35 publiés en 2000) ;
2. du Forum de stabilité financière (42 classés en 3 groupes selon la hiérarchie des risques) ;
3. du GAFI (29 identifiés et finalement 15 publiés).

**Ces 3 listes ont été publiées en 2000 puis actualisées à la baisse chaque année jusqu'à être vidées de leur contenu en 2005-2006.**

# MULTINATIONAL COMPANIES

Multinational companies are key actors in tax fraud and tax evasion. In recent times, not a week goes by without another tax fraud or tax avoidance case exposed which involves a multinational company.

According to an OECD report, so-called aggressive tax planning by multinational companies in 2013 corresponded to between 100 and 240 billion dollars every year. This represents a blackhole of between 4 and 10% in tax revenues (Development, 2013). The same report estimates that the effective rate of taxation that is applied to companies' profits is, on average, between 4 and 8.5%.

According to UNCTAD's<sup>3</sup> definition, a multinational company is an enterprise that shares an international investment with an equity capital stake of 10% or more in a foreign company that was established or purchased in a third country. In simpler terms, a multinational company can be defined by its ownership of companies or subsidiaries in various countries that it controls totally or partially. Such control is exercised from a unified command centre located in the so-called 'parent company'.

Multinational companies first emerged in the second half of the 19th century, with the consolidation and liberalisation of joint stock companies. Such companies were first established in the 19th century because there was a need to put together increasingly larger volumes of capital for increasingly larger investments. Up to a certain moment in

time, the establishment of such companies had to conform to a series of requirements and was subject to a whole range of authorisations. The establishment of joint stock societies was first liberalised in Sweden in 1848, where they became subject only to registration. Similar developments took place in 1856, 1867 and 1873 in the United Kingdom, France and Belgium, respectively.

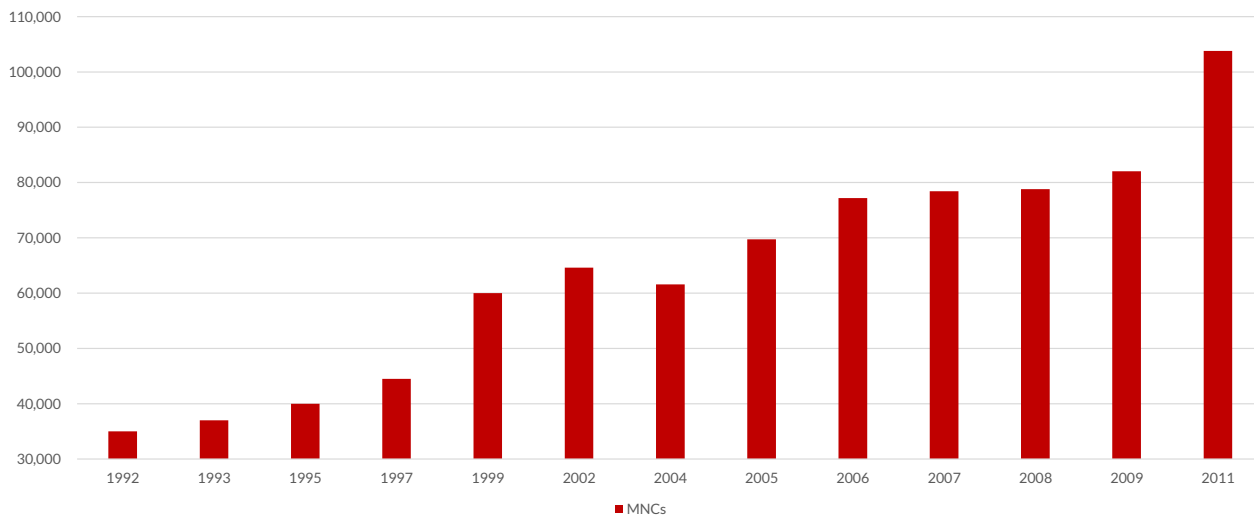
**80% of the world's wealth is concentrated in barely 0.7% of all existing companies**

Throughout the 20th century, we have witnessed the growth and consolidation of multinational companies. By internationalising their activities, they aim to reduce their costs, be it labour costs, energy or transportation costs, or so-called transaction costs. Multinationals aim to circumvent protectionist policies and seek jurisdictions with

the most favourable tax systems, always with a view to maximising profits which are placed high above any social concerns regarding their workers or the populations affected by their activities. But it was from the 1980s onwards in particular with financial deregulation that Foreign Direct Investment (FDI) truly exploded - whether as direct investment and fixed capital formation or through massive waves of mergers and acquisitions. It was then that the number of multinational companies grew exponentially and their influence became overwhelming. According to UNCTAD data, in 2011 there were about 65,000 multinational enterprises (compared with about 7,000 in the 1960s) that employed about 53 million workers in their 850,000 subsidiaries. According to a report by UNCTAD that covers the period between 2010 and 2012, such multinational companies controlled two-thirds of

<sup>3</sup> <http://unctad.org/en/Pages/Home.aspx>

## NUMBER OF PARENT CORPORATIONS



international trade and represented about 11% of the world's GDP. More than 60% of international trade was made up of intra-group transactions. This is an important fact in understanding the mechanisms used to engage in tax fraud and tax avoidance.

Figure 5

Source: UNCTAD World Investment Report

A study published in 2011 went further and concluded that 147 multinational companies controlled 40% of the world's wealth. That is, 80% of the world's wealth is concentrated in barely 0.7% of all existing companies. This concentration gives them significant leverage to influence decision-making processes at national and international level. Could this mean the independence of political power and the overriding principle of the public interest in decisions made by national governments and international bodies is in jeopardy? The existing institutional architecture is multinational-friendly and has facilitated widespread tax avoidance and evasion. Together with the continuing scandals, it suggests a significant level of promiscuity between powerful private lobbies and major political actors. This naturally causes great concern. But ultimately, it is up to the readers to judge and make up their minds.

Over the years, multinational companies have adapted themselves to new times and new technologies. The evolving internal management and organisational models help us to understand the underlying rationale of the mechanisms that were designed to promote tax fraud and tax evasion. Not that long ago, the prevailing model among multinational companies was that of a parent company (a holding company) that managed a group of affiliated companies or subsidiaries abroad. These affiliated companies were relatively autonomous. They had their own board of directors and financial services and oversaw almost all of the production chain: from the purchase of raw materials to the marketing of the manufactured products. Transactions between affiliates within a group were infrequent and of limited value.

Today, the situation is quite different. For various reasons, including technological developments, digitisation and financial globalisation, the internal organisational structure of multinational companies has evolved. A new international division of labour emerged. Whereas in the past, affiliated companies would be responsible for the production of certain goods from beginning to end, we now have subsidiaries specialising in a specific portion of the production chain. The final stage of the production process often involves the assembly

of parts produced by different subsidiaries, sometimes located in different continents. This process of division of labour and specialisation has also affected administration, and there is a trend towards increasing centralisation. The purchase of raw materials and financial management are now dealt with centrally from the parent company or from specialised subsidiaries in strategic location. This trend is reflected in an OECD statistic which said around 70% of world trade is currently between companies belonging to the same group.

Unfortunately, many of the so-called 'reorganisations' of multinational companies have little to do with the efficient use and allocation of resources. As shown in the practical examples mentioned in previous pages, many organisational structures were set up solely with the aim of reducing or even eliminating the tax bill of these large corporations.

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Starbucks has concentrated the purchase of its raw materials in a Swiss-based subsidiary that charges above-market prices for its coffee, thus draining the group's profits into that country. McDonald's has centralised its intangible assets in Luxembourg, from where it then charges royalties to the same effect. FIAT has established a sister company in Luxembourg responsible for the financial management of the whole group which charges manipulated interest rates on its services. What is at stake in these examples and what we strongly criticise and denounce are corporate re-organisations that are aimed solely at promoting more or less artificial intra-group exchanges. By manipulating prices, such companies are able to concentrate their profits in jurisdictions that are more attractive from a taxation viewpoint.

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***Many organisational structures were set up solely with the aim of reducing or even eliminating the tax bill of these large corporations***

# CONCLUSION

The current scenario of outright impunity in tax matters requires a thorough response from political actors. However, merely scratching the surface will not do. It cannot focus only on one or a few cases involving well-known multinational companies that received significant media coverage. Such cases are important because they attract public attention and force governments to act. Nevertheless, they are not isolated cases. Tax fraud and tax evasion are widespread, benefiting from a legal and political ecosystem that has been set up laboriously over decades by key governments in the western world, along with the backdrop of the liberalisation and financialisation of economies. Hence, fighting tax fraud and tax evasion means fighting such a system and proposing alternative measures based on greater public control over the financial system and capital flows.

That must be our fight!





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Miguel Viegas MEP has been a member of the European United Left/Nordic Green Left in the European Parliament since 2014. He serves on the Committee of Economic and Monetary Affairs as well as on the Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance.

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