

Funding the Future

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Many people have been asking us about Cyprus. Its tax haven status is central to the drama that has seen big depositors there stand to suffer large losses, while small depositors holding amounts below 100,000 Euros, who had previously been threatened with a 6.75 percent levy on the capital value of their deposits, will be spared.

The question is: is this the right deal, from our perspective?

In broad terms, yes. It absolutely is. And much of the world's media has simply failed to take into account all the factors that are at play here. (Though we do particularly like this recent interpretation of events by Paul Krugman of the New York Times, of course.)

Most notably, Cyprus has been running a pernicious, unpleasant, grubby and often violent tax haven racket for years. It long since left the community of decent, respectable nations. (We should note here that the ordinary population of a tax haven is different from the financial services industry of a tax haven; but more on this below.)

This deal will, we fervently hope, kill off Cyprus' entire offshore model which goes far beyond banking deposits, and includes offshore companies and other structures. We know, via specific cases, that Cyprus has been harbouring and protecting vast subterranean funds from criminal activities. Krugman notes that:

"Whatever gloss you put on it, it's basically about money-laundering."

Quite so.

Cyprus, of course, loudly denies being a tax haven: they all do. It's part of the theatre of probity that is de rigeur among corrupt tax havens that is required to reassure the world's hot money that their money is safe.

The reality is entirely different. This has been, in effect, a criminalised state, and it is now being brought to book. So this is a highly positive development, all things considered, and there are grounds for hope that the offshore model will be effectively killed: as this article notes in the Cyprus Mail:

"The troika has potentially vaporised the Cypriot-based financial services sector and undermined its status as a tax haven, a deliberate act which aimed to police the wilder shores of capital flow in and out of Europe. . . .The financial services sector may now prove dead in the water and the tax haven status of Cyprus has been swiftly and comprehensively compromised. If you have money to hide, you are not going to park it in Cyprus any more.

Or, in the words of a Russian cited in the FT (in an article that deserves a blog all to itself),

"The Cypriots killed their country in one day."

The Cyprus Mail article is fascinating, for it describes something that we at TJN have long described and will explore in far greater depth, in a forthcoming long paper: the complete capture of, and capitulation by, an entire nation state, to the offshore financial services industry. And this is the big point that the world's media has largely missed, and which is perhaps the most fundamental of all. As the same article notes:

"The interest of the Cypriot political elite has, in large part, been tied to the financial services sector since the early 1990s with lawyers, accountants and others massively over represented in public life and wielding inordinate power . . . the broader interests of the Cypriot economy have become, to a significant degree, dependent upon this economic regime."

David Officer, one of the coauthors (along with Yiouli Taki) of the Cyprus Mail article, is an academic who has been conducting a "democratic audit" of Cyprus. Officer told TJN in emails:

"Cyprus is a remarkably un-reflexive society so this issue appeared to have been ignored by every single journalist, academic and political actor on the island. A consensus emerged here that if the goods were being delivered there was nothing to be gained by reflecting on how those resources were secured."

Or, as that same Russian businessman cited in the FT put it:

"They are saying we laundered all the money, but they lived on that money for 10 years and forgot about it."

Back to the Cyprus Mail article:

The crisis has caught up with us and I have grown inured to international media attention since stories are spreading across the media but with no connection to the context described above. Gave a 45 min interview to [a U.S. newspaper] a couple of days ago which was reduced to two lines on their front page on Saturday. The outsider cannot grasp the context and the Cypriot insider is not in a position to join the dots

because they have never been given the conceptual framework or the motivation to do so."

TJN has been told by Cypriot journalists that they had (until the recent crisis) quite literally been afraid to report on the offshore sector, for fear of reprisals. Anyone who has read *The Life Offshore* chapter in *Treasure Islands* will instinctively understand what is happening here. Officer continues:

"Why we can talk about 'state capture' by the financial services industry is how a nominally left-wing party such as AKEL has never once raised any substantive issues about how the economy had become absolutely dependent upon the tax haven model and Cyprus a conduit for the flow of foreign finance capital between jurisdictions. Political consensus emerged around this model because it appeared to deliver the goods and common resistance was forged to any attempt by international organisations - World Bank, IMF, FAFT, EU....the list goes on - to impose an effective regulatory regime which would undermine this particular cash cow."

And now Cyprus - ordinary Cypriots - have a huge, existential problem. When an island gets captured by an offshore financial services industry - and we've seen this again and again - it tends to kill off substantial parts of alternative sectors. Among other things, it creates "Dutch Disease" effects where local price levels rise in response to the inflows of money, either via the exchange rate or via inflation, and the resulting higher-cost environment then makes it harder for various other sectors to compete in international markets. They wither. More importantly, though, the salaries in this sector are far higher than in any other, and this leaches all the best and most highly skilled people out of other sectors (private and public) and thus further worsens their prospects. In the face of all these adverse trends, policy makers then lose interest in 'difficult' problems such as creating a viable agriculture or manufacturing or tourist industry and instead let the easy money roll in in pursuit of secrecy and lax criminal enforcement, no questions asked. Dissenters are bought out or threatened. This makes the problem worse still. Worse still, it criminalises originally law-abiding people who come into contact with this sector, who are required to turn a blind eye to foreign criminality if they want to prosper.

And here we get to what exactly it is that Cyprus has been peddling. Its secrecy score on the *Financial Secrecy Index* is not especially egregious in comparison to some other havens, but that's not quite the point. From our knowledge of what has been going on, Cyprus's top offering has been to peddle non-compliance with its own laws. When gangster money comes in, its regulators and forces of law and order have deliberately turned their face away. That is what happens when you allow criminal financial interests to 'capture' your state. Officer continues:

"The usual vested interests from the President to the financial services industry have been repeating the mantra that 'there is no dirty money in Cyprus' and deflecting attention from implementation issues to the comprehensive legal framework in place -

this is the same issue.

Small, close knit societies like Cyprus thrive on a lack of transparency and inadequate regulatory regimes in dealing with their own population. This is the competitive advantage they then use to attract foreign capital."

Quite so. This is exactly, exactly, the sort of thing that Treasure Islands, and our forthcoming paper, describe. The trouble that Cyprus now faces is that there is no plan B now. Other sectors have withered, skills have been lost, none of the politicians know what to do, the rest of economy has been hollowed out, and even the banking sector is unable to function, since it was only ever a business in pursuit of those easy, secrecy-suffused rents, cosyng up to Russians, Ukrainians and others. Cyprus turned itself into into a dodgy wealth management economy, and those skills (if that is what you call them) aren't transferable to other sectors. As alternatives wither, political capture deepens, in a self-reinforcing dynamic.

We do of course feel sympathy for large swathes of the Cypriot population who never actively voted for such a system - but we should note that by and large the consensus described above by Officer demands a certain degree of acquiescence by the general population. We sympathise - but only up to a point.

And now, the consequences.