

On Cyprus

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I think it's time to say some things about Cyprus.

The people of Cyprus are, I suspect, rightly frightened this evening, and why not? Whatever the outcome of the negotiations now ongoing they will suffer massive austerity, deep recession and economic hardship and prolonged unemployment for many in the years to come. Inevitably many will leave a country that has already suffered mass emigration for generations. The question is, why are they suffering this fate?

There is always a risk to being simplistic; equally there is a real risk in presuming that some issues are so complex that they are incomprehensible. I will take the risk of being simplistic.

Cyprus has willingly committed a number of serious errors, some willingly, others unwittingly, I suspect.

First, like so many small states with uncertain identities (and the existence of North Cyprus inevitably created problems with Cypriot identity) and limited economic options Cyprus exploited one of the few distinct economic competitive advantages it had available to it, namely, it's right to legislate.

The result was it created lax banking law, low taxation, light regulation and easy incorporation and secrecy to shroud it all: Cyprus is a classic tax haven, by choice. Like many such places it found a distinct niche, in its case as a conduit. The first use was and is as a transit point or conduit for funds entering Europe from developing countries. Sometimes these funds were wholly legitimate; other times I suspect not. The second is as a location for round tripping funds from Russia i.e. for receiving capital flight funds that then are reinvested in that state where they appear to be foreign direct investment.

The business model worked well for a while, and now it has failed. The loans made by Cypriot banks to institutions outside Cyprus are now turning bad without recourse

against deposits also from outside the state. The offshore model - which merely describes the fact that the transactions undertaken were on both sides with parties not located within Cyprus - has failed. In a nutshell that is the cause of the Cypriot banking crisis.

But there are two other reasons why Cyprus has failed. These are more subtle, but as important. By promoting tax haven activity on a low tax base Cyprus did something no state can afford to do; it undermined its own legitimacy that in no small part is dependent upon its right to tax. By openly questioning its own right to do that by deliberately promoting the idea of tax as something best avoided Cyprus diminished its own status: now it is treated as a diminished state as a result. But that diminished status is not patronising: it reflects the choice it made about itself, and the choice it made in relation to other states whose regulation it sought to undermine through its actions. If there is a lack of sympathy now in return it may look harsh, but it is not wholly inexplicable.

And Cyprus compounded its own problem by joining the Euro. As a small state its sovereignty was dependent upon its right to legislate and tax, its economic currency - and, quite literally its own currency or money - was validated and given value by the fact that it was the only means acceptable for settling the tax debts due to it. When its currency was gone and its tax base was denuded by tax haven status the legitimacy of its other choices was open to doubt because it no longer had the freedom to control its banks, who now dealt in what was, in effect, a foreign currency given its limited power over it. Its mandate over those banks went when the Cypriot pound ceased to be, just as its means of settling debt with its own IOUs - denominated in its own currency and validated by its own taxing rights went on the arrival of the Euro.

And so Cyprus ends up the pawn of others. Its choice to be a tax haven, its choice to undermine other states as a result, and its giving up its right to economic independence and so its rights over its banks and future income streams guaranteed that it would end up without negotiating powers.

The odd thing is it chose to be a tax haven because it could use its sovereign status to legislate and so earn an income stream, whether justified or not. And when it forgot that and gave up its right to sovereign status over large parts of its economy that tax haven model that was predicated on that independent status was bound to fail.

And now it has.

This does not mean all tax havens need fail in the same way, but it's an issue I will look at again.

What seems certain though is that Cyprus cannot come out of this situation as a tax haven. Maybe more important is what is the status it has as a state after the next few days, because if, as seems likely, it loses power over large parts of its economy and

political process what then has it become? That now seems a vital question, because how the remaining hollowed out state is to be viewed is vital to its future and stability and poses many more important questions than any short term bail out can answer.