The Finance Curse

How oversized financial centres attack democracy and corrupt economies

By Nicholas Shaxson and John Christensen

***"Occupation Jersey" (2007)**.*
With kind permission from Pat Lucas, a local artist in the tax haven of Jersey.

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INTRODUCTION

It is now well known that many countries which depend on earnings from natural resources like oil have failed to harness them for national development. In many cases it seems even worse than that: for all the hundreds of billions of dollars sloshing into countries like oil-rich Nigeria, for instance, such places seem to suffer more conflict, lower economic growth, greater corruption, higher inequality, less political freedom and often more absolute poverty than their resource-poor peers. This paradox of poverty from plenty has been extensively studied and is known as the Resource Curse.

This book asks whether some countries with oversized domestic financial centres may be suffering from a similar, and related, phenomenon.

We find strong evidence that the answer is yes – and not just for reasons related to the global

financial crisis that erupted in 2007/8. Perhaps more surprisingly, this phenomenon that we are calling the Finance Curse is similar in many ways to the Resource Curse*:* there are big overlaps in both their causes and their effects.

The Finance Curse has been evident for decades – and if untreated it may well endure for years or even decades after the latest crisis has blown over.

Every economy needs its financial plumbing, and for decades academic studies suggested that bigger is generally better when it comes to financial sector growth. The crisis has called all that research into question. New evidence is starting to emerge from the IMF, the Bank for International Settlements and others, revealing that above a certain size, finance turns bad.

Our book, drawing on our many years of hands-on experience of both resource-dependent countries and finance-dependent ones, goes far beyond the boundaries of their research to create an unprecedented comprehensive body of evidence about the perils of oversized finance.

Despite the trillions flowing into and through the City of London, for instance, Britain performs worse on major human development indicators – inequality, infant mortality, poverty, and more – than Germany, Sweden, Canada and most of its other rich-country peers. Each ailment has many explanations, but oversized finance appears to be a major contributor.

Country capture

The Finance Curse is a story about "Country Capture" – where an oversized financial sector comes to control the politics of a finance-dependent country and to dominate and hollow out its economy. Some elements of this 'capture' are already well understood but our book introduces a wide range of new ideas and analysis.

In large finance-dependent countries such as Britain or the United States, the Finance Curse*'s* causes and effects are masked by background noise in large, raucous democracies. But in the small finance centres and tax havens such as the Cayman Islands or Cyprus, these complexities are stripped away and the phenomenon is laid bare in purer, more crystallised forms which are easier to see and understand.

The tax havens, which we have studied extensively, carry important lessons – and warnings – for larger finance-dependent countries.

The book

This book starts with a brief overview of the Resource Curse. The main sections that follows, on the Finance Curse, start by looking at the most important and most widely publicised claims made by defenders of large financial sectors.

We then examine these claims in turn and reveal why nearly all of them are wrong. Along the way we expose catastrophic errors in studies that claim to demonstrate to policy makers the 'contribution' of finance.

Next, we show that not only is the 'contribution' of finance usually much smaller than advertised, but it is worse than that: a wide and diverse range of harms flow from having an overly large financial centre. One can plausibly say that for many countries, the net 'contribution' of finance is likely to be negative – in some cases strongly so.

The picture is – of course – not a simple one. Many of these effects, particularly the political ones, cannot be quantified. The political damage is probably more acute in small countries hosting financial centres, while in larger countries such as Britain or the United States the damage is probably felt more heavily in economic terms.

And just as some resource-rich countries like Norway or Chile seem to have successfully avoided or managed the Resource Curse, some finance-dependent countries like Switzerland or Luxembourg seem to have tempered or even avoided the Finance Curse.

But some countries such as Britain and the United States genuinely do seem cursed by their oversized financial centres. A sector widely regarded as the Goose that Lays the Golden Eggs often turns out to be a very different bird: a Cuckoo in the Nest, crowding out, hollowing out and undermining other economic sectors. Very often, the interests of the financial centre conflict directly with the national interest.

Our analysis has profound implications. Financiers routinely cry 'don't tax or regulate us too much or you will be 'uncompetitive' and we will run away to Geneva or London or Hong Kong' – and far too often the politicians quail and give them what they want. These threats and fears are perhaps the most important reasons why it is so hard to regulate finance appropriately, and why big banks are bigger and potentially more dangerous today than before the crisis erupted.

Our Finance Curse thesis cuts through this Gordian knot. Taking it on board puts power right back in the hands of democratically elected officials. If too much finance is harmful, then it makes clear political and economic sense to regulate and tax this sector appropriately. If the end result is less financial activity, then that will be beneficial. It is therefore absolutely not necessary to participate in the 'competitive' race on lower standards of financial regulation, and the obvious course of action is national leadership on better standards, even in the absence of collective international agreements.

Finally, this is *not* a book about how global financial centres can transmit damage to other countries, important though that subject is. It is about how an over-sized financial sector can harm its *own* host country.

Quotable quotes

Oil: it is the Devil's excrement… we are drowning in the Devil's excrement

Juan Pablo Pérez Alfonzo
OPEC founder and politician
from oil-rich Venezuela, 1976[1]

If the Cabinet does not have the wit and imagination to reconcile our industrial needs with the fact of North Sea oil, they would do better to leave the bloody stuff in the ground.

Michael Edwardes
chairman of ailing carmaker British Leyland, 1980

Too high a price for oil is bad for an innovation economy. If the price is too high all the engineers will want to work at the banks and at Gazprom.

Viktor Vekselberg
Russian conglomerate owner[2]

Over the past decade, the attitude took hold that what was good for Wall Street was good for the country… a whole generation of policy makers has been mesmerized.

Simon Johnson
former IMF Research Director, 2009

The bankers don't speak for Britain

Vince Cable
UK Business Secretary[3]

1 Interview with Terry Lynn Karl, Caracas, 1976, cited in Karl, *The Paradox of Plenty: oil booms and petro-states*, California, 1997, p4. Karl's books was one of the seminal books about the Resource Curse.

2 Cited in Chrystia Freeland, *Plutocrats: The Rise of the New Global Super-Rich and the Fall of Everyone Else*, 2012

3 Put aside the City's whingeing, Vince Cable, *The Guardian* Dec 20, 2011

Beyond a certain point, financial development is bad for an economy. Instead of supplying the oxygen that the real economy needs for healthy growth, it sucks the air out of the system and starts to slowly suffocate it.

Stephen Cecchetti
author of a Bank for International Settlements study on the issue, 2012

There is no evidence that a much bigger financial sector, relative to the rest of the economy, has led to an improvement in resource allocation or to better returns for savers and investors. If anything, the opposite appears to have been the case.

Tony Dolphin
IPPR, former adviser to UK Treasury

The first action is to downsize the banking sector in the UK

David Potter
ex-entrepreneur and
former senior Bank of England official

Good riddance, I would say.

Martin Wolf
Financial Times' chief economic commentator on risky financial trading activity that tougher banking rules would drive away[4]

When the capital development of a country becomes the byproduct of the activities of a casino, the job is not likely to be well done.

John Maynard Keynes

This quiet cross-subsidy from North and West to South East has been running un-noticed for a long period of time. Its unanticipated result is a kind of regional moral hazard: the metropolitanisation of gains, and the nationalisation of losses.

The Manchester Capitalism blog
collectively written by academics focusing on the UK's regional economic disparities.

4 Banking reforms after the Libor scandal, Martin Wolf's Exchange, FT blogs, July 2, 2012

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1.0 THE RESOURCE CURSE

Introduction

Countries whose budgets depend heavily on natural resources[5] not only tend to fail to harness them for national development, but often seem to be even worse off than their resource-poor peers. Symptoms of the so-called Resource Curse include slower economic growth, a loss of entrepreneurialism and a rise of rent-seeking carpetbagging; reduced economic diversity; more conflict; greater corruption; steeper inequality; more repressive government; and greater poverty.

Researchers disagree over the strength of the "Curse". A weak version merely says that many countries seem not to have been able to harness the windfalls for national development as they should. A strong version holds that natural resources make things even worse than if no resources had been discovered.

There is general agreement that *at least* the weak version of the curse holds as a general rule: study after study shows that minerals like oil certainly do not produce the hoped-for benefits, and they can make matters worse.[6] (Foreign aid inflows can bring about similar effects.[7])

One can use many different metrics to judge performance and some (such as degrees of authoritarianism) cannot easily be measured. Timing is important too: during secular upswings in global commodity prices – as is the case recently – growth figures are inevitably high, due to rising commodity export revenues showing up automatically in GDP figures. Taking a longer view can yield very different results.[8]

Outcomes[9] are also highly varied. Oil-rich and highly developed Norway seems to have escaped the Curse but countries such as recently war-ravaged and corrupted Angola or The Democratic Republic of Congo, by contrast, really do seem cursed by their bountiful mineral resources. It seems that countries that are already well governed are less likely to be 'cursed' by their minerals than poorly governed ones.[10]

The next sections look briefly at the drivers of the Curse, and at the outcomes.

5 Some studies include agricultural raw materials in their definitions of natural resources, though most focus purely on minerals like copper or crude oil.

6 This has been widely studied. One of the seminal studies was Jeffrey D. Sachs' and Andrew Warner's paper *Natural Resource Abundance and Economic Growth* from 1997 which economies abundant in natural resources have tended to grow slower than economies without substantial natural resources. See also Karl, T. L. (1997), 'The paradox of plenty: oil booms and petro states'. University of California Press, Berkeley; or *Escaping the Resource Curse*, Edited by Macartan Humphreys, Jeffrey D. Sachs, and Joseph E. Stiglitz, Columbia University Press, 2007.

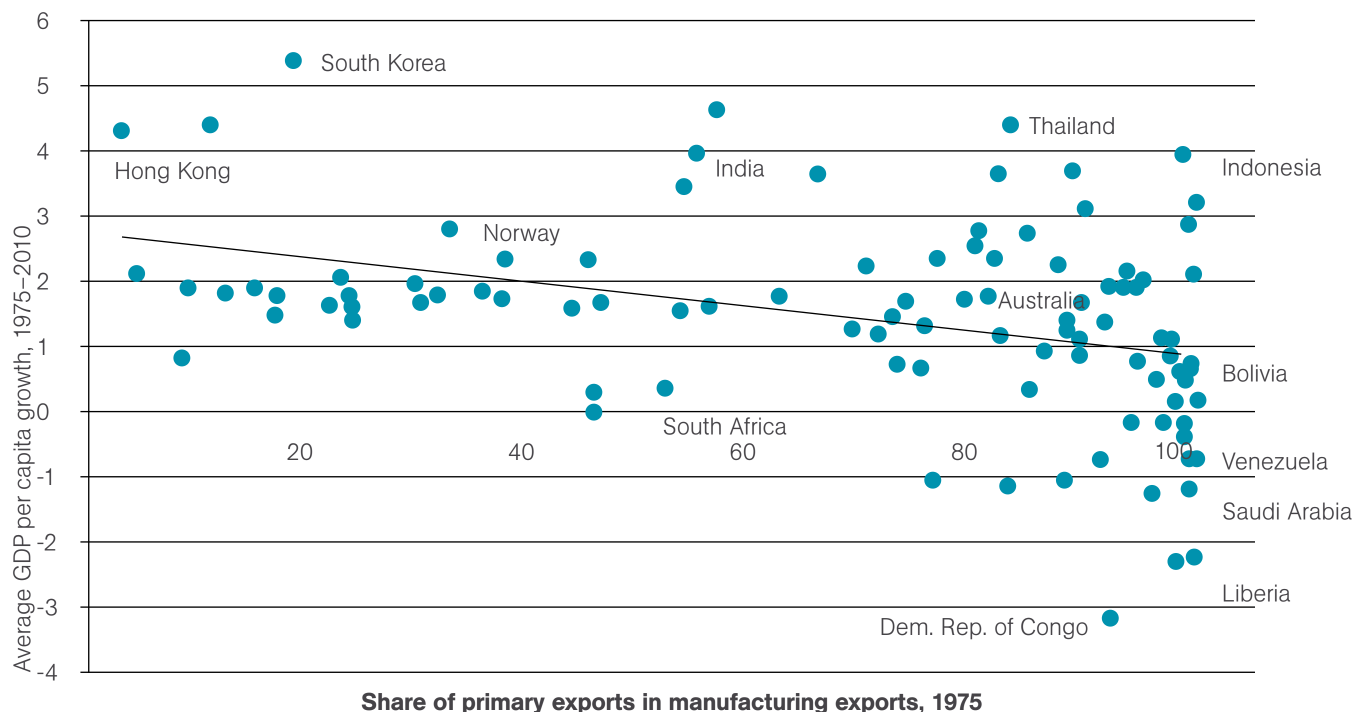
7 See, for example, *Aid and the Resource Curse How Can Aid Be Designed to Preserve Institutions?* By Tim Harford and Michael Klein, World Bank Note No. 291, Apriil 2005.

8 For instance, the World Bank's Africa's Pulse of October 2012 summarises research showing overall poor performance of resource-rich countries for the two decades since 1980, but higher growth in the period 2000-2010, when the price of some commodities rose more than tenfold.

9 Results of studies can also depend on whether one measures dependence on resource exports, instead of resource endowments in the ground For a brief discussion of this, see for example this Resource Curse-skeptical article by Charles Kenny, "What Resource Curse?" in *Foreign Policy*, Dec 6, 2010.

10 See, for instance, *Natural Capital and the Resource Curse*, World Bank Economic Premise, May 2012, Number 83. As they say: "Intangible wealth in the form of governance quality is a key determinant to the outcome of natural resource abundance as a blessing or a curse."

Figure 1. Correlation between GDP growth and resource dependence



Source: *Are Natural Resources Good or Bad for Development?* FREE, Nov 2011. Using World Bank World Development Indicators database

1.1 The Resource Curse: Outcomes

Countries that depend heavily on mineral exports suffer a range of negative outcomes. This section explores these outcomes; the following section explores the drivers behind these outcomes. (Cause and effect are often closely intertwined, making it hard to separate them at times.)

1.1.1 Slower economic growth

Some studies show that countries with abundant natural resources experience slower long-term economic growth than those without.[11] See Figure 1.

Not all studies show this relationship. While few argue that natural resources have been an outright blessing from a growth perspective, there is less agreement on whether the results are broadly neutral for growth or whether matters are worse than that: a clear curse.

Assessments depend quite heavily on where one is in the commodity cycle, or on the time scale measured, or which group of countries is measured, or whether one is measuring natural resource *exports* or natural resource *endowments* in the ground. As a result, consensus in the literature is hard to find.

1.1.2 Crowding-out

In resource-rich economies, alternative sectors such as manufacturing or agriculture tend to be 'crowded out' by the dominant minerals sector.[12] The impacts can be massive. For example, by the turn of the 1970s Nigeria was the world's second producer of cocoa, while agriculture contributed three-quarters of exports. In the 1970s, amid a massive petro-

11 See *Meeting the Challenge of the Resource Curse: International Experiences in Managing the Risks and Realising the Opportunities of Non-Renewable Natural Resource Revenue Management,* ODI / UNDP, January 2006. Graph is taken from p9.

12 This finding, while not unanimous, is commonly argued. For instance, Torfinn Harding and Anthony J. Venables of the University of Oxford argued in a study of 134 countries in 2011 that "Exports of natural resources seem to crowd out non-resource exports, at a rate of around 50 cents to the dollar, while drawing in imports at around 15 cents to the dollar, the remaining 35 cents of revenue going to the capital account." See *Foreign exchange windfalls, imports and exports*, Harding and Venables, Feb 2011.

boom, the total area under active cultivation fell by more than half, and recorded production of major crops fell by a similar amount.[13]

Politicians in every resource-rich country argue routinely for economic diversification – but this rarely happens: instead, dependence tends to grow.

Many of the outcomes and drivers of this crowding-out, discussed in Section 1.2 below, are also found in finance-dependent economies.

1.1.3 Unemployment, poor job creation

As mentioned above, the crowding-out of alternative sectors by a dominant natural resource sector (see above) can cause large-scale unemployment and economic dislocation.

Yet the resource sector does not usually compensate sufficiently for these losses. Sectors like oil production are often capital-intensive 'enclaves' producing relatively few jobs – and shortages of local skills often mean that expatriates fill many of the best jobs. With few productive linkages between the enclave and the wider economy, there is often relatively little "knock-on" job creation beyond a minerals-financed expansion in public sector employment. This often creates a 'curse' from an employment perspective.

Conflict, corruption and rent-seeking (see Sections 1.1.6, 1.1.7 and 1.2.4 below) do not generally harm mineral production rates but they do make it progressively harder to promote alternative wealth-creating sectors, which generally require good governance and stability to prosper. So mineral wealth often makes economies become more flaccid and less entrepreneurial.

Rulers lose interest in alternative non-oil sectors that are struggling to prosper: those who focus on access to the mineral-sourced cash become more prosperous and powerful, while those who focus on 'difficult' sectors become weaker and more marginalised. Boom-bust cycles associated with global commodity price fluctuations worsen matters further: valuable skills are lost permanently, in a self-reinforcing spiral leading to increasing path dependency.

Finance-dependent economies display similar dynamics, though job creation potential in finance can be somewhat greater than (and different to) job creation in mineral sectors.

1.1.4 Inequality, poverty, human indicators

As with finance-dependent economies, nations that depend on natural resources tend to suffer greater economic (and political) inequalities than their peers.[14]

This is partly because resource rents are easily appropriated by élites, and partly because of the death of alternative economic sectors, reducing opportunities for the majority. Conflict and the growth-chilling effects of resource dependence can lead to even greater poverty levels among ordinary citizens than would have been the case had no minerals been discovered. Infant mortality rates, for instance, seem typically to be worse in mineral-rich developing countries than for their non-mineral peers.[15]

Higher levels of inequality are also apparent in finance-dependent economies, often (but not always) for similar reasons.

1.1.5 Authoritarianism, political freedom

Authoritarianism is hard to measure precisely, but mineral wealth can clearly entrench rulers in power, giving them the tools to divide their opponents and the resources to suppress

13 See Nicholas Shaxson, *Poisoned Wells: The Dirty Politics of African Oil,* Palgrave, 2004, p18, and associated endnotes.

14 See, for example, *Poverty, Inequality, and the Local Natural Resource Curse,* Norman Loayza, Alfredo Mier y Teran, Jamele Rigolini, March 9, 2013

15 *Resource curse: An analysis of causes, experiences and possible ways forward*, Paul Stevens, Evelyn Dietsche Centre for Energy, Petroleum and Mineral Law and Policy (CEPMLP), University of Dundee, Scotland, UK, Table 2 and associated analysis, p59. "Our simple assessment would suggest that the experiences of natural resource-abundant countries are rather bad." It should be noted, however, that a plethora of studies on this subject have found mixed results.

dissent.[16] Plenty of anecdotal evidence from rather authoritarian petro-states such as Iran, Russia, Saudi Arabia or Angola is backed by scholarly research that has found significant negative correlations between mineral dependence and political freedom.[17]

1.1.6 Conflict

Natural Resource can and do provoke conflicts within societies, either through secessionist movements (such as in the Angolan enclave of Cabinda) or inside the political system, as factions compete for access to mineral rents. According to one widely cited World Bank study, the risk of civil war in a country where primary commodity exports are equivalent to five per cent of GDP is just six per cent; while that risk rises to 33 per cent once primary commodities make up 25 per cent of GDP.[18] Other studies find less pronounced effects.

16 See, for instance, Thomas Friedman's succinct summary in his First Law of Petropolitics: "the price of oil and the pace of freedom always move in opposite directions." *The First Law of Petropolitics,* Thomas L. Friedman, *Foreign Policy*, April 25, 2006

17 See, for instance, *Does Resource Wealth Cause Authoritarian Rule?* Michael L. Ross, Phil Keefer , Steve Knack , Miriam Lowi, 2000. Ross finds that "oil exports are strongly associated with authoritarian rule; that this effect is not limited to the Middle East; and that other types of mineral exports have a similar anti-democratic effect, while agricultural exports do not."

18 See Table 1.1 in *Natural Resources and Conflict: What We Can Do.*

Ian Bannon and Paul Collier in *World Bank, Natural Resources and Violent Conflict: options and actions,* Ian Bannon Paul Collier editors, 2003

1.1.7 Corruption

The easy economic 'rents' that flow from minerals extraction are particularly prone to corruption and looting by political élites. Research has shown that more corrupt countries tend to have more natural resources, particularly in non-democratic societies.[19] Section 1.2 below explores the drivers of this.

19 See, for example, Sambit Bhattacharyya, Roland Hodler, *Natural resources and corruption: Is democracy the "missing link"?* , VoxEU, 13 November 2009.

1.2 The Roots of the Resource Curse

The standard literature generally identifies three key drivers of the Resource Curse – Dutch Disease, volatility and governance effects; and from these drivers emerge the range of negative outcomes identified in the section above. The governance effects are in turn driven by factors inherent to mineral extraction, as the sections immediately below explain.

Many feedback effects happen between and within these drivers and the outcomes outlined above.

The subsequent Section 2, exploring the Finance Curse, reveals a phenomenon whose drivers and outcomes are in many cases similar to those driving the Resource Curse. Table 1 provides a dramatic pointer to this.

1.2.1 Resource Curse roots: Dutch Disease

The Dutch Disease is named after deadening economic impacts of large natural gas discoveries in the Netherlands from the late 1950s.

Large inflows of windfall money from natural resources raise local price levels: either through appreciation of the nominal exchange rate, or through higher domestic inflation, or both. It is no coincidence that the world's most expensive city is reckoned to be Luanda in oil-rich Angola.[20] Higher local price levels make it harder for local tradable goods and services, typically in agriculture or manufacturing, to compete with imports: so those sectors wither.

The resource sector is typically a capital-intensive economic enclave, with relatively few jobs created and few productive linkages to the rest of the economy, so its growth typically does not compensate for these losses elsewhere, particularly in larger economies.

20 For Luanda see 2011 *Cost of Living survey highlights* – Global, Mercer Consulting, 2011.

As top British industrialist Michael Edwardes said at the time of the UK's North Sea oil boom: "They would do better to leave the bloody stuff in the ground".[21]

As Section 2.6.1 explains, finance-dependent economies can suffer similar effects.

1.2.2 Resource Curse roots: The brain drain

In most resource-dependent economies the highest salaries will be found in the minerals sector, which consequently sucks the best educated and skilled citizens from other sectors, leaving both government sector, and alternative private sectors, bereft of skilled, educated and qualified managers and staff.

These resulting harms result in the "crowding-out" of other sectors, which in turn reinforces mineral dependence.

The brain drain is also a very potent negative factor in finance-dependent economies, as Section 2.6.1 shows.

1.2.3 Resource Curse roots: Volatility

Mineral prices are notoriously volatile. The crude oil price, for instance, has ranged between $10 and 150 per barrel over the past 15 years. For export-dependent economies, this can lead to destabilising surges and stoppages in state revenues.

Some countries are remarkably dependent on minerals: over 99.5 per cent of Angola's exports in 2009 were minerals, according to the IMF, and oil accounted for well over

21 In the wake of a huge financial windfall from North Sea oil following OPEC's 1979 oil price shock, the pound sterling currency appreciated rapidly and manufacturing output plunged by 8.7% and 6% in 1980 and 1981. The quote was from Michael Edwardes, the chairman of carmaker British Leyland, who exclaimed: "If the Cabinet does not have the wit and imagination to reconcile our industrial needs with the fact of North Sea oil, they would do better to leave the bloody stuff in the ground."

70 per cent of government revenues.[22] A rapid doubling of oil prices will overwhelm such a government's absorption capacity, playing havoc with planning and fostering rash spending and corruption. Violent swings in the overall business environment create widespread contract-breaking, damaging business confidence and the rule of law. Economic instability can also generate political instability and even conflict.

Secondary effects exacerbate the problem. Mineral booms also inevitably fuel speculative real estate bubbles, which turn to painful busts when prices fall, amplifying the cyclical economic effects. Borrowing can be similarly procyclical: during booms governments are more creditworthy so their borrowing rises – in line with Mark Twain's observation that "a banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain." When bust comes, the debt overhang becomes unmanageable and debt rises further under penalty arrears, in a ratchet effect.

This volatility problem thus negatively impacts economic growth; job creation; crowding out; inequality and poverty; corruption; and these in turn create further feedback effects.

As the latest financial crisis reminds us, volatility is also a large problem in finance-dependent economies.

1.2.4 Resource Curse roots: Rents

Economic rents are not the result of hard work and skills but are instead free windfalls: what Adam Smith called "the income of men who love to reap where they never sowed." This involves wealth *extraction,* not wealth *creation*. Mineral extraction involves a strong element of rent-seeking: as long as the oil is there, it will squirt obligingly from the ground when tapped (and the revenues may squirt just as obligingly into offshore bank accounts.) A rise in the world oil price, for example, creates additional revenues without any talent or investment or even effort.

When such 'free' income is available, policy makers can lose interest in the troublesome long-term challenges of fostering better agriculture or industry, or educating their citizens. Incentives to create a better local business climate wither too, since the revenues will flow as long as there is a safe pipeline or route for the minerals to reach export markets, secured by military means if necessary.[23]

Potential entrepreneurs turn their attention away from productive activity towards devising ways to get access to a share of the mineral-based windfalls. This harms entrepreneurialism, which harms innovation and job creation.

In such a climate, politics becomes a scramble to obtain the biggest possible share of the revenue "cake", in a zero-sum game. This harms governance and the ensuing scramble thus generates both conflict and corruption, which in turn can worsen authoritarianism, inequality and economic growth.

Significant parts of financial sector activity in finance-dependent economies also involve rent extraction, as Section 2.6.3.1 explains.

1.2.5 Resource Curse roots: "Top-down" money flow

Mineral revenues typically enter at the top of an economic and political system, as a 'point source' generator of income easily controlled by a small élite. The rents are then distributed downwards to supporters in exchange for political support. In effect, the money flows downwards, and political power flows upwards.

22 According to the IMF in 2011, crude oil, refined oil products and diamonds were estimated at US$49.8bn of Angola's US$50.2bn of exports in 2011. The IMF estimated that oil revenues accounted for 24.2% of GDP in 2009, while total revenues accounted for 34.5% of GDP. Dividing one by the other gives about 70 per cent. This is an underestimate, however: the supposedly 'non-oil' sectors in mineral-rich countries like Angola are typically dominated by the construction and domestic finance sectors, which themselves rise and fall in fairly close correlation with oil revenues. For the data, see p27 and p28 of IMF, *Angola—Fifth Review Under the Stand-By Arrangement* December 2011 IMF Country Report No. 11/346.

23 In Angola, for instance, the mostly offshore oil industry was almost never disrupted during the country's long civil war. In the early 1990s, when the United Nations was describing Angola's conflict as 'the worst war in the world', oil companies were signing enormous new contracts for deepwater oilfields, and oil production was rising. (Shaxson was Reuters' correspondent in Angola at the time.)

This basic bargain becomes a key (or *the* key) way in which political power is exercised, and this conflicts with democracy and the rule of law.[24]

Governments do not really 'need' their citizens to raise revenue, and if citizens are unhappy then the mineral wealth can pay for military force to crush dissent.

This contrasts with a more 'normal' economy where a diverse array of economic actors in manufacturing, agriculture, tourism, teaching, healthcare and other productive sectors add genuine value at the 'bottom' or grass roots level. They interact through many 'horizontal' and co-operative relationships, which can reinforce the social fabric and create more distributed sources of power.

In this scenario, citizens generate wealth and rulers must bargain with them for tax revenues, in a healthy 'no taxation without representation' relationship that encourages the search for common solutions to shared problems.[25] Tax revenues flow upwards from people to rulers, who must concede power downwards to people in exchange. This helps build accountability.

In crude summary: tax makes rulers accountable to citizens, foreign aid makes rulers accountable to donors, and oil makes rulers accountable to nobody.[26]

This dynamic helps directly explain the Resource Curse symptoms of authoritarianism, inequality, and corruption. These in turn slow down economic innovation, growth and job creation and lead to crowding-out and even conflict.

Financial sectors, particularly small ones where there are few alternatives, also see this top-down dynamic in action, as Section 2.6.3.4 explains.

1.2.6 The 'scramble', or the contemptible struggle

When political relationships are more 'vertical' than horizontal as a result of the top-down flow of resources (as the previous section explains), politics becomes the art of fighting for a share of the cake. This can lead to overt civil war, such as "resource wars" in Sudan or the Democratic Republic of Congo, or smaller secessionist conflicts, such as in the oil and gas-rich Indonesian province of Aceh or Angola's Cabinda enclave, or violent, godfather-based turf wars such as in Nigeria's Niger Delta. More commonly, however, the conflicts happen inside or between government ministries and state oil companies, as political actors seek access to resources before anyone else can get their hands on them. This 'scramble' can perhaps best be understood with the analogy of a queue, as Box 1 explains.

---

24 One of the more dramatic examples is how political 'godfathers' in Nigeria pay armed supporters to raid oil facilities, and find ways to profit from these actions. Co-author Shaxson's 2007 book *Poisoned Wells* explores this in great detail.

25 The relationship, with respect to a 'normal' economy, has been summarised concisely as follows.

"The political importance of taxation extends beyond the raising of revenue. We argue in this book that taxation may play the central role in building and sustaining the power of states, and shaping their ties to society. The state-building role of taxation can be seen in two principal areas: the rise of a social contract based on bargaining around tax, and the institution-building stimulus provided by the revenue imperative. Progress in the first area may foster representative democracy. Progress in the second area strengthens state capacity. Both have the potential to bolster the legitimacy of the state and enhance accountability between the state and its citizens.'

See *Taxation and State-Building in Developing Countries: Capacity and Consent*, ed. Deborah Brautigam, Odd-Helge Fjeldstad, Mick Moore, Cambridge University Press, 2008

26 As the World Bank put it: "The dominance of oil revenue has reduced the Government's incentives to rely on non-oil tax revenues for the financing of its activities. This means that the relationship between the Government … and its people is less based on the normal "social contract" arising from a better functioning taxation system." This was written about Angola but as a summary of the Resource Curse literature. See *CSR in the Oil Sector in Angola: World Bank Technical Assistance Study, World Bank, 2003*

BOX 1: THE QUEUE

Nicholas Shaxson's book *Poisoned Wells* cites the Nigerian author Chinua Achebe:

> *Achebe: "A normal sensible person will wait for his turn if he is sure that the shares will go round; if not, he might start a scramble.*
>
> *Nigeria is a bit like the queue that Achebe suggests. A functioning queue is really two queues: a physical one and a mental one. Disrupt the physical queue–by nudging a truck through it, say, or dousing it with a fire hose–and if the mental queue remains intact, then order will re-emerge, in the same way that stable countries recover from economic shocks or terrorist attacks.*
>
> *But there is a more damaging way to disrupt a queue: push in at the front. This assaults everyone's belief in it, and if it happens enough, the scrambling starts and it will collapse. There is then no easy way to rebuild it.[1]"*

The more the queue collapses into a scramble, the more corruption people perceive, and the less sense it makes to stand obediently in line. (Remember, too, that each individual police official is also in the queue.)

What is more, if members of competing ethnic or other groups stand in line, antagonisms are sharpened[2] and the scrambling intensifies. As corruption increases, society becomes more conflicted and fragmented, in a self-reinforcing cycle. Ultimately, this results from the top-down flow of money.

1 See *Poisoned Wells: the Dirty Politics of African Oil,* Nicholas Shaxson, Palgrave, 2007. For a further development of the ideas of fragmentation, see *There Will be Blood*, Nicholas Shaxson, Foreign Affairs, Sept / Oct 2008, and in greater detail, *Oil, corruption and the Resource Curse*, Nicholas Shaxson, International Affairs (Chatham House), Oct 22, 2007

2 Separatist movements in mineral-rich zones are an extreme (and common) example of this, and any examination of the discourse of Nigerian politicians, say, will find a regular pattern of antagonism towards other factions or groups which are taking an 'unfair' share of the cake. Pressures for Scottish independence from the United Kingdom are fueled by exactly this dispute over North Sea oil.

Viewed this way, it becomes apparent that corruption and conflict are, in an important sense, two sides of the same coin.

The scramble tends to worsen authoritarianism too, with the ensuing political fragmentation making it harder to create credible political alliances that can resist being 'bought off' by rulers, bringing to mind Edmund Burke's famous quotation: "When bad men combine, the good must associate; else they will fall one by one, an unpitied sacrifice in a contemptible struggle."

1.3 Norway: a counter-example?

Norway appears to have prospered despite – perhaps even because of – its oil. It seems to have outperformed other Scandinavian countries since its oil boom started in the 1970s. At risk of over-simplifying, two related factors seem to explain its performance.

Norway set up an oil reserve fund, which "sterilised" the inflows by keeping the oil money outside the economy and thus serving as a buffer against the Dutch Disease and against revenue volatility. It also serves as a savings mechanism for future generations[27] that is kept under close scrutiny by a robust and free media.

Norway was also a country with well-developed and strong institutions before the oil boom began. Well aware already of the risks from rent-seeking, volatility and the Dutch Disease, Norway was politically strong and sufficiently stable to put in place measures to insulate itself from the destabilising effects of oil and redistribute windfalls equitably.

Its strategies here include:

i) centralised wage formation and income co-ordination;

ii) a 'local content' policy of trying to build up domestic supply chains for the oil industry;

iii) heavy investment in education, research and development;

iv) active countercyclical economic policies, with help from the oil fund;

v) other labour market policies;

vi) other industrial policies to diversify exports; and

vii) expansion of the public sector to boost employment.

Oil funds have had only patchy success in other countries, particularly for those with weak institutions which find it hard to summon up the tremendous effort of collective self-discipline required to defer spending today in order to pay money into the savings fund. In other words, those countries that need a fund the most have found it hardest to set them up. This is because resource revenues tend to foster conflict and patronage which militate directly against such collective self-restraint and self-discipline, especially in countries with weak institutions in the first place.

Just as the Resource Curse has clear counter-examples, so Section 2.4.10 looks at Switzerland as a possible counter-example to the Finance Curse.

Summary

The causes and outcomes outlined here strike each resource-dependent country in a different way, and some countries appear to have mitigated or even avoided a curse. However, the weight of evidence points to a Resource Curse in many countries, particularly poorer and less well governed countries. Many of the outcomes from, and causes of, the Resource Curse are also found in finance-dependent economies.

27 See, for example, *When and Why Norway Caught Up with and Forged Ahead of Its Neighbors," American Journal of Economics and Sociology* 65 (July, 2006), 605-640.

2.0 THE FINANCE CURSE

A pound spent in Croydon is of far more value to the country than a pound spent in Strathclyde. You will generate jobs and growth in Strathclyde far more effectively if you invest in Hackney or Croydon or in parts of London.

Boris Johnson, Mayor of London (and *de facto* financial sector lobbyist), April 2012[28]

2.1 Introduction to the Finance Curse: A *Prima Facie* Case.

For decades many people considered it self-evident that expansion in a country's financial sector broadly benefits the local economy. This assumption is intuitively so attractive that many still believe it, despite all that has happened in the recent global financial crisis.

Yet evidence is accumulating that above a certain size, financial sector growth fails to deliver expected benefits to a country, and can even harm it. Now, following the global financial and economic crisis of recent years, many people feel instinctively[29] that this is true.

Figure 2 below colourfully illustrates the problem.

The data here comes from the United Nations' Human Development Index (HDI), which ranks countries according to three indicators of national development: education, life expectancy and income per capita. The UNDP provides a statistic called "GNI per capita rank minus HDI rank" which takes a jurisdiction's HDI rank (to illustrate, where highly developed Norway is ranked 1) and subtracts this from its GNI per capita ranking. A negative number, indicating that its GNI ranking is worse than its HDI ranking) suggests that the country's wealth may not be feeding through into true human development.

28 Job Creation Should Be The Mayor's Top Priority, Concludes LinkedIn Poll, Huffington Post UK, 28/04/2012. Johnson's comments occur about 3.00 minutes into the video.

29 For instance, recent Pew Research revealed that "just 36% of people say Wall Street helps the economy more than it hurts it; 51% say it hurts more than it helps." See, for instance, *77% – Public Views of Inequality, Fairness and Wall Street, Pew Research, Jan 2012*

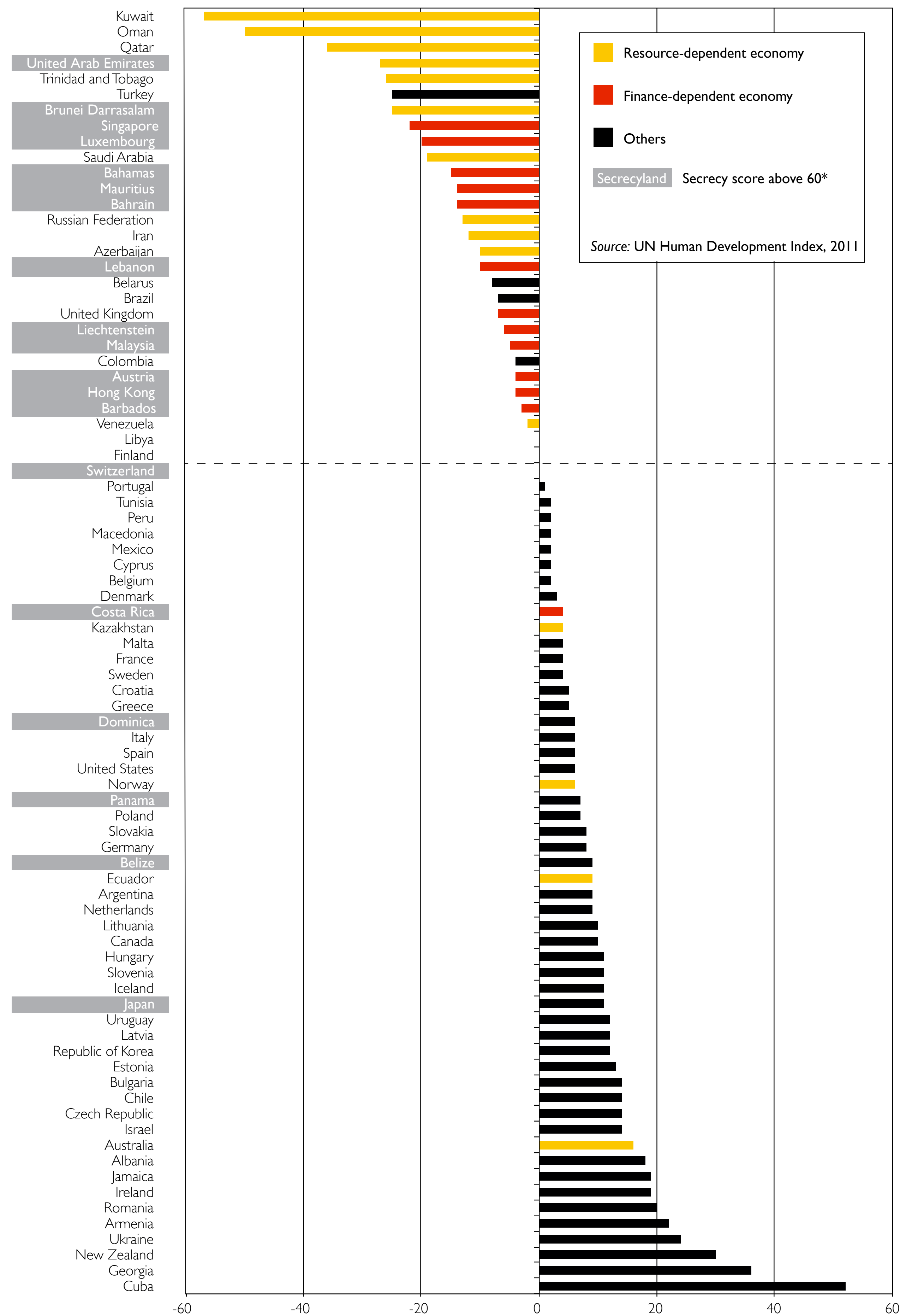
Although not an especially scientific measure,[30] the pattern that emerges is striking: the poorest performers tend to be resource-dependent economies or finance-dependent ones.

This table shows just one aspect of economic development. The rest of the book explores a wide array of other aspects – some of which are impossible to measure – and shows that they are all bound together in a core phenomenon we call Country Capture. The next short section, the central element in this book, explores this.

Section 2.3 that follows will then look at the case for finance: the arguments that are used to justify having large and 'competitive' financial centres. This will be followed by Section 2.4, which examines these arguments in detail and shows why these claims are largely bogus. Section 2.5 then explores in detail the range of harms that flows from overdependence on finance, and concludes that there is a strong case to say the Finance Curse is real, and powerful.

30 Human Development Index and its components, United Nations Human Development Report 2011. The "GNI ranking minus HDI ranking" is not our construction but the UNDP's. The table should be treated merely as illustrative – but the pattern is clear enough to be worth showing. One failing of the UNDP's methodology is that by subtracting one ranking from another one is using ordinal numbers (1, 2, 3, 4 …) when a closer comparison would look at the underlying data (based on cardinal numbers, which may involve different orders of magnitude). In addition, the HDI incorporates an income per capita component (given a weighting of one-third in the index), which muddies the comparison somewhat –though by doing this the current HDI tends to flatter countries with high income per capita: so removing this complication would tend to make our graph even more dramatic. Some commenters on drafts of this paper also expressed doubts about the methodology of the UN's Human Development Index itself. Note that this chart takes only those countries exhibiting high or very high human development, for which the relevant data is available. This is because finance-dependent economies are found exclusively in these higher-income categories.

Figure 2: GNI per capita rank minus human development rank



* From the Financial Secrecy Index

2.2 The Core Narrative: Country Capture

The Finance Curse is a complex, multi-layered set of phenomena bound together into a phenomenon that we call 'Country Capture.' Many of the phenomena that make up Country Capture resemble elements of the Resource Curse.

This section briefly summarises the two kinds of capture. Each is explored in detail in the rest of the book.

2.2.1 Economic Capture

Finance-dependent jurisdictions suffer Economic Capture from finance, which has two core elements: financial growth, and crowding-out.

2.2.1.1 Economic capture: Crowding-Out

This book finds that an oversized financial sector can act like a cuckoo in the nest, 'crowding out' other sectors, notably manufacturing, agriculture and tradable non-financial services. This, in turn, happens in various ways, the first two of which will be very familiar to students of the Resource Curse:

- **The Dutch Disease**, where financial sector growth raises local price levels and makes it harder for alternative tradable sectors to compete in world markets (See Section 2.6.1);
- **Brain Drain**. Higher salaries in finance suck the most skilled and educated people out from both government and the non-finance alternative private sectors, damaging both (See Sections 2.4.4 and 2.5.1.3); and
- **Financialisation:** a rising role for financial motives, financial markets, and financial actors and institutions in the economy. Financial activities start to take precedence over and damage genuine productive activities, as the financial sector generates its own endogenous growth, involving money creation and rent extraction. (See Section 2.5.1.5.)

Various other factors covered in this book contribute to the crowding-out.

Country Capture can be summarised simply:

Country Capture = Economic Capture + Political Capture.

2.2.1.2 Economic capture: financial growth on steroids

Adding to the crowding-out, finance has grown faster than broad economic growth – far faster in some cases. This involves two related processes:

- Financialisation of the domestic economy.
- Rapid growth in international financial operations.

Sections 2.5.1.5 and 2.6.3.3 below explore this further.

2.2.2 Political capture

The political capture of jurisdictions by financial élites is widely researched and reported. The phenomenon was encapsulated succinctly in the title of the above-mentioned U.S. article, *The Quiet Coup*, by former IMF Chief Economist Simon Johnson.[31] This capture generally involves a sophisticated political and societal consensus shaped by a usually rather deferential media. We add two new elements to this.

31 See also Johnson's book 13 Bankers, Johnson describes three main channels through which the financial sector influences government policy: a) the revolving door; b) campaign contributions; and c) ideology. We would agree but add 'economic capture' to his analysis. See also the U.S.-focused film documentary Inside Job.

First, smaller financial centres or 'tax havens', where finance can comprise 50 per cent or more of GDP (versus 10 per cent or so in the UK or US) provide striking evidence of the negative effects of financial dependence. Here, the 'capture' of the political realm by one sector is more conspicuous, and the financial consensus can veer towards authoritarianism. In what follows we use these smaller financial centres to isolate the curse in an acute, purified form, so as to understand its general characteristics better.

Second, we explore how skittish global capital demands a particular kind of political and economic 'stability' – that is, insulation from the vagaries of domestic politics – if is not to relocate elsewhere. Several though not all aspects of this demand for 'stability' are harmful.

This economic capture creates very strong problems of path dependency, meaning it is hard to reverse – as Sections 2.5.1.3 and 2.5.1.4 below explain.

The political and economic processes involved in Country Capture reinforce each other in feedback loops. For example, political capture ensures that state resources are increasingly directed towards supporting the 'easy' dominant sector, at the expense of more 'difficult' alternative sectors, reinforcing economic capture. Meanwhile, damage caused to non-financial sectors increases the political weight and influence of finance. And, as with the Resource Curse, a financial focus on rent-seeking (Section 2.6.3.1) displaces genuine productive and entrepreneurial activity, further weakening alternative sectors; at the same time easy economic rents from finance weakens government officials' incentives to create a conducive environment for alternative sectors to flourish. And so on.

Effective policies can counter this Country Capture. But Country Capture will make it much harder to find the political will to put such policies in place.

2.3 The case for finance

Can finance be harmful? Actors in the financial sector and their defenders make a series of arguments in defence of both having a large financial centre, and having what they call a 'competitive' financial centre. The arguments are generic though this section focuses quite heavily on the UK and the City of London.

This section outlines ten arguments made in defence of finance. These arguments and associated stories help financial centres create powerful narratives that they are the 'engines' driving the local economy and must therefore be fiercely protected against 'excessive' tax and regulation which will lead to a 'tipping point' that will 'destroy the local economy'.

The subsequent Section 2.4 critically examines these claims.

2.3.1 We need finance!

All countries need effective, well developed financial sectors for development. As the Austrian economist Joseph Schumpeter put it:

> *Bankers are the gatekeepers of capitalist economic development. Their strategic function is to screen potential innovators and advance the necessary purchasing power to the most promising.*

2.3.2 Finance makes you rich

Defenders of large financial sectors commonly highlight evidence such as the table below, showing the heavy representation of finance-dependent economies among the world's richest countries. Table 2 illustrates the issue.

Table 1: Who is the richest?

Rank	Country	GDP per capita (at PPP)
1	Qatar	$ 98,900
2	Liechtenstein	$ 89,400
3	Luxembourg	$ 80,600
4	Bermuda	$ 69,900
5	Singapore	$ 59,700
6	Jersey	$ 57,000
7	Falklands	$ 55,400
8	Norway	$ 53,400
9	Brunei	$ 49,500
10	Hong Kong	$ 49,400
11	United States	$ 48,300
12	United Arab Emirates	$ 47,700
13	Guernsey	$ 44,600
14	Switzerland	$ 44,500
15	Cayman Islands	$ 43,800
16	Gibraltar	$ 43,000
17	Netherlands	$ 42,000
18	Kuwait	$ 41,700
19	Austria	$ 41,600
20	Ireland	$ 40,800

Source: CIA World Factbook, 2012. **Red** indicates a finance-dependent economy. **Yellow** indicates mineral dependence

This would appear to show, at least on the face of it, that a big financial sector is a route to prosperity – directly contradicting the Finance Curse thesis.

2.3.3 The tax contribution.

TheCityUK, a leading UK financial lobbying organisation backed by the City of London Corporation, provides the following data on the tax contribution of the UK financial sector:

> *The estimated total tax contribution of financial services in the UK is £63bn (2011/12), the largest contribution by any sector, accounting for 11.6% of total tax receipts.*[32]

32 The *Regional Contribution of UK Financial and Professional Services*, TheCityUK, Jan 2013. Unless otherwise indicated, subsequent citations of TheCityUK data are sourced to this report.

Over a longer period, the contribution appears equally impressive.

Table 2: The tax contribution from the UK financial services sector

Year	Total tax contribution £bn	Of which: corporation tax
2011/12	63.0	5.4
2010/11	63.0	7.2
2009/10	53.4	5.6
2008/9	61.4	7.7
2007/8	68.0	12.2
2006/7	67.8	12.4
Total	376.6	50.5

Sources: PWC, TheCityUK, International Financial Services London

TheCityUK reports (and their antecedents) are widely reported in the media as evidence of the sector's gigantic tax contribution.

2.3.4 The jobs contribution

TheCityUK adds:

> *The 1,071,200 employed in UK financial services at the end of 2011, was up 22,200 on the previous year. A further 987,300 were employed in related professional services. The combined total [2.05 million jobs] is responsible for some 7.2% of total UK employment.*

2.3.5 The GDP/growth contribution

TheCityUK:

> *UK financial and professional services contributed £194.9bn to the UK economy (2011), accounting for 14.5% of total economic output (financial services 9.6%, professional services 4.9%).*

2.3.6 The Regional Contribution

TheCityUK cites a tremendous regional contribution from the financial services centre. Here is its take on employment, with nearly 1.4 million jobs cited as being created outside of London:

Table 3: financial sector jobs, per UK region

Region	Employment, 000 jobs
London	663
South East	243
North West	218
Scotland	148
South West	147
Yorkshire + Humber	144
East of England	139
West Midlands	138
East Midlands	74
Wales	61
North East	50
Northern Ireland	31
TOTAL	**2,058**

Sources: TheCityUK, 2013

TheCityUK has also produced data showing all the UK regions except for Greater London as being in fiscal deficit, portraying the home of the financial sector as an 'exporter' of money to the regions[33] to the tune of an average of £17 billion over the decade to 2008/9.

33 See Table A8 in *London's Competitive Place in the UK and Global Economies*, City of London Corporation / Oxford Economics, January 2011.

From TheCity UK:

> *London's economy continues to make a substantial net contribution to the UK Exchequer, with tax revenues from London exceeding spending in the greater London region.*

Such claims potentially have a potent political impact. As one influential commentator said:

> *The subsidy from London and the South East to the rest of the country is truly astonishing… This area needs its own party. It needs a leader who believes that the striving classes in the South are overtaxed and overburdened.*[34]

2.3.7 The efficiency contribution

It is often claimed that large financial sectors promote efficiency, by providing essential liquidity and smoothing the flow of capital around an economy.

2.3.8 The trade surplus contribution

TheCityUK again:

> *Financial organisations in the UK [contributed] £47.2bn in 2011, which represents around 3% of GDP. This is larger than the combined surplus of all other net exporting industries in the UK.*

2.3.9 "It's all we've got!"

Smaller islands such as Caribbean tax havens or landlocked states like Liechtenstein present a simple argument: what other competitive advantage do we have? What else would we do? Finance is our only possibility for development.

Versions of this can be found in the discourse in larger financial centres like the UK and even the U.S.

2.3.10 "What about Switzerland?"

Switzerland, a prosperous, highly developed country with a big financial sector is likely to be cited as strong evidence against this book's conclusions.

34 Kelvin MacKenzie, *The Telegraph* 2 December 2012

2.4 The Bogus Claims

The above claims and various associated studies, often sponsored in one way or another by financial actors, massively overstate the true, meaningful contribution made by supporters of the financial sector – and this is true even before we consider the harms that may flow from finance. One might even call these claims a form of benefits fraud.

Probe beneath the numbers, and the picture changes completely. As the authors of one landmark study on this subject put it:

> *This narrative – which did convince politicians, civil servants, regulators, and leaders of financial institutions themselves – does not pass the test of evidence.*[35]

There are several reasons why this narrative is not just wrong – but comprehensively wrong, as this section explains.

Let's address each claim in turn. Again, the analysis below focuses on the UK, though similar calculations could be made for other finance-dependent jurisdictions.

2.4.1 How much finance do we need?

We fully accept the important contribution of finance to economic development. The core thesis of this book is not that finance is bad *per se*, but that *above a certain level*, financial sector growth can be harmful.

Certainly, the financial sector seems to have massively outgrown its 'utility' role servicing the domestic (and, at times international) productive economy.

One example involves the technology giant Apple, which in May 2013 raised $17 billion in a bond issue – despite having $143 billion sitting in reserves on its balance sheet. It did this for reasons of tax-related financial engineering, and John Kay in the *Financial Times* uses this episode to make a more general point about modern capital markets.

> *When large companies do access capital markets, the reasons – as in Apple's case – more likely relate to financial engineering, or the acquisition of existing assets, than to new investment. Their corporate treasurers may be trying to make a turn on foreign exchange or on credit risk or yield curve differentials. Mostly these activities are only tenuously related to the operations of the company.*
>
> *Nevertheless, company executives are far more attentive to capital markets than they were. Great industrialists once viewed markets with disdain. It is hard to imagine Alfred Sloan of General Motors or Harry McGowan of ICI making regular checks on their company's share price, still less taking time out of their schedules to schmooze junior analysts at investor conferences.*
>
> *Capital markets are no longer mechanisms for putting money into companies, but mechanisms for getting money out.*[36]

An astonishing 2013 statistic from McKinsey & Co highlights how the functions of finance have changed, on a global level.

> *Several unsustainable trends—most notably the growing size and leverage of the financial sector itself—propelled much of the financial deepening that occurred before the crisis. Financing for households and corporations accounted for just over one-fourth of the rise in global financial depth from 1995 to 2007—an astonishingly small share, since providing credit to these sectors is the fundamental purpose of finance.*

35 After the *Great Complacence: Financial Crisis and the Politics of Reform* by Ewald Engelen, Ismail Ertürk, Julie Froud, Sukhdev Johal, Adam Leaver, Michael Moran, Adriana Nilsson & Karel Williams, Centre for Research on Socio Cultural Change, University of Manchester, Oxford University Press, 2011. The book notes that the City Corporation's figures are "frustratingly incomplete" and the employment contribution of finance is peculiarly difficult to understand and measure from the available figures. The narrative they refute centres on the tax contribution and the employment contribution of UK Financial services.

36 *Why business loves capital markets, even if it doesn't need capital,* John Kay, *Financial Times*, May 14, 2013

It is even more surprising given that this sector's share includes large increases in the volume of mortgage lending during the housing bubble in several large economies.[37]

The section on financialisation in Section 2.5.1.5 takes this further.

2.4.2 Does finance really make you rich?

The ranking of countries by GDP per capita in Table 1 (Section 2.3.2 above) does not lead to the conclusion that "finance makes you rich" – for three big reasons.

The **first reason** is massive selection bias: correlation does not imply causation. Finance inevitably gravitates towards countries that are *already* well-governed and wealthy. Who would park their savings or financial vehicle in Somalia just because it offered a fabulous new secrecy facility or clever trust law? This same selection bias would be evident in many other tables one might construct, such as those based on Human Development Indicators.

Our Figure 2 above showing "GNI per capita ranking minus HDI ranking" helps address this, even if the ranking is a relatively imprecise measure of performance. Finance-dependent economies seem to be failing to turn high GDP per capita into true human development. Many other dimensions of development beyond GDP per capita must be considered; finance-dependent economies tend to perform surprisingly poorly in many respects, as the sections below illustrate.

Second, GDP per head is a very imperfect measure of performance, since the financial sector tends to increase economic inequality substantially. Experience and research shows that large wealth accruing to the top echelons of society, notably from the financial sector, are accompanied by economic stagnation for the (much larger) middle and poorer sections.

Third, consider a small finance-dependent jurisdiction such as the Cayman Islands. A very large share of the value added being measured is generated by the activities of skilled (typically white, male) expatriates imported from overseas. (Or, to cite one particularly strong example, it is estimated that fewer than 10 per cent of Dubai's working-age population are nationals:[38] both highly-paid finance professionals and low-paid workers.) Whether importing foreigners who are denied full citizenship constitutes 'national development' is a matter for debate. The benefits for established indigenous people are typically obtained substantially through trickle-down effects and "indigenisation" policies for foreign businesses, which are invariably contentious. But these benefits are not what Table 2 above measures. (Sections 2.4.4 and 2.5.1.3 below examine this further.)

Most of the other claims for finance made in Section 2.3 above are fatally flawed by two big factors, as Box 2 and the rest of Section 2.4 below explain.

2.4.3 What is the real tax contribution?

As mentioned above, the City of London/ TheCityUK and PWC show an apparently magnificent 'total tax contribution' of the financial sector, at £376.6bn for the six years to April 2012, or an annual average £62.8bn.

Box 2 notes that these numbers must be scaled drastically downwards for policy purposes, for a total tax 'contribution' of around £20 billion per year.

37 See *Financial globalization: Retreat or reset?* McKinsey Global Institute, March 2013, by Susan Lund, Toos Daruvala, Richard Dobbs, Philipp Härle, Ju-Hon Kwek, and Ricardo Falcón. "Financial depth" in the report means total financial assets relative to GDP: a ratio that grew from 120 per cent in 1980 to 355% in 2007. The widely accepted failure of the UK's "Funding for Lending" scheme also suggests how ineffective the financial sector has been at providing loans to small and medium enterprises. The other components of financial deepening include financial sector assets (bond issues by financial institutions grew to US$39 trn in 2007, roughly five times the issues by nonfinancial corporations;) along with government debt and "equity market valuations rising above long-term norms–gains that were erased in the crisis." Sections 2.5.1.4 and 2.5.1.5 below discuss these issues further.

38 See *Edifice Complex, The Economist*, Jan 5, 2013. Many are, admittedly, employed in non-financial jobs such as construction, but this in turn is heavily finance-dependent. TheCityUK estimates that "There are more head offices of banks in London than in any other place in the world. These banks employ around 150,000 people, 40,000 of whom have a foreign passport."

BOX 2: TWO FATAL FLAWS IN THE LOBBYISTS' ARGUMENTS

1. The Net versus Gross problem

Here lies one of the great misconceptions about the 'contribution' of finance outlined in Section 2.3: the taxes raised, the jobs created, and so on.

The lobbyists invariably provide gross numbers for this – but it makes no sense for policy makers to pay any attention to gross numbers: it is always the net figures they should consider. Once one takes into account the bailouts, the crowding-out, the loss of entrepreneurialism, the financial instability, and many other harmful impacts from oversized finance (see Section 2.5 below) – the net number will be far smaller and may well be negative. This book argues that in Britain's case, it is strongly negative.

In addition, an even bigger factor in the net/gross calculation is that oversized financial sectors tend to crowd out other sectors. So if a country's financial sector were to be smaller, most people currently employed in finance would have found productive employment elsewhere: these highly-paid financial sector players tend to be the country's brightest and best educated citizens. It seems likely that in many cases oversized finance has reduced net employment, tax contributions and so on in the long term.

2. Mobile and immobile finance: what will move?

The central threat repeatedly made by financiers to justify less financial regulation goes along the lines of "don't tax or regulate us too much or your financial centre will become less 'competitive' and we will relocate to Zurich or London or Hong Kong." But every time policy makers and regulators hear this threat they must remember: the financial centre is composed roughly of two parts. First is the immobile part, which is rooted in the local economy and cannot and will not leave in response to stronger financial regulation. The second is the flightier mobile part, which could potentially be prone to departure.

So when policy makers and regulators worry about the 'competitiveness' of, say, the local financial centre they must consider only the mobile part to be at risk of relocation, and disregard the locally-rooted immobile part. For the purposes of policy making, these must be regarded as separate sectors.

The question then becomes: how much of the financial sector is mobile? Data from the United Kingdom provides a useful benchmark.

In Section 2.3.3 above, TheCityUK estimated that UK financial services contributed £63 billion in tax revenue in the 2011/12 financial year, and that of this £63bn "£20bn is mobile and could move from the UK."[1]

So we calculate that if financial regulators and other policy makers are worried about the 'competitiveness' of the financial sector, they must consider only 20/63, or about 32 per cent of the published numbers for the City of London's gross "contribution," for policy purposes. This can be applied not just to figures for the tax contribution, but to other figures such as employment.

This 32 percent share is obviously a very rough rule of thumb but it is a far better approximation than the 100 percent figure TheCityUK would like us to take on board. What is more, this share should be considered an extreme upper limit, for several reasons. First, TheCityUK and the City of London Corporation which collaborate to put together this data are official lobbying organisations[2] whose standard modus operandi is to frighten impressionable politicians and journalists about the "competitive" threat that financial regulation might pose to local jobs and so on. So the £20 billion figure, which TheCityUK stated without providing any identifiable

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1 This figure from TheCityUK's December 2012 newsletter, emailed to the authors by Chris Cummings, Dec 21, 2012. The report cited is *Competitiveness report: an 'amber warning' on attractiveness of UK to financial services companies*, TheCityUK, Nov 9, 2012.

2 The first line of the "About Us" section on TheCityUK's website states that "TheCityUK champions the international competitiveness of the financial services industry." The president of its Advisory Council is the Lord Mayor (of the City of London Corporation), whose principal role, he says, is "as ambassador for all UK-based financial and professional services." Genuine independent research on the City of London Corporation is extremely sparse; one useful guide is *The Role of the City of London Corporation and Lord Mayor in the Global Financial Crisis*, by Ingrid Hauge Johansen, 2012.

BOX 2: CONTINUED

methodology, is likely to have been inflated to maximise the potential for scaremongering.[3] Second, other pointers suggest strongly that the 32 per cent scale-down factor for the UK may be far too generous to the City of London: a figure of 20 per cent may be more justified.[4] Third, contrary to received wisdom, even if financial institutions based in the UK do shift substantial activity overseas, much of this will be retained in the UK tax net because of so-called Controlled Foreign Company (CFC) rules and capital adequacy rules, which make it hard to shift a lot of profits overseas for tax purposes. Furthermore, talk is cheap and there is enormous evidence that financiers' threats to relocate abroad if taxes are raised or regulation tightened are almost never carried out when their bluff is called.[5]

Even so, we will take a cautious view and use this 32 per cent extreme upper limit as the basis for our calculations in Section 2.4 below.[6]

To summarise: for the purposes of debate, analysis and policy making, the mobile and the immobile sectors must be considered as separate sectors. To make a political case for the importance of a 'competitive' financial sector, one must strip out all the data from the locally-focused, relatively immobile 'utility' sector, and consider only the immobile sector. From these scaled-down numbers, we can then subtract other costs to reach a net 'contribution.'

A note on 'casino' and 'utility'

The mobile/immobile distinction is similar to another rough analytical distinction that is commonly made in finance: between the 'utility' sector (the essential financial plumbing of an economy: offering ATM services, taking deposits, cashing cheques, financing local businesses and so on), and the 'casino' sector (the banks' speculative proprietary trading side that has been heavily implicated in the wake of the global financial and economic crisis[7]).

The utility is generally rooted in the local economy and is therefore immobile, while the casino is involved in both the mobile and the immobile sectors. The overlap here is certainly not at all exact, but it is a reasonable approximation.

We suggest that a financial centre becomes oversized and the Finance Curse starts to afflict a country once the financial centre outgrows its utility role and expands into the casino sector. (This is not proven, but it fits all the evidence.) So higher capital requirements or other essential financial regulation will not put the more useful 'utility' parts of the sector at any 'competitive' risk: only the more harmful 'casino' parts will be in play. In short, appropriate tax and regulation will not only make the financial system safer – it will make the entire local economy more competitive too.

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3 In the United States, where a similarly sized financial sector is diluted in an economy that is over five times the size of Britain's, one would scale down financial lobbyists' statistics about the gross contribution of the financial services sector by a much greater factor than in the UK, since the less mobile 'utility' sector serving the domestic U.S. economy would loom far larger as a share of financial activity, and the relevant 'mobile' sector proportionally smaller. In smaller countries and tax havens, the scale-down factor would be smaller than for the UK.

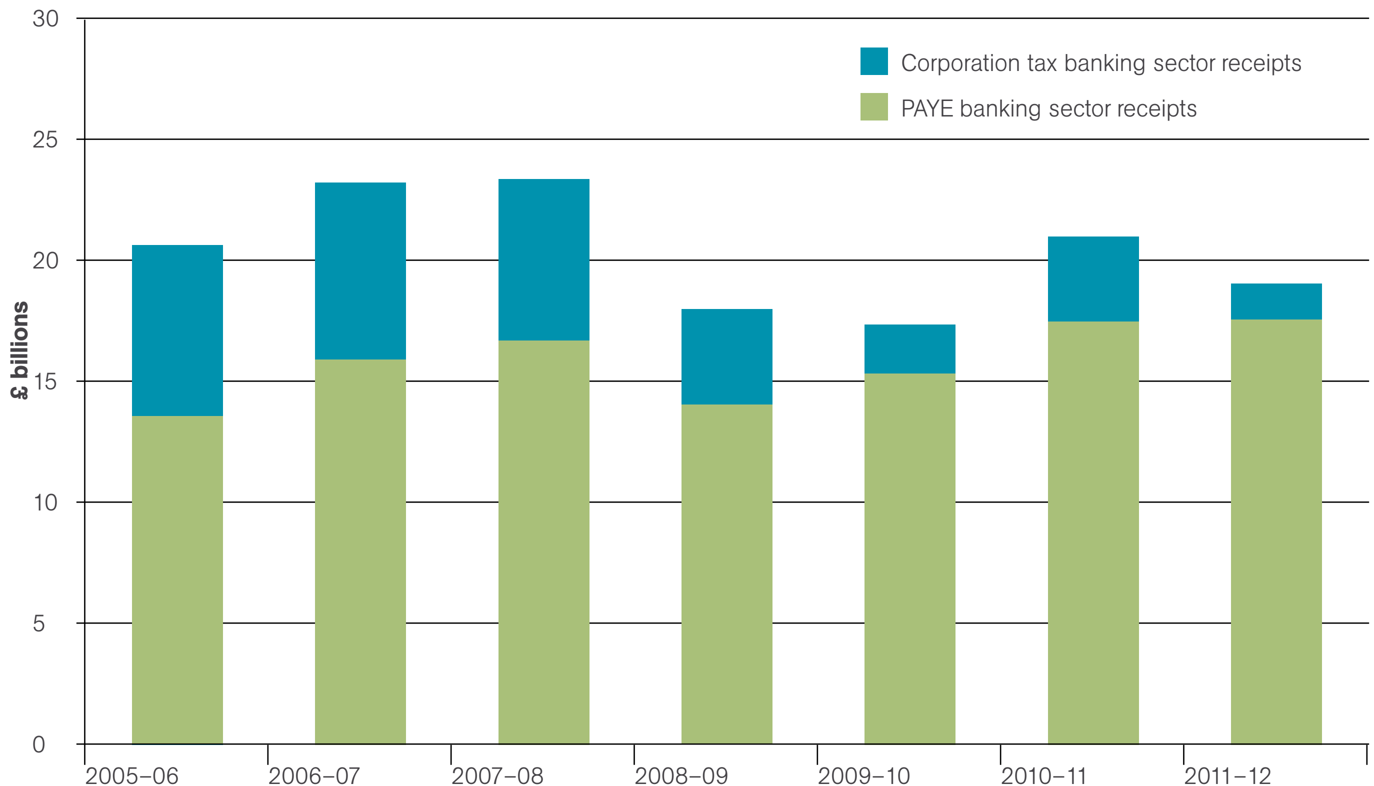
4 A second, imprecise pointer is provided by the 2011 book *After the Great Complacence* by Manchester University's Centre for Research on Socio-Cultural Change (CRESC). The authors estimate direct employment in UK financial services, including 'para-finance' (supporting professional services) at just 1.5 million (lower, it should be noted in passing, than the City's 2.05 million estimate.) Of these, CRESC estimates, 1.0 million are directly employed. While the City's data is 'frustratingly incomplete' and cannot easily be broken down, CRESC says about half the direct employment in financial services – 432,000 at the end of 2006 – was in banking, and nearly 80 percent of those jobs were in the locally rooted 'utility' retail sector including many workers in call centres and other low-paid jobs. "Most of that would exist," the authors add, "even if Canary Wharf [a pole of investment banking in the City] was derelict."

5 See, for instance, a discussion of this in Financial Times finds evidence of huge flight of rich after French tax hikes, Tax Justice Blog, March 12, 2013

6 In the United States, where a similarly sized financial sector is diluted in an economy that is over five times the size of Britain's, one would scale down financial lobbyists' statistics about the gross contribution of the financial services sector by a much greater factor than in the UK, since the less mobile 'utility' sector serving the domestic U.S. economy would loom far larger as a share of financial activity, and the relevant 'mobile' sector proportionally smaller. In smaller countries and tax havens, the scale-down factor would be smaller than for the UK.

7 John Kay, who originally coined the term, describes a distinction between 'utility' banking and 'casino' banking: "We attached a casino – proprietary trading activity by banks – to a utility – the payment system, together with the deposits and lending that are essential to the day-to-day functioning of the non-financial economy." *Taming the Financial Casino*, John Kay, *The Guardian*, March 23, 2009. This has been widely remarked upon. The separation into two parts is not straightforward, however. For instance, local booms and busts can be generated by the locally-based financial sector lending too much to property owners in a housing bubble. These kinds of risky lending practices straddle both 'casino' and 'utility.'

Figure 3: UK Corporation tax and PAYE banking tax receipts



Source: Pay-As-You-Earn and corporate tax receipts from the banking sector, HMRC, Aug 2012.

Beyond this, however, there are other reasons for scaling the numbers down still further. There are various different measures that can be used to calculate the tax contribution.

The figures provided in Table 2 include not only taxes *borne* by the financial sector (£27.6bn) but also taxes merely *collected* by financial institutions (£35.4bn) which are actually borne by others: workers, suppliers, and so on. It even includes such items as taxes levied on alcohol. In essence, theCityUK has scooped up every tax that has some linkage with the financial sector, to create an estimate that some may consider inflated. So the headline number involves further sleight of hand.[39]

Other analyses produce different figures, depending on what is measured. CRESC, for instance, finds a gross tax 'contribution' from the financial and para-financial sector adding up to to £193 billion between 2002/3 and 2007/8, or about £32bn per year.[40] Summarising the CRESC report, *The Guardian* said:

> *[British politicians widely believe that] the City is pretty much the last engine functioning in Britain's misfiring economy...*
>
> *The Cresc team totted up the taxes paid by the finance sector between 2002 and 2008, the six years in which the City was having an almighty boom: at £193bn, it's still only getting on for half the £378bn paid by manufacturing. It would be more accurate to say that the widget-makers of the Midlands paid for Tony Blair's welfarism.*[41]

39 Data from *The Total Tax Contribution of UK Financial Services*, paper prepared by PwC for the City of London Corporation, Dec 2011. For a discussion of the Total Tax Contribution methodology, see *Transparently Dishonest*, Bob McIntyre, *American Prospect*, Aug 30, 2006.

40 *After the Great Complacence*, pp147-8, Table 5.1. The £193bn figure includes total taxes paid by employers and employees. Sources were from Nomis, HMRC, ONS, and PriceWaterhouseCoopers.

41 See *Britain is ruled by the banks, for the banks*, Aditya Chakrabortty, *The Guardian*, Dec 12, 2011. In the article, exploring UK Prime Minister David Cameron's recent statement defending his use of a veto to defend the City of London, Chakrabortty added: "In my recollection, no British minister in recent times has termed one industry as being of "national interest"… I asked *The Guardian*'s librarians to check the archives [for this] from 1997 onwards. They came back empty-handed."

Using the scale-down factor would bring average tax receipts for the relevant mobile sector to around £10 billion per year.

HMRC data, looking at Corporation tax and PAYE banking sector receipts, produce an average of £20 billion annually, which we would scale down to a maximum £6bn annual average for the last seven years. (See Figure 3 over page.)

Going further back in time, the total tax contribution is not available but a narrower measurement scale, income tax + corporation tax, is published by International Financial Services London, as follows.

Table 4: Corporation taxes, 2001–2006

Year	Tax contribution £bn	Of which: Corporation tax £bn
2005/6	26.5	11.4
2004/5	22.2	8.8
2003/4	19.4	7.7
2002/3	18.6	7.4
2001/2	19.6	7.3
Total	**106.3**	**42.6**

Source: IFSL Research, 2008.

For this earlier period the annual average corporation tax contribution is also about £8.5bn, which we scale down to just **£2.7 billion annually.**

Indeed if one takes the more recent data from TheCityUK, a very similar figure emerges for the six years to April 2012. It puts the total *corporation* tax contribution at £50.5bn for the six years, or £8.4 billion per year. Using the same scale-down factor would then yield a total corporation tax yield for the relevant mobile sector of (again) **£2.7 billion annually**, on average.

2.4.4 What is the real jobs contribution?

Whereas TheCityUK asserts that the financial sector has created over 2 million jobs in the UK (see Section 2.3.4 above). This is over-inflated for several reasons.

First, the claim depends on the definition of jobs. TheCityUK data includes banking, fund management, legal services, insurance, accountancy, management consultancy and other auxiliary services.[42] However, it is not clear that all of these should be classed as 'financial services' jobs. Remember that TheCityUK's political purpose as a lobbying organisation is almost certainly to portray the maximum possible contribution from this sector.

A different calculation by CRESC estimates that the gross number is smaller:

> *The total number of finance and para-finance employees is never more than 1.5 million, or not much more than half the number employed by British manufacturing even in its current emaciated state. When all the qualifications about para-finance have been considered, finance remains a relatively small source of employment, which has created almost no new jobs over the past fifteen years.*[43]

Second, the "Mobile versus Immobile" and "Net versus Gross" problems described in Box 2 above mean that the City of London's job-creation claims for the relevant sector are probably overstated by perhaps a factor of three or more.

In addition, and as Section 2.4.2 above mentions, many jobs are created for expatriates, not for locals, particularly in small jurisdictions where direct job creation can be less than is commonly supposed. This bias to foreign employees is weaker but still significant for larger financial sectors. TheCityUK

42 See TheCityUK, *Regional Contribution of UK Financial and Professional Services*, Jan 2013

43 *Undisclosed and unsustainable: problems of the UK banking model,* Cresc, December 2009.

estimated in 2012 that for UK-headquartered big banks, 40,000 (over a quarter) of their 150,000 employees held a foreign passport. The extent to which providing jobs for temporary expatriate residents constitutes domestic job creation is a matter of judgment.

A landmark 2012 study for the Bank for International Settlements (BIS) finds strong evidence that high salaries in an oversized financial sector will suck the best talent out of an economy:

> *Finance literally bids rocket scientists away from the satellite industry. The result is that erstwhile scientists, people who in another age dreamt of curing cancer or flying to Mars, today dream of becoming hedge fund managers. More finance is definitely not always better.*[44]

(This study is discussed further in Section 2.5.1.1 below.)

Finance drains talent not just from the private sector but from government too, harming economic policy-making, management and governance. A widely cited 2009 research paper provides an example, illustrating potential dangers and feedback effects:

> *Given the wage premia that we document, it was impossible for regulators to attract and retain highly-skilled financial workers, because they could not compete with private sector wages. Our approach therefore provides an explanation for regulatory failures.*[45]

This book argues that the rise of the City of London was a significant (though by no means the only) factor behind the dramatic crowding-out of and decline in British manufacturing, from employing 6.8 million people when Margaret Thatcher came to power in 1979, to 2.5 million in 2010.

44 *Reassessing the impact of finance on growth*, Stephen G Cecchetti and Enisse Kharroubi, January 2012.

45 See Philippon, Reshef, 2009.

2.4.5 What is the real GDP contribution?

In addition to the Casino/Utility and Net/Gross problem discussed above, national statistics around the world routinely overstate the contribution of the financial sector to GDP growth.

A hallmark of the 'casino' has been its massive pre-crisis profitability, contributing to GDP growth figures. Returns which had been in line with general stock market growth until the 1970s exploded to over 20 per cent annually in several countries.[46] In the U.S. and UK, for instance, recent official figures put the value-added contribution of financial services recently at 8–10 per cent of GDP.[47] However, Andrew Haldane and Vasileios Madouros of the Bank of England explained in a paper in November 2011 that the crisis had exposed the falsity of the traditional narrative of financial innovation helping the financial sector to manage and allocate capital better, thus reaping high returns:

> *High pre-crisis returns to banking… reflected simply increased risk-taking across the sector. This was not an outward shift in the portfolio possibility set of finance. Instead, it was a traverse up the high-wire of risk and return.*
>
> *In what sense is increased risk-taking by banks a value-added service for the economy at large? In short, it is not. Bearing risk is not, by itself, a productive activity.*
>
> *The current framework for measuring the contribution of financial intermediaries captures few of these subtleties.*[48]

In other words, that value was not real value added but a transfer to the financiers from taxpayers, pension fund holders and others.

46 For a good discussion of this in a UK context, see "What is the contribution of the financial sector?" in Adair Turner *et al*, *The Future of Finance: the LSE Report,* summarised effectively in Martin Wolf, What do the banks' target returns on equity tell us?, *Financial Times* blogs, September 25, 2011. Wolf notes that this was not UK-specific: "banks internationally were engaged in a highly competitive ROE race."

47 See *The Contribution of Financial and Professional Business Services to the City of London*, Greater London and UK Economies, Oxford Economics, April 2011.

48 For a summary of the paper, see *What is the contribution of the financial sector?* By Andrew G Haldane and Vasileios Madouros, Nov 22, 2011.

Tentative estimates for some of these costs are given below.

Beyond the financial sector's direct contribution to growth, it has indirect effects too, as this quote summarises:

> *[Britain has] a national business model that relies less on the manufacture of things and more on the manufacture of credit. It is a startling fact that the real value of housing equity withdrawal under Thatcher and Blair was marginally larger than the real value of GDP growth, suggesting that for our national economy to grow we require free flowing credit pushing against asset prices which can quickly and easily be cashed out.*[49]

Furthermore, large financial sectors seek to attract global 'hot money' by offering tax breaks, secrecy or lax enforcement. This is tax haven activity. Ireland, for instance, used corporate tax loopholes combined with a headline 12.5% tax rate to attract foreign corporate activity. But economist Simon Johnson estimates that around 20 per cent of Irish GDP is actually profit transfers by foreign companies, which raise little tax and should not be counted as part of Ireland's tax base.

> *The Celtic Tiger's impressive reported growth over the past decades was in part based on its aggressive attempts to help major corporations in the United States reduce their tax bills.*

A better measure is Gross National Product (GNP) instead of GDP, which ignores these transfers and in Ireland's case means a significantly smaller genuine national income. Among other things, overstating the size of the economy (and hence the potential tax base) makes Ireland's debts seem more sustainable than they are.[50]

49 See *If They're London's Revenues, They're London's Liabilities*, Manchester Capitalism, Dec 6, 2012.

50 See *Irish Miracle – Or Mirage? Simon Johnson, NY Times Economix blogs,* May 20, 2010.

2.4.6 What is the real regional contribution?

As Section 2.3.6 above notes, TheCityUK cites a tremendous contribution to the UK regions from London-centred financial services.

Yet this analysis, which is UK-focused but applicable in many finance-dependent countries, is fatally flawed, for two main reasons, and a few others.

First, the "contribution" of the relevant sector needs to be scaled down by the usual factor, as above. However, in this particular case the scale-down factor should be substantially larger than for the UK as a whole, since a disproportionate bulk of mobile 'casino' banking is London-based. (We won't hazard a guess as to the size of this extra scale-down factor, but it will be very substantial.)

Second, as above, the City data report gross, not net contributions. Set the costs associated with finance against the heavily scaled-down gross regional contributions from the relevant mobile sector, and the balance looks ugly. In the words of the Manchester Capitalism blog, a keen academic observer of this phenomenon:[51]

> *The banks are a net recipient of State funds which the whole country must pay for, even though the private gains are largely realised in London and the SE. From this perspective, we, in the North, have also seen our bank notes disappear over the Watford Gap to keep well-heeled investment bankers in a manner to which they are accustomed.*

The (related) Centre for Research on Socio-Cultural Change (CRESC) notes:

> *Both Conservative and New Labour governments balanced 'neo-liberal' reforms with an undisclosed, redistributive national settlement of publicly-funded employment and service provision.*

51 See *If They're London's Revenues, They're London's Liabilities,* Manchester Capitalism blog, Dec 6, 2012.

After 2008, the financial crisis and the ensuing politics of austerity will traumatically terminate a redistributive social settlement which disproportionately benefited ex-industrial regions of the North and West.[52]

The basic tax-and distribute bargain may have also created more fine-grained problems of imbalance in the UK regions away from London, further weakening alternative sectors. In many poorer regions the pay differentials can work in the other direction, where public sector pay rates – negotiated nationally and driven by this regional redistribution effort – are higher than the local private sector alternatives, thus "crowding out" those private sector players in the regions[53] and putting a 'brain drain' in the other direction. This may be a minor factor, but it serves further to unbalance these regional economies, making it harder for local businesses to thrive there. In summary, the enormous imbalance created by a finance-heavy southeast of England has, via national-level pay bargaining, further damaged regional economies, magnifying the effect of a finance sector already sucking the best talent down to London.

The London-based financial sector has also undoubtedly driven strong UK regional wealth and income inequalities.[54]

Regional growth has been heavily predicated on consumption based on mortgage equity withdrawal. Manchester Capitalism again, in the same article:

Global cities like London do attract capital, but they do so because they are a kind of conversion machine, taking national and international assets, converting them into revenue streams from which well placed individuals skim high pay.

And those individuals are nearly all in London. Section 2.5.1.5 on financialisation has more.

State subsidies to finance play a regional role too. The UK's Public-Private Partnerships (PPPs) and Private Finance Initiative (PFI,) effectively involve a financialisation of what would have previously been state spending, with a redistribution towards London:

Before PPPs and PFIs, projects that were State funded had revenue streams that would congeal in the regions where those projects were based, kicking in multipliers that would further benefit the local economy. The fragmentation of activities has led to a concentration of certain functions like financing and asset management in London. This has diminished capacity in the regions through the withering of broad competences, the fragmenting of supply and project chains, and skills drift as talent is forced to relocate down South to find a job. State-sponsored investment projects across the country have benefited private sector growth in London and the South East.[55]

These schemes are often highly leveraged, and while their benefits flow disproportionately to London, the liabilities lie heavily on the regions' shoulders, via the state.

The regional distortions aggravated by finance can be self-reinforcing, in a winner-takes-all dynamic. As *The Economist* has argued:

National politicians oscillate between a zeal to prop up Britain's regions and a resigned acceptance that scarce investment must go to its behemoth of a capital. The latter has been winning of late.

Larry Elliott provides an example, in *The Guardian*:

The £15bn invested in Crossrail [a London-based rail project] dwarfs spending on

52 See *City State against national settlement: UK economic policy and politics after the financial crisis*, Ismail Ertürk, Julie Froud, Sukhdev Johal, Adam Leaver, Michael Moran, Karel Williams, CRESC, June 2011.

53 This particular dynamic was highlighted in one of the author's conversations with Anthony Travers of the London School of Economics.

54 For example, the Hills report puts median wealth in Wales at £150,600 versus £287,900 in the South East.

55 From the same Manchester Capitalism blog.

infrastructure in the north. Indeed, the £322m earmarked for new rail lines to boost the big northern cities is exceeded by the £350m to lengthen two platforms at Waterloo station.[56]

Peter Hetherington, chair of a UK cross-party commission on UK regional policy, summarises:

Every government action has reinforced London… the capital eats up England's transport budget… Such a disparity shows a vast subsidy to the capital, dwarfing the rest of England (and Britain) – truly the generous hand of an active state writ large.[57]

2.4.7 What is the real efficiency contribution?

An appropriately sized financial sector is essential for the construction of an efficient economy. The evidence in the rest of the book shows, we believe, that oversized financial sectors, not financial sectors *per se*, promote inefficiency.

Generally, the claims made for the 'efficiency' of large financial sectors, and for the 'efficiency' of financial deregulation, rest on another fallacy.

What is 'efficient' from the point of view of an individual or company does not automatically make the system as a whole efficient. Bribery is 'efficient' for the company that wants to get its container quickly through a port, but a system plagued by bribery is inefficient. What is more, the rules, laws and taxes that finance's defenders say are 'obstacles' to the free and efficient flow of capital are put there for good reason: in fact for all their many warts and problems, appropriate democratically constructed regulation and taxes are *required*, if markets are to be efficient and to avoid such pitfalls as market monopolisation.

The words of John Maynard Keynes are relevant here, highlighting that notions of financial efficiency in terms of rates of return on capital may be far removed from true efficiency:

Experience is accumulating that remoteness between ownership and operation is an evil in the relations among men, likely or certain in the long run to set up strains and enmities which will bring to nought the financial calculation.[58]

Finance is an intermediate good, not an end product like a car: in this sense it is a cost, not a benefit. Research shows that this 'cost' has increased over time.[59] The expansion of finance consumes scarce resources (such as the country's brightest, best educated people) that could be deployed productively elsewhere.[60] Shrinking the financial sector to appropriate levels could reap large savings, improving economic efficiency.

2.4.8 What is the real trade surplus contribution?

The 'utility' sector is locally rooted and therefore will contribute relatively little to the trade surplus.

56 *Margaret Thatcher was loved and hated – both for sound economic reasons,* Larry Elliott, *The Guardian*, April 14, 2013. The £322m and £350m statistics are presumably sourced from Investing in rail, investing in jobs and growth, gov.uk, July 16, 2012. "Completion in full of the "Northern Hub" cluster of rail enhancements with the approval of £322 million of outstanding track and capacity upgrades across Manchester city centre, Manchester Airport and across to Liverpool."

57 HS2 simply masks the North-South Divide, Peter Hetherington, *Financial Times*, Jan 29, 2013

58 John Maynard Keynes, *"National Self-Sufficiency,"* The Yale Review, Vol. 22, no. 4 (June 1933), pp. 755-769.

59 See, for instance, Thomas Philippon, *Has the U.S. Finance Industry Become Less Efficient?*, NYU, May 2012. He finds that the unit cost of intermediation is higher today than it was at the beginning of the 20th century, despite all the technological advances.

60 Dean Baker explores this in his presentation *Why we need to tax Wall Street transactions, Public Citizen,* Jan. 29, 2010, reposted on the "Tax Wall St." blog on Oct 24, 2011. Here is part of a transcript of what he said: "The financial industry is an intermediate good. It is not an end product for us, it is not like they are making food for us or building houses. The analogy I make is to trucking. We need a trucking industry, it is very very important: it is about bringing goods from point A to point B. Now the financial industry has exploded relative to the rest of the econonmy over the last 3 decades: it has quintupled… The question is: what have we gotten for that? Are we more secure in our savings? Do we think capital has been better allocated? Maybe that is true but at least on the face of it it is hard to argue that that's the case. Now suppose we get our FTT (financial transactions tax) and we see a big decline in the volume of trading. To my mind, that is a benefit. What that means is that the financial sector is becoming more efficient. Why would we want more people employed in trucking, if they are not better able to get goods from point A to point B? If we reduced the volume of trading without impeding the financial sector from doing its proper function, securing our savings, allocating its capital – that's a pure gain for the economy. So I would argue that both we stand to raise an enormous amount of revenue – about $100 billion a year – and changing the way Wall St. works, and that is at least as important."

TheCityUK's claim on the trade surplus contribution seems acceptable to us, on a technical level, though we would only note that trade surpluses are not automatically a benefit for the country: large surpluses can, for instance, contribute to Dutch Disease effects as noted above, whereby surpluses bid up the value of the currency, making other sectors less competitive against imports.

2.4.9 "It's all we've got;" path dependency

Many jurisdictions pursue financial sector growth because alternatives seem absent or unviable.

But this is partly a circular argument: as Section 2.5 below show, finance can "crowd out" other sectors and for many finance-dependent jurisdictions – particularly large ones – there are strong grounds to argue that the overall effect is that of a 'curse.' If something is actively harming a population, then it is unclear why it is a good idea to pursue it further, even if alternatives are not immediately obvious.

These "what else would we do?" arguments are often accompanied by a challenge to the critics: "You suggest an alternative." However this is not the critics' role: as if they should tour a country with a helicopter and say 'put a tractor factory here' or 'focus on wind farms' and so on. If finance shrinks, other activity is likely eventually to take its place even if we can't foresee what that might be. If jobs are lost in the financial sector, this may not mean more unemployment in the medium or long term, since these workers, particularly in the 'casino' sector, are usually the best-educated minds who can and will most easily find and create jobs elsewhere.

So the gross 'contributions' of finance are often massively overstated. The next section shows why the net contribution is, in many jurisdictions, likely to be negative: a far more serious matter that constitutes strong support for the Finance Curse thesis.

Active long-term government policies to rebalance economies can be successful, though dependence on finance creates tremendous problems of path dependency, making Country Capture very hard to reverse. In the words of a January 2011 report:

> *The multiple symptoms of 'unbalance' are not easily addressed, managed or reversed by the mix of available policy instruments carried over from the previous period of complacency.*[61]

Once an alternative non-finance industry or sector has been killed off, skills, experience and supply chains are lost, reinforcing the 'it's all we've got' argument. The population as a whole increasingly buys into the argument, and path dependency deepens. Furthermore, property prices typically soar on the back of financial booms, giving influential sections of the population a major personal wealth interest in preserving the status quo, thus creating huge political pressure against 'rebalancing.' Matters in small islands can be far more extreme than in big jurisdictions:

> *Small Island Economy hosts (of OFCs) have become locked into their relationships with the offshore financial industry by their dependence upon the earnings potential of predominantly imported skills and expertise, and their lack of skills and knowledge in alternative sectors. This means that any attempts at diversification into other sectors would be constrained by the need for wholesale re-skilling and the acquisition of new knowledge bases.*[62]

This "it's all we've got" argument is a central element of the Country Capture phenomenon.

2.4.10 Why is Switzerland rich?

Just as the Resource Curse has notable counter-examples such as Norway, so are

61 *Rebalancing The Economy (or Buyer's Remorse),* CRESC Working Paper No. 87, Jan 2011.

62 From Hampton, M.P, and Christensen, J.E. (2002) 'Offshore Pariahs? Small Island Economies, Tax Havens and the Re-configuration of Global Finance.' *World Development*, 30 (9) p.168.

there countries that seem to have thrived alongside a large financial sector, enjoying low unemployment, good human development indicators and high incomes. Switzerland, whose financial sector contributed over 13% of GDP at its peak in 2007, (somwhat larger than in the UK and US),[63] is a case in point.

But Swiss joy is far from constituting evidence that financial sector growth is a recipe for national success. First, this is a particular version of the 'finance makes you rich' argument, tackled in Section 2.4.2 above. Second, Switzerland's success stems from a wide range of reasons, most of which are not easily replicated. They are:

- Switzerland's co-operative federal political system – the result of historical efforts to manage its cavernous linguistic, religious and other divisions – creates political stability that underpins economic growth and attracts investment.
- Political neutrality insulates Switzerland from destructive wars, producing a counter-cyclical economic 'smoothing' effect : amid political and economic turbulence elsewhere, disrupting Swiss goods export markets, foreign money flows into 'haven' Switzerland – and vice versa.
- Swiss decentralised direct democracy as a key factor in producing efficient public administration. (Switzerland's 100% state-owned railways, whose punctuality and efficiency are legendary, for example.)
- A cooperative "social partnership" labour relations model since 1937 modeled on its co-operative political system, which historian Olivier Meuwly says has been "the result of a constructed phenomenon through which Swiss people learnt to deal with conflicts and come up with solutions."
- Banking. Swiss banks traditionally focus more on wealth management, which is relatively stable, in contrast to the more volatile trading-dominated Anglo-Saxon approach. Many argue that the Swiss financial sector is a core driver of Switzerland's prosperity, but the Finance Curse analysis suggests Switzerland may have prospered "despite" its oversized financial sector.
- Swiss banks have historically focused heavily on attracting criminal and tax-evading foreign money, but its role as a 'haven' attracting money fleeing turmoil elsewhere is equally important. This 'haven' bedrock at least generates incentives to foster stability and curb the 'casino.' See more on this in Section 2.6.3.2 below.
- Fairly equitable and redistributive public policies. Switzerland has very high public sector pay, for instance, at over SFr 7,000 per month, and heavy investment in education and infrastructure. Swiss society and culture are highly egalitarian.[64]
- Switzerland is a fairly low-tax country, but not excessively so: with tax revenues at approximately 35 per cent of GDP in 2009, this was similar to Ireland's, higher than the United States' (at 31 per cent) but lower than the UK at 41 per cent.[65]
- Swiss industry has historically occupied highly specialised market niches less subject to price competition than commoditised goods, and therefore better insulated from "Dutch Disease" effects. Heavy public investment in public education has helped. Exported goods currently account for about 35% of Swiss GDP, over twice the value of its services exports.
- Switzerland has its own currency, the Swiss Franc, which has given it flexibility in contrast to Euro-based countries such as Greece or Ireland.

63 See *Switzerland as a Location for Financial Services*, www.sif.ch, June 2010.

64 Public sector pay: see *Statistical Data on Switzerland 2012*, Federal Statistical Office, p13: Gross Monthly Wage: public and private sector, 2010. For an exploration of this egalitarian streak see, for example, The Swiss Turn on the Super-Rich, Reuters, Jan 21, 2013. (The "Minder" initiative was subsequently approved by a large majority in a March 2013 referendum.)

65 See *Consolidated government expenditure as per centage of GDP, OECD tax database.*

- Effectively, a finance fund. Switzerland has periodically intervened massively in foreign markets to hold down the Franc, similar to Norway's oil fund (though less structurally embedded). By June 2012 the fund held CHF 365bn (around US$360bn,) and rising fast. This has had strong counter-cyclical effects, as has a 'debt brake' ("Schuldenbremse") since 2002 that curbed sovereign borrowing during the pre-crisis boom years.

Most of these positive factors are peculiar to Switzerland and are not easily replicated. As one commentator notes:

> *Like an Alpine glacier, Switzerland is a sight for other Europeans to admire. But you cannot take a glacier home.*

A tacit recognition of the 'Dutch Disease' has long been a factor in Swiss politics, with clashes for decades between finance and other economic sectors: a conflict that revolves heavily around the level of the Swiss Franc. Put simply, financiers often want a strong and stable Franc to bolster Switzerland's reputation as a 'haven'; manufacturers and agriculturalists, keenly aware of potential 'Dutch Disease" effects, have fought for a weaker Franc.

Not all is well in Switzerland. It is only slightly less unequal than the UK on income inequality, and on wealth inequality it is one of the world's most unequal societies.[66] It may also be too early to reserve judgement: with bank assets at over 800 per cent of GDP,[67] compared to under 500 per cent in the UK, and mortgage credit at over 100% of GDP, the world's second highest rate, its relatively rosy economic picture is subject to risks.[68]

66 See for example *Study Finds Wealth Inequality Is Widening Worldwide,* New York Times, Dec 6, 2006, which ranks Switzerland as the world's most unequal country.

67 See *Remarks by Treasury Secretary Tim Geithner to the International Monetary Conference*, Atlanta, June 6, 2011.

68 See *Challenges for Switzerland as a financial centre*, Thomas J. Jordan, Swiss National Bank, Sept 3 2012. See also *Homeowners sitting on a mountain of debt*, Swissinfo, Feb 12, 2013.

BOX 3: WHAT ARE WE MEASURING?

Our analysis about oversized financial sectors hinges on the size of a country's local financial sector relative to its local economy. So how do we measure this?

We see finance outgrowing local economies in two main ways.

1. International, Offshore orientation

Financial centres can outgrow local economies by focusing on international business. Small tax havens such as Jersey or the British Virgin Islands focus almost exclusively on offshore (rather than domestic) financial operations; and this is still true but to a lesser degree for larger financial centres such as the City of London and even Wall Street.

This can be measured with variables such as financial services exports as a share of the local economy.

2. Financialisation, "candy floss."

In addition to (and overlapping with) international financial activity is what one might call the financialisation of the domestic economy, which Section 2.5.1.5 explores. This involves the parceling up of genuine economic activity into financial forms, which one might say are parasitical on the real economy.[1] The Financial Times writer Gillian Tett describes this financial outgrowth:

> Bankers had become so adept at slicing and dicing debt instruments, and then re-using these in numerous deals, they had in effect spun a great web of leverage and trading activity – in much the same way that sugar is spun in a bowl to create candy floss. From a distance, that activity looked impressive. But the underlying asset base was surprisingly small.[2]

There are no clean measures of financialisation, which is a diversified phenomenon, but some studies (such as one described in Section 2.5.1.1 below) look at levels of credit to the domestic economy.[3]

Other possible distinctions: utility and casino

Another common distinction that is made is between 'utility' finance and the 'casino' sector, as Box 2 above explains. This cuts across the international/candy floss distinctions. Other distinctions are possible: between 'retail' and 'investment banking,' for example, or between "narrow banking" and its opposite: too-big-to-fail banking.

These distinctions are useful if imprecise, and we occasionally mention them, but they are not exactly what we are measuring.

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1 This concept goes back to the writings of Thorsten Veblen in his book *Theory of the Business Enterprise*, where he compared the business world to the functioning of a machine, and businessmen deliberately insert themselves as intermediaries to leverage the machine process for pecuniary gain -- even if it means undermining the smooth functioning of the machine process. In the modern era, the private equity industry perhaps best epitomises this process: a core part of the business model is to buy up companies then extract value via financial engineering.

2 *Web of shadow banking must be unravelled*, Gillian Tett, *Financial Times*, Aug 12, 2010.

3 For instance, see Ahmed Zorome, IMF Working Paper WP/07/87 *Concept of Offshore Financial Centers: In Search of an Operational Definition*, April 2007, Figure 1, p16 provides a graph of financial services exports to GDP. This is in contrast to other studies, such as the BIS' study cited in Section 2.5.1.1, and *World Bank studies* which look at other factors such as private credit to GDP. This latter has big data gaps particularly for small tax havens such as the Cayman Islands.

2.5 Is it even worse than that: A Curse?

The last section looked at the various claims made in defence of large financial sectors, using the United Kingdom as an example to show how the gross benefits are often far smaller than claimed. A development strategy for the entire United Kingdom has been constructed, based on wildly inflated data.

This section explains how matters are still worse than that, because these (shrunken) gross benefits are offset by many harmful outcomes from finance dependence. (Section 2.6, below, discusses root causes of these outcomes.)

We find that many, though not all, of these harms, and many of the processes that lie behind them, are similar to those found with the "Resource Curse."

To begin with, however, a few provisos.

First, many would argue that the processes and outcomes we describe here are caused by other factors: technological advances, healthcare costs, innovation plateaus, business cycles, sunspots, tornadoes, and more. They would be partly right: *none* of what we discuss below has a mono-causal explanation. We are merely pointing to Finance as a major and under-recognised driver.

Second, all studies should be treated cautiously, not least because the growth-killing effects of the latest crises will be felt for years: much of the 'growth' was predicated on accumulating debt, and only limited deleveraging has happened. So a definitive picture cannot yet be constructed. For example, the UK has public and private liabilities equal to nearly 10 times GDP[69], and the long-term impacts of this cannot be known yet.

Third, some of the impacts we describe – such as authoritarian tendencies and the erosion of democracy – are hard to prove or even measure. To fill some gaps, we rely quite heavily on local testimonies and anecdote from experts, reflecting insider experience and insights that can be just as powerful as statistical approaches.

Fourth, most of the existing academic research on the local impacts of financial centres focuses on large, advanced economies. Several smaller financial centres, typically 'tax havens' or 'secrecy jurisdictions,' have even larger financial sectors as a share of GDP than those measured by the BIS, but reliable cross-country data on this is scarce or non-existent.[70]

Fifth, note (again) that while financial centres can transmit a range of benefits and harms onto other jurisdictions elsewhere, and that this is a hugely important topic, that is *not* our focus here. We are only looking at the local impacts of hosting a large financial centre.

2.5.1 Economic losses and other outcomes

Section 2.5 is divided roughly into two overlapping parts:

a) economic losses, and

b) political losses.

2.5.1.1 Slower, narrower growth: Peak Finance?

Top US policy maker Paul Volcker said in December 2009:

> *I wish that somebody would give me some shred of neutral evidence about the relationship between financial innovation recently and the growth of the economy.*

69 See *Exhibit 1: G10 Debt Distribution, Haver Analytics, Morgan Stanley Research*, table from Steve Keen, Debt Britannia, Dec 31, 2011 This table breaks debt down into government, household, financial and non-financial; in the UK's case the large majority is financial debt.

70 One of the few systematic analyses of the size of financial sectors as a share of GDP can be found in *Concept of Offshore Financial Centers: In Search of an Operational Definition*, Ahmed Zorome, IMF Working Paper WP/07/87, April 2007. The data problems can be seen in , which finds a huge data mismatch in the Cayman Islands, among the world's biggest financial centres, where the Net Asset Value reported by hedge funds totaled over $2.2 trillion at end-2007, while portfolio equity claims on the Cayman Islands reported by the main investor countries were only $768bn. See IMF Working Paper WP/10/38 *Cross-Border Investment in Small International Financial Centers*, Philip R. Lane and Gian Maria Milesi-Ferretti, Feb 2010.

Adair Turner, chairman of the UK's Financial Services Authority, said in 2011:

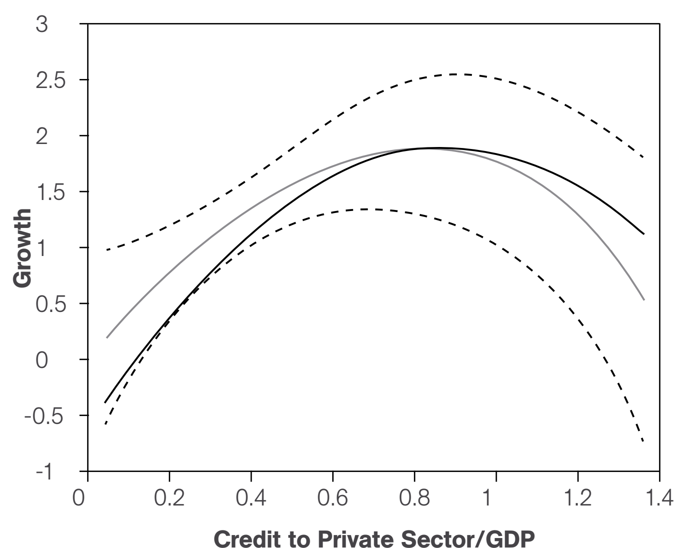
> *There is no aggregate level empirical evidence to support the belief that financial liberalisation and financial deepening has generated superior economic performance.*[71]

Indeed, before the financial crisis, the large volume of studies on the subject found a general positive correlation between financial sector growth and economic growth.

The crisis, however, threw all those studies into question, and now the first studies are starting to emerge that seem to suggest that one might validly talk about "peak finance." Above a certain point, it seems, growth in a country's financial sector is likely to harm its economic growth.

For example, a June 2012 IMF Working Paper entitled "Too Much Finance?" carries a graph, reproduced in Figure 4.

Figure 4: Credit to the private sector, and GDP growth.



Source: *Too Much Finance? IMF Working Paper WP/12/161, p42*

The IMF explains Figure 4 as follows:

> *GDP growth reaches a maximum when credit to the private sector is at 76% of GDP.*

It measures this effect in different ways too, and another graph the paper presents is described like this:

> *The positive effect of financial depth is no longer statistically significant when credit to the private sector reaches 42% of GDP, it becomes negative [at] 90% of GDP, and negative and statistically significant when financial depth reaches 113% of GDP...*
>
> *In 2006 there were 64 countries above the 50% threshold, 27 countries above the 90% threshold, and 17 countries above the 113% threshold.*
>
> *The list of countries above the 110% [113%] threshold includes almost all of the countries which have been most affected by the current crisis: Iceland, the United States, Ireland, the United Kingdom, Spain, and Portugal. The exception is Greece, which has a relatively small financial sector but serious public finance problems.*

The paper concludes:

> *Our results show that the marginal effect of financial depth on output growth becomes negative when credit to the private sector reaches 80–100% of GDP. This result is surprisingly consistent across different types of estimators.*[72]

In other words, growth in credit to the domestic economy helps economies grow, but turns bad at a certain point.

The paper does not provide a country breakdown, but Table 5 shows the following:

71 See Turner's same speech, *Reforming finance: are we being radical enough?*

72 IMF Working Paper No. 12/161: *Too Much Finance?* Arcand, Jean-Louis ; Berkes, Enrico, Panizza, Ugo, June 2012

Table 5: Credit to the private sector

Country	Credit to private sector, % of GDP, 2008
Greece	97
Iceland	127
Japan	171
Portugal	174
Netherlands	193
Luxembourg	193
United States	195
Spain	202
United Kingdom	211
Ireland	220
Cyprus	252

Source: *World Bank*[73]

The most crisis-hit rich countries were all, except for Greece, significantly above this level.

The above-cited BIS study of 50 advanced economies for the Bank for International Settlements in 2012 looked at different metrics. Its conclusion is:

> *With finance you can have too much of a good thing. That is, at low levels, a larger financial system goes hand in hand with higher productivity growth. But there comes a point – one that many advanced economies passed long ago – where more banking and more credit lower growth.*[74]

Credit to the domestic economy is just one benchmark for measuring the size of a financial sector, however. They find that finance turns bad at the point where private credit equals about 100 per cent of GDP or where it hits a 3.2 per cent fraction of overall employment, or when finance is 6.5 per cent as a share of value added.

The BIS also looked at how real *growth* in finance, measured by employment or value added, impacts economic growth:

> *We find evidence that is unambiguous: faster growth in finance is bad for aggregate real growth.*

(Figure 6 in Section 2.5.1.4 illustrates this.) Another IMF paper in 2013 concludes:

> *Additional [financial] deepening is not always desirable. We provide preliminary evidence that overshooting the predicted level of financial development is associated with credit boom-bust episodes, underlining the importance of optimizing rather than maximizing financial development.*[75]

Other recent studies find similar results.[76]

It is important to remember, too, that the larger the domestic financial sector, the greater the artificial and improper inflation of headline GDP growth numbers, as Section 2.4.5 (Haldane) above explains. Allowing for this factor would make the BIS' latter result starker still.

These cross-country patterns are complemented by long historical patterns, raising concerns about finance.

73 See Domestic credit to private sector (% of GDP), World Bank database. This is not a particularly representative sample, but it shows crisis-hit economies or those with very high credit to the private sector.

74 Cecchetti and Kharroubi, BIS, 2012.

75 *Too Cold, Too Hot, Or Just Right? Assessing Financial Sector Development Across the Globe*, Adolfo Barajas, Thorsten Beck, Era Dabla-Norris, and Seyed Reza Yousefi, IMF Working Paper, WP/13/81, 2013.

76 See *Revisiting the Link Between Finance and Macroeconomic Volatility*, Era Dabla-Norris and Narapong Srivisal, IMF Working Paper WP/13/29, Jan 2013. The paper also concludes that financial sector depth is positive up to a certain point, then turns negative: "there may be levels beyond which the beneficial effects on stability of financial depth diminish, and even become negative." Also see, for instance, *Finance: Economic Lifeblood or Toxin?* Marco Pagano, Working Paper no. 326, Centre for Studies in Economics and Finance, December 2012. See also *Financialization and Its Entrepreneurial Consequences*, Kaufmann Foundation, March 2011. It looks at entrepreneurial company formation and concludes, among other things, that: "the reversal of financialization and the flowering of parallel trends could work to substantially increase firm formation, and also at the table in Section 2.5.1.6, looking at volatility. See also À partir de quand le secteur financier pèse-t-il trop lourd dans l'économie?, BAKBasel, May 2013. They see a growth-maximising level when financial sector employment reaches 7.6% of the real (non-financial) economy.

For a quarter century or so after the Second World War financial speculation across borders was tightly constrained under the Bretton Woods co-operative arrangements: taxes were high, and progressive legislation (such as the New Deal in the U.S.) placed severe curbs on financial sector activity. This period was accompanied by remarkable prosperity: high economic growth, low unemployment, economic stability, falling debt and shrinking inequality, around the globe. Now known as the Golden Age of Capitalism, this period was summarised by British Prime Minister Harold MacMillan:

> *Most of our people have never had it so good.*[77]

The subsequent period of financial liberalisation from the 1970s saw growth fall, inequality soar, financial crises proliferate, median incomes stagnate, and unemployment rise worldwide.

Correlation is not causation, and one cannot conclude that suppressing finance during these eras 'caused' the equalising booms or that the explosive financial sector growth from the 1970s 'caused' the subsequent poor performance. But the evidence here puts the onus on financial sector defenders to prove otherwise. In any case other strong conclusions can still be reached, as the next sections show.

More research is needed. Still, this preliminary evidence already constitutes a devastating case against oversized financial sectors, and suggests that the economic growth 'curse' from oversized finance may well be stronger than for the Resource Curse, where the growth results are more nuanced.

There is plenty more to say, because the harm plays out on many other levels.

77 In this speech he has widely been quoted as saying *"You've never had it so good"* but apparently this is a (mild) misquote, established by wide repetition.

2.5.1.2 Further tax losses

The conventional story is that financial centres generate substantial tax revenues for their host countries: and they typically do.

But the conventional story has two key problems. First, as section 2.4.3 above explains, the claims for gross tax contributions from the financial sector are often heavily overstated for policy purposes.

Second, gross tax contributions are meaningless from a policymaker's perspective: what is needed are the net tax contributions. So against the gross contributions outlined in Section 2.4.3 we need to set the losses. These come in several forms.

Bailouts: Private gains, socialised losses

The recent crisis exposed how financial actors took risky gambles that paid off handsomely during the boom years; and when markets crashed, governments rescued the banks, socialising the losses with other taxpayers' money – while largely leaving financial actors with their earlier winnings.

David Potter, a former senior Bank of England official, said in October 2012:

> *Why do we allow our banks to speculate for such a small and doubtful contribution to GDP? Before the financial collapse the bank lobby pointed to the contribution to tax revenues. If the published loans and support supplied by the taxpayer through the Bank of England and the Treasury are summed, the Banks are in the red over the last decade.*[78]

It is impossible to be at all precise because estimates of taxpayer losses are volatile. As usual, however, some things may be said.

The UK's National Audit Office (NAO) estimated the total outstanding support to the banks reached £1.2 trillion at the height of the crisis, falling to £456 billion in March 2011 and

78 *Let's welcome the enmity of bankers*, David Potter, *Open Democracy*, Oct 5, 2012.

£228 billion by March 2012.[79] By May 2013 bank shares had risen by some 30 percent from there, reducing that number somewhat. The NAO adds:

> *The final cost to the taxpayer would not be known for a number of years.*

More forensically, Bloomberg in January 2009 calculated that RBS paid £16 billion of corporation tax from 1998–2007, compared to bailout support costs at the time of £20bn.[80] Had Bloomberg scaled that number down by the relevant factor (to roughly one third of the size, or some £5 billion) the bailout costs would have swamped those ten years' worth of corporation tax revenues many times over. RBS' share price has risen substantially since then, implying lower but still very substantial ultimate costs.[81]

For the whole sector, take a conservative £100–150 billion, say, as the explicit ultimate cost of taxpayer support. Set this against the maximum average tax contribution of the entire relevant (mobile) part of the financial sector of around £20 billion annually – which includes VAT payments, fuel duties and all, as Section 2.4.3 explains – and the bailouts will have wiped out five to eight years' total tax contributions.

However, if one were to take a narrower view of banks' tax contribution and set these losses against the relevant £2.7 billion annual corporation tax contribution (Section 2.4.3), we are talking about the bailouts easily wiping out all the corporation tax revenues from the relevant part of the financial sector since the UK corporation tax was introduced in 1965.

To repeat: though these are imprecise calculations, the scaled-down gross tax contributions produce a far better benchmark against which to set losses.

Implicit subsidies

In addition to the direct bailout costs, banks benefit from ongoing implicit subsidies that stem from their 'too big to fail' status, via their ability to take profits from risks while saddling others with the costs.[82]

The Bank of England estimated in January 2011 that the implicit subsidy to UK banks amounted to about £100 billion in 2009 alone – equivalent to the cost of the UK's National Health Service. That subsidy, again a highly imprecise estimate, overwhelmingly went to the big global banks. (The Bank of England added an estimate of an implicit subsidy of up to £220 billion in 2010; and Andrew Haldane of the Bank of England added in October 2012 that globally, the implicit subsidy was worth "several hundreds of billions of dollars" per year.[83])

Has this implicit subsidy fallen in value since then? It may have, somewhat, given that the banks' cost of funding is likely to be most heavily subsidised by the government during times of extreme stress, such as in 2009. Nevertheless, it remains a major issue: this comment from Anat Admati and Martin Hellwig, acknowledged experts in this field, suggests that the answer is no:

> *The problem posed by some banks being too big to fail is greater today than it was in 2008... the magnitude of the implicit subsidy has generally grown since the crisis.*[84]

Even so, the explicit and implicit costs borne by taxpayers are just two of several dimensions of overall losses.

79 See *The Comptroller and Auditor General's Report to the House of Commons,* National Audit Office, 13 July 2012.

80 See *RBS Taxes, Hailed as Contribution to Society, Erased by Rescue*, Bloomberg, Jan 22, 2009.

81 See *RBS head to send signal for reprivatisation*, *Financial Times*, May 3, 2013. By early May 2013 the RBS share price was still only about 60–75 per cent of the £4.10–£5.00 a share where it is estimated that the UK government, which holds 82 per cent of the bank, might break even on its investment. This implies a potential loss of up to £17 billion.

82 In very broad terms, the implicit subsidy is calculated by looking at how banks enjoy a reduced cost of funding due to taxpayer implicit guarantees, then multiplying this by the size of each bank's risk-sensitive liabilities.

83 See *Tackling the Credit Cycle and Too-Big-To-Fail*, Andrew Haldane, presentation at the Institute of International and European Affairs, 20 Jan 2011. A pdf of his presentation is given in UK's implicit bank subsidy = cost of NHS – Haldane, Treasure Islands blog, Feb 23, 2011. He defines the implicity subsidy as the subsidy "that comes from the expectation of a ride to the rescue" by the UK government. See also *A leaf being turned?* Andrew Haldane, Bank of England, Oct 29, 2012. Separately, Simon Johnson in November 2012 skewered US financial lobbyists' assertions that *Too Big To Fail* has been ended, in his article '*Too Big to Fail*' Remains Very Real, NY Times Economix blog, Nov 1, 2012.

84 *The Bankers' New Clothes*, Admati and Hellwig, Princeton University Press, 2013, p12. Martin Wolf in the *Financial Times* described the book as "the most important to come out of the financial crisis."

Tax "losses" will damage future tax revenues

Beleaguered taxpayers are finding out that banks can carry 'tax losses' forwards to offset against tax bills in future years. (In 2009 Barclays, for instance, paid just £113m of corporation tax in the UK, significantly for this reason.) The European Banking Authority in 2012 estimated that Barclays, Royal Bank of Scotland and Lloyds would have "deferred tax assets" worth €4bn (£3.3bn,) €5bn and €7.3bn in 2012 between just these three banks. (Worse, banks can sometimes set these tax 'assets' against bank capital.)[85]

In the United States, claims that the U.S. government made a 'profit' on its bailout investments in the stricken insurance giant AIG are fatally undermined by the issue of these deferred tax losses, among other things.[86]

Yet there are still more ways in which banks impose costs on other taxpayers.

Banks help others cheat on taxes

Banks actively and often aggressively assist other corporations to escape tax. Consider these words from Dave Hartnett, head of the UK's HM Revenue and Customs Service, in February 2009:

> *The banks have three roles. They provide schemes for tax avoidance for others; they use avoidance themselves and they fund schemes.*[87]

Evidence on the scale of this is impossible to pin down, but it is substantial. According to one official estimate, the total UK tax losses to tax schemes provided by Barclays bank alone amounted to £638 million (US$1.0 billion) in the 2002/3 tax year, not including an additional £300 million in known schemes where the tax saving was outside the UK.

Richard Brooks, a former UK tax inspector and author of *The Great Tax Robbery*, a book about the UK's tax system, describes Barclays' Structured Capital Markets unit as "a souped up tax avoidance factory;" with the unit averaging over £1 billion annually in revenues from 2005–11.[88]

So tax avoidance by banks is just part of a bigger story about the tax costs banks help impose on other taxpayers: they help others avoid and evade tax too, on an ongoing basis.

Still other losses need to be taken into consideration.

Wider macroeconomic harm

Taxpayer losses are just part of a much bigger picture of losses from the financial crisis. There were also costs associated with the disruption of the financial 'heart attack' in finance-dependent countries like the UK. Adair Turner of the UK Financial Services Authority FSA noted in 2011:

> *These direct support costs are swamped by the macroeconomic harm produced by the financial crisis. US public debt to GDP will increase by at least 50% in this recession, even if the direct cost of support ends up as zero. UK public debt similarly will increase by at least 50% of GDP, even though the direct costs may not exceed 5%.*[89]

Half of UK GDP would add up to nearly £800 billion at current prices.

Haldane estimated in 2010 the net present value global cost of the crisis to be "anywhere between one and five times annual world GDP."[90] In February 2011 he estimated global output losses at US$ 50–200 trillion.

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85 For the Barclays, Lloyds and RBS statistics, see *"Barclays stockpiles 'losses' to soften tax obligations,"* Philip Aldrick, *Daily Telegraph*, Jan 1, 2012. There is no point counting deferred tax losses as capital: they can only be used when there are profits to offset the losses against. The point of bank capital is to serve as a loss-absorbing buffer: when there are losses, it is not possible to use the deferred losses as offsets – so they cannot be loss-absorbing.

86 See *It Was Not a Free Lunch: The True Cost of the AIG Bailout,* James Tilson and Robert E. Prasch, The Big Picture, January 24, 2013.

87 See *Profile: Dave Hartnett, HMRC*, *Daily Telegraph*, Oct 12, 2011.

88 *Fundamental Review of Major Cases*, HMRC internal report, obtained by Richard Brooks, former UK tax inspector and author of the *Great Tax Robbery*, a book about the UK and its tax policies. Brooks confirmed to the authors that the figure relates only to Barclays. For the Barclays SCM data, see the *Salz Review*, April 2013, p72.

89 See Adair Turner, *Reforming finance: are we being radical enough?* 2011 Clare Distinguished Lecture in Economics and Public Policy, 18 February 2011.

90 *The Contribution of the Financial Sector Miracle or Mirage?* Andrew Haldane, Executive Director, Financial Stability, Bank of England, 14 July 2010.

In summary, the bailouts alone are likely to have wiped out many years, even decades' worth, of tax revenues from the relevant sector, depending on what is measured. To this we may add:

- implicit subsidies currently obtained by banks under 'too big to fail';
- banks' deferred tax losses, still to be fully realised;
- tax losses as a result of banks helping other companies cheat on their taxes.
- wider macroeconomic harm resulting from the disruption to economic life in finance-dependent economies.

All this leads to quite startling conclusions.

We estimated above that (though precision is impossible) bailout costs easily wiped out corporation tax contributions from the relevant mobile part of the sector since the corporation tax was introduced in Britain in 1965. Taking all these other losses into consideration, however, this conclusion may well be applicable not just to corporation taxes, but to the entire gross direct and indirect tax contribution of the financial sector.

A note on banks' tax avoidance: subsidies from taxpayers

Banks also avoid tax themselves, and they obtain special tax privileges. This is not just a matter of corporation taxes: the UK financial sector for example enjoys big exemptions for Value Added Taxes.[91]

It is worth putting their own tax avoidance into context. Like any other businesses, banks take benefits from society – healthy and educated workforces, infrastructure, police forces and fire services, reputable legal systems and much more – and under the democratic social contract they are supposed to pay for these things through their taxes. In this context, tax avoidance by banks – the amount by which their payments are less than is economically justified – can be considered as a subsidy from taxpayers: they are receiving public goods and services without paying for them.

There is no conventional way to determine what a bank's tax payments "should" be. One way to make a rough estimate, however, is to consider the question through a combined reporting / unitary taxation perspective, where one ignores accounting measures (which can often result in zero tax being paid, without the law being technically broken) and instead to judge this by tracking the genuine economic substance of what these global multinational institutions do and where they do them - then applying the local tax rate to those profits. An April 2013 estimate of the UK businesses of HSBC and Barclays suggested that these two banks alone underpaid tax to the tune of £2.6 billion from 2009–12.[92]

This tax avoidance and the tax privileges do not form part of the net 'contribution' calculations in this section – since this is already factored into estimates for their gross tax contributions – but it is still worth underlining that banks are enjoying important tax subsidies.

2.5.1.3 Crowding Out, withering of alternative sectors

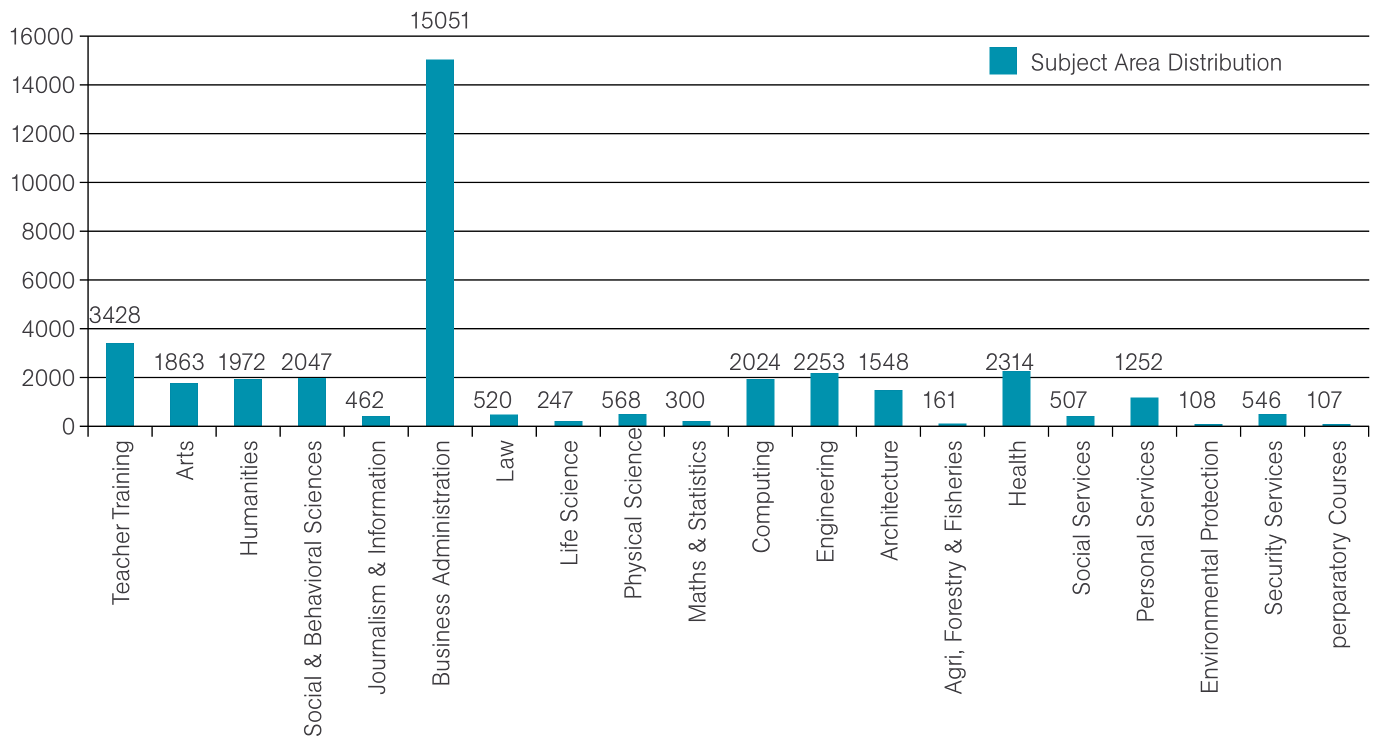
There is ample evidence that oversize financial sectors can crowd out alternative sectors, similar to what happens in resource-dependent economies. The above BIS study notes:

> *We find that industries in competition for resources with finance are particularly damaged by financial booms. Specifically, we show that manufacturing sectors that are either R&D-intensive or dependent on external finance suffer disproportionate reductions in productivity growth when finance booms.*

91 See, for example, *Section 6.2 in HMRC's Finance page.*

92 Under Combined Reporting with Formula Apportionment, you take the total global profits of an institution, and then you allocate those profits to jurisdictions according to the economic substance of what you do and where you do it. The allocation is done under a simple formula that usually involves measuring the assets, sales and payroll in each place where it does business. Each jurisdiction can then tax its allocated share of the global profits at its own local rate. See *The case of HSBC and Barclays and how unitary taxation would help the UK collect the tax that appears to be owing to it,* Richard Murphy & Meesha Nehru April 2013. (These 'avoided' taxes should not, however, be subtracted from the gross tax contributions, since the published gross tax contributions already take this into account.)

Figure 5: Cyprus, educational enrolment 2010/11



Source: Officer/Taki. Data measures total Number of Enrolments in 2010/11 and Graduates of the Previous Year by Field of Study (Includes both University and Non-University Institutions Cyprus Statistical Service – *Statistics of Education – 2010/11*. Graph provided by David Officer, University of Nicosia, via email, with thanks.

They estimate, for instance, that in the five years to 2005 Irish and Spanish output per worker fell by 2.7 per cent and 1.4 per cent annually, and that financial sector growth accounted for one-third and two-fifths of these declines respectively.

This BIS study is not the last word on the issue but the results chime very closely with our experiences, particularly in some smaller tax havens and financial centres where financial-services dominance has led to an almost 'monoculture' economy as tourism and other sectors are decimated alongside the rise in finance.

A research paper looking at the British tax haven of Jersey, where finance now makes up over 50 per cent of GDP, summarises:

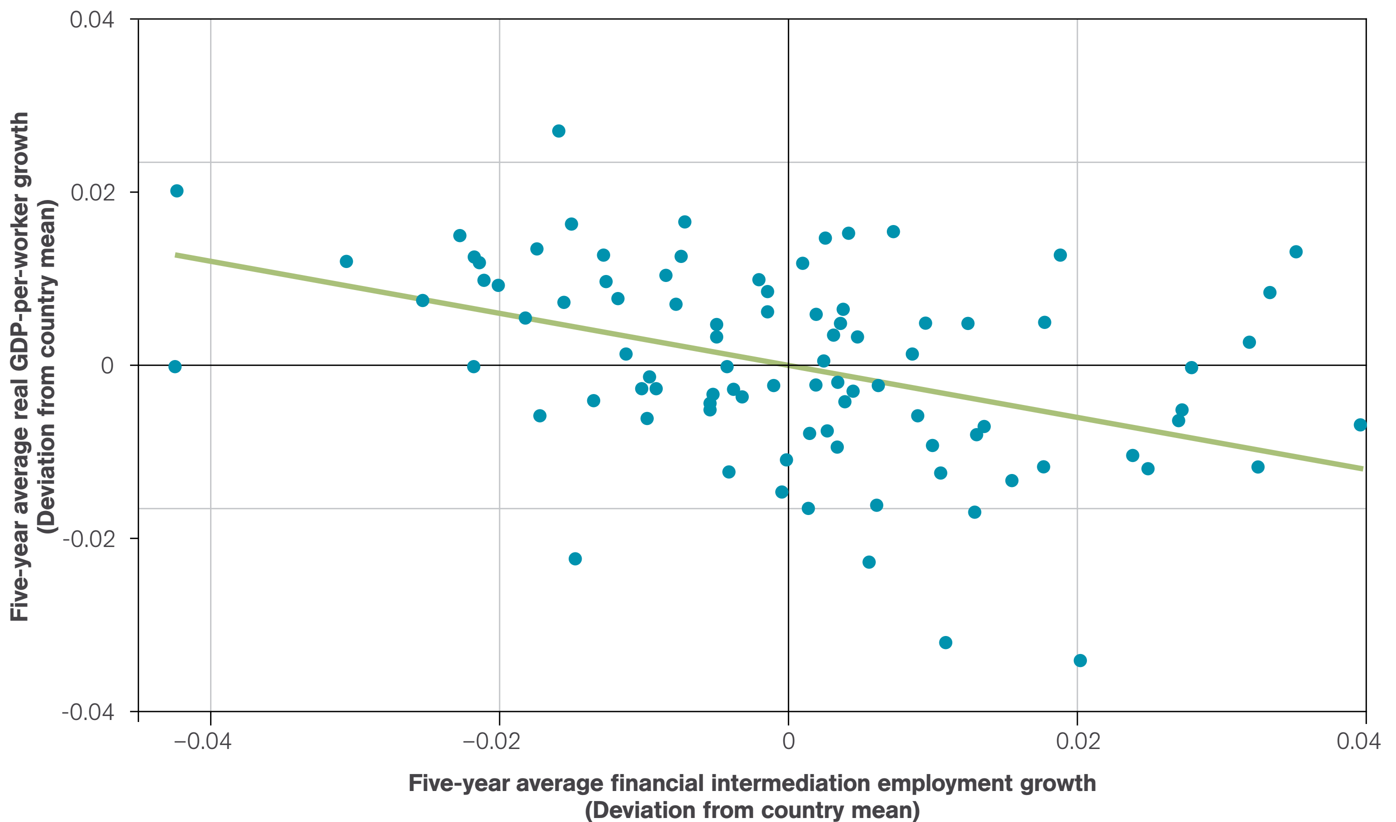
> *Tourism has been crowded-out by the island's OFC [Offshore Financial Centre]. This process is revealed by several indicators, including a dramatic reversal between tourism and financial services since the 70s as seen in contribution to GDP, share of direct employment and contribution to government revenues. Moreover, the macroeconomic consequences of such crowding-out in a small island economy include labor cost inflation; widening income disparity; chronic labor shortages; and severe pressure on the island's land and real estate markets. In other words, financial capital appears to be able to out-compete other industries, particularly tourism, to gain dominance within the local political economy.*[93]

According to David Officer and Yiouli Taki at the University of Nicosia in Cyprus, crowding-out is evident in many areas of life. Figure 5, looking at student patterns in the tax haven of Cyprus, shows one dimension of the 'crowding out' problem in sharp relief.

The disproportionate size of "Business Administration," the course specifically tailored

93 Hampton, M.P. and Christensen, J. (2007) Competing Industries in Islands: A New Tourism Approach, Annals of Tourism Research, vol 34, no.4, pp1013-1014

Figure 6: Financial Sector Growth and Productivity Growth



Source: Cecchetti, Kharroubi, BIS, July 2012.

to the tax haven industry – at 42 per cent of all student enrolments – highlights the extent of this capture. Many other small financially-dependent jurisdictions with higher education facilities see similar trends. Box 4, below, outlines the capture of Cyprus in more detail.

This crowding-out of alternative sectors and most of the processes that cause it will be highly familiar to students of the Resource Curse.

2.5.1.4 Loss of entrepreneurialism and productivity; hollowing-out

Closely related to the issue of crowding-out is another feature of finance-dependent economies, similar to what happens in many resource-dependent ones: a significant loss of productivity and of entrepreneurialism. The process is also closely tied up with financialisation, as Section 2.5.1.5 below explains.

For example, in a March 2011 paper for the US-based Kaufmann Foundation,[94] Paul Kedrosky and Dane Stangler found that a rapid rise in the financial sector's recruitment of new graduates in technical disciplines, correlated with a steep decline in the retention rates of the highest-performing students in science, mathematics, engineering, and technology, particularly since 1980, as well as a decline in "entrepreneurial intentions" among high-skill workers, and in the rate of new start-ups (though other indicators were more nuanced.) They conclude:

> *It seems certain that financialization, an effect and cause of entrepreneurial capitalism, subsequently cannibalized entrepreneurship in the U.S. economy.*

Separately, Figure 6 from the BIS report shows productivity trends for 21 OECD countries. The BIS study adds:

94 Kauffman Foundation Research Series: *Firm Formation and Economic Growth; Financialization and Its Entrepreneurial Consequences*, March 2011 Paul Kedrosky and Dane Stangler Ewing Marion Kauffman Foundation.

Industries that are in competition for resources with finance are particularly damaged by financial booms. Specifically, we show that manufacturing sectors that are either R&D-intensive or dependent on external finance suffer disproportionate reductions in productivity growth when finance booms.

A quote from Janan Ganesh in the *Financial Times* crystallises a significant part of the problem, for the UK

The UK's laxity, however chaotic and crude, is the way it earns its living. This is not a country able to trade on world-beating productivity or infrastructure. Its competitive advantage is the relative ease of doing things here, even if that means hiring foreign staff or trading financial instruments.[95]

(Section 2.6.3.1 below explores the issue of economic rents, which in both resource-dependent and finance-dependent economies are destructive of true entrepreneurialism and long-term productivity.)

The loss of entrepreneurialism and consequent hollowing-out also creates path dependency, as Section 2.5.1.4 above notes. This can be particularly dangerous in finance-dependent economies which depend on a highly volatile sector: lost alternative industries and lost skills are not substantially or quickly resuscitated or compensated for. This seems to be a side-effect of "financialisation", discussed in the next section.

Britain seems to be a case of this long-term hollowing-out: a 25 per cent fall in the value of the Pound Sterling since the onset of the financial crisis does not seem to have revived export performance: the current account deficit was higher in 2012 than in 2007,[96] and manufacturing output was eight per cent lower. UK Plc has so far proven too weak to respond to one of the largest monetary boosts in recent history, and despite the government's "funding for lending" project to encourage banks to provide credit to local businesses, the project has been regarded as a damp squib.[97] The Cambridge economist Ha-Joon Chang comments:

Despite the huge incentive to export created by such devaluation, Britain is still running trade deficits because it has lost the productive capacity to respond.[98]

Compounding this, there also seems to be little correlation between the size of a financial centre in an economy, and domestic access to financial capital, a key ingredient in productivity growth.[99] Figure 7, from the UK, illustrates the issue.

This chart illustrates that only a small proportion of lending – less than a third – was directed towards manufacturing and other parts of the productive economy, while the large majority (70 per cent, the blue sections in the chart) went to financial services and real estate. Lending to the real economy has been displaced by growth in banks' trading books, which include a rapid rise in assets such as structured credit products.

This would seem to call into question one of the core benefits one might instinctively attribute to a large financial centre: access to capital for business.

Resource-rich countries do suffer this problem to a certain extent: in heavily resource-dependent countries financial activities do focus quite heavily on the oil sector, sometimes to the detriment of other less lucrative sectors.

95 *Strange death of a more liberal Britain*, Janan Ganesh, March 25, 2013.

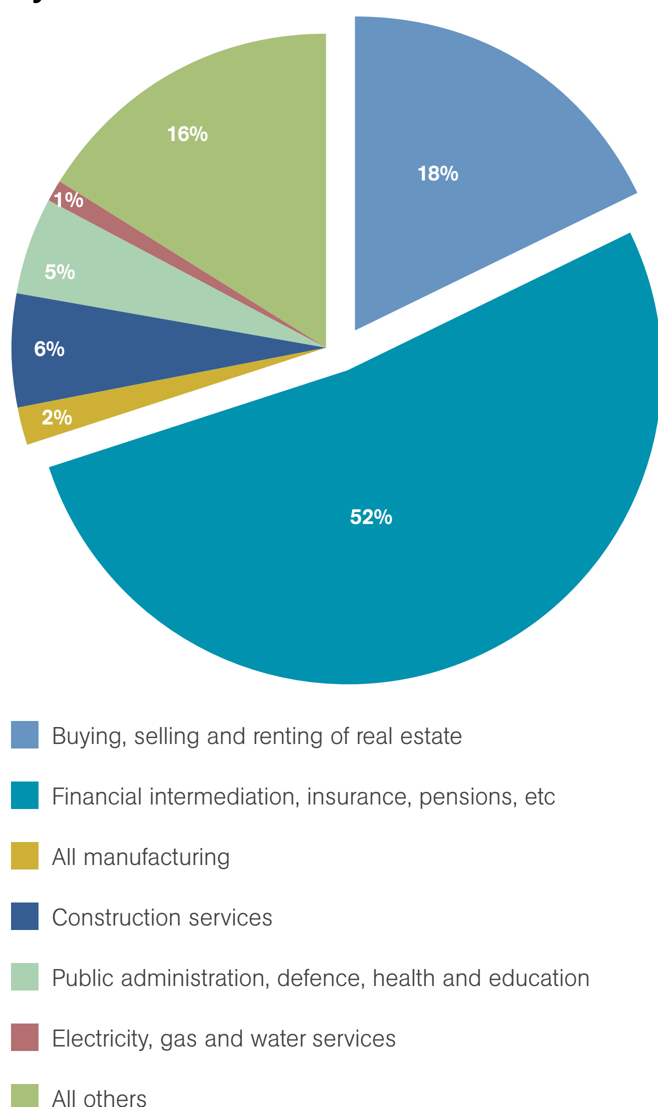
96 See, for instance, *Britain's Trade Deficit is as worrying as its budget deficit, The Guardian*, Jan 28, 2013.

97 On Funding-for-lending, see, for instance, *So much for Funding for Lending stimulating bank lending in the UK, Mindful Money*, April 19, 2012. For a brief summary of the UK's wider problems discussed in this paragraph, see *Balancing Britain*, editorial, *Financial Times*, April 10, 2013. Among other things, it notes: despite enjoying the benefit of a sustained and steep fall in the value of sterling – the pound is still down about a fifth from where it was before the financial crisis – Britain's exporters have failed to set much of a pace. The trade figures for February were dire. Far from foreign sales expanding as companies directed their sales efforts away from an austerity-hit UK, exports were stubbornly flat… The bleak fact may be that the UK does not have enough exporters making and selling the right goods.

98 Ha-Joon Chang, *Britain: a nation in decay, The Guardian*, March 8, 2013.

99 Widely noted. See, for instance, *Entrepreneurial Profile of the UK in the Light of the Global Entrepreneurship and Development Index*, Imperial College, April 2012. Of the 14 'pillars' cited, access to risk capital was repeatedly highlighted as the UK's key failing, in spite of it having by some measures the world's biggest financial centre. See this discussed also in the July 2012 Kay report.

Figure 7: Lending to UK residents, by sector



Source: Bank of England, *Industrial analysis of monetary financial institutions lending to UK residents* Table C1.2, Feb 2013.

2.5.1.5 Financialisation as economic capture

'Financialisation' is a term that scholars use to mean several related things. In part, it concerns the increasing elevation of financial capitalism over the industrial economy, and the expropriation of economic profits by financial actors through financial techniques. It involves manufacturing or services entities becoming more leveraged and increasingly resembling financial businesses, dominated and led by financial markets. It involves financial services growing as a share of the economy, and often serving as a cuckoo in the nest that pushes out, hollows out and harms productive economic sectors. Meanwhile, financial elites gain greater influence over economic policy. Clearly, this resonates with the Finance Curse analysis. The above notion of large candy flosses being spun out of small amounts of sugar – just as daisy chains of collateralised debt obligations are spun out of underlying mortgages – can help to visualise this.

A commonly used definition for financialisation is:

The increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies.

Almost by definition, jurisdictions with oversized financial centres are disproportionately financialised.[100]

Different observers emphasise different elements of the phenomenon:

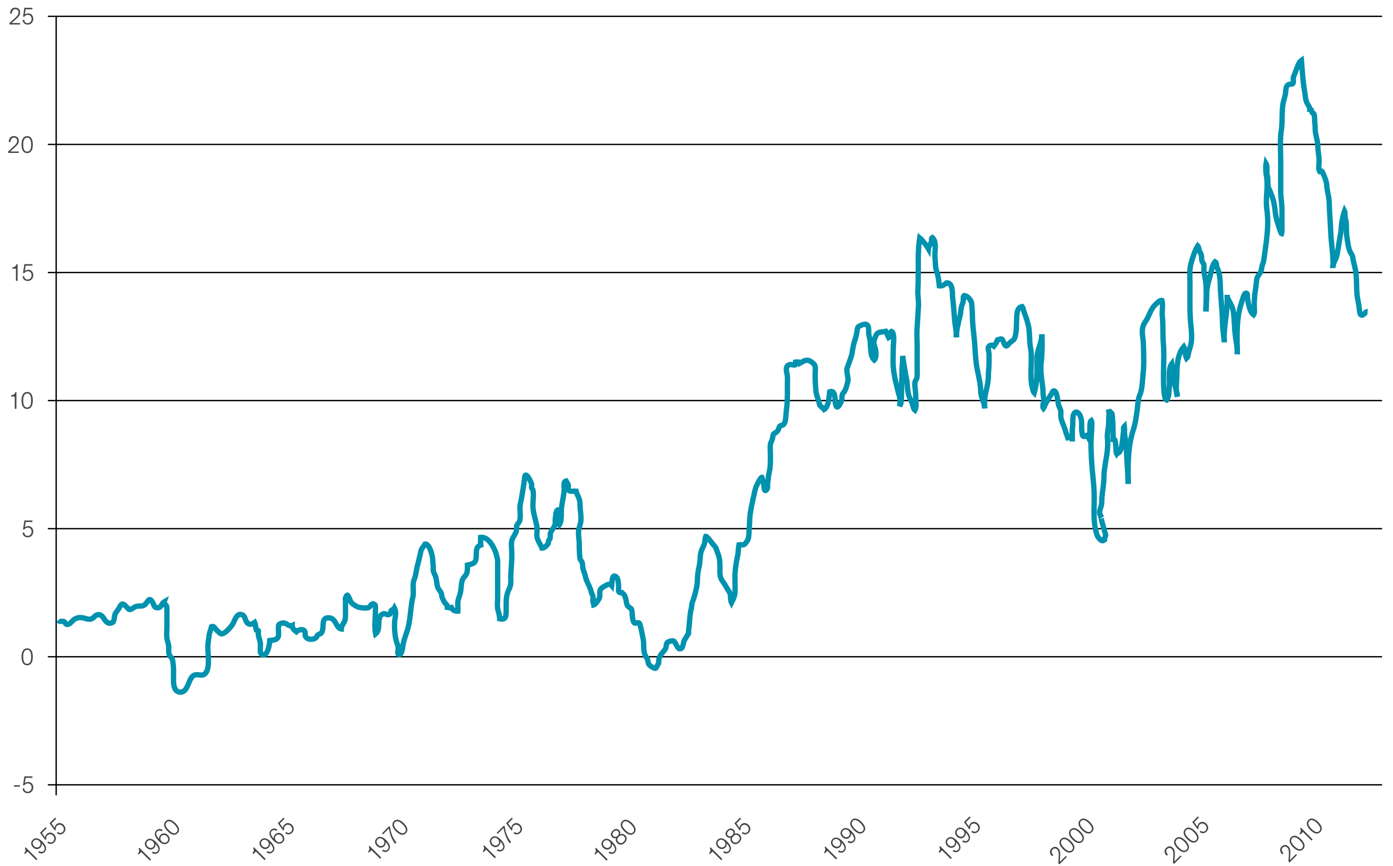
- Financial expansion: Growth in financial markets, capital markets, and financial trading, alongside a fall in bank lending.
- Rapid growth in credit and debt, particularly of households
- Financial liberalisation
- The elevation of interests of shareholders over those of other stakeholders and the obsession with 'shareholder value'.
- The shift in corporate CEOs' focus away from long-term company-building and real productivity to shorter-term financial engineering.
- Crowding-out of alternative sectors by a dominant finance sector

Figure 8 below illustrates aspects of how financialisation has increased in the UK and US.

Note that financialisation is stronger than these graphs suggest. They understate the true economic profits (as opposed to accounting

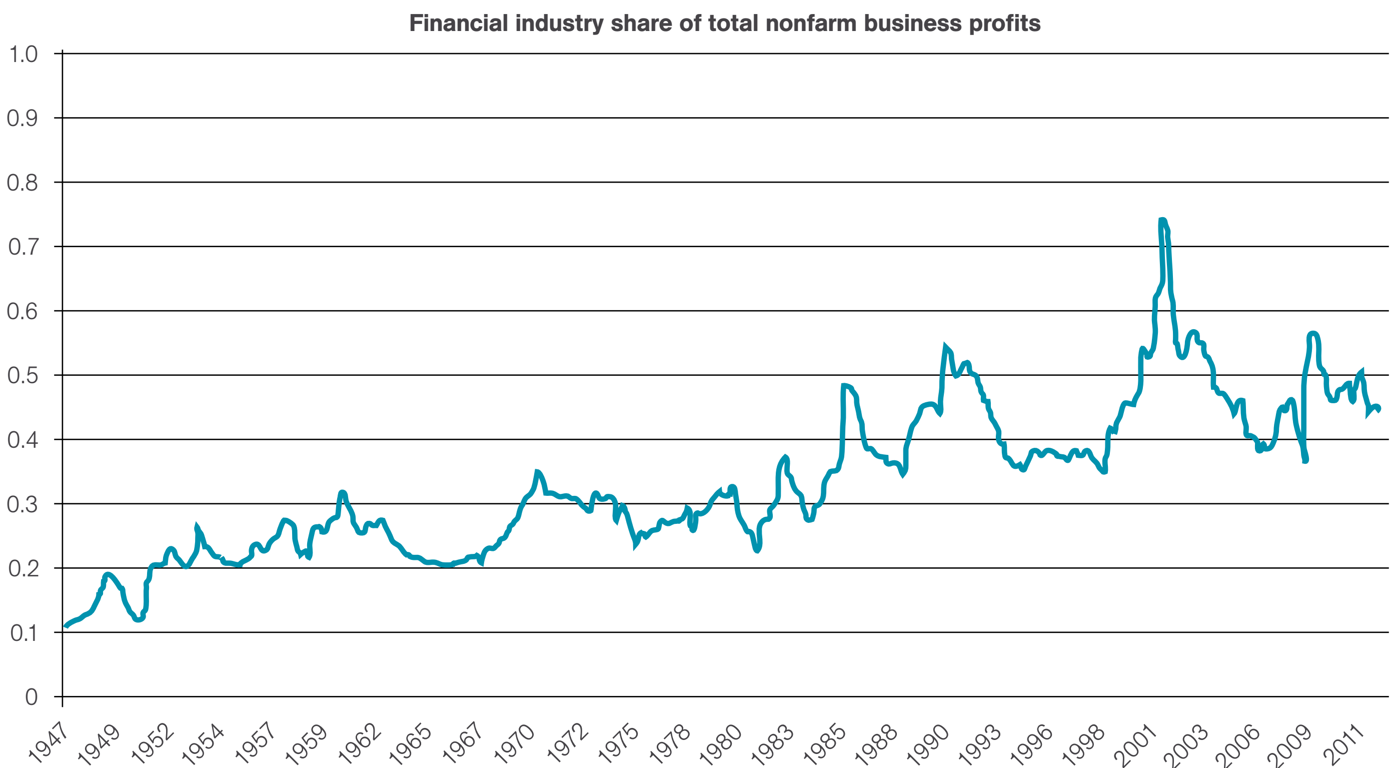
100 And there is plenty of evidence of this too. As a September 2012 study put it: "In countries with large financial industries, households and non-financial companies generally rely more on external capital. Consequently, in these nations, shocks to the financial system have larger output effects." *Challenges for Switzerland as a financial centre*, Thomas J. Jordan, SNB board chair, Sept 3 2012.

Figure 8: Growth of the financial sector in the U.S. and UK



Source: *Don't Bank on It: the financialisation of the UK Economy*, IPPR, Dec 2012.

Gross operating surplus of UK private financial corporations (% of total)



Source: *The Rise of Finance*, Evan Soltas, Feb 24, 2013.

profits) of financial organisations, since a big share of the economic profits feed into salaries and bonuses which are not reflected in this data on business profits.[101]

While globalisation has been welcomed by many (though not all) analysts as broadly beneficial, most analysts of financialisation see it as harmful, involving a shift of resources away from the 'real' economy towards finance – which is essentially not productive activity but a cost of doing business, as Section 2.4.7 explains. Financialisation significantly involves the *extraction* of wealth or of economic rents, rather than wealth *creation.*

Some scholars, analysing financialisation over several centuries, have suggested that a 'financialised' phase of capitalism represents the final phase of a nation's power, heralding ultimate weakness.[102]

Financialisation involves short-termism. A landmark 2012 report by John Kay into UK equity markets argues:

> *Short-termism in business may be characterised both as a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and as hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental operational capabilities of the business.*[103]

Professor Clayton Christensen of Harvard Business School explains how short-termist financial perspectives emphasise the use of financial ratios such as Internal Rate of Return (IRR), Return on Net Assets (Rona,) Earnings Per Share (EPS) or Gross Margin Percentage, as definitions of profitability:

> *A company could improve its RONA by generating more revenue and put that in the numerator. But the other way to improve this ratio is to reduce the denominator by a company getting rid of assets. Reducing assets is much easier than increasing revenue…*
>
> *Empowering innovations tend to emerge 5 to 10 years after the investment. But IRR encourages investors to get in and out of a company fast. IRR disappears for something that will take five years to pay off. It effectively prevents investors, private equity players, and venture capitalist from investing in the long term.*[104]

Financialisation is, in an important sense, both an example and a cause of economic capture. Professor Michael Hudson of the University of Missouri (Kansas City) explains part of this capture, in his characteristically polemical style:

> *The tactic is to load economies (governments, companies and families) with debt, siphon off their income as debt service and then foreclose when debtors lack the means to pay. Indebting government gives creditors a lever to pry away land, public infrastructure and other property in the public domain. Indebting companies enables creditors to seize employee pension savings. And indebting labor means that it no longer is necessary to hire strikebreakers to attack union organizers and strikers… The aim is not merely to acquire land, natural resources and key infrastructure rents as in military warfare; it is to centralize creditor control over society.*

101 For a good exploration of this, see *Hidden profits, Hidden rents, Interfluidity*, Feb 27, 2013.

102 See, for example, *Financialization and the U.S. Economy*, Ö Orhangazi, p42 onwards. Giovanni Arrighi, the best-known proponent of this "long waves of capitalism" thesis, saw similarities in secular processes first in the Italian city states of the late Renaissance; then the Dutch United Provinces of the 17th century; England during its long imperial heyday; and finally the United States. In each new cycle, the main ascendant power won its role by being the world's great exporter of capital. As reviewer Benjamin Kunkel put it: "Over time, this power became a net importer of capital–indebted to the newcomer waiting in the wings, as the Dutch were once to the British, and then the British to the Americans. This turn toward financialization was, on Arrighi's account, a reliable "sign of autumn."

103 *The Kay review of equity markets and long term decision making*, John Kay, July 2012.

104 See Christensen's article *The New Church of Finance: Deeply held belief systems and complex codes must be changed*, *Deseret News*, Dec 9, 2012. This and subsequent Clayton Christensen quotes are complemented by comments he made in a telephone interview by Shaxson, May 1 2012.

Increased indebtedness is exacerbated by the favourable tax treatment often given for debt over equity, which creates strong incentives to shift lending businesses offshore, leaving onshore borrowing costs to be deducted against tax. In heavily financialised economies, the negative impact of those policies will be that much larger, due to the greater prominence of debt.

As Section 2.5.1.3 above explains, a shift of high-skilled workers away from wealth-creating sectors towards rent-seeking and wealth extraction also involves a permanent loss of skills which damages true entrepreneurialism, as has been found in many resource-rich countries. This is crowding-out in action, and it is usually accompanied by path dependency as key skills in crowded-out sectors are often lost permanently.

The private equity (PE) industry provides a classic case study of how corporations can be 'financialised,' with parasitical candy flosses of financial engineering spun around them. PE firms buy established companies then typically load those companies with debt to fund "special dividends" for their managers (and, to a much lesser extent, for their co-investors), and to create tax breaks. Following a financial (rather than a productive industrial) logic, PE firms pass the debt liabilities onto the companies they acquire, and can squeeze out further profits by wiping out those companies' pension obligations or responsibilities to creditors, and dumping these costs onto society. None of these activities, in themselves, are socially useful or economically productive, but instead involve the extraction of economic rents while inflicting widespread collateral damage on the companies they acquire and on their wider stakeholder groups.

Professor Louis Brennan of Trinity College Dublin describes private equity as "not even a zero-sum game but a game that involves both value shifting and value co-destruction."[105] Figure 6 above, showing the small proportion of UK lending that goes to industry and other productive sectors, points to one aspect of the problem.

One can even talk about the 'financialisation of finance itself' – in the sense that big banks, for instance, appear to be failing to provide their traditional 'utility' services effectively, as they focus on more super-charged 'casino' business lines elsewhere. An example of this failure is provided by a newspaper article about the UK's Halifax Bank, now part of the global banking giant HBOS:

> *The Halifax Bank's policy of discrimination against small businesses was made embarrassingly public yesterday. A flipchart listing a catalogue of professions which should be refused business was mistakenly left in the foyer of a branch.*
>
> *Titled 'We don't want', the chart said new business startups, businesses that deal with coinage, taxi drivers, window cleaners, market traders and shops and supermarkets would not be welcomed as customers.*[106]

A July 2012 article by Jonathan Ford in the *Financial Times* provides a concise *summary*[107] of the problem.

> *For a country that constantly extols the virtues of its large and prosperous financial sector, Britain can sometimes seem curiously inept at providing basic banking services.*

He cites the "monstrous charges levied on simple products", for instance, poor call-centre service, the "rolling barrage of mis-selling scandals", the Libor scandal, and the "inexcusable cock-up" of banks such as Royal Bank of Scotland temporarily denying their customers access to their money, through incompetence. Ford continues:

105 See *Grand Larceny of Private Equity*, Prof. Louis Brennan, *Financial Times*, letters, Jan 17, 2012. Another good short overview of the problems of private equity is *Private Inequity*, James Surowecki, *The New Yorker*, Jan 30, 2012. See also Ludovic Phalippou.

106 *Halifax, the bank that says No to small businesses*, *Daily Mail*, 2002.

107 *Bankers should emulate Captain Mainwaring,* Jonathan Ford, Financial Times, July 1, 2012.

These are basic failings. If banks cannot be trusted not to fiddle figures or rip off their customers, or even to give them access to their money, more and more people will start asking what they are for. It's a bit like discovering that the vicar not only runs a casino but controls the roulette wheel from a hidden pedal in his pulpit.

This has been a long ongoing process: a lifetime away from James Stewart's conscientious local banker in the film *It's A Wonderful Life*. The article continues:

The traditional retail banker may sometimes have been complacent and snobbish. But he was generally conscientious and would rather have died than have to deny customers access to their accounts. His incentives to gouge were relatively few. Charges were fixed, as was his pay.

When high-street banks later absorbed the City's investment bankers – through acquisition and recruitment – it was assumed that retail bankers would remain in charge because the high street bit was so much larger and more important. [But] the high-paying, risk-taking investment banking culture has swept all before it.

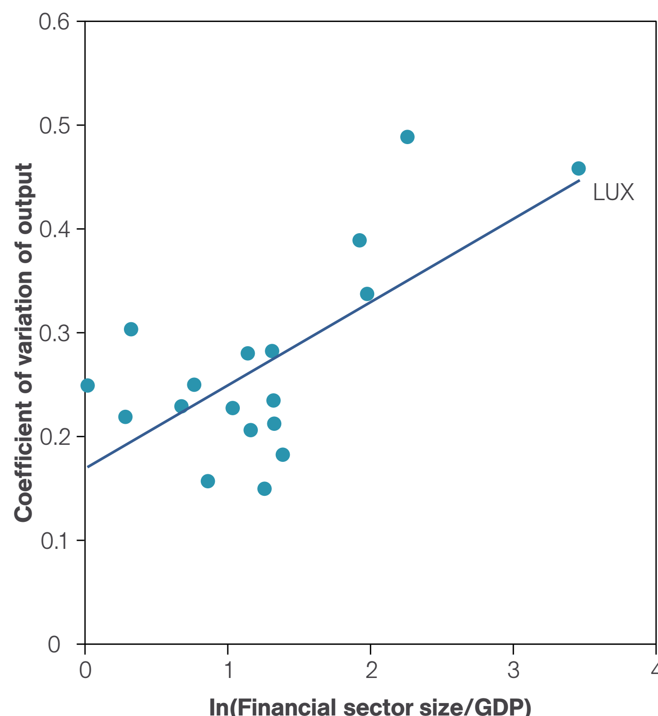
In modern times, the financialisation of the U.S. and UK economies has been accompanied by tepid economic growth, soaring inequality and stagnant middle class incomes, and this book suggests a high degree of causation behind this correlation.

Financialisation is one of the aspects of the Finance Curse that has no obvious counterpart in the Resource Curse.

2.5.1.6 Volatility, instability, and crises

The latest financial crisis reminds us that having an overly large financial sector seems to correlate with instability and economic crisis. (The public finance problems in, say, Greece, for example, are substantially due to weak tax collection and offshore financial leakages.)

Figure 9. Output volatility and financial sector size, 1980–2010



Financial liberalisation usually precedes financial-sector growth as a share of an economy, and crisis. "Financial liberalisation and financial crises go together like a horse and carriage," wrote Martin Wolf, chief economic commentator for the *Financial Times,* in a review of Carmen Reinhardt's and Ken Rogoff's overview of 800 years of global financial crises. "The incidence of banking crises proves to be remarkably |similar in the high- and the middle- to low-income countries."[108]

Figure 9, from the IMF, shows that financial crises also appear to be correlated with financial sector size.

This volatility is a problem strongly shared with resource-dependent countries too, though the timing and nature of the cycles differs.

108 *This time will never be different,* Martin Wolf, *Financial Times,* Sept 28, 2009.

2.5.1.7 Inequality and poverty

It is hardly surprising – and widely documented[109] – that financial sector growth can be a powerful driver of inequality, and of outright poverty too.

Research by Philippon and Reshef, for instance, shows financial sector pay as a key driver of this inequality. For most of the past century or so, U.S. financial sector pay was roughly at parity with other sectors. This ratio rose to 1.7 ahead of the 1929 Wall St. crash; it also rose to 1.7 in 2006, ahead of the recent crash.

For the United Kingdom, Brian Bell and John Van Reenen of the London School of Economics conclude that:

> *The growth in inequality has been driven by increasingly large bonus payments made to the better off. Unsurprisingly, these payments have been primarily in the financial sector and we calculate that around 60% of the increased income share attained by the top per centiles has accrued to such workers even though they account for only around 5% of the UK workforce.*[110]

Separately, a December 2011 report by the OECD found that income inequality among working-age people had risen faster in Britain than in any other rich country since the 1970s, driven substantially by the City of London.[111] Other reports suggest how growth in credit to the economy, an aspect of financialisation, has also been shown to be a driver of both inequality and economic instability.)[112]

In the UK, the Joseph Rowntree Foundation found that 13 million people (or one in five) live below the poverty line , and of the 27 EU countries, only six have a higher poverty rate; Britain also reportedly has "the worst social mobility in the Western world."[113]

A January 2011 report for the UK government, the so-called "Hills report," found that the top 10 per cent of the population had 97 times the wealth of the bottom 10 per cent; inside London itself the figure was 273 to one.[114] Income inequalities were also high, with a 90:10 ration of 12.4. (Even these stark figures, however, significantly fail to capture the extremes in the top 0.1 per cent of income and wealth.)

Smaller financial centres can suffer higher inequality effects too. In Jersey, for instance, labour market policies have placed severe downwards pressure on wages, yet average house prices are over three times as high as those in the UK, and growing, as Table 8 reveals.[115]

109 For instance, see James Galbraith's book *Inequality and Instability*, and his summary in *How economists have misunderstood inequality: An interview with James Galbraith*, *Washington Post* blogs, May 3, 2012. Galbraith argues that rising inequality is driven in large part by the financial sector.

110 Bankers' pay and extreme wage inequality in the UK, Brian Bell, John Van Reenen, April 2010

111 The OECD report is *Divided We Stand Why Inequality Keeps Rising*, OECD, Dec 2011. For a summary, see *Income inequality growing faster in UK than any other rich country*, says OECD, *The Guardian*, Dec 5, 2011. Also see *The Changing Picture of Earnings Inequality in Britain and the Role of Regional and Sectoral Differences*, Mark B. Stewart, National Institute Economic Review 2011 (link.) He argues that changes in London and in the financial sector have driven the inequality, particularly since 1995.

112 On average, Reinhart and Rogoff note, long historical evidence shows that government debt rises by 86 per cent during the three years following a banking crisis. Haldane notes of the latest crisis: "Debtors were meant to act as a brake on risk-taking incentives. Instead they had served as an accelerator." See also *How economists have misunderstood inequality: An interview with James Galbraith*, *Washington Post* blogs, May 3, 2012. Galbraith argues that rising inequality is driven in large part by the financial sector, and his research links economic inequality in the U.S. to credit booms, which themselves are destabilising, so "controlling inequality and controlling instability are the same issue." A report *Inequality, debt and growth* by the UK National Institute of Economic and Social Research (NIESR) shows that in the face of rising inequality, low-income households in the UK only maintained their standard of living through the late 1990s and early 2000s by borrowing heavily.

113 See Monitoring poverty and social exclusion 2011, Hannah Aldridge, Anushree Parekh, Tom MacInnes and Peter Kenway, December 2011, and Seven Up!: A tale of two Englands that, shamefully, still exist, Daily Telegraph, May 16, 2012

114 See *An Anatomy of Economic Inequality in the UK*, Hills Report, Jan 2011.

115 Under Jersey's Regulation of Undertakings and Development law, businesses must apply for a government licence to hire employees, and this is used quite stringently, curbing demand for labour. Meanwhile, immigration is essentially unrestricted. The combination of reduced demand for labour and unrestrained supply of labour has forced wages downwards towards the minimum wage level. Until 2005, Jersey had no minimum wage.

Table 6. Housing price inflation in Jersey and the UK.

	JERSEY	UK
1985	100	100
1990	207	155
1995	244	142
2000	454	236
2005	570	451
2010	830	465
Annual average change (%)	**29**	**15**

Sources: Jersey House Prices Index, Nationwide. The average nominal weighted house price at end- 2010 was £162,249 in the UK (source: Nationwide); in Jersey the mixed adjusted average dwelling price was £504,000 (source: Jersey House Prices Index).

A former Jersey Minister comments:

> *Jersey has appalling standards of wealth-distribution, with large working and under-class populations who struggle to exist in an environment that directly taxes basic foodstuffs, and which has a cost-of-living higher than that of central London. Jersey is, undoubtedly, a good place to be if you are middle-class or rich. For the rest of us, living here is a daily struggle.*[116]

The most recently published official data gives Jersey a Gini coefficient of 39, locating it between Tanzania (38) and Mali (40), but still less than Russia (42) and the United States which, according to the CIA World Factbook, had a Gini coefficient of 45 in 2007.117

116 Stuart Syvret, former health minister, in his blog of June 27, 2012.

117 The Gini index is a measure of income inequality. Zero means perfect equality, where everyone has the same income, and 100 means perfect inequality, where one person has all the income, and everyone else has nothing. Note also that the financially-dependent countries of the UK and Switzerland both have relatively high Gini coefficients, while financial sector-dependent Luxembourg has a much lower Gini, demonstrating that it is possible to mitigate inequality given the right policies of tax and redistribution.

(Gini data is unavailable for nearly all the small financial centres, so it is hard to reach definitive conclusions here.)

Every study of inequality has seriously underestimated the problem at the very top, as the Tax Justice Network demonstrated in 2012 with estimates of between $21–32 trillion stashed offshore.[118] These assets, whose ownership is crammed at the very top of the income and wealth scales, cannot be linked to their owners because of secrecy of beneficial ownership. Some studies do try to take account of this, but nearly every expert canvassed for this book said that under-measurement remains a huge problem. It is reasonable to assume that the offshore 'cloaking' of assets and income is more pronounced in finance-dependent economies.

Inequality can have strong regional dimensions in a country, as Section 2.4.6 explains.

In summary, finance appears to be a major driver of inequality in various economies. This is also a feature of natural resource-dependent countries.

2.5.2 Political outcomes

Beyond the obviously economic losses, a range of other losses stem from finance, most notably through political 'capture.' This happens in several areas.

2.5.2.1 Consensus, authoritarianism, and political capture

Many finance-dependent economies suffer what can be surprisingly strong authoritarian tendencies. This tends to be most pronounced in smaller jurisdictions where finance as a share of the economy can be extremely large: over 50 per cent of GDP in some cases, compared to under 10 per cent in the United States where such pressures are more 'diluted' by a relatively much larger democracy.

118 Nicholas Shaxson, John Christensen, Nick Mathiason, Inequality: You Don't Know the Half of It, Tax Justice Network, July 22, 2012. Includes names of all experts consulted.

The authoritarian tendencies tend to take specific forms: not so much generalised authoritarianism as with natural resource-dependent countries, but instead undemocratic and sometimes repressive responses to challenges to the financial sector – which can in some cases spill out to wider political suppression and control of dissent, particularly when those protests concern inequality.

This dynamic also involves the strenuous and often highly sophisticated and subtle shaping of a "Finance Consensus" favouring a financial centre, reinforced by and reflected in a degree of 'capture' of the local media and academia, particularly during boom times.

In his award-winning article The Quiet Coup, former IMF Research Director Simon Johnson explained how what he had found while on IMF missions to developing countries – the capture of nation states by élites – was being replicated in the United States.

> *Elite business interests—financiers, in the case of the U.S.—played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse. More alarming, they are now using their influence to prevent precisely the sorts of reforms that are needed...*
>
> *Even though some [of these policies] are traditionally associated with Democrats and some with Republicans, they all benefited the financial sector.*

In the UK, Philip Oppenheim, former exchequer secretary to the UK Treasury, summarised:

> *In developed, established democracies, powerful and well-funded interest groups such as financial services have captured government policy to their own ends, helping to ensure a benign fiscal environment for their industry.*[119]

The result has been, in the words of one commentator:

> *A kind of modern day credit-based equivalent of Eisenhower's military-industrial complex of the 1960s and 70s.*

Box 6 below provides a specific example from Britain, revealing how dramatically this capture has progressed since the 1970s.

Lobbying is clearly a part of the story. There are endless accounts of this – the film *Inside Job* or more recently PBS' *The Untouchables*[120] are good starting points.[121] This description of the U.S. "Dodd-Frank" financial reform bill provides a close-up, highlighting the role of lobbyists:

> *Dodd-Frank is groaning on its deathbed. The giant reform bill turned out to be like the fish reeled in by Hemingway's Old Man – no sooner caught than set upon by sharks that strip it to nothing long before it ever reaches the shore.*[122]

The power asymmetries can be spectacular. The *Washington Monthly* recently reported:

> *According to the Sunlight Foundation, the top twenty banks and banking associations met with just three agencies—the Treasury, the Federal Reserve, and the CFTC—an average of 12.5 times per week, for a total of 1,298 meetings over the two-year period from July 2010 to July 2012. JPMorgan Chase and Goldman Sachs alone met with those agencies 356 times. That's 114 more times than all the financial reform groups combined.*
>
> *"For every one hundred meetings I have, only one of them is with a consumer group or citizens' organization," said [Bart] Chilton, [a commissioner at the CFTC]. "The deck is just stacked so heavily against average people.*
>
> *[Another study] found that while public interest organizations met with agencies*

119 *A good time to look at all the players in the crisis,* Philip Oppenheim, letter to the *Financial Times*, Feb 3, 2012.

120 *The Untouchables,* PBS Frontline, Jan 22, 2013.

121 Accounts of this abound. For an insider view, also see, for example, Jeff Connaughton's book *The Payoff: Why Wall Street Always Wins.*

122 Matt Taibbi, *How Wall Street Killed Financial Reform*, *Rolling Stone,* May 10, 2012.

BOX 4: THE CAPTURE OF CYPRUS

Much has been made of the economic mistakes that led to the implosion of Cyprus' offshore banking sector in March 2013, and the consequent suffering inflicted on ordinary Cypriots. What almost no media accounts explained was the extraordinary degree to which Cyprus' economy and its political system had been 'captured' by the offshore industry. This involved an all-embracing consensus favouring offshore finance, in which almost no questions were ever asked of the criminal-suffused sector.

Figure 5 in Section 2.5.1.3 already provides a dramatic indicator of the extent of this capture in the academic field. Shortly after the main phase of the crisis began, two academics at the University of Nicosia, David Officer and Yiouli Taki, contacted us to describe the nature of this Mediterranean tax haven. Edited insights, sent to us by Officer via e-mail, include:

> *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…*
>
> *There was ecumenism at work – the material benefits which flowed sustained all the main politics parties and the leading actors within Cypriot society as a whole. This is one of the clearest cases of state capture you are ever likely to see revealed and in an EU, liberal democratic state at that…*
>
> *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…*
>
> *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.*

This communication from Cyprus struck a very strong chord with us: Christensen recognised immediately what he himself had experienced directly while serving as Economic Adviser to the British tax haven of Jersey. The communication also mirrored very closely what Shaxson had discovered while researching the "Life Offfshore" and "Ratchet" chapters of his book *Treasure Islands*. Officer, likewise, had a similar 'eureka' moment while reading *Treasure Islands* and another tax haven book entitled *Tax Havens: How Globalisation Really Works*:[1]

> *For us, we began with an issue such as corruption experienced within Cypriot society as an aspect of daily life and we could have remained at that level of analysis. We convened a conference on the topic back in the summer of 2011 and published a discussion paper. We began to explore the issue as the outcome of the failures of the state to regulate effectively as well as an accompaniment to party driven-clientelism. In doing so we could also place the issue in the context of discussions about the 'quality of governance' on the island. Given this refined approach we accumulated considerable data on forms and functions of 'localised' corruption, explored the category of 'state capture' and established, through verifiable evidence, the secretive nature of the state and its conduct towards its own citizens. So far, so good. But you can see how reading both your book as well as [Tax Havens] was revelatory. We knew immediately what it was that you had identified in the tax haven phenomenon. … That was a 'eureka moment' for me personally.*

---

1 *Tax Havens; How Globalization Really Works,* by Ronen Palan, Richard Murphy and Christian Chavagneux, Cornell, 2010.

BOX 4 CONTINUED

Taki and Officer also criticise the Tax Justice Network's Financial Secrecy Index, which creates a ranking of tax havens or 'secrecy jurisdictions' by combining a 'secrecy score' based on 15 objective criteria rooted in local laws and regulations, with a global scale weight according to the size of the offshore financial sector.

> *The index indicators through which measurement occurs are incomplete because they concentrate on the formal legal framework rather then the actual practice of lawyers, accountants and others which deviate from the legal norm established…*
>
> *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 island jurisdictions obscure from view the informal practices which circumvent the law…*
>
> *This is the competitive advantage they then use to attract foreign capital to Cyprus.*

A photograph of the Cyprus corporate registry in Norway's Business Daily Dagens Næringsliv (dn.no) helps illustrate the difference between the rules in place, which are supposed to provide a degree of corporate transparency, and the actual practice.

When the Norwegian journalists attempted to get information from this registry about Norway's richest man, John Fredriksen, the conversation went like this:

> *- Are you the police?*
> *- No.*
> *- Are you a detective?*
> *- No.*
> *- But who are you?*
> *- I'm a journalist.*
> *- These documents are secret.*
>
> *… For the second time in one year The Norwegian Business Daily orders the folders for over 30 companies, including all the key Fredriksen companies. The result is the same as in 2011. None of the 30 folders contains a single statement for the years after 2000.*[2]

Reports in Greece's Ekathimerini and Ethnos newspapers also highlight how overt and direct the 'capture' can be. As Ekathimerini reports it:

> *A list of Cypriot companies and politicians that allegedly had millions of euros in loans written off by the three Cypriot lenders at a center of an unprecedented banking crisis on the Mediterranean island has been forwarded to Cyprus's parliamentary ethics committee … The list reportedly features the names of politicians from all Cypriot parties except Social Democracy (EDEK) and the Social Ecology Movement (KKO).*

All this has happened in the heart of Europe: from July to December 2012, Cyprus held the Presidency of the EU.

2 This is all reported in *What the Cyprus Company Registry Actually Looks Like*, Treasure Islands blog, April 7, 2013.

in giant group meetings on the same day, head honchos from the industry often met with the agencies' top staff alone. Former Goldman Sachs CEO Lloyd Blankfein, for instance, was not expected to share the floor."[123]

Less information on lobbying is available in the UK, but 2012 research by the Bureau of Investigative Journalism describes the lobbying machine in some detail, with the most important single lobbyist arguably being the City of London Corporation, a unique quasi-autonomous jurisdiction inside the British city-state which *officially* combines the roles of municipal authority with that of financial lobbyist.[124]

Another part of the story is the creation of a consensus by an often complacent or willing media. Professor Aeron Davis of Goldsmiths, University of London describes how a 'City-is-indispensable' consensus" has been propagated:

Media reports will often cover scandals and ire over banker bonuses but will rarely question the basic narrative around City indispensability.

The story is frequently repeated unquestioningly in mainstream news coverage. It has justified successive waves of financial deregulation.

There are some journalists who regularly question the activities and value of the City at a more fundamental level. However, the vast majority of day-to-day coverage is broadly supportive of the UK financial centre and usually willing to support the City-is-indispensable line. As one financial executive confidently explained to me 'The national financial press are written for the City by the City.'[125]

123 Haley Sweetland-Edwards, *He who makes the rules,* Washington Monthly, April 2013. A superb article on the lobbying process.

124 *Revealed: The £93m City lobby machine,* Bureau of Investigative *Journalism*, July 9, 2012 and associated articles. The co-author's book *Treasure Islands* looks in detail at the City of London Corporation.

125 Aeron Davis, *Tax Justice Focus, Second Quarter 2013, Volume 8 Issue 1.*

Davis cites several factors. One is that financial journalism has suffered from media budgetary cuts and falling reporting resources, and is therefore more susceptible to "easy" stories spoon-fed by financial actors and to the rise of financial public relations activities (such as TheCityUK, in Section 2.3). The complexity of finance also makes it easier to pull the wool over outsiders' eyes.

The 'capture' also, of course, involves the shaping of ideology. Professor Clayton Christensen of Harvard Business School describes one particularly important aspect of this, with respect to theories of businesses and productivity:

Professors of finance in the main business schools and the professors of economics have over the last 40 years created a church. The doctrines they teach are taught with the same force as the Catholic Church preaches their catechism. Their students get baptized into this church, they go to work for all these funds, and they follow the catechism.

If you ask people who belong to a church "Do you believe the doctrines?" most people will say 'of course I believe them.' People on the outside might think that their doctrines are crazy, but for the true believers on the inside, it is inconceivable that they are not right. For the high priests of finance, it is inconceivable to them that they are the problem. I believe that this is the causal mechanism behind this stagnation.

(Christensen discusses the essence of this doctrine in Section 2.5.1.5 on financialisation, above.) The consensus-shaping is often accompanied by a sneering attitude to more traditional sectors: in Britain, for instance, words and terms such as 'smokestack industries' and 'nuts and bolts' were used for decades to denigrate alternative sectors in favour of the shiny, high-tech, ultra-wealthy "whizz-kids" of the financial sector.

The results of this 'capture' abound, such as the UK parliamentary inquiry into the Libor scandal which UK MP John Mann in July 2012 called 'a total whitewash, or the UK's "Vickers" bank reforms which have been similarly panned as 'feckless' and as paying 'lip service' to reform.'[126]

Whereas in larger tax havens such processes are typically hidden behind a bewildering multitude of other processes, the issues become far more 'crystallised' and purer in small tax havens, where this financial capture is often near-absolute, and the outright repression of critics is more overt. Anyone wishing to understand the political processes involved is urged to read a chapter entitled "Ratchet" in Treasure Islands, which explores two episodes thousands of miles and many years apart – in Delaware in 1980/81 and the British tax haven of Jersey in the mid 1990s – and finds almost exactly the same phenomenon at work. A similar dynamic is evident in Ireland, a smallish tax haven and financial centre. A report in the *Financial Times* in April 2013 contains the following description of a meeting between top Irish civil servants and financial sector participants in November 2011:

> *They met under the auspices of the "Clearing House", a secretive group of financial industry executives, accountants and public servants formed in 1987 to promote Dublin as a financial hub.*
>
> *The participants thrashed out 21 separate taxation and legal incentives sought by the financial industry at the meeting, which took place in room 308 in the prime ministers' offices…*
>
> *"The lobbying was done in secret behind closed doors," says Nessa Childers, an Irish member of the European parliament, who got minutes of the meeting using freedom of information laws last year. "The bankers and hedge fund industry got virtually everything they asked for while the public got hit with a number of austerity measures".*[127]

Andrea Matt, a former opposition leader in the tiny financially-dominated principality of Liechtenstein, where the capture is far 'purer', notes the subtle silencing of critics that can happen:

> *No one talks about the repression. But everybody is aware of it. It is like a ghost: it`s all invisible, and it´s very difficult to fight against something that is invisible.*[128]

Box 6 below, exploring post-financial-crisis regulation, provides a case study.

The cases of Cyprus and Jersey, below, help reveal more about the deep processes at work, which show very close similarities in jurisdiction after jurisdiction.

The drivers of political capture and even authoritarianism are to be found in various sections in Section 2.6 below. These drivers go far deeper than the widely reported lobbying and consensus-creation, important though those are.

Examples of such governance problems from smaller tax havens abound.[129] Box 5 below, looking at the British tax haven of Jersey, finds similar insights. The chapters "Life Offshore" and "Ratchet" in the book *Treasure Islands* provide a series of additional insights into how these small financial centres function.

126 See *Libor scandal: banking inquiry branded 'total whitewash' before it starts*, *The Guardian*, July 13, 2012.

127 From *Great tax race: Ireland's policies aid business more than public*, Jamie Smyth, *Financial Times*, May 1, 2013. Childers provided the minutes of the meetings here. A longer discussion of Ireland's emergence as a tax haven and financial centre is provided in the Ireland narrative report for the 2011 Financial Secrecy Index, *here*.

128 Author's interview with Matt in Vaduz, Liechtenstein, Nov 10, 2011. In February 2012 the royal family said it would veto the results of any referendum that removed the powers of hereditary Prince Alois to veto the results of referendums.

129 A fuller exploration of political repression and corruption in Jersey is provided elsewhere. See, for example, "A Legislature for Hire: the Capture of the State in Jersey's Offshore Finance Centre," chapter in and John Christensen and Mark P. Hampton, *Offshore Finance Centres and tax Havens: the rise of Global Capital,* Macmillan Business, 1999. See also the chapter "The Life Offshore" in *Treasure Islands*.

BOX 5: AUTHORITARIANISM IN JERSEY

The British Crown Dependency of Jersey, a major global tax haven, is remarkably repressive. This is hard to quantify, but testimony from several figures is striking. Lenny Harper, a former Deputy Police Chief said in an affidavit signed in May 2011:

> *I went to Jersey in 2002 full of expectation of the challenge that lay ahead. I soon learnt that it was like nowhere else in the British Isles… . There are no checks and balances on power and the abuse of it. This is obvious each time one tries to make a complaint against any member of the government. With such an absence of controls, such an absence of accountability, the ordinary decent people of Jersey are helpless.*[1]

Harper was ousted and smeared after investigating allegations against senior politicians. Graham Power, former Chief Officer of the States of Jersey Police, issued a long statement outlining the 'unfettered' authority of certain ministers and the 'bullying' approach to critics, motivated partly by a desire to head off "unwelcome media interest in the island." In the statement he said of Harper's dismissal:

> *A political and media campaign was waged against Mr Harper. The core of the argument against him was that the award of business in exchange for favours was a traditional part of Jersey life and that Mr Harper was an intruder who was interfering in "The Jersey Way."*

It is illustrative that the Jersey media – including the local BBC – have at the time of writing failed even to report on Mr. Power's statement or on the content of Mr. Harper's long affidavit (though there has been much reporting on denunciations of them by Jersey politicians). Several Jersey officials contacted by the authors of this book described the local BBC outlet as having been almost entirely 'captured' by Jersey's financially-dominated establishment, while the Jersey Evening Post, the island's newspaper, known to dissidents as The Jersey Evening Pravda, is almost entirely uncritical of the offshore finance industry and its abuses.

The UK Member of Parliament John Hemming MP said:

> *Her Majesty's subjects in Jersey are not protected by effective checks and balances … the island's authorities are permitted to repress opposition activists… ordinary powerless people are oppressed by an entrenched oligarchy.*[2]

Trevor Pitman, one of the relatively few critical Deputies on the islands, issued a petition in 2012 in which he said:

> *Jersey's government, to this day, squanders millions from the public purse to try to silence and discredit its critics… The people of Jersey are being denied the democracy they deserve… On behalf of the people of Jersey, this is quite literally an S.O.S.*[3]

Commenting on a legal case he was involved in, he summarised his view of the relationship between rulers and ruled:

> *The unchecked abuse and failings in what is passed off as 'justice' in Jersey obviously cast light on deeply disturbing matters that will impact on anyone else – particularly of 'peasant stock' – daring to stand up against the bullying, elitism and abuse of position on which Jersey's Establishment has been constructed and survived over all these decades.*[4]

---

1 See, for instance, *Top ex-cop blasts Jersey corruption*, Treasure Islands blog, June 20, 2011 and The Life Offshore, a chapter in *Treasure Islands* exploring corruption in Jersey and the Cayman Islands.

2 See *Jersey and the Imprisonment of Stuart Syvret*, Early Day Motion, UK parliament, Nov 3, 2011.

3 *Petition at Change.org* to Restore the visa of banned journalist Leah McGrath Goodman, Statement by Trevor Pitman, Deputy of the States of Jersey. This concerns the case of a US investigative journalist banned from the US after investigating corruption and child abuse allegations in Jersey.

4 *The Dual Role of the Bailiff Farce,* Bald Truth blog, April 19, 2013.

BOX 5 CONTINUED

Former Jersey health minister Stuart Syvret, arguably Jersey's most vocal dissident who has been widely smeared and imprisoned more than once, is more forceful:

> *Jersey is governed by a crypto-feudal oligarchy which, of itself, is captured by the international offshore banking industry. It is a gangster regime, cloaked with the "respectability" of the trappings of the British establishment.*[5]

One of the few published academic studies of Jersey backs up this testimony:

> *The extent of this (economic) dependency is demonstrated by the manner in which the offshore finance centre has captured the local economy, not in a sinister sense but in terms of its power and influence, and its effect on the politicians, the (political) Committees, even the way the Island thinks – that the offshore centre is somehow synonymous with Jersey.*[6]

By way of comparison, it should also be noted that rather similar, if less forceful, statements can be found in the United Kingdom about both the criminality and the smearing of critics. Rowan Bosworth-Davies, a former detective and prominent critic of criminality in the City of London, said:

> *The British Banking Industry has become identical with an Organised Criminal Enterprise…*
>
> *I have been making these observations for many years now… I have brought down a regime of opprobrium on my own head in so doing…*
>
> *I have been privately described as a 'brand liability', on the basis that anyone who employed me would be blackballed by the City Establishment. My name was taken off a list of speakers at a major public banking compliance conference because as the Conference owner said, '…none of the clients we want to pay to come to this event will come if they know he is speaking…'*[7]

5 See *Resisting the Climate of Fear*, Syvret's personal blog, April 12, 2011.

6 Hampton, M.P., and Christensen, J., (1999) *A Legislature for Hire: The Capture of the State in Jersey's Offshore Finance Centre.* In Hampton, M.P., and Abbott, J.P., *Offshore Finance Centres and Tax Havens: The Rise of Global Capital.* MacMillan Business. Basingstoke, p183.

7 Rowan Bosworth-Davies, Rowan's Blog, *Response to the Parliamentary Commission on Banking Standards*, published on his blog, March 25, 2013, and *Regulating the criminal banks in the future and why Standard Chartered Bank deserve a really good kicking!*, April 1, 2013.

2.5.2.2 Offshore Secrecy

Offshore secrecy for non-residents is a defining and growing aspect of global finance. Research shows that secrecy is higher in countries with large financial centres, and is particularly strong in smaller financial centres.[130] Reasons are discussed in Section 2.6 below.

The economic losses that arise from financial secrecy are unquantifiable, but undoubtedly very large indeed. The Tax Justice Network estimated in 2012 that upwards of US$21 trillion in financial assets lie shrouded in offshore secrecy, worldwide, though its author James Henry concedes that measurement is 'an exercise in night vision' due to measurement difficulties.[131] Secrecy is also a feature of resource-dependent economies, though for different reasons.

130 The most comprehensive measure of this is provided by the *Tax Justice Network's Financial Secrecy Index*. The higher secrecy scores heavily feature the smaller players.

131 See James S. Henry, *The Price of Offshore Revisited,* Tax Justice Network, 2012.

BOX 6: THE CAPTURE OF THE BRITISH ESTABLISHMENT

The City of London – that is to say, the British financial establishment – has exerted significant control over British politics to varying degrees for centuries. We could cite countless episodes to illustrate the 'capture' of the British political establishment by the City, but we will choose a brief period in 2008–9, soon after the onset of the financial crisis, to illustrate what has happened. In many ways these episodes resemble developments in Jersey, Cyprus and many other small financial centres around the world.

Under fierce public pressure for "something to be done" about the financial calamity, two reports were commissioned. One was commissioned by Boris Johnson, the Mayor of London, to produce a report on the City of London's post-financial future. It was produced by a group led by Bob Wigley, the European chair of Merrill Lynch, and it included John Varley, the chief executive of Barclays, and Lord Levene, the chairman of Lloyd's of London. The second was co-chaired by Alastair Darling, UK Chancellor of the Exchequer and by Win Bischoff, the former chairman of Citigroup.

This post-crisis moment was probably Britain's one great chance for fundamental reform. The two reports, predictably, warned about the dangers of London losing its global 'competitiveness' as a financial centre, and used this as an excuse for what could broadly be described as inaction, or a preservation of the status quo. In fact, this was explicit in their very terms of reference: the Bischoff report was tasked "to examine medium to long term challenges to London's continued competitiveness in international financial markets," while the Wigley report was a 'review of the competitiveness of London's financial centre." These facts in themselves highlight that the reports, which in the public mind were supposed to chart a new, democratically chosen and better way forwards for the City of London, were effectively presenting the public with a *fait accompli.*

After the Great Complacence, an analysis by the Centre for Research on Socio-Cultural Change (CRESC) at the University of Manchester, documents the nature and extent of the 'capture' of financial policy-making at this crucial moment. First, it makes a historical comparison to illustrate how a previous era of democratic consultation on financial policy making has given way to the careful and deliberate removal of this sector from democratic control.

Figure 8 shows the comparison with the "Wilson Committee," which was formed in January 1977 and produced its report in 1980. It had been tasked with investigating the extent to which financial institutions could be blamed for the decline of British manufacturing at the time; its terms of reference were to "enquire into the role and functioning, at home and abroad, of financial institutions in the United Kingdom and their value to the economy."[1]

CRESC notes the stunning difference not just in the terms of reference, but also in the composition of experts asked to contribute to the Wilson report in the late 1970s, on the one hand, and then the Bischoff and Wigley reports in 2008/9. Figure 10 below shows the difference.

The Bischoff report, which is not shown here in graphical form, fits the pattern, as CRESC analysed it and described it:

> *[The report] was, after all, an officially published report, crown copyrighted, and available on the Treasury web site. That might lead readers to expect a report that was drafted by civil servants… In fact, was researched and written by the functionaries of finance PR and lobbying who have made careers out of telling stories about the beneficial effects of the activities of firms in the financial sector.*

CRESC then summarises the differences shown in the two tables:

> *In terms of representation, committee members in pre-1979 inquiries were a diverse group with academics, elected politicians, trade unionists, and industrial employers substantially represented. The standard practice was then to initiate and sustain debate by inviting written submissions and hearing evidence from witnesses who represented a broad range of interested groups…*

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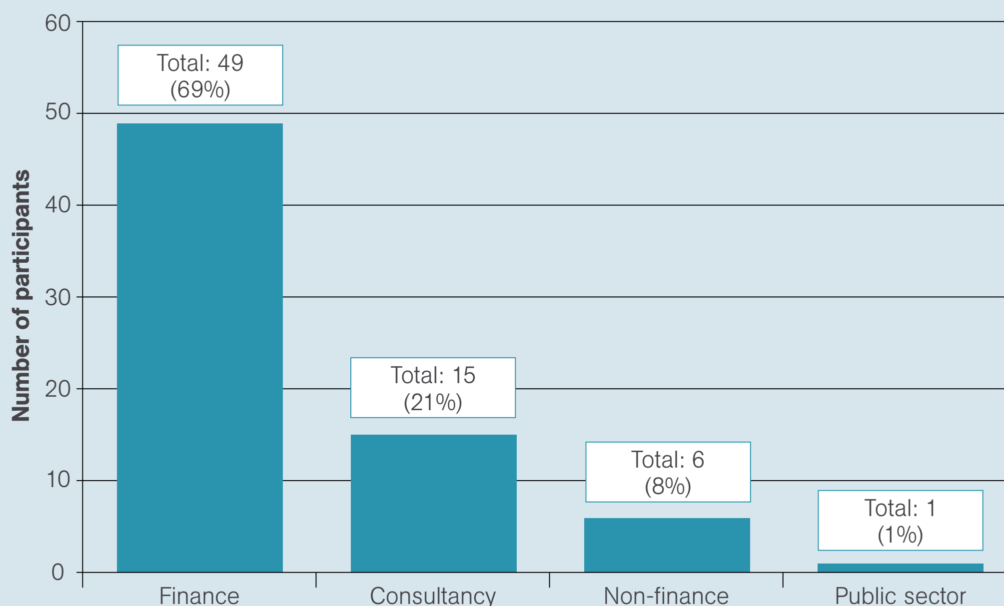
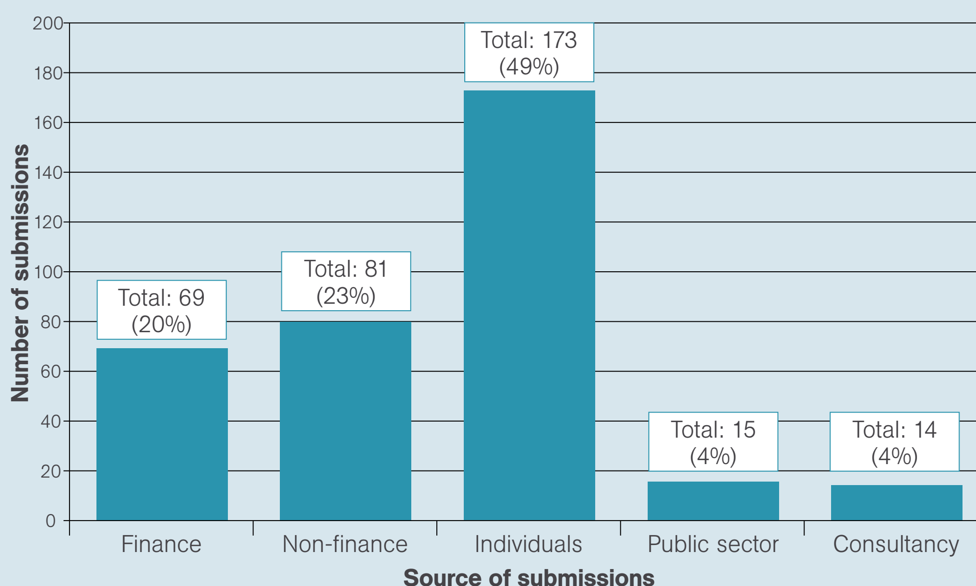
1 See *The Wilson Committee Review of the Functioning of Financial Institutions*, Peter G. Moore, 1981.

Figure 10: The Wigley report, 2009: An analysis of the expertise of the witnesses



The Wilson Committee, 1980: an analysis of submissions



Source: Cresc, After the Great Complacence.

None of these other interested non-City groups were consulted in the information-gathering, problem-defining phase before Bischoff and Wigley told their story about (the benefits of) finance and drew their policy implications. The membership of these inquiries contained no non-financial businesses and their trade associations; no trade unions (despite the unionization of retail finance workers); no NGOs to represent consumers or press social justice agendas; no mainstream economists or heterodox intellectuals; and very few politicians or civil servants… The technocratic legatees of John Maynard Keynes and William Beveridge have severed their predecessors' connection with social democratic values and popular politics which gave them traction.

BOX 6 CONTINUED

The all-important Secretariat for the Bischoff report, for instance, contained eight members and included just one civil servant, four employees from Citigroup, and three from the City of London Corporation. As regards the Wrigley report:

> *The question and answer sessions were a matter of finance speaking to finance… Remarkably, the public sector provided just one witness: presumably the knowledge and expertise of HM Treasury or Department of Business Enterprise Regulatory Reform (as it was then known) were irrelevant to the story that Wigley told about the importance of defending this valuable activity.*

And they summarise the capture of financial policy making both to the right and to the left of the political spectrum:

> *The political classes on both front benches had a bad case of Stockholm syndrome – the syndrome by which those captured identify emotionally with their captors.*

The sheer force of the financial calamity, however, forced the government to nationalise a very large section of the British banking system. Again, this once in a lifetime opportunity to take democratic control of financial institutions, steps were taken to carefully isolate the nationalised banks from democratic control. A new body, UK Financial Investments (UKFI) was set up to hold the public stakes in the partly nationalised banks, and it was filled to the brim with City of London grandees. UKFI's first chief executive, John Kingman, declared that it would operate 'at arm's length' from the government, and stressed repeatedly its emphasis on seeking 'shareholder value' for taxpayers (even though as Section 2.5.1.5 explains, an obsession with shareholder value played a major role in fostering the crisis in the first place.) As CRESC summarises:

> *The creation of UKFI was a critical institutional move in sheltering the operations of the publicly owned institutions from democratic control… the doctrine of the 'arm's-length' relationship has been a central feature of constitutional rhetoric in Britain and a key device insulating the workings of agencies with delegated functions from accountability pressures of the democratic state.*

UKFI also moved its operations physically out of the UK Treasury into the City to emphasize the original 'arm's length' operating philosophy.

2.5.2.3 Corruption and criminalisation

Corruption and criminalisation are two different, though closely overlapping things. This section[132] addresses both.

Some cross-country studies purport to show that financial centres are, on balance, bastions of good governance. For instance, a 2006 study by Dharmapala & Hines, widely cited by defenders of tax haven, asserts that:

> *There are almost no poorly-governed tax havens.*[133]

This is backed by intuitive assumptions that a need for economic and political stability, in order to attract flighty global capital, creates incentives for good governance.

However, even if Hines' statement *were* true, it would not be particularly meaningful, because there would be no identifiable chain of causation. Countries that are *already* well-governed are likely to attract financial capital. The lure of international financial capital is unlikely – for all the reasons explored in this book – ultimately to *promote* good governance.

What is more, several dynamics inherent to finance push in exactly the opposite direction. More authoritarian societies with political impunity (see Section 2.5.2.1 above) inevitably contain tendencies to corruption and criminalisation – as does rent-seeking activity,

132 This section refers to corruption in the traditional sense, as defined by the likes of Transparency International: the abuse of entrusted power for private gain. There is an entirely separate question of what corruption means in a global context, which involves looking at the corruption of financial and other markets. For an alternative view of corruption, see *Catching up with Corruption,* Raymond Baker, John Christensen, Nicholas Shaxson, *The American Interest,* September 2008.

133 *Which countries become tax havens?* Dhammika Dharmapala, James R. Hines Jr., Journal of Public Economics 93 (2009) 1058–1068.

explored in Section 2.6.3.1. The "Too Big to Jail" problem, recently highlighted by the non-prosecution of HSBC in the U.S. over money laundering violations (See Box 8, below,) is another.'[134]

Few would dispute that there has been a substantial criminalisation of finance. Recent examples that have surfaced just in the last year include the Libor and Euribor scandals;[135] insurance fraud (euphemistically known as 'mis-selling') scandals, vast unpunished money laundering scandals involving HSBC,[136] Standard Chartered Bank, ING, Lloyds TSB, Credit Suisse, ABN Amro / RBS, and Barclays[137] – plus, of course, numerous others involving the facilitation of tax evasion, or widespread mortgage fraud ahead of and in the wake of the financial crisis. As Charles Ferguson of the acclaimed film *Inside Job* summarises:

> *Since the 1980s much of the global financial sector has become criminalised, creating an industry culture that tolerates or even encourages systematic fraud… . none of this conduct has been punished in any significant way.*

Cross-country rankings or indices of corruption and criminalisation are of little help in understanding this problem: partly because many financially dependent economies are small jurisdictions that tend to be excluded from major world indices, and partly because these indices rely heavily on international investors' perceptions – which in turn depend heavily on levels on corruption in the financial centre itself, rather than in the political structures of the jurisdiction. This is a significant distinction precisely because of the nature of global financial capital, which requires financial centres strenuously to insulate themselves from domestic politics (as Sections 2.5.2.1 and 2.6.3.2 below explain). Measuring one may not be particularly relevant for the other – and from the citizens' perspective, that part that the surveys do not measure is what matters.

In evidence submitted to the UK Commission on Banking, Rowan Bosworth-Davies, a former British financial detective, explores the criminalisation of the UK financial sector. His evidence contains the following:[138]

> *The British banking sector has become an organised criminal enterprise which has been allowed to develop because of the criminogenic environment in which it functions, which has resulted from the absence of any meaningful regulation which those who control and manage the banks would fear.*

He says that there has been a fundamental failure by the authorities to address financial crime in a 'policing' manner:

> *This state of affairs has been allowed to develop because of the failure of the regulatory process to develop the necessary skills and knowledge of the conduct of criminals to enable them to deal professionally with the misdeeds of the banking sector.*
>
> *Those who are employed to provide the regulatory oversight of the market… do not exhibit any great inclination to wish to deal with the egregious activities of these individuals in a 'policing' manner.*
>
> *Ultimately, it is prosecution for crime which the financial practitioner truly fears. Conviction puts them in the same 'criminal class' category and it spells social and commercial death.*

He sees this reluctance to prosecute substantially in terms of a societal consensus as a form of political 'capture,' based on what

134 Widely reported. See, most notably, *The Untouchables*, PBS Frontline, Jan 22, 2013.

135 *Bank documents seized in Euribor probe, Financial Times*, Oct 19, 2012.

136 For a superb investigation of this see Matt Taibbi's *Gangster Bankers: Too Big To Jail, Rolling Stone*, Feb 14, 2013.

137 See, for instance, *HSBC let drug gangs launder millions: First Barclays, now Britain's biggest bank is shamed – and faces a £640million fine*, *Daily Mail*, July 17, 2012 and *Tallying Up U.S. Regulators' Money-Laundering Fines, WSJ Deal Journal*, Aug 15, 2012, which provides a short summary of some recent cases. Just for example.

138 See *Response to the Parliamentary Commission on Banking Standards: Professional standards and culture of the UK banking sector*, Rowan Bosworth-Davies M.A, published on his blog on March 25, 2013. *Part 1, Part 2, Part 3.*

he calls "the huge social gulf that existed between the crimes of the streets as opposed to the crimes in the suites."

> *A hidden agenda begins to be glimpsed, one which positively discriminates against the adoption of any methods or skills which, while they might have proved to be effective against the activities of working-class criminals in the past, are positively discouraged when it came to dealing with the crimes of the powerful.*
>
> *They use the age-old civil service tests of suitability, are they the 'safe pair of hands?', or 'is he one of us?', requirements.*[139] *How many former senior, experienced police detectives, men and women who have real skill and experience in dealing with major criminals, have ever been recruited to become senior figures in the regulatory agencies?... It is as if the skills required to catch common working class thieves are considered to be unsuitable to catch criminals from a more elevated social sector of society.*

Bosworth-Davies also puts his finger on higher tendencies to criminal behaviour in the financial sector:

> *Psychologically, many of these men and women can be defined as being 'regulatorily resistant'. Theirs is a primarily deviant, norm- evasive, criminogenic culture, not much given to the willing acceptance of regulatory control. Which predispose them to break the rules more readily than practitioners in other commercial sectors. These are the traders to whom the compliance officer is generally seen as 'the business prevention officer'*

Empirical evidence is available to support this assertion. In a recent survey, a quarter of Wall Street executives said they saw wrongdoing as a key to success,[140] and many believe the problem is getting worse. A senior central banker recently said that the City of London is now considered to be 'the money laundering capital of the world.'[141] Bosworth-Davies also cites personal experience as a financial detective:

> *My squad got into real trouble for going round the DTI [Department for Trade and Industry]. Instead of charging with their perennial 'Fraudulent Trading' which was always a bastard to prove, I preferred charges like 'False Accounting' and 'Procuring the execution of a valuable security by deception'. We could charge those on our own because they were Theft Act offences and didn't need DTI authority to prosecute. Then, after a couple of real headline successes, the DTI got nasty and insisted that in future, all our investigations be passed across them. We could have and should have done more, but we had managers who were frightened of their own shadows in some cases, and wouldn't move for fear of offending the DTI, and possibly their careers, or so they thought.*
>
> *During my career, even when I could demonstrate that my squad was dealing with named US mafia organised criminals who were setting up share dealing operations in London, DTI officials refused to do anything about it, and just laughed at us, accusing us of 'seeing the mafia behind every bush.'*

In smaller financial centres, far more dependent on finance, the tendencies to criminality are greater still. One marker of this is the high secrecy levels in small island tax havens.[142] For instance, the UK investigative publication Private Eye dubs the tax haven of Jersey the *Septic Isle*, with good reason; and former minister Syvret calls Jersey, perhaps with some hyperbole:

139 Elsewhere, Global Witness caught one practitioner stating this 'one of us' problem almost verbatim, in a secret video recording of corrupt business dealings in Malaysia, where a lawyer to the ruling family in Sarawak claimed that it was impossible for the Malaysian government to get information out of the tax haven of Singapore and that Singapore was a jurisdiction for "people like us".

140 *Many Wall Street executives say wrongdoing is necessary*: survey, Reuters July 10, 2012.

141 See *How London became the money-laundering capital of the world*, Ian Fraser, July 15th, 2012.

142 *The Financial Secrecy Index*, the only ranking of its kind, shows a very strong correlation between jurisdiction size and secrecy score.

The most corrupt wretched little backwater to be found anywhere in the established democratic world.

Box 5 above, on Jersey, provides further details.

Even if unquantifiable, the costs of this 'criminalisation' are undoubtedly very large. As the US economist George A. Akerlof put it, in a version of Gresham's Law:

[D]ishonest dealings tend to drive honest dealings out of the market. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.[143]

In the words of James Henry, author of the Tax Justice Network's widely cited report *The Price of Offshore Revisited,* the key driver of tax evasion since the 1970s has been "the rise of the global private banking industry," whose bread and butter is to create offshore structures as ways of evading tax and criminal laws. Disrespect for national laws is embedded in the very business model. Section 2.6.3.3 on arbitrage, below, has more on this.

It is not unreasonable to suggest that the damage caused by a country's 'capture' by criminalised and corrupted financial élites, while unmeasurable, might easily rival the harm caused by the death of alternative economic sectors, or of the apparently growth-killing effects of oversized finance.

The above discussion also raises curious questions. Why is it, for example, that the world's largest financial centres – such as the City of London or the Swiss financial centre – are located in jurisdictions whose citizens are among the most widely trusted for their probity and honesty in their business dealings; for the rule of law; for incorruptible judges and trustworthy courts and land registries, and so on – and yet at the very same time these centres serve as the world's largest repositories for criminal and other forms of 'dirty' money, typically hidden behind layers of secrecy?[144] And why is it that Transparency International's Corruption Perceptions Index contains some of the world's biggest and murkiest tax havens among its 'least corrupt' countries: Switzerland, New Zealand, Singapore, Luxembourg and Hong Kong?[145]

The paradox is easily resolved, in fact. Financial centres and tax havens seek to balance these two apparently opposing forces through a simple business model designed to attract the world's hot money: a model that can be crudely summarised as follows:

We will not steal your money – but we won't kick up a fuss if you steal other people's money.

The studies that look at corruption or criminalisation typically look at the former aspect, while the latter aspect may be of greater relevance from a governance perspective. To put it differently, this 'offshore' model holds that *domestic* laws and rules are to be scrupulously applied, to reassure foreign capital owners that their money is safe – but that *foreign* laws are to be disregarded, so that foreign capital owners are also reassured that they may, for example, evade their home countries' taxes or fraud laws, say, or escape domestic financial regulations.

While much of the criminality typically concerns the breaking of foreign laws – such as the harbouring of assets protected by secrecy, facilitating foreign tax evasion and other crimes – this approach is likely to 'leak' into the domestic sector, as Bosworth-Davies notes:

If a man is prepared to break the law in his home country, France, Holland or wherever – why would you think he wouldn't break the law in this country?[146]

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143 Akerlof: *"The market for "lemons", Quality Uncertainty and the Market Mechanism."* *Quarterly Journal of Economics*, Vol 84 no 3, Aug 1970.

144 For further exploration of the theme of dirty money, see Shaxson's *Treasure Islands.*

145 Contrast the Corruption Perceptions Index (CPI) with the Tax Justice Network's *Financial Secrecy Index.* New Zealand, while not measured in the current index, has a particularly murky companies and trust sector, which has handled large quantities of (among other things) Mexican drugs money.

146 Interview with author, Oct 2012

2.6 Root Causes

A range of factors help explain these negative outcomes flowing from financial sector dependence. Many if not most of the root causes bear more than a passing resemblance to the drivers behind the "Resource Curse." They can be grouped into three sections: Jersey Disease (similar to Dutch Disease), Volatility, and, most importantly, "Governance."

'Root causes' feed back into the 'outcomes,' and vice versa, in myriad feedback effects.

One big root cause underlying the growth of big financial centres is the ideology of 'laissez-faire' financial regulation, which has been very extensively discussed elsewhere so will not be explicitly examined in detail here, other than to briefly examine jurisdictional 'competition' as a key driver for deregulation.

2.6.1 Root causes: Dutch Disease, Jersey Disease

Resource-dependent countries suffer from the "Dutch Disease" – where financial inflows from the resource sector makes local price levels rise, either through the exchange rate or inflation, and these rising domestic price levels make it harder for alternative sectors to compete with imports. When commodity prices fall, it is much harder for sectors that have been killed off to be resuscitated, in a ratchet effect.

Finance-dependent economies appear to suffer from a similar, though not identical, phenomenon.

A global financial centre such as the City of London exports financial services, receiving dollars, say, in fees for services, often for capital that does not have the UK as a final destination. In this sense, it is just like a mineral exporter earning export revenues. Some capital – as when a Saudi prince buys a property in Mayfair or a Russian oligarch buys a football club – also stays behind.

This all affects local price levels: an inflow of fees bid up the pound Sterling currency, while foreign purchases of real estate, say, boost house prices. Higher local price levels make it harder for alternative tradable sectors to compete globally. They consequently shrink.

Figure 11, showing the annual growth rate of various sectors in the UK from 1992–2012, a time of particularly fast financial sector growth, is consistent with this, revealing particularly steep declines in the all-important tradable sectors of manufacturing and agriculture and with far less damage to the non-tradable sectors. This is a similar pattern to what has been found in resource-dependent countries, though of course the changes in Figure 8 are the results of many different factors.

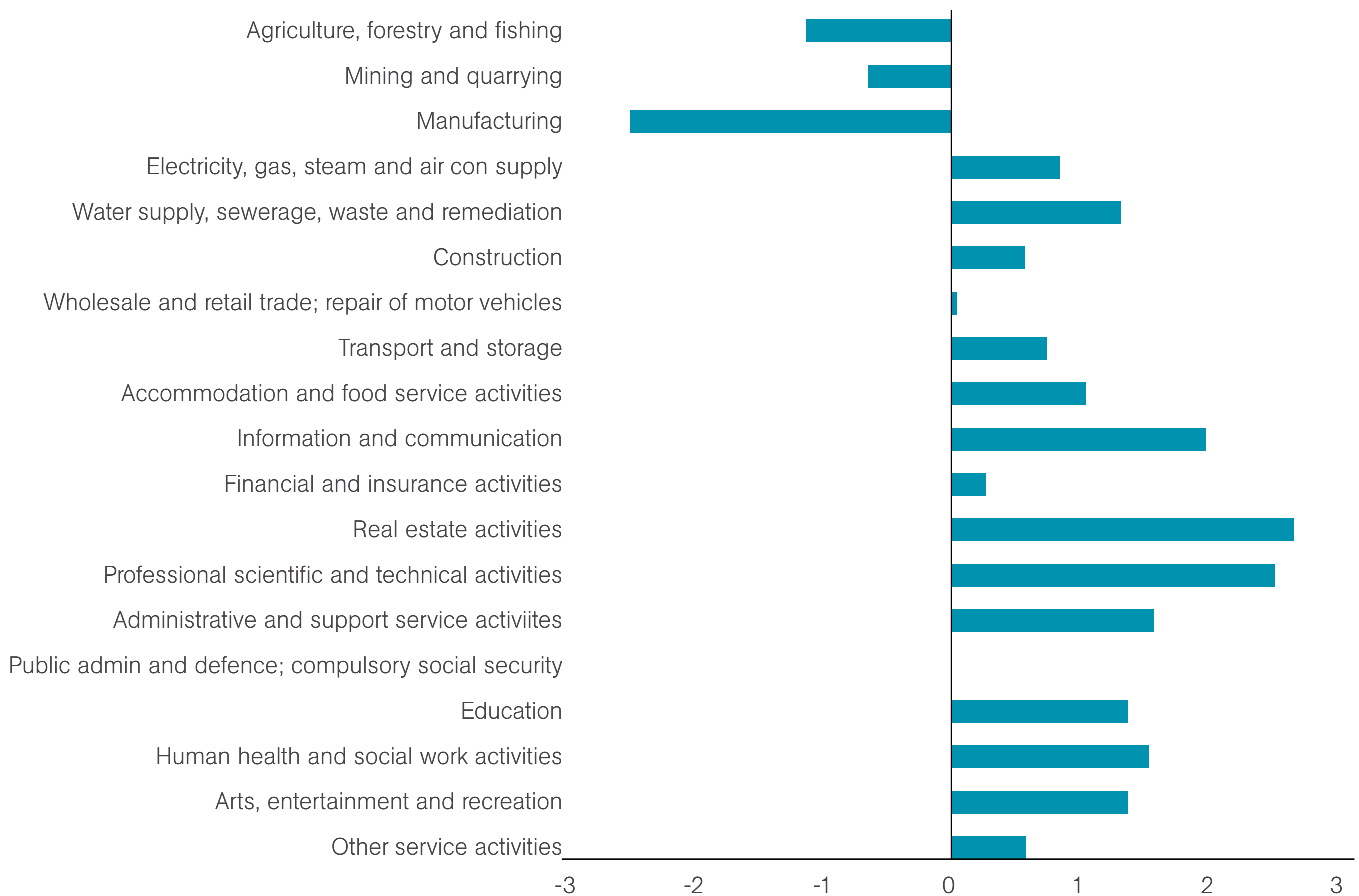
Switzerland's near-octupling of official foreign currency reserves since 2008 (to CHF 365bn by June 2012) – due to efforts to hold the Swiss Franc down in the face of large financial inflows – mark a clear and explicit recognition of the dangers of the Dutch Disease.[147] The fall in the Pound Sterling from over 1.50€ / £1 in January 2007 to under €1.10 amid turmoil in the financial sector led the UK economist Willem Buiter to note:

> *In these data there is nothing that cannot be explained as a (long overdue) correction of a persistent overvaluation of sterling – a misalignment that has biased the economic playing field against industries, both exporting and import competing, that would have had a fairer crack of the whip at a more reasonable exchange rate.*
>
> *One interpretation of the drivers of this persistent overvaluation would be a Dutch disease story, where the role of the natural resource sector in the standard version of the Dutch disease is taken by the UK banking sector. In this interpretation, a long financial industry bubble in the UK has driven up the real exchange rate in the whole economy and crowded out other sectors producing internationally tradable commodities. The recent sharp depreciation of sterling corrects this long-standing anomaly.*[148]

147 See *Bilanzpositionen der SNB /SNB balance sheet items,* Swiss National Bank, 2012

148 *Could the UK face a sterling crisis, or are we in one already?* Willem Buiter, *Financial Times* Maverecon blog, Nov 17, 2008. More recently, Bank of England Governor Mervyn King in October 2012 linked the two again, stating that "Total exports have risen sharply in the wake of sterling's depreciation."

Figure 11: Crowding-out in the UK?



Source: IPPR, 2012

We have decided to call this aspect of the Finance Curse the **Jersey Disease**. It is not easy to spot in large economies such as the UK's, which has been running persistent trade deficits in any case, but it is much easier to spot in smaller tax havens.

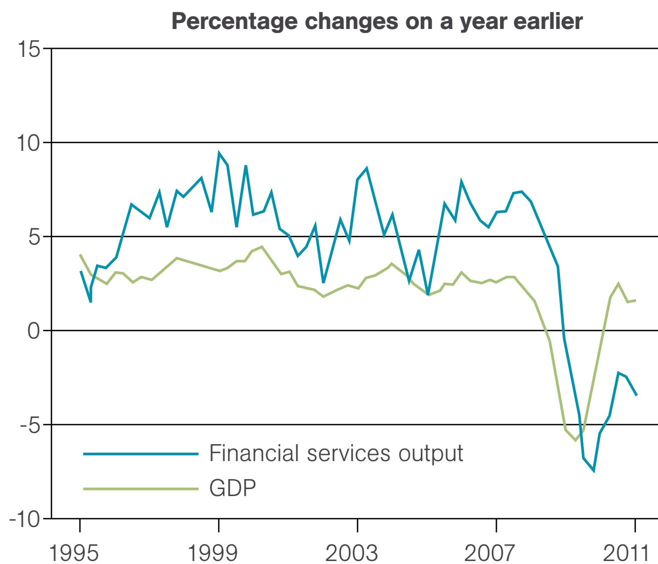
The Jersey Disease is similar to, though not exactly the same as, the Dutch Disease, since in smaller financial centres and tax havens currencies are typically pegged to a major currency such as the U.S. Dollar so the 'competitiveness' effect tends to happen not through exchange rate movements but through nominal rises in local price levels. As mentioned in Section 2.5.1.4 above, this creates path dependency problems where sectors killed off or squeezed during booms are not easily rebuilt.

As well as creating international competitiveness problems, high salaries in the financial sector also create internally destabilising domestic effects, which one might also consider part of the *Jersey Disease*. The "brain drain" away from other sectors and into finance is shown by the evidence found by the BIS outlined in Section 2.4.4 above, where highly remunerated finance "literally bids rocket scientists away from the satellite industry".

The ensuing damage to alternative sectors, in turn, weakens alternative economic voices, making the threat of job loss particularly potent, with implications for authoritarianism (see Section 2.5.2.1 above). In our cumulative years of research into tax havens and smaller financial centres, we have found this particular threat ("you will never work in this industry or in government again") cited again and again as a potent deterrent to critics of the finance industry, particularly in small jurisdictions where there are few career alternatives. Former Jersey politician Stuart Syvret adds:

> *I spoke out against the corruption. The result? I have been subjected to*

Figure 12: Financial volatility, UK financial services output



Source: *Bank of England quarterly bulletin,* Q3 2011

illegal massed police raids, arrest, malicious prosecutions, trials heard by directly conflicted judges, vilification, imprisonment, harassment from political office, bankruptcy. I'm now penniless, have no assets, no pension, am unemployed and live in social housing.

I will never – ever – have any kind of meaningful career again – for as long as I remain living in Jersey.[149]

The authors have obtained several testimonials along similar lines.

2.6.2 Root causes: volatility

As with the Resource Curse, the latest global financial crisis shows us that volatility is clearly a central component of the Finance Curse.

The latest financial bust is the culmination of a gigantic, complacent decades-long boom period in the financial sector, a great mega-cycle in global finance whose previous mega-bust was the Great Depression.[150] Within these mega-cycles, many smaller cycles exist, accompanied by banking crises in various countries; this has been particularly apparent since the period of financial liberalisation and growth in financial centres from the 1970s. Figure 12 provides an example for the UK.

The drivers behind financial cycles are different from those driving commodity cycles, and various explanations are offered, such as by the economist Hyman Minsky who explained how periods of stability and prosperity breed complacency, rising leverage, and the move towards a "Ponzi" economy, and ultimately a bust;[151] or Charles Kindleberger or even Karl Marx who examine other internal dynamics of financial capitalism that lead to manias and panics.

As with the Resource Curse, debt is a major contributor to the volatility: lending is easy during booms, and tough during busts, exacerbating the problems. The suffocation of alternative sectors makes economies more fragile and vulnerable to this volatility. A ratchet effect is at play: in financial booms the crowding-out is magnified though the underlying damage is masked by the countervailing financial euphoria; when boom turns to bust, those sectors that have been killed off cannot easily be resuscitated.

Evidence suggests that minimal or weak financial regulation, which is widely associated with jurisdictions having oversized financial sectors, tends to generate financial crises.

149 Stuart Syvret in an email to Nicholas Shaxson, Feb 8, 2012. One of very few academic analyses of this issue is provided in Competing Industries in Islands: a new Tourism Approach, Hampton M., Christensen J., *Annals of Tourism Research*, Vol. 34, No. 4, pp. 998–1020, 2007. This paper argues that in small islands the 'crowding out' of tourism happens in large measure due to the financial sector appropriating the best land, labour and capital – all scarce factors in small islands.

150 There has been widespread analysis of long-term cycles in the world economy and in the financial sector: see, for example, *Kondratieff wave theory, Marxist analysis*, the work of Hyman Minsky, and many other analyses. This is outside the scope of this essay.

151 As Martin Wolf explains in the *Financial Times* in January 2011: "Periods of stability and prosperity sow the seeds of their downfall. The leveraging of returns, principally by borrowing, is then viewed as a certain route to wealth. Those engaged in the financial system create – and profit greatly from – such leverage. When people underestimate perils, as they do in good times, leverage explodes. Finance then progresses from what Minsky called "hedge", in which interest and principal is repaid out of expected cash flow, to "speculative", in which interest is paid out of cash flow but debt needs to be rolled over, and finally to "Ponzi", in which both interest and principal is to be paid out of capital gains. Does this sound familiar? It certainly should." See Seven ways to fix the system's flaws, Martin Wolf, *Financial Times*, Jan 22, 2012.

Data is muddied, however, by the fact that instability can be globally contagious: a large financial centre may suffer instability, which is then transmitted to many other countries (and smaller financial centres and recognised tax havens have been shown to serve as conduit transmitters of financial contagion[152]).

2.6.3 Root causes: Governance effects

As with the Resource Curse, the most important and the most complex root causes of the varied adverse outcomes concern the effect on political institutions and governance, which some believe to be the most important determinants of an economy's success.[153]

Some but not all dynamics here are similar to those that underlie the Resource Curse.

2.6.3.1 Economic rents

Natural resource extraction can provide large unearned economic "rents", as Section 1.2.4 explains. The Polish author Ryszard Kapuscinski summarises oil rents effectively:

> *Oil is above all a great temptation. It is the temptation of ease, wealth, strength, fortune, power. It is a filthy, foul-smelling liquid that squirts obligingly into the air and falls back to earth as a rustling shower of money. Oil creates the illusion of a completely changed life, life without work, life for free. Oil is a resource that anaesthetizes thought, blurs vision, corrupts. Oil is a fairy tale and, like every fairy tale, it is a bit of a lie. It does not replace thinking or wisdom.*

This text could be applied, almost unchanged, to describe large parts of what happens in the financial sector. The Ganesh quote cited in Section 2.5.1.4 above neatly indicates this.[154]

Research by Philippon and Reshef[155] finds that 30 to 50 per cent of the wage differentials between the financial sector and other economic sectors in the United States are accounted for by unproductive rent extraction.

Some financial "rents" accrue from benign factors. In Britain's case, for instance, these factors include the English language, the rule of law and stable property rights, the fact that Britain's ex-colonies have legal systems derived from its own, its time zone straddling Asia and the Americas, or cluster effects from having a large pole of associated services in London.[156]

But there are less benign sources of financial sector rents.

For example, a large share of financial sector profits are extracted from taxpayers and others via "socialisation of losses and privatisation of gains" – where bankers take the cream from risk-taking activities, while shoveling the risks onto the shoulders of others.

Another example of financial sector rents would be Switzerland's banking secrecy laws. This can attract large financial inflows from which easy rents can be extracted, and the losses in terms of criminality (for example) are borne by others elsewhere. Clients accept lower interest rates (or large fees) in exchange for secrecy, and these fees or the bank's ability to pay lower interest rates, are sources of pure unearned 'rents' for the financial provider.[157]

Similarly, 'light touch' financial regulation can attract huge flows of capital, whose owners can

152 See, for example, the IMF graph highlighted in *"Tax Havens at the Core of Greek Crisis,"* Tax Justice blog, Nov 26, 2010, and associated commentary.

153 See, for example, *Why Nations Fail* by Daron Acemoglu and James Robinson. They argue that the strongest indicator of a successful economy is the presence of "inclusive" institutions, rather than "extractive" ones, which "are structured to extract resources from the many by the few", to preserve their privileges and their hold on power. 'Extractive' dynamics are clearly evident in the financial sector.

154 As a reminder, the quote was: "the UK's laxity, however chaotic and crude, is the way it earns its living: this is not a country able to trade on world-beating productivity or infrastructure".

155 See *Wages and human capital in the U.S. financial industry: 1909-2006*, Thomas Philippon, Ariell Reshef, NBER Working Paper 14644, January 2009.

156 Until the mid 1950s, London's role as a centre of global finance was based largely upon Britain's role as an Imperial power, enabling it to ensure that global financial services routed themselves through London. When the Empire collapsed from the mid 1950s, London re-engineered itself as a 'light touch' financial centre, initially with the Eurodollar markets. For a detailed discussion of this history, see Treasure Islands, chapter on the Eurodollar markets. As UK MP John Mcdonnell said of UK Labour Prime Ministers Tony Blair and Gordon Brown: "Blair and Brown made a Faustian pact to give the City its head. The idea was to let them do their profiteering and just take the tax benefit. It was not a relationship on our terms; it was simply 'Give them what they want.' " *Treasure Islands* p265 (UK edition).

157 For instance, Bloomberg cited a study by Booz & Co in 2011 noting that Swiss banks could lose 500 million Swiss Francs annually as a result of as customers "demand fees closer to those charged for onshore accounts" on assets regularised in agreements between Switzerland and the UK and Germany. Banks' margins on offshore accounts, it reported, were 60 to 80 basis points higher than for offshore accounts in Germany. See *Swiss Banks May Lose $51 Billion in German, UK Assets After Tax Accord*, Bloomberg, Nov 29, 2011.

profit at the expense of taxpayers elsewhere (the case of AIG Financial Products, the unit located in London which was at the heart of the AIG debacle, with U.S. taxpayers on the hook, is an example). Similarly, lax enforcement of rules and laws has made some financial centres such as the City of London particularly attractive.[158] These are externalities: essentially one group gets the cream, while the costs are borne by others.

Insider trading and price-fixing – which are rife in the financial sector due to massive assymetries in expertise and information – provide further ways to extract rents. As Robin Harding noted in the *Financial Times*: "the financial sector is ground zero (where) some firms and individuals have power and information, while others do not".[159] The potential losses to the wider public here are incalculable. The Libor scandal provides one high-profile example, but there are many others, such as the "ISDA fix" which *Rolling Stone* journalist Matt Taibbi describes as Libor's "twin brother."[160] He quotes:

> *It's just amazing how Libor fixing can make you that much money," chirped one yen trader. "Pure manipulation going on," wrote another.*

By no means all this kind of "insider" rent extraction is illegal. High frequency trading, for example, was described by Warren Buffett as "legalized front-running.' "[161]

Many other specific sources of rents exist. Adair Turner, chair of the UK's Financial Services Authority, identifies four other arenas for rent extraction in the City of London:[162]

- Banks helping others escape tax ("a depressingly large proportion of 'innovative product structuring' is based on tax management".)[163] The UK Commission on Banking Standards has claimed, for instance, that Barclays' Structured Capital Markets unit dedicated to tax schemes in one year generated 110% of the entire bank's profits.[164]

- Complex products that bamboozle investors, "exploiting deep asymmetries of information and expertise," (as mentioned above.)

- Activities like market making that allow systematic profit extraction at the expense of customers.

- "Valueless" increased trading activity such as high-frequency trading.

Other rent extraction possibilities for Wall Street beyond the "too-big-to-fail" (and "too-big-to-jail") subsidies include homebuyer tax credits and many other tax subsidies; federal guarantees on debt, interest on reserves at the Federal Reserve, the FDIC guarantee, or the Fed's policy of stabilising the value of the U.S. Dollar. Private equity and hedge fund owners fleece co-investors through exorbitant fees: according to a study of 541 buyout deals since 1990, 98 (yes: 98 per cent) per cent of internal returns generated by hedge funds were absorbed in

158 See, for example, *US takes lead in summer of discontent*, *Financial Times,* Aug 27, 2012, looking at U.S. efforts to tackle London-based financial shenanigans, and UK lobbyists' efforts to challenge the beefing up of UK financial watchdogs. This was often justified with the argument that 'markets will regulate themselves effectively;" for more on this see *Lazy-Faire in the Court of King Mervyn,* Treasure Islands blog, May 8, 2012. See also Ian Fraser, *How London became the money-laundering capital of the world*, July 15th, 2012.

159 *Economics and society: Barrier to a breakthrough,* By Robin Harding, *Financial Times*, Feb 22, 2012.

160 See *Everything Is Rigged: The Biggest Price-Fixing Scandal Ever,* Matt Taibbi, Rolling Stone, April 25, 2013. The ISDA fix manipulation allegedly involves interest rate swaps but the article also discusses manipulation of gold and silver prices.

161 See Warren Buffett explains *'Colourful Charlie'," CNBC, May 6, 2013*. He was commenting on quotes by his deputy Charlie Munger, who called HFT "a bunch of short-term people trying to get information one-millionth of a nano-second ahead of somebody else. It's legalized front-running; I think it's basically evil."

162 See *Reforming finance: are we being radical enough?* Speech by Adair Turner, Chairman, FSA Clare College, Cambridge, 18 February 2011. U.S. financial commentator Yves Smith sees two main forms of this "extractionism" – either by charging too much for goods or services (customer's can't easily judge the appropriate price of complex products, so get fleeced), or by producing products that are so complex that the embedded risk can't be seen.

163 Wikipedia defines rent-seeking like this: "An attempt to obtain economic rent by manipulating the social or political environment in which economic activities occur, rather than by creating new wealth… the extraction of uncompensated value from others without making any contribution to productivity." Clearly, tax avoidance fits this definition precisely, and many forms of financial 'innovation' – those that involve 'privatising gains and socialising losses' as Stiglitz puts it – fit neatly too.

164 See *Tweaking the tax system isn't enough: Britain needs to back words with action, Observer* editorial, Feb 10, 2013.

fees,[165] and studies show that once all factors including hidden fees are incorporated into the calculations, investor returns are lower than if they had invested into comparable public stock indices such as the S&P 500.

Another very large source of rents in the financial sector – which has been all but ignored in the mainstream literature – is the 'feeder' effects of satellite financial centres, where associated financial centres almost automatically, often for old historical, cultural and jurisdictional reasons, deliver a constant stream of foreign wealth management business, (or mergers and acquisitions or other business) to the financial centre, substantially routed through offshore tax havens. Britain stands as the main example of this, as Box 7 below explains. This 'feeder' network, almost automatically channeling large flows of capital to London, is a major source of economic rents and a major component of the power and wealth of the City of London, and it also contributes substantially to other financial centres including Wall Street.

Easy rents encourage policy-makers to turn their attention away from the hard graft of nurturing 'challenging' sectors like manufacturing industry as they are attracted instead to shiny, high-tech and super-wealthy global finance and the easy rents it generates. (Thus, 'laissez-faire' financial regulation could be called 'lazy-faire'.) Productivity suffers. Martin Wolf, writing in the *Financial Times* in April 2013, summarises Britain's plight:

> *Increasingly, the British became rentiers. That was one reason why the City became the leading global financial centre. It has a huge financial centre, weak domestic manufacturing, a deregulated labour market, rising inequality and low private and public investment. It all looks remarkably late-19th century.*

> *As Richard Lambert, former director-general of the CBI, the business organisation, and former FT editor, noted in a recent lecture, the British business sector still shows a "relatively low commitment to long-term investment, [and] to research and innovation". When the City determines how companies are run, that is sure to happen. A company such as Rolls-Royce could hardly be created today. That is not what the City would dare to support.*[166]

This growing political indifference to other sectors reinforces the 'crowding-out' and path-dependency dynamics – as well as the authoritarian tendency described in Section 2.5.2.1.

Similar processes are at play in resource-dependent economies.

2.6.3.2 The double-edged stability requirement

Financial centres require stability and the appearance of probity, or the money will flee. Crude, generalised authoritarianism often goes hand in hand with crude, generalised corruption, which global finance will shun – at least as a base for doing business. This creates some positive incentives for stability and the rule of law, and as a result crude and destabilising patronage politics is less prevalent in finance-dependent countries than in resource-rich ones.

However, a narrower yet still potent financial-authoritarian dynamic is still evident.

Global finance needs not just relative political stability but also a particular aspect of stability that could be described as a reliably pliable polity anchored in a Finance Consensus. This must be based on the stability of domestic financial laws and rules.[167] The needs of finance must be protected from domestic challenge. The

165 Simon Lack, *The Hedge Fund Mirage, 2012*. A *Financial Times* review summarised: "Investors would have been better off putting their money in US Treasury bills yielding just 2.3 per cent a year. Roughly 98 per cent of all the returns generated by hedge funds, he estimated, had been eaten by fees." The hedge fund industry (predictably) responded furiously; see discussion of this response, in turn, in Felix Salmon's *Why investors should avoid hedge funds*, Reuters, Aug 8, 2012.

166 *Britain should not go back to the future*, *Financial Times*, April 12, 2013.

167 Examples abound. For instance, on the day of writing this sentence, the Financial Times is carrying a story quoting a senior British opposition politician complaining of a 'gaping hole' in future financial regulation in the City of London which "could prevent important warnings from reaching the chancellor of the exchequer." See *Balls sees gaping hole in City revamp*, *Financial Times*, Feb 1, 2012.

host jurisdiction must be trusted not to tax or regulate capital too sternly.

To put it crudely, if local democratic politics threatens the privileges of finance, then two possibilities emerge: either financial players and capital will flee elsewhere, or the governing classes must neutralise that particular aspect of democratic politics, to reassure the financiers. The Capture of Jersey, Cyprus and the UK establishment, described in Boxes 4, 5 and 6 above demonstrate this process in action.

The latter approach usually happens on multiple fronts, but most powerfully through the construction of a social consensus favouring finance, and the 'capture,' to varying degrees, of the local media. In some cases, as Box 4 on Jersey above illustrates, this can become outright repression of dissent. If money is to be free, some citizens may have to be jailed.

Typically, this consensus involves creating the idea that the interests of the financial sector are synonymous with those of the jurisdiction as a whole: the exact opposite of the Finance Curse thesis.

This dynamic constitutes an integral part of the phenomenon of Country Capture, and will be familiar to citizens of many small tax havens – and even to many in the U.S. or UK who have sought to challenge the powerful narratives of their respective financial sectors.

The situation is not identical in resource-rich countries, where levels of authoritarianism are often harsher. Political repression and even political violence are unlikely to have much impact on the ability to export minerals: as long as production sites and export routes are secured, by military means if necessary, then the minerals can be exported. Rulers can get the money, and they often appropriate it and hold it offshore, and pay directly for the suppression of dissent, by violent means if necessary.

Another crucial difference is that with the Resource Curse, authoritarianism is an outcome of resource dependence, whereas with the Finance Curse, the (narrower) authoritarianism dynamic is a requirement for a successful financial centre: it is important not to let the messy, noisy compromises of democracy get in the way of finance. This dynamic is, again, particularly felt in smaller financial centres. As the authors Palan, Chavagneux and Murphy note, the 'independence' of British tax havens like Jersey or the Cayman Islands:

> *is more apparent than real, for their developmental and social goals are subject to the whim of foreign capital*[168]

So in this particular respect the Finance Curse is in a way more dangerous than the Resource Curse, because it *requires* financial actors to take deliberate and sustained steps to neutralise democracy and undercut potential democratic challenges to finance.[169]

Also tied up with the notion of stability of a jurisdiction's laws is the notion of the jurisdiction as a safe haven from foreign turbulence. Many would regard 'safety' as unambiguously a good thing (which of course it typically is), but in financial centres it can have a more insidious meaning: for example, 'safe from taxes' or 'safe from foreign criminal laws', for instance. International financial centres (tax havens) offer escape routes, or havens of 'safety,' from other jurisdictions' laws, rules and regulations – which are, for all their imperfections, usually put in place for good reasons.

The tension between the two competing dynamics (one, where mobile finance demands stability and the rule of law, and two, where finance demands a degree of capture' creating incentives towards authoritarian dynamics, corruption and criminalisation) is typically bridged through well-funded public relations, as explained earlier:

> *Secrecy jurisdictions steeped in sleaze confront this by putting on a strenuous*

168 *Tax havens: how globalization really works,* Ronen Palan, Christian Chavagneux, Richard Murphy, 2010, p187.

169 With thanks to Alex Cobham for this particular insight comparing the two Curses.

BOX 7: THE BRITISH "SPIDER'S WEB"

The City of London is fed by a large network of tax havens spread around the world, the remnants of the British Empire.

It is organised in concentric rings. The inner ring consists of the three Crown Dependencies of Jersey, Guernsey and the Isle of Man. As an example of their 'feeder' role, a British government report notes:

The Crown Dependencies … provided net financing to UK banks of $332.5 billion in the second quarter of calendar year 2009, largely accounted for by the 'up-streaming' to the UK head office of deposits collected by UK banks in the Crown Dependencies.[1]

The upstreaming of deposits is just one component of the 'feeder' effect. For example, many transactions booked in these tax havens send the heavy lifting (legal work, accountancy, debt structuring) up to the City of London. Much, though by no means all, of the City's financing involves tax-evading and criminal funds from around the world. Jersey Finance, the lobbying arm of Jersey's finance industry, notes that:

> *Jersey represents an extension of the City of London."*[2]

The next ring of 'satellite' havens are Britain's 14 Overseas Territories, of which half (Anguilla, Bermuda, British Virgin Islands, Cayman Islands, Gibraltar, Montserrat Turks & Caicos) are recognised tax havens. Statistics are scarce but in 2008, for example, Bermuda insurers and reinsurers alone reportedly wrote nearly a third of the premiums at Lloyd's of London, a total of £5.4 billion."[3]

The havens themselves are usually fairly regionally focused: so the Crown Dependencies heavily target Europe, Middle East and Africa, while the Caribbean havens will more commonly target the Americas.

This British web provides the City with two main things. First, the tax havens scattered across the world capture passing foreign business and channel it (often via structures that involve a variety of other jurisdictions) to London, just as a spider's web catches insects. Second, it lets the City get involved at arm's length in 'dirty' business, but with enough distance to maintain plausible deniability.

Various other havens such as Hong Kong, Luxembourg and Switzerland, while not British, still feed large volumes of business to the City. (Similarly, Caribbean and other tax havens feed large volumes of capital, and the business of handling capital up to Wall Street too.)

The UK partly controls the Overseas Territories and Crown Dependencies and can strike down their legislation at will,[4] yet almost never intervenes to check abuses perpetrated from these tax havens – and this is fundamentally due to the influence and interests of the City of London.[5]

1 *Final report of the independent Review of British offshore financial centres* ("Foot Report,") October 2009, p6.

2 See *Jersey: For Banking,* Jersey Finance, 2010.

3 Foot report, 2009, p7.

4 "[The UK] Parliament does have power to legislate for the Island without their consent on any matter in order to give effect to an international agreement" **Source**: Hansard, UK House of Commons Debates, 3 June 1998, cols. 471 and 465.

5 For longer overview of the British offshore system, see *The City of London & Its Offshore Empire*, Nicholas Shaxson, the *Occupied Times*, January 2012.

performance of rectitude, a theatre of probity that involves repeatedly projecting the essential message – 'We are a clean, well- regulated, transparent and cooperative jurisdiction.'[170]

One of the most powerful tools in the financiers' toolkit, in terms of shaping the required societal consensus and neutralising challenge, is the threat of 'don't tax or regulate us too much or we will relocate to Geneva / Singapore / London.' Section 2.6.3.3 below expands on this. Another tool is the 'too big to jail' argument, which Box 8 explores.

170 *Treasure Islands,* p236 of the UK edition. This theatre of probity also involves a reluctance or even refusal to engage with critics: for example, co-author Christensen has a standing challenge to the authorities of his former home Jersey for a public debate about the financial sector, which has not only never been accepted, but never been reported in the media.

BOX 8: "TOO BIG OR TOO MOBILE TO FAIL OR TO JAIL"

The 'too big to fail' and 'too big to jail' problems associated with large banks is well known, particularly in the United States, and fairly easily explained: the forces of law and order hold back on prosecuting large financial institutions for fear of creating financial instability – but also for fear that the business will relocate overseas.

The most well-documented example of the too-big-to-jail problem stems from the HSBC case in the United States. It follows revelations by the U.S. Department of Justice that HSBC had illegally failed to monitor over $670 billion in wire transfers from Mexico, which the DoJ said made HSBC Mexico "the preferred financial institution for drug cartels and money launderers." The (slightly shortened) transcript of a PBS interview with Assistant Attorney-General Lanny Breuer below explains:

MARTIN SMITH: You gave a speech before the New York Bar Association. And in that speech, you made a reference to losing sleep at night, worrying about what a lawsuit might result in at a large financial institution.

LANNY BREUER: Right.

MARTIN SMITH: Is that really the job of a prosecutor, to worry about anything other than simply pursuing justice?

LANNY BREUER: Well, I think I am pursuing justice. If I bring a case against institution A, and as a result of bringing that case, there's some huge economic effect – if it creates a ripple effect – it's a factor we need to know and understand.

TED KAUFMAN: That was very disturbing to me, very disturbing. That was never raised at any time during any of our discussions. That is not the job of a prosecutor, to worry about the health of the banks, in my opinion. Job of the prosecutors is to prosecute criminal behavior. It's not to lie awake at night and kind of decide the future of the banks.[1]

Subsequently, Attorney-General Eric Houlder said the U.S. Justice department decided not to pursue a criminal prosecution of HSBC because:

> *The size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps even the world economy.*

There is, in fact, what one might consider to be an official list of global 'too-big-to-jail' banks, provided by the Financial Stability Board. These are what it calls the "systemically important financial institutions" (SIFIs.) The list, updated on November 2012, contains 28 big banks:

> *Citigroup, Deutsche Bank, HSBC, JP Morgan Chase, Bank of America, Bank of New York Mellon, Credit Suisse, Goldman Sachs, Mitsubishi UFJ FG, Morgan Stanley, Royal Bank of Scotland, UBS, Bank of China, BBVA, Groupe BPCE, Group Crédit Agricole, ING Bank, Barclays, BNP Paribas, Mizuho FG, Nordea, Santander, Société Générale, Standard Chartered, State Street, Sumitomo, Mitsui FG, Unicredit, Group Wells Fargo.*[2]

It is worth noting that the FSB and its member organisations are heavily staffed with representatives of these same large banks. It is also worth mentioning that many smaller financial institutions based in smaller jurisdictions (such as Luxembourg) would be considered Too Big to Jail.

The U.S. Financial criminologist Bill Black explains three areas in which criminalisation happens:

> *The embrace of the three "de's" by both parties – deregulation, desupervision, and de facto decriminalization – has created ever more criminogenic environments.*

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1 *See transcript of The Untouchables,* PBS documentary, Jan 22, 2013.

2 *Update of group of global systemically important banks (G-SIBs), Financial Stability Board*, Nov 1, 2012. Thanks to the Golem XIV blog for pointing this out.

BOX 8 CONTINUED

Although 'decriminalisation' might appear at first glance to be the opposite of 'criminalisation,' in fact they are just two aspects of the same process: rules are made, rules are broken, and then, as the rule-breaking becomes systemic and amid the 'competitive' threats from rule-breaking in other jurisdictions, the rules are relaxed: decriminalisation. In an increasingly rules-free environment, the anomic behaviour described by Bosworth-Davies in Section 2.5.2.3 above becomes prevalent.

These processes are also, significantly, one-way ratchet effects, as Black continues:

> *The finance industry will exploit any severe financial crisis and recession by arguing that it is essential to embrace the three de's in order to spur a recovery. The finance industry makes different arguments when times are good. It argues then that the banks are so profitable and losses so low that it is perverse to prevent the banks from engaging in their total wish list of activities while reducing or eliminating any restrictions the banks find onerous. In good times or bad finance has only one position – a more passionate embrace of the three d's is vital."*

The international mobility of finance is also a crucial reason why criminalisation is often not tackled, as the next section explains.

2.6.3.3 The arbitrage threat

The relationship between financial centres and their domestic populations and local politics is substantially affected by apparently credible threats by mobile capital and wealthy individuals to relocate elsewhere if their demands are not met.

HSBC's regular threats to relocate to Hong Kong in the face of higher capital and other requirements in London are a case in point.

A more colourful example comes from the Alpine tax haven of Liechtenstein. When a Liechtenstein supreme court judge challenged the extensive, quasi-feudal powers of Prince Hans-Adam, whose family owns the principality's largest bank, he threatened to leave and take his wealth with him:

> *If they do not want the head of our family to be the reigning prince, that is OK. But then they will have to find another head of state willing to pay the costs out of his own pocket. Maybe Bill Gates will be interested and then they could call themselves Microsoft instead of Liechtenstein.*[171]

Hans-Adam won the ensuing referendum.

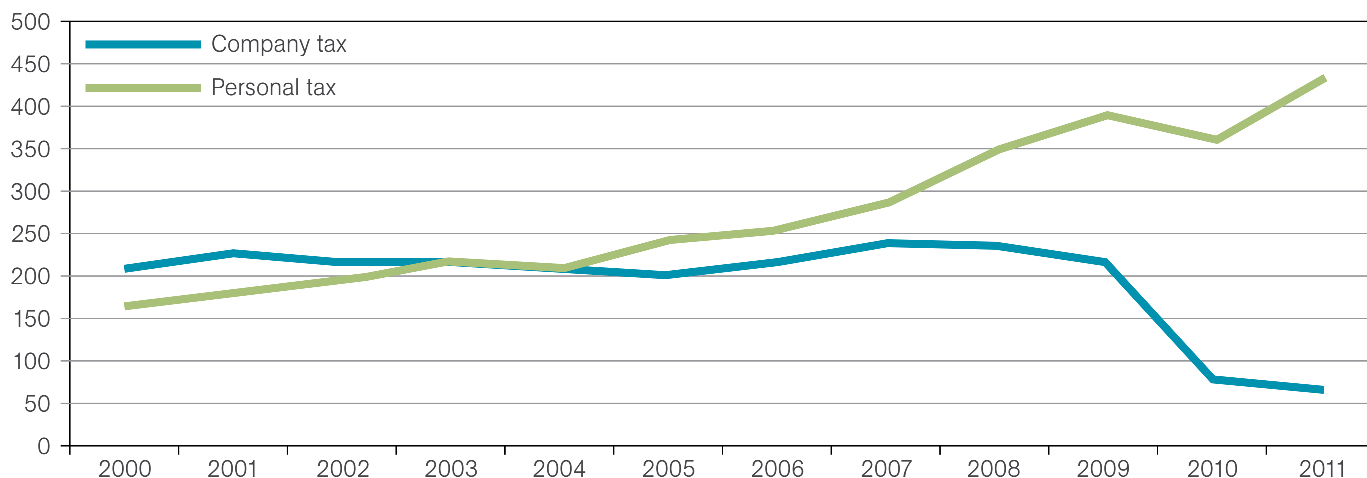
This dynamic is far more potent with finance than with the Resource Curse, because the oil is in the ground and cannot flee. Similarly, a car assembly plant, say, is far more rooted in the local economy and its threats to relocate are less credible than those of mobile capital. People or corporations, including banks, rarely act on these threats when their bluff is called, but talk is cheap and their widespread threats can be highly effective: politicians are often highly suggestible.

This threat is often couched in the language of 'competitiveness,' a term that is almost always abused by the defenders of finance in this context. (Box 9 below briefly explores this).

Financial centres 'compete' with each other to provide the next best secrecy facility or loophole in order to attract tax-evading and other law-breaking forms of capital, producing a 'race to the bottom' on secrecy that has helped private élites escape taxation and the wider rule of law. This race undermines democracy and the rule of law and boosts corruption and criminalisation, on a global systemic basis – and the involvement of local

171 See *Is the City selling Britain short?, The Independent*, Nov 23, 1997.

Figure 13: Company versus personal taxes, Jersey, 2000-2011 (£m)



Source: States of Jersey.

professionals in this harmful global game rebounds on the host nation.

The U.S. financial criminologist Bill Black explains, with respect to the world's two largest financial centres:

> *The finance industry in the U.S. and the U.K claims that their nation must win the regulatory "race to the bottom" so that they can out-compete residents of the other financial center.*[172]

In the U.S., the Commodity Futures Modernization Act of 2000, which exempted whole areas of derivatives from regulation and which some regard as the most damaging financial bill in recent US history, was "all about the City of London," said Black.

> *London is vital to Wall Street's ability to argue that it needs weak regulation ... The City is the Bogey Man.*[173]

Tax havens and small financial centres are often the 'sharp edge of the axe in this competitive race, because their legislatures are more insulated from weak domestic politics and therefore more pliable and receptive to the wishes of or threats from the owners of mobile capital.[174]

This 'arbitrage' effect has various harmful outcomes.

One is to increase economic and political inequalities. Since mobile capital (and the income from that capital) is predominantly enjoyed by the world's wealthier individuals, the overall effect is to force down tax rates on the wealthy and on corporations, while taxes on other factors of production – such as indirect taxes on poorer households – are raised, around the world.

The British tax haven of Jersey is a case in point: while yields from company taxes have declined, poorer sections of society are seeing a fast-rising tax burden via personal taxes. Figure 13 illustrates.

Another outcome is to increase impunity (reflecting political inequality): by playing

172 Bill Black, *Bluto: Please Smash the Guitar and End the Bipartisan Deregulatory Kumbaya Chorus,* New Economic Perspectives, March 25, 2012.

173 Author's interview with Black, Sept 15 2012.

174 A very good case study of how this 'rebound' effect works in practise comes is *No Accounting for Tax Havens,* by Austin Mitchell Prem Sikka John Christensen Philip Morris Steven Filling, Association for Accountancy and Business Affairs (AABA), 2002. This looks at the adoption by Jersey of a Limited Liability (LLP) Law, for the use of big accountancy firms, enabling them "to reduce their liabilities to stakeholders injured by poor audits". These firms subsequently used Jersey's LLP law as a crowbar for achieving their goal of an LLP law in the UK and elsewhere – and with the consequent, but hard-to measure result that they have exercised less care and oversight in their work. Chapter 6 is the most relevant chapter, but it is all pertinent. See also the "Ratchet" chapter in Treasure Islands, which looks at the same Jersey LLP saga then compares it to the process by which the U.S. state of Delaware enacted its 1981 Financial Center Development Act. The similarity of these two episodes reveals deep truths about the processes underway.

jurisdictions off against one another capital owners can escape from the normal responsibilities of society – taxes, financial regulations, criminal laws, disclosure rules, and more. This is achieved either by shifting to another more pliable jurisdiction, or using the threat of such a shift to force a change in the law at home.

The deliberate pursuit of escape routes from the laws and rules of society through international arbitrage inevitably engenders disrespect and even contempt for those laws and rules at the top of society, as has been widely documented[175] in the Libor scandal and many others. The comment in Section 2.5.2.3 by Bosworth-Davies, an experienced observer of this, bears repeating here:

> *If a man is prepared to break the law in his home country, France, Holland or wherever – why would you think he wouldn't break the law in this country?"*[176]

This criminalising 'arbitrage' dynamic of regulatory and legal escape also reinforces the arguments of those lobbying for financial deregulation, the relaxation of criminal laws, and the cutting of taxes on mobile capital.

It is our contention (which is hard to prove, but harder to disprove) that these closely related 'arbitrage' and 'escape' dynamics, rooted in the global system of offshore tax havens, are among the most important explanations – if not the most important explanation – for the criminalisation of the financial sector described above.

The damage ensuing from this is unmeasurable, though undoubtedly immense.

2.6.3.4 Top-down, concentrated source of money

A financial sector provides a somewhat more diversified source of revenues than the 'point source' revenues from an oilfield (see Section 1.2.5). However, financial services rents are still fairly concentrated, as the sector typically operates as something of an enclave with only limited linkages to the rest of the economy. Largely immaterial trading activity does not require the kind of supply chain linkages that are found in manufacturing or retail, say. Often the linkages that do exist are substantially foreign.

This top-down problem, when combined with other aspects of financial dependence, also has major implications for inequality.

Political power flows from money, so top-down rents from the financial sector help concentrate economic and political power in places like the City of London or Wall Street. As explained above, in many smaller (offshore) financial centres the financial lobby is so powerful that meaningful opposition to finance is almost impossible.

In addition, just as with the natural resources sector, when the government gets a large share of its revenue from the financial sector rather than from its own people, this also undermines the healthy 'no taxation without representation' relationship between rulers and citizens that has underpinned the growth of democratic and responsive states. This, in turn, weakens governance and partly helps explain tendencies for authoritarianism and criminalisation.

This factor is not limited to natural resources or finance: any economy with one oversized industry (such as Samsung in Korea or Nokia in Finland) is likely to suffer this problem to a degree, and other problems such as Dutch Disease effects. The more concentrated the source of income, the greater the problem.

Finance does have other particularities, however, which makes it stand out. One is the tendencies towards authoritarianism that lie in the generic relationship between debtor and creditor (a relationship that the people of Greece, say, would instinctively understand as their democracy is eroded while the

175 The chapter The Life Offshore in the co-author's book Treasure Islands documents the theme of financial and tax havens hosting strongly anti-government, libertarian tendencies and a disrespect for other countries' laws.

176 Interview with author, Oct 2012.

government squeezes the populations to repay foreign bondholders.) In the words of James Carville, U.S. President Bill Clinton's campaign strategist:

> *I used to think if there was reincarnation, I wanted to come back as the President or the Pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everyone.*

2.6.3.5 Inequality as a root cause

The financial sector, as explained in Section 2.5.1.7 above, is a driver of inequality, which in turn is a driver of adverse human outcomes, and of poor economic performance. Inequality also feeds back to political exclusion and further financial sector dependence.

The book *The Spirit Level: Why more equal societies almost always do better* also shows very close correlation between income inequality and health and social problems.

Inequality also appears to be a *cause* of poor economic performance, as documented by Stiglitz, Galbraith and many others. Stewart Lansley, another expert on inequality, sees the problem as not only driven substantially by the growth in finance, but also as creating structural economic imbalances which inflict economic instability and damage growth.[177] The Bank of England's Haldane comments:

> *The hard-headed facts suggest that, at the heart of the global financial crisis, were and are problems of deep and rising inequality.*[178]

The *New York Times* summarises recent IMF research:

> *Intense inequality actually stunts growth, making it more difficult for countries to sustain the sort of long economic expansions that have characterized the more prosperous nations of the world... in high-inequality nations spurts of growth ended more quickly, and often in painful contractions... income distribution contributes more to the sustainability of economic growth than does the quality of a country's political institutions, its foreign debt and openness to trade, the level of foreign investment in the economy and whether its exchange rate is competitive.*[179]

Jurisdictions dominated by financial services also tend to have more libertarian, less interventionist (and therefore less redistributive) governments, with regressive effects (though for reasons outlined above they are less likely to defend human rights or free speech.) Financial sector goals which include the relaxation of financial regulations, and limited taxes on the financial sector and on the wealthy,[180] tend to favour wealthier sectors of society, with poorer sectors expected to take up the slack. Figure 11 in Section 2.6.3.3 illustrates this clearly.

2.6.3.6 The lobbying, revolving doors

The lobbying power of the financial sector is so widely documented that we will only give this cursory attention here. The finance, insurance and real estate (FIRE) sector spent a combined $6.8 billion on federal lobbying and campaign contributions from 1998–2011, according to the Center for Responsive Politics. In the UK, over half of all donations to the ruling

177 For a short summary of Lansley's main points, see *The Cost of Inequality* by Stewart Lansley, March 3 2012. The main channels are: a) as wages stagnate for low- and middle-income earners, they seek to preserve their standard of living through debt; b) executive remuneration structures, particularly in finance, created perverse, economically unproductive and harmful accumulation strategies; c) the rich became awash with cash which became a destabilising force; and d) the distribution of power worsened, along with the wealth distribution; e) as wages fail to keep up with productivity, a dangerous productivity-wage gap develops where supply outpaces demand, with deflationary effects.

178 *A leaf being turned*, Speech by Andrew G Haldane, Bank of England / Occupy Economics, Oct 29, 2012.

179 See *The 1 Percent Club's Misguided Protectors*, NY Times Sunday Review, Dec 10, 2011. It cites *Equality and efficiency: is there a trade-off between the two or do they go hand in hand?* By Andrew G. Berg and Jonathan D. Ostry, IMF Finance and Development, Sept 2011.

180 The tendency for financial sector-dominated economies to have libertarian governments is a large subject and outside the scope of this paper. There is considerable discussion of this in *The Life Offshore*, a chapter in *Treasure Islands*. This tendency is not always so: the European financial haven of Luxembourg, for instance, has a strongly Social Democratic government that has worked hard to redistribute wealth from the financial sector, and as a result has lower inequality than the European average.

Conservative Party come from the financial sector.[181,182]

The financial sector lobbyists make several key arguments, overtly or more subtly.

- "Do not tax or regulate the financial sector too much or they will go offshore," (see the above section 2.6.3.3).
- "Global finance brings in money, which must automatically be good for the economy"
- Finance is the 'engine for growth.'
- "What is good for Wall Street is good for Main Street": The interests of global financial services are identical to the national interest; it is 'patriotic' to support financial services[183]
- The grimy industrial (and agricultural) 'smokestack" economies are old news; the shiny, high-tech, whizzy, brainy 'knowledge economy' is the future.
- Laissez-faire: the best approach is for government to get out of the way and to let markets and financial actors work their magic.
- "We are not a tax haven; we are a responsible, clean, co-operative and well-regulated financial centre." All tax havens deny being tax havens.[184]
- The financial crisis had its origins in the state, not in finance.
- Smears and threats against dissidents; see Section 2.5.2.1 above. Dissenters are 'traitors' and 'internal enemies.'[185]
- It is important for the financial sector and the tax regime to be 'competitive". Box 9 explains how this term is routinely misused.
- Critics of the financial sector are 'anti-business' or want to 'stifle entrepreneurialism.'

These arguments, most of which directly oppose the Finance Curse thesis, are discussed in Sections 2.4 and 2.5 above.

2.6.3.7 The small island syndrome

In his novel *Snow Falling on Cedars*, David Guterson writes:

> *An enemy on an island is an enemy forever. There is no blending into an anonymous background, no neighbouring society to shift toward. Islanders are required by their very nature of their landscape to watch their step, moment by moment. [The political and social inhibitions islanders feel] are excellent and poor at the same time, poor because it means an inbreeding of the spirit, too much held in, regret and silent brooding, a world whose inhabitants walk in trepidation, in fear of opening up.*

Our knowledge of small tax havens confirms the accuracy of these observations by Guterson, who is a long-term island resident. This "small island syndrome" is a powerful generic reason why it is particularly hard for locals to challenge a carefully constructed Finance Consensus in small islands.

Small jurisdictions with outsize financial sectors (such as Jersey or the Cayman islands)

181 See *Hedge funds, financiers and private equity make up 27% of Tory funding*, Bureau of Investigative Journalism, Sept 30, 2011. The entire financial services sector made up 51.4% of Conservative funding, the Bureau found. See also the Bureau of Investigative Journalism's 2012 study into the financial sector's lobbying operations in the UK. For the United States, see *The Payoff: Why Wall Street Always Wins*, by the insider Jeff Connaughton, or the documentary *Inside Job*, the U.S movie about the run-up to the financial crisis; as well as a range of resources such as Opensecrets.org

182 See *Tory Party funding from City doubles under Cameron*, Bureau of Investigative Journalism, Oct 25, 2011.

183 A case in point is UK Prime Minister David Cameron's assertion in 2011 that "I had to pursue very doggedly what was in the British national interest" when defending his use of a veto to block a Eurozone treaty change after France and Germany had refused to agree to a "protocol" giving the City of London protection from EU financial service regulations amid the Eurozone financial crisis. See *Britain is ruled by the banks, for the banks*, Aditya Chakrabortty, *The Guardian*, Dec 12, 2011. More pernicious is the regular use of the word 'traitor' in small tax havens to tar the reputation of dissidents.

184 Almost every tax haven makes this claim. See, for instance, *"We are not a tax haven,"* Tax Justice Network, Sept 10, 2008, outlining numerous examples.

185 Prem Sikka, who conducted one of the few in-depth investigations into one of Jersey's regulatory changes, its introduction of an LLP law, was routinely branded an "enemy of the state" in the Jersey media. See *Race to the Bottom: the case of the accountancy firms*, Association for Accountancy and Business Affairs, Jim Cousins, Austin Mitchell, Prem Sikka, 2004

BOX 9: THE "COMPETITIVENESS" MYTH

Many arguments in defence of finance rest on an assertion that it is essential to be 'competitive' in the areas of tax, financial regulation, and even criminal enforcement.

The way politicians and financiers routinely use this term typically rests on two fatal fallacies. **First**, it is wrongly assumed that since market competition is a good thing, competition between nation states states on tax and regulation must also be good. The exact opposite is true. **Second**, it is assumed that what makes the global, 'casino' part of the financial sector more 'competitive' will make the economy as a whole more 'competitive:' a notion that the Finance Curse thesis directly contradicts.[1]

Think about the first assumption like this. When a company cannot compete it goes bust and a better one takes its place. This 'creative destruction,' for all the pain involved, weeds out bad firms and is a source of capitalism's dynamism. But what is the result if a country cannot "compete?" A failed state? That is a completely different matter. As the Financial Times commentator Martin Wolf said: "the notion of the competitiveness of countries, on the model of the competitiveness of companies, is nonsense."[2]

There are meaningful ways in which countries do 'compete.' Take the World Economic Forum (WEF)'s 12 'pillars' of competitiveness: these include infrastructure, healthcare, education, technological readiness and more – factors that depend heavily on tax revenues.[3] Of the WEF's four most 'competitive' countries in 2011, two – Sweden and Finland – are among the world's highest tax countries. There is no clear empirical link between corporate tax rates and real economic competitiveness, and no clear link between countries' long-term economic growth and their tax burdens as a share of GDP.[4]

Surveys regularly show that tax comes some way down investors' list of factors after such things as political and economic stability, access to markets, infrastructure, or a healthy and educated and workforce (these are generally tax-financed benefits).

In the area of tax, countries 'compete' not just on tax rates but also by offering tax loopholes, typically through offshore strategies, thus giving larger firms which use these loopholes a 'competitive' advantage over smaller, more local firms (which are often the real job creators and innovators). This advantage, which helps big firms kill smaller firms in markets, has nothing to do with real productive efficiency: it just transfers wealth from taxpayers elsewhere, while distorting market competition.[5]

Similarly, relaxing financial regulations to help foreigners escape 'onerous' legal and regulatory requirements elsewhere has been defended as a way to boost 'comparative advantage' – whereas it merely reflects a 'race to the bottom' which fails to deliver true economic competitiveness.[6]

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1 For a good discussion of this, see *A debate framed by fallacies*, Speech given by Robert Jenkins, Member of the Financial Policy Committee, Bank of England, September 2012.

2 From his book *Why Globalization Works.*

3 See *The Global Competitiveness Report 2011–2012*, World Economic Forum, 2011.

4 For a clear exposition of this, see Martin Wolf's *Exchange, Taxation, productivity and prosperity*, *Financial Times* Blogs, May 31, 2012. For a broader overview of the issue of tax competition, and links to a number of articles on the topic, see Tax Wars: International Tax Co-operation and Competition, webpage of the Tax Justice Network *www.taxjustice.net* Also see, for example, *Is tax competition harming developing countries more than developed?* Michael Keen, Alejandro Simone, Tax Notes International, June 2004.

5 See, for instance, "A competitive tax system is a better tax system" – myth busted, Nicholas Shaxson and Ellie Mae O'Hagan, TJN/NEF Mythbusters series, April 2013.

6 Until the mid-1950s, London's role as a centre of global finance was based largely upon Britain's role as an Imperial power, enabling it to ensure that global financial services routed themselves through London. When the Empire collapsed from the mid 1950s, London re-engineered itself as a 'light touch' financial centre, initially with the Eurodollar markets. For a detailed discussion of this history, see *Treasure Islands,* chapter on the Eurodollar markets. As UK MP John Mcdonnell said of UK Labour Prime Ministers Tony Blair and Gordon Brown: "Blair and Brown made a Faustian pact to give the City its head. The idea was to let them do their profiteering and just take the tax benefit. It was not a relationship on our terms; it was simply 'Give them what they want.' " *Treasure Islands* p265 (UK edition).

therefore tend to be more vulnerable to adverse governance effects than larger jurisdictions like Britain or the United States,[186] for obvious reasons. Their economies can become little more than monocultures, with few alternative employment opportunities.

John Christensen, a co-author of this book and former Economic Adviser to the States of Jersey, described his experience of the "goldfish bowl" politics of the British tax haven:

> *Small communities have their own mechanisms. It takes the cojones of an elephant to go against the conservatism. If you do it in a sustained and effective way the entire community is against you. You are an enemy.*
>
> *... In meetings and round-table discussions with the Finance and Economics Committee and other government committees, there were moments when I was literally choking with anger. It took real strength to stand up and say, 'I'm sorry, I don't agree with this.' I felt like the little boy farting in church. I felt so lonely during those committee meetings; nobody ever supported me ... Dissenting in committee means saying, 'I'm not interested in my career here.'*[187]

The media in small jurisdictions is particularly prone to capture. In Jersey, for instance, a local journalist (who wishes to remain anonymous) admitted that the Jersey Evening Post semi-officially equates the interests of the financial sector to those of the island as a whole; it carries almost entirely uncritical coverage of Jersey's tax haven industry, and never questions the official (and false)[188] line that Jersey is 'clean, transparent and co-operative.' Local critics describe BBC Jersey, the dominant radio outlet, as being entirely 'captured' and subservient to tax haven interests. Patrick Muirhead, a former television anchorman in Jersey, remembers:

> *In an island of 90,000 souls, one is only removed from another by the smallest step of separation. In such an atmosphere of closeness, any meaningful challenge becomes impossible...*
>
> *Jersey is entrenched in a concealment culture dating from its wartime Nazi collaboration, reinforced by its shadowy banking industry ... They have a saying on the island: "If you don't like it, there's always a boat in the morning." ... The implicit message is that Jersey islanders do not entertain criticism or complaint.*[189]

One of few political economy studies of Jersey and its financial sector explains another important driver of this 'capture':

> *The uneven nature of the relationship between the transnational financial institutions operating offshore and their small island economy hosts results in the latter competing to accommodate their fiscal and regulatory structures to the interests of financial capital.*[190]

Co-author John Christensen has described what he saw while serving as Jersey's Economic Adviser:

> *When I talked to the politicians on the Finance and Economics Committee, time and time again I talked about proposals coming forward. They said, 'I'm being honest, John: I don't understand the detail, but I trust the lawyers and the bankers when they say it is necessary... They can argue at enormous length about the budget for the local pony club, but a new limited liability law or a new trust law will go unchallenged.*

186 For a focus on small jurisdictions, see *Competing Industries in Islands: a new Tourism Approach*, 2007, especially pp 1010-1012

187 Quote by John Christensen, describing his time as Economic Adviser to the States of Jersey, and an author of this paper, cited in Treasure Islands, supplemented with additional comments for this paper.

188 See the co-author's book *Treasure Islands* for multiple examples of the abuses and corruption run out of Jersey.

189 *Jersey's culture of concealment*, *The Times*, April 24, 2008, By Patrick Muirhead. Some parts of the quote have been shortened slightly to remove references to a child abuse scandal, which lies outside the scope of this essay.

190 Hampton, Christensen, 1999, p166.

Meanwhile, finance sucks skills and talent out of government, leaving behind either the less talented, or those with independent wealth (and often conflicts of interest), without the skills to oversee this complex globally focused sector. The Wall Street Journal once summarised the island's 'parish council syndrome':

> *Jersey is an island that [used to live off] boat building, cod fishing, agriculture and tourism. It is run by a group who, although they form a social and political elite on Jersey, are mostly small-business owners and farmers who now find themselves overseeing an industry of global scope involving billions of dollars.*

In such an environment, individuals with financial sector interests drive through change,[191] against little or no opposition. There are often no truly independent think tanks or watchdogs or an 'uncaptured' media to question legislation. Appleby, a leading offshore law firm and member of the "Offshore Magic Circle," even publicises its own conflicts of interest:

> *Appleby Partners have been members of the elected legislatures, and ministers in governments in a number of our offshore financial centres. Members of the firm have gone on not only to political office but also in a number of centres (Bermuda, Jersey, the Isle of Man and Cayman) to senior judicial office… Appleby is engaged with governments, regulatory bodies and industry representative bodies, as well as professional bodies and associations, in all our offshore financial centres. In particular Appleby participates in discussions on law and regulatory reform, the development of new products*[192]

That Appleby so brazenly highlights this 'revolving door' suggests that conflicts of interest seem normal offshore – even something to boast about.

Power structures in small jurisdictions often compound the problem. The financially dependent principality of Liechtenstein is an 'absolute monarchy,' for example, ruled by a family whose wealth derives from secret banking based on local secrecy laws. In Jersey, there is no clear separation of powers between the executive, the legislature and the judiciary, many conflicts of interest embedded in government structures, and there is no organised system of political parties – hence no coherent political opposition.[193] Jersey's former health minister Stuart Syvret explains:

> *It is axiomatic – an inescapable structural feature – that small island jurisdictions cannot govern themselves according to modern, acceptable standards of good governance. So it is axiomatic that any activity that brings vast sums of money: tax avoidance, secrecy and offshore finance, will not – not ever – be properly regulated and policed.*

Jersey is not alone. Ahead of a visit in 2011 to the European tax haven of Luxembourg, co-author Shaxson received an email from a Luxembourg citizen who had confronted financial sector interests (and lost) in a court battle. He said:

> *You just don't make it in this country unless you've proven your absolute loyalty to the system in place, including being OK if not more with all of its malpractices. I also know by personal experience how difficult it is for foreigners to get a firm grasp of the mafia-like functioning of Luxembourg. No foreigner can imagine how bad it really is.*

191 One important example is the case of the Irish Financial Services Centre, whose creation was pushed through by the "voraciously corrupt" Taoiseach Charles Haughey, in partnership with the businessman Dermot Desmond and with the help of Haughey's discreet right hand man, Padraic O'hUiginn. For a brief description of this episode, see *Report on Ireland, Mapping Financial Secrecy*, Tax Justice Network, 2011. The Irish writer Finlan O'Toole described the Irish economic project as "a lethal cocktail of global ideology and Irish habits."

192 From *History of Appleby*, Appleby website accessed Feb 9, 2012

193 For a brief overview of the structure of government, see *Liechtenstein prince wins powers*, BBC News, March 16, 2003. *Treasure Islands* explores Jersey's conflicts of interest extensively. In the Cayman Islands a new and apparently well-resourced initiative emerged in 2012 called "Coalition for Cayman," a lobbying effort presumably backed by the finance industry apparently to try and neutralise the system of political parties there. The coalition says it is "an advocacy group working to rid our country of political partisanship… committed to promoting independent leadership free of political ties… only since the introduction of political parties have we stumbled."

His particular case perhaps overstates the extent of this in a country that does have strong democratic traditions, but research in Luxembourg found that when it came to challenging the financial sector, there was much truth in his assertions.[194]

There is a sense in which financial centres in large countries can gain small-island characteristics. Wall Street and the City of London exist as fortress-like 'islands' of technical expertise inside their respective mother countries, equipped with massive financial and intellectual power, and sources of patronage. The technical complexity (both real and invented) of banking and associated professions creates opportunities to exclude outsiders and develop tight communities of interest, in which relatively small numbers of people can define a political consensus through highly sophisticated means: appeals to authority, more or less subtle cooption, threats and threatening innuendo to unruly insiders and rewards to journalists and politicians, and so on.

For a much fuller exploration of the role of small-island politics in the creation of a Finance Consensus, see co-author Shaxson's book *Treasure Islands*, and particularly the chapter entitled "*The Life Offshore*."

2.6.4 Final points.

This book concentrates on the domestic impacts of having an overly large financial sector. We re-iterate that the international impacts of financial 'country capture' are outside its scope.

The tried and tested way of building a big financial centre is to engage in a "competitive" race to the bottom on financial regulation, tax loopholes, secrecy and other unproductive factors. This race is not only ultimately self-defeating (as others join in to undercut and outdo these facilities) and inflicts harm on the populations of other jurisdictions, but it is potentially a recipe for systemic global problems resulting from soaring inequality, higher debt levels and greater financial instability.

194 This quote is from the forthcoming French language edition of Treasure Islands, in a new chapter looking at Luxembourg and the role of tax haven activity in Europe.

3.0 CONCLUSIONS

After exhaustive research of numerous small and large financial centres, we have found many common patterns. First, the claims that are made for finance – typically parroted with few questions in the media – are routinely overstated, and often massively so.

But matters seem to be worse than that. There is strong evidence that above a certain size relative to the local economy, growth in a financial sector harms the country that hosts it in a wide variety of ways.

Excessive financial sector growth tends to reduce long-term economic growth. In some jurisdictions the sector's net tax and jobs contributions is likely to be negative, all things considered. The financial sector, widely touted as the Goose that Lays the Golden Eggs, is revealed often to be a different bird: a cuckoo in the nest, crowding out and damaging alternative sectors. Excessive financial sector growth is likely to heighten economic (and regional) inequalities in a country and to increase rent-seeking activities and harm productivity and productive efficiency. Jurisdictions overly dependent on large financial sectors also tend to become 'captured' by the financial services industry, in a self-reinforcing cycle. Rulers lose interest in 'difficult' alternative sectors that are being crowded-out, and a Finance Consensus emerges, which holds that There Is No Alternative. The Finance Consensus is particularly strong in smaller countries and tax havens, and often veers into a form of authoritarianism.

These impacts strike finance-dependent economies in different ways. Some jurisdictions tend to be harmed more by the political capture effects, while others tend to suffer more from the economic capture and crowding-out. These two components of political capture and economic capture combine to create a broader phenomenon, which we call Country Capture, and which is at the heart of the Finance Curse.

Many of the phenomena – both the outcomes and the drivers of those outcomes – that we have found while researching financial centres are similar to, and in some cases nearly identical to, phenomena that will be familiar to students of the Resource Curse that strikes countries that are dependent on natural resources. The overlap between the Finance Curse and the Resource Curse is very large, though there are important differences.

3.1 Recommendations

Six years into the global financial and economic crisis, 'recommendation fatigue' is firmly entrenched.

To avoid contributing to this, we will offer just a few short recommendations, offering a fresh narrative which others could turn into more precise forms. Our five core recommendations, one traditional and four non-traditional, follow.

We will repeat here the essential point that the Finance Curse thesis implies that national leadership is possible on all of these recommendations: international agreement is unnecessary.

1. **Massively higher levels of bank capital**. This is our only 'conventional' recommendation. It would cut through a Gordian knot of legislative complexities and would go a long way to achieving some of our other objectives below. A Bank of England team in 2011 suggested 20 per cent of all assets; Admati and Hellwig suggest 20–30 per cent.[195] Capital requirements could also be set to encourage the breakup of big banks.

2. **Set explicit targets for the maximum size of a financial sector**, whether as a share of GDP, or employment, or otherwise. We will not prescribe details here. This is a task for governments, domestic central banks and financial regulators.

3. **Balanced pay policies.** Strive to minimise pay inequalities across all sectors, including finance, industry, non-financial services, government – and as far as possible **across geographic regions**. A senior doctor, or architect, or civil servant, would be paid at comparable rates to a senior banker or senior businessman in the manufacturing sector. This directly addresses one of the core elements of 'country capture' at the core of the Finance Curse. From this, multiple remedies and solutions flow.

4. Governments and other interested parties should **measure the true net domestic contribution of finance,** disaggregated into its components, using **published and verifiable methodology**. This would have two elements. First, measure the jobs, tax and GDP contribution of the financial sector appropriately, with a view to which sectors are 'mobile,' and use *only* this as a basis for all policy debates about the 'contribution' of finance.[196] Second, compile a full and comprehensive list of effective subsidies to the financial sector. These would include tax expenditures (including, in the UK's case, the subsidy provided to 'non-domiciled' taxpayers).

5. **Jail bankers.** Take a 'policing' approach, rather than a 'safe pair of hands' regulatory approach to financial criminality.

6. **Support extraterritorial financial regulation**. The latest financial crisis exposed how financial centres in one country can take the cream from risky financial activities, while putting taxpayers and others elsewhere on the hook for losses.

As top U.S. Regulator Gary Gensler put it:[197]

> *Transactions booked in London or anywhere around the globe can wreak havoc on the American public.*

195 For an excellent summary of why the arguments over bank capital have been misunderstood, see Anat Admati and Martin Hellwig's *"The Bankers' New Clothes."* Described by Martin Wolf in the *Financial Times* as the most important book to emerge from the global economic crisis, it is a superb and highly accessible skewering of the arguments put forward in defence of lower capital ratios. It explains how low bank capital levels are paid for by implicit (and eventually explicit) taxpayer subsidies; large capital increases would only be 'costly' for bankers in the sense that they reduce taxpayer subsidies. For a summary of the book, see *Running on Empty*, by John H. Cochrane, Wall St. Journal, March 1, 2013, or the longer *The Magic Lever,* London Review of Books, May 2013. The Bank of England report is summarised by its author David Miles in "What is the optimal leverage for a bank?," Voxeu, April 27, 2011. According to the report, a doubling of banks' capital from current levels might increase the average cost of bank funding by as little as 0.1 per cent – while providing "very large benefits" to society.

196 All this data should be disaggregated on a sectoral and regional basis, and published in a single, easily accessible report.

197 For good discussion on this crucial issue see, for example *The Extraterritorial Provisions of the Dodd-Frank Act Protects U.S. Taxpayers from Worldwide Bailouts*, Michael Greenberger, *University of Missouri-Kansas City Law Review*, vol. 80, 2012. See also letter regarding legislation HR 3283, The Swap Jurisdiction Certainty Act, Americans for Financial reform, March 27, 2012.

A classic example is AIG Financial Products in London, at the heart of the AIG collapse, which provided large incomes for London-based officials, real estate and UK tax revenues, then landed US taxpayers and others with large bailout costs.

END

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