

FINANCE CURSE AND ILLEGALITY

The Impacts of Financialization and Illegality on
Malta's Economic Development

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Introduction

“Muscat won popularity for his economic successes, but image unraveled after anti-corruption journalist was killed.”

– Aljazeera (2019, December 2)

In November 2019, thousands of protestors demonstrated in Valletta with signs and banners with eye-catching words like *Ġustizzja* (justice), *mafia*, *assassini* (assassins) and *barra issa* (out now), forcing the resignation of the former Prime Minister (PM) – Joseph Muscat (Carabott, 2019). Under Muscat’s leadership from March 2013 to January 2020, Malta experienced outstanding economic successes like robust Gross Domestic Product (GDP) growth at an average of 7.2%, an unemployment rate below 4%, the transformation of the national budget into surplus and reduced public debt (International Monetary Fund (IMF), 2019). This makes Malta an economic miracle, especially after the financial crisis, therefore it is rather shocking that Muscat’s heyday ended so suddenly.

Public attention was garnered since the murder of Daphne Caruana-Galizia, a Maltese anti-corruption activist who accused the Muscat government for involvement in financial crime. Simultaneously, the European Union (EU) accused Malta for its failure to comply with Customer Due Diligence (CDD) and the Anti-Money Laundering Directive (AMLD) (European Parliament (EP), 2017). These accusations are mainly derived from the Individual Investor Program (IIP), the Pilatus Bank scandal and Malta’s tax system. Furthermore, one of Malta’s biggest money generators happens to be the iGambling industry, which is a notorious money-laundering tool for organized crime groups (OCGs). Besides, Malta also shaped its jurisdiction to be friendly to the blockchain and cryptocurrency industry (Vaghela and Tan, 2018), albeit knowing it is prone to financial crime.

Malta is a microstate without any natural resources and it possesses few advantages that well-known offshore finance centers (OFCs) like New York, London and Hong Kong enjoy. However, Malta’s economic reform led to the influx of foreign investment accounting for 1474% of the Maltese economy (EP, 2019a). Yet, the presence of illegality together with (over-)financialization that extracts public finance and attracts (illegal) “hot money”, disturb the rule of law, distort the redistribution of welfare, and threaten the societal security, which are the underlying problems of this finance-based economic reform.

Financialization is not an all-new concept, but there is an acceleration of financialization in the last decade, leading to the increase in quantitative and qualitative role of financialization in our economy. For the former, there is an expansion of financial market in our economy (Epstein, 2005, p.33); For the latter, there is increasing penetration of financial instruments in the non-financial economy that makes non-finance sector resembling the finance sector (Shaxson, 2019). Financialization as an economic development model has been widely debated, but this model is welcomed by microstates. Microstates' structural weaknesses push them to reform their economy to attract finance (Palan, 2002, p.151-152). However, there is no guideline on how far financialization should go to achieve optimal growth.

Financialization is a double-edged sword, as it attracts both good and bad finances. It is bad finance that makes the finance-based economic development model risky. The Finance Curse theory contends that an over-sized finance sector, known as over-financialization, hinders economic development, as over-dependence on finance leads to effects resembling the Resource Curse (Christensen et al, 2015). Over-financialization attracts bad finance that is mobile, speculative and not locally-targeted, therefore its impacts on the political, economic and societal realms must be considered. Besides, illegality is inherent in our economy and this is the bad finance that extracts wealth from the economy, as criminals exploit the illicit economy the same way how other economic actors benefit from the licit economy (Andreas, 2011, p.406; Andreas, 2002). The risks arising from illegality increase, when it accounts for a big portion of the economy, and when politics and organized crime intertwine. The risks generated by illegality when intertwined with financialization, therefore, also leads to political, economic and societal perils.

Academic debates surrounding financed-based economic development model, Finance Curse and illegality are present, yet they are discussed separately. Shaxson (2019) explains over-financialization as the shortcoming of financialization as an economic development means, yet there are two elements that are beyond the scope of his research. First, he focuses solely on the United Kingdom (UK), but the focus of this thesis is Malta, a microstate. Second, insufficient attention is given to the impacts of illegality vis-à-vis the Finance Curse. For the former, the Finance Curse might or might not be less detrimental to a microstate due to its smallness, namely if negative impacts are easier to spill-over from economic to political and societal dimensions, or such effects are easier to be contained or prevented. Besides, given a

microstate's structural weakness, economic risk is often already present, therefore political and/or societal risks might pose a more significant problem. For the latter, the influence of illegality in the economy is often neglected (Andreas, 2004, p.642). Nevertheless, the influence of illegality cannot be underestimated, especially for a finance-dependent microstate, as microstates often have a clientelist/patronage political system that increases the chance of illegality intertwining with politics (Veenendaal, 2019). Consequently, this thesis raises the questions: **“How are financialization and illegality intertwined and what consequences could this have for the path of economic development?”**

To answer this question, this thesis adapts the analytical framework developed by Shaxson and Christensen et al. The Finance Curse focuses on three types of risks – political, economic and societal – that arise from financialization as a strategy for economic development, and applies it to study the impacts of financialization and illegality on Malta. By doing so, this thesis aims to serve a double purpose of theory-testing and theory-building for the Finance Curse. For the former, Malta serves as a most-likely case-study, as it follows the classic trend of microstates adopting the finance-based economic development model. By applying the Finance Curse, this thesis tests if the impacts of the Finance Curse might differ in a microstate from a great power. For the latter, Malta serves as a least-likely case-study, as it is traditionally not an OFC and it has both national and supranational supervision to curb illegality. If the thesis can show that illegality is strongly related to financialization, this makes it more likely to be the case in other more weakly-regulated developing states, therefore the Finance Curse should take illegality into account in future research. The sources collected for this thesis are qualitatively tested and process-traced based on primary sources including reports from the EU and independent investigators and secondary sources like news articles.

This thesis argues that economic development has to be analyzed in terms of the economy's net growth or the net contribution of financialization. In Malta's case, the Finance Curse and illegality make Malta's financialization strategies risky to its economic development, due to the political, economic and societal risks involved. Malta is an interesting case, as the Finance Curse originates from its political risk. Malta's financialization strategies went hand-in-hand with illegality, giving the country's elites growing power and the incentives to extract wealth from the economy. It is such political risks that sabotaged Malta's stability, which later spilled-over to economic and societal risks. This is contrary to the traditional Finance Curse theory

that sees economic risk as the roots of political and societal risks. When these risks are taken into account, the net contribution of these strategies is significantly lowered; decreasing Malta's aggregate wealth.

The finding of this thesis aims to show the underlying problem of the "more finance, more growth" model by emphasizing the importance of studying the net growth of an economy, instead of gross growth. Economic development should not be studied solely based on a state's economic performance, but the inclusion of Finance Curse and illegality is needed, because it also incorporates political, economic and societal dimensions. In other words, economic development should be inclusive and cover a more holistic picture of the impacts of financialization, taking all short- and long-term effects. This way, the net contribution of finance to the economy can be studied. Such insights can contribute to Global Political Economy (GPE) and Security Studies academically, and also address the danger of this economic development model.

Literature Review

Financialization as Economic Development

There is no universal definition for "financialization", as its role changes from time to time, depending on its significance in the economy (Sawyer, 2013, p.7). This thesis adopts a broader definition that describes "financialization as a process" that involves two trends: (1) "the increasing role of financial motives, financial markets, financial institutions in the operation of the domestic and international economies" (Epstein, 2005, p.33) and (2) "the increasing penetration of financial techniques, and especially debt into different parts of industry...many parts of the non-financial economy, so that they increasingly resemble financial actors" (Shaxson, 2019). Since this thesis explores financialization as economic development, the goal of financialization here stresses the emergence of a regime of capital accumulation (wealth creation). Financialization is namely "a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production" (Krippner, 2005, p.174).

Epstein's definition suggests the quantitative role of financialization, which is generally measured by financial intermediaries size, namely "the value of some type of financial assets generally expressed as a ratio of the GDP" (Giovannini et al, 2013, p.108). This role can be

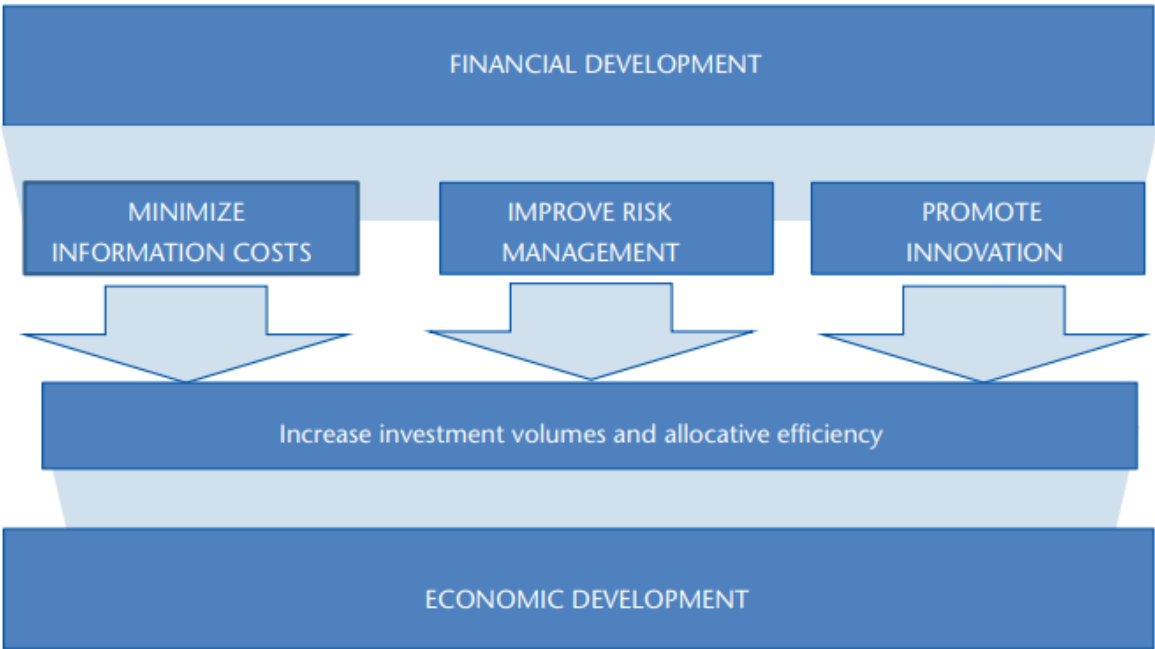
witnessed through “the increase in activity in financial markets, a rise in the value of financial assets, an increase in foreign exchange transactions compared to the volume of international trade, and other indicators of financial activity” (Kotz, 2015, p.23). Financial innovation brought the emergence of new actors like hedge funds and private equity firms (Lawrence, 2015, p.202). There are also increasing financialization activities like buyouts, junk bonds, sub-prime mortgages, derivatives and securitization, that shape the language of the finance sector today (Ibid), and are indicatives of the bigger role of finance and the presence of speculative financial activities.

This trend of using financialization as a means of economic development can be observed throughout the 20th century, but there are several patterns that suggest the acceleration of financialization over the last decade. First, there is the proliferation of financial transactions and increase in financial integration due to financial globalization that opened up many economies through deregulation and capital liberalization (Mishkin, 2005, p.14-15). Consequently, there is an increase in investment, whereby states nowadays hold more foreign assets to GDP, indicating a growth in the global financial system (Poelhekke, 2016). Plus, digitalization has now changed the financial service operation, making financial transactions almost instantaneous (Vleck, 2008, p.20), leading to the rise of globalizing finance and huge capital flows. Many microstates welcome these phenomena with open-arms believing that they will boost economic development, thus they seize this opportunity to become independent, instead of relying on neighboring states (Ibid, p.6). After all, financial isolation discourages economic growth (Coulibaly, 2009).

The prominence of financialization can be recognized through new techniques of capital accumulation. First, the Global Financial Crisis (GFC) in 2007-2008 revealed the power of financialization, namely showing the interconnectedness of finance and its potential on the world economy. Second, financial scandals like Luxleaks, Swissleaks and Panama Papers, exposed how states and banks offer financial secrecy to facilitate financialization (Bouvatier et al, 2017, p.3). Third, states are introducing ingenious ways like residency- and/or citizenship-by-investment (CBI) to exchange sovereignty for financialization in the last decade (Christians, 2017). These phenomena suggest that financialization is becoming more popular to develop economies in the last decade.

The role of financialization in economic development has garnered much attention. Literature from cross-country regressions (Goldsmith, 1969; King & Levine, 1993; Levine & Zervos, 1998) to regional or sectoral within-country variation (Rajan & Zingales, 1998; Fisman & Love, 2004, 2007), suggest that there is a strong positive finance-economic development relations, namely supporting the “finance-causes-growth” standpoint (Popov, 2017). This is mainly because capital inflow increases liquidity and lower capital costs, which stimulates investment and economic growth (Mishkin, 2005, p.15). Besides, a developed finance sector can usually increase investment and savings volumes, and their allocative efficiency (Giovannini et al, 2013, p.121-139). This is done through minimizing information costs (reduce information asymmetries between lenders and borrowers), improving risk management (bank’s low-cost services to reduce cross-sectional, liquidity and intertemporal risk) and promoting innovation (through research and development (R&D) evaluation and finance) (ibid).

Figure 1: Finance development and its effects on economic development (Giovannini et al, 2013, p.122)



However, financialization’s role in the economy differs from time to time per region and per country. The extent to which states embrace financialization also differs; the same goes for their financialization strategies for economic development. While many states are embracing

financialization, microstates in particular seem to have seen this as a promising method and more and more of them are engaging in financialization for economic development.

Many microstates suffer from economic challenges due to inherent structural weaknesses. First, microstates often face economic challenges due to limited domestic transactions caused by low efficiency of scales of production, therefore creating high production cost (Armstrong & Read, 2000, p.287). Second, microstates generally open their economies to foreign income surpluses, markets and investments, due to a lack of natural resources combined with scarce domestic capital and low human capital (Fabri & Baldacchino, 1995, p.141; Kakazu, 1994). As most microstates rely on tourism for income, financialization proves to be a beneficial method for economic diversification (Persaud, 2001, p.208). In this way, a double-capital-accumulation strategy is developed.

To achieve this diversification, the only asset microstates have to exchange for finance is their national sovereignties, or more specifically, “the right to write the laws” to shape their national economic development plans (Palan, 2002, p.151-152). This “importance of being unimportant” is what gives them freedom “to develop businesses within a framework of flexible financial, environmental and commercial registration regulations” (Armstrong & Read, 2000, p.289). Many microstates share similar financialization strategies that have legal and economic structure suited to lower the entry barriers for finance, e.g.: favorable law and tax treatment to investors, bank secrecy and owning double taxation agreements (Koligkionis, 2017; p.1357; Dharmapala & Hines, 2009, p.155-156). Not surprisingly, microstates have a higher probability to become a tax haven (Ibid). Yet, it is not easy for them to be recognized as players within the international finance world. Nonetheless, many microstates push larger states, especially richer OECD states, to “walk the talk” of inclusive multilateralism for closer cooperation and recognition, instead of “talk the talk” (Vleck, 2008, p.4). These moves further portray microstates’ efforts in financialization for economic development.

While there is certainly some evidence to support the finance-growth nexus, the GFC seems to fail in explaining the perils of finance, as can be seen from the qualitative rise of financialization – the penetration of financial techniques into the non-finance sector (Shaxson, 2019). The non-finance sector today has grown so powerful that it can profit from its own financial activities, instead of serving the finance sector (Kotz, 2010, p.4-6). Many non-finance firms are adopting the Wall Street logic, whereby financial assets and share value

maximization are given priority in the expense of the long-term profitability and survival of the firms (Aalbers, 2019, p.7). “Financial narratives, practices and measurements” are also applied in government institutions for capital accumulation (Ibid, p.9-10). This marks the beginning of “influence of finance on economy, ideology, politics and the state” (Shaxson, 2019).

The danger is that there is no guideline on how far financialization should go. Many states defend and legitimize financialization by arguing for national competitiveness, yet those benefitting from finance are not the aggregate economy but the economic elites (Christensen et al, 2015, p.257-258). This is due to the risk of “too much finance, finance that is too powerful, and the wrong kind of finance, unchecked by democracy” (Shaxson, 2018, p.13). Hence, the emphasis should be on the economy’s net growth, or the net contribution of financialization, namely “benefits minus the costs of oversized finance”, instead of gross growth (Shaxson, 2019). This is exactly what the Finance Curse is about.

Over-Financialization and Finance Curse

The “more finance, more growth” model has gained so much prominence for many reasons. Structural weaknesses from microstates make financialization an appealing economic strategy, as “it [does] not occupy a lot of land, [does] not pollute, and [does] not compete with local business” (Vleck, 2008, p.24). This strategy also generates a substantial amount of capital for further investment, which creates white-collar jobs and “increases the education and training prospects for citizens” (Ibid, p.27). This way, the domestic economy can be enhanced and increased employment could also decrease crime rates, and produce educated workforce (Ibid, p.13). Hence, it is believed that financialization enhances the aggregate welfare of the economy.

However, finance-driven growth models face growing critiques since the GFC. Shen and Lee (2006) see the financialization-economic development relationship as a “weak inverse U-shape”, namely a non-linear relationship. Checchetti and Kharroubi (2015) argue that when over-financialization occurs, finance retards the economy due to the over-reliance on the finance sector. This standpoint is agreed by literature stemming from the Finance Curse, which believes that over-financialization is harmful to the economy, because the Curse occurs when an economy is filled with speculative finance, rather than the essential finance that is needed

to boost the economy (Shaxson and Christensen, 2013). The former is mobile finance, which presents in an over-financialized economy, as it is often filled with “hot money” and runs the risk of relocation; whereas the latter is immobile finance that is locally-focused and contributes to the economy net growth (Ibid). The Finance Curse focuses on the former, as it is what should be subtracted to calculate the net contribution of financialization. The Finance Curse is therefore seen as “a development trajectory of financial overdependence involving a crowding out of other sectors and a skewing of social relations, geography and politics” (Baker et al, 2018, p.1).

Finance Curse literature claims that an oversized-financial system resembles negative effects similar to the Resource Curse, as finance could be perceived as resource for economic development (Christensen et al, 2015). The difference between the two is that developing states are oftentimes the victim of the Resource Curse, whilst the Finance Curse tends to affect developed states (Ibid, p.257-258). The Finance Curse lays down both short-term and long-term impacts of financialization, namely the eleven factors in Figure 2.

Figure 2: Finance Curse and Resource Curse: similarities and differences (Christensen et al, 2015, p.257-258)

	Resource Curse	Finance Curse
Dutch Disease, crowding out, brain drain	Widely recognised. Forex inflows bid up real exchange rate, make other tradable sectors internationally less competitive. High-wage resource sector sucks skilled labour from other sectors, public and private.	Similar dynamics. Financial services exports cause appreciation of currency, capital inflows bid up local prices of non-tradables: real exchange rate appreciates, damaging alternative tradable sectors like manufacturing. High-wage finance sector sucks skilled labour from other sectors, public and private.
Economic instability Higher private debt, public debt	Follows commodity cycles. Drivers mostly external. When commodity prices are high, bankers lend freely; when prices fall, debt rises further as arrears build. A ratchet effect.	Cycles track financial booms and crises. Drivers often internal. Also a debt ratchet effect, but boom-bust cycles, underlying drivers are different. Private debts driven by intra-financial lending, housing; these become public debts after crises.
Long-term growth damage	Growth below 'potential'; for some, a 'curse' is evident.	Research indicates that financial overabundance harms long-term growth. UK enjoys no long-term growth premium over OECD peers despite City of London.
Corruption, rent-seeking	Fundamental part of Resource Curse. 'Easy rents' from oil. Politics becomes winner-takes-all game of who gets what: favoured clients benefit.	Myriad rent-seeking activities in City of London. Finance abhors chaotic local corruption, but official tolerance for foreign 'corrupt' and dirty money creates rent-seeking opportunities. Products often designed to undermine, arbitrage or circumvent state regulation.
Damage to entrepreneurialism	'Easy rents' from resources distract, detract from tasks of building alternative sectors, made tougher by crowding out.	'Easy rents' from finance distract, detract from tasks of building alternative sectors, made tougher by crowding out.
Inequality	Inequality fuelled by high, resource-based incomes at the top and corruption which privileges wealthiest. Crowding out and damage to other sectors impacts the bottom.	Links between financial services growth and inequality widely acknowledged. Key difference with Resource Curse: much of financial wealth at the top is extracted from those lower down the income scale, for example, via 'socialisation of losses'. Political capture worsens inequality via policy capture, financialisation, preferential tax treatment to city firms and so on.
Conflict	Battles for 'share of the cake' foster conflict: political and even military.	International/offshore finance abhors instability: military conflict is a no-no, though economic warfare, for example, through tax wars (beggar-thy-neighbour processes) and regulatory degradation abounds.

	Resource Curse	Finance Curse
Political capture, country capture,	Political capture an inevitable byproduct of resource dependence.	Political capture required for 'stability' of privileges of finance, to keep local democracy out. Deep capture: lobbying, media capture, societal capture.
Political repression	Local society can be 'surplus to requirements' as resource revenues flow in; revenues can pay for brute force to suppress dissent.	Repression mostly limited to protests about finance, and privileges of wealthy. Repression is most visible in small havens. Political, cultural, societal repression. Usually subtle: brute force is very rare.
Relocation risk	The oil is in the ground, and will not flee: low relocation risk. Yet, resource sector interests often whip up fears of relocation to gain privileges.	Relocation risk exists but usually far less than feared: finance is rooted in cluster effects. Much of the sector is domestic. Yet finance sector interests win privileges by whipping up often unjustified fears via 'Don't tax or regulate us too much or we'll flee to lower-tax, laxer-regulated places'. 'Race to bottom': deregulation, tax-cutting, is contagious.
International contagion, inwards and outwards.	Outwards contagion not significant. Most oil producers are not big enough to destabilise world oil markets. Inwards contagion from global booms and busts.	International interconnectedness increases financial sector opacity, instability and crises impacts. International contagion works in both directions. 'Competitiveness' fears transmit deregulation/tax-cutting inwards.

OECD = Organisation for Economic Co-operation and Development.

Political risk (red)

Economic risk (blue)

Societal risk (green)

Not all states face the same impacts as the UK. As risks are case specific, the intensity of each impact is also different per country. Thereby, this thesis categorizes these eleven factors into political, economic and societal risks to be applied on Malta. Political risk includes corruption, rent-seeking, political/country capture, political repression and conflict. Political risk is usually exposed, because states often undergo financialization at the expense of society's political sovereignty. The political risk is greater, when the society is aware of the negative impacts of financialization. Economic risk includes Dutch disease, crowding out, economic instability, higher private debt, public debt, long-term growth damage, damage to entrepreneurialism, relocation risk and international contagion. Lastly, societal risk includes inequality, which is welfare risk – a sub-category of societal risk, as the finance sector is often advanced to please

the investors at the expense of aggregate welfare. By studying Malta with the guideline of three risks, this thesis also explores whether there are other impacts under these three risks that are not included under the Finance Curse.

Christensen et al (ibid) studied the Finance Curse contextualized to the UK and were preoccupied with its ability to skew the overall structure of its economy. Shaxson (2019) highlights that in the UK's case, economic risk is the motivator for political and societal risk. This is not a negligible problem, but it is one that presents itself quite differently to smaller developing countries, and especially for microstates, which already suffer from structural disadvantages and are actually hoping to achieve economic development and diversification through financialization. Such skewed structures have long been considered as a source of vulnerabilities, especially in circumstances of external shocks and crises (Armstrong & Read, 2003; World Bank, 2019; Rustomjee, 2016), which means that economic risks have been present in microstates. This raises two questions: (1) whether financialization reduces, or further amplifies vulnerabilities inherent to microstates and (2) whether political or societal risks can pose bigger problems to microstates, given the existing economic risk.

To answer these questions, it is essential to consider one further factor of financialization that is likely to have larger economic, political and societal impacts on microstates and other vulnerable economies: illegality.

Finance Curse and Illegality

Researching the Finance Curse in the UK, Shaxson (2018) mentions the “unmeasurable cost”, namely the cost originated from organized crime and other illicit activities. However, only corruption and rent-seeking, that are related to this “unmeasurable cost” are included in Christensen et al's (2015) research. This negligence is problematic, as Shaxson (2018, p.11) sees the City of London's competitiveness as “Britain's soft-touch approach to policing dirty money and financial crime”. Every economy “has its illicit counterpart”, as “licit and illicit funds flow through the same global banking system and are sheltered in the same off-shore financial havens” (Andreas, 2004, p.644). This indicates the risk of illegality, especially when the size of this “illicit counterpart” is big. The underlying logic of finance's interconnectedness to illegality is based on financialization's interpretation as a double-edged sword. Policies and systems that are attractive to good finance also attract bad finance. This is because criminals, as *homo*

economicus, run the same logic and would exploit the illicit counterpart of the economy similar as how other economic actors benefit from the licit sector. This is most dangerous, when the richest and most powerful actors in the economy involve in this “illicit counterpart”, resulting in “whoever has the gold, makes the rules” becomes the Golden Rule of the economy (Shaxson, 2018. p.23). This is particularly evident in microstates, where “smallness” actually fosters clientelism that increases the chance of corruption and involvement in organized crime, because “smallness” enables “constant direct contact and overlapping” citizen-politicians role relations and “stronger monitoring mechanisms” (Veenendaal, 2019). Therefore, illegality’s danger encompasses economic, political, and societal risks. Even worse, the infiltration of organized crime in finance also leads to security risks, another sub-category of societal risks that is missing from the Finance Curse. Here, for microstates, there lies significant danger when illegality intertwines with politics. This is because a healthy political climate is important to safeguard the economy from financial volatility, which is exceptionally risky for states that depend on financialization for economic development.

Simply put, financialization is often intertwined with illegality and the consequences resemble what the Finance Curse states, namely economic, political and societal risks. This shows the importance of studying illegality. Yet, this topic has never garnered enough attention due to its awkward position in academia that falls “through the disciplinary cracks of social science” (Andreas, 2004, p.642). This is certainly true for GPE and Political Science, as shown by the Finance Curse. This lacuna is exactly what this thesis aims to fill in, by studying the impacts of illegality using the Finance Curse.

In short, mainstream debates on financialization as economic development strategy are dominated by the “more finance, more growth” model. This is falsified by the Finance Curse in the case of over-financialization. However, the Finance Curse has its shortcomings, namely: (1)the focus on great powers like the UK, yet this thesis focuses on microstates, and (2)neglecting illegality. The answer to this thesis’ research question is also scattered all over different literature. Hence, this thesis aims to combine all these elements to study what consequences the interconnection between financialization and illegality have on the path of economic development for microstates. This is done by considering the risk of illegality when it comes to undertaking financialization strategies. It is also still unknown if the Finance Curse

would be more or less harmful to microstates, therefore this thesis first studies how financialization strategies undertaken by Malta intertwine with illegality, and then analyzes the outcomes based on political, economic and societal risks. This way, this thesis serves the double-purpose of theory-testing and theory-building.

Methodology

This thesis chooses Malta as the within-case-study for double purposes of theory-testing and theory-building. For the former, Malta constitutes the universal trend of microstates adopting financialization for economic development. Malta serves as a good example for this purpose, because it seems to be successful in this development model, proven by e.g.: reduced public debt, budget surplus and high GDP growth. By studying Malta, this thesis tests whether the impacts of the Finance Curse are more or less detrimental to microstates, namely if spill-over effects to political and societal terms would take place, or if it is easier for a microstate to contain and/or prevent such spill-over to occur.

For the latter, Malta is the least-likely case for this style of economic development, because it is traditionally not an OFC, but has recently embarked on this route for economic development, as shown by its acceleration in financialization between 2013-2019. Plus, Malta is a critical case, as it is an EU Member-State, which has relatively extensive mechanisms and strict regulations to curb illegality. For example, the EU has the AMLD, Europol that frequently checks on economic crime and the supervision of European Central Bank (ECB) to reduce illegality risk. Besides, Malta prides itself in having the “most stringent and of the highest standard” four-tier due-diligence process (MIIPA, n.d.). This means that there are national and supranational measurements to restrain illegality. In this least-likely scenario of involving illegality, Malta serves as an ideal state to test the impacts of illegality intertwined with financialization. If the analysis shows that the illegality risk exposed to Malta is devastating, this thesis would serve good theory-building purpose, as it would entail that illegality is important to be emphasized in the Finance Curse. If this holds true, impacts found beyond the Finance Curse can also strengthen this theory.

This thesis focuses on the period 2013-2019 when Malta accelerated its financialization strategies. It focuses in particular on the following reforms:

1. The introduction of Individual Investor Program in 2014
2. Low taxation to attract investors
3. Regulatory support to the expansion of the banking sector
4. Financialization through digital innovation

These strategies demonstrate the purpose and manifestation of financialization – (1)the expansion of the finance sector, (2)the increasing penetration of financialization in the non-finance sector and (3)capital accumulation. With these strategies, Malta succeeded in attracting more capital, which can be seen from its economic improvements. Besides more traditional fiscal strategies like tax relaxation, Malta’s also introduced a more contemporary strategy by establishing its own CBI scheme – IIP, to attract more capital. Additionally, Malta utilizes digitalization by integrating more digital methods (i.e.:iGaming, blockchain and cryptocurrency) to undergo financialization. Such digital innovation shows Malta’s creativity in financialization, which represents the finance sector characteristics today. Being introduced since 2013, these strategies indicate the acceleration of financialization process. Hence, this thesis analyses the impact of four financialization strategies, aiming to provide a more accurate picture of financialization today and to increase the validity of the result.

The dependent variable here is illegality. Illegality is a form of “unmeasurable cost”, yet this cost cannot be neglected. This thesis uses a GPE lens to study illegality, which means a more-rounded cost is analyzed. This is why the eleven factors from Finance Curse are categorized into economic, political and societal risk (both welfare and security risks), to serve as indicators to study the impacts of illegality when it intertwines with financialization in economic development. In this way, these three risks make this “unmeasurable cost” measurable. Furthermore, they analyze both short-term and long-term damage, serving a better reference for states that embark on this route for economic development.

These impacts are qualitatively tested and process-traced using first, primary sources like reports from the EU and investigative reports from various independent investigators; and second, secondary sources like news. Since the death of Caruana-Galizia, her work is mainly continued by “a group of 45 journalists representing 18 news organizations from 15 countries”

that run independent investigations to reveal the truth behind Malta (OCCRP, n.d.). These sources provide valid inputs, because governmental reports are likely to glorify the impacts of financialization on its economic development. Moreover, illegality and white-collar crime are often covered for the government's own interests, e.g.: to maintain in power, prevent political turmoil and gain public confidence.

Overall, the contemporary nature of this case gives a useful insight in terms of first, the techniques of financialization today; second, the problems that might arise from such techniques taking the *modus operandi* of modern illegality into account, despite the presence of strict mechanisms and regulations. These factors further strengthen the thesis' aims of theory-testing and theory-building.

The Trajectory of Financialization in Malta

The evolution of the Maltese financial system is better understood from the 1990s onward, when Malta started to pursue trade liberalization by lowering its interest rate and forgoing capital controls (Grech, 2015). Its accession to the EU in 2004 has further smoothed this process, yet its financial sector had always remained very traditional, based on standard lending, with "local banks depending on resident deposits to finance their activities" (Ibid). For this reason, Malta's finance sector was relatively limited, as it accrued its main income from tourism and manufacturing sectors. However, Malta's transition to economic liberalization was hindered by multiple adverse demand and supply shocks in the 2000s and the GFC (Grech & Zerafa, 2017, p.17). Malta's real GDP growth averaged at 2%, and the island ran a current account deficit (Ibid, p.18). The European debt crisis further worsened Malta's situation when it plunged many European states into a financial crisis. However, due to Malta's banking system and limited finance sector that resulted in less international exposure, Malta survived the crisis.

The turning point took place when the fear of bail-out crept into Malta's finance sector following the Cypriot Financial Crisis. To gain political confidence, Malta's newly-elected Labor party undertook economic reform to temper the fear and avoid itself from being dragged into the crisis. In an attempt to understand the quantitative and qualitative roles of financialization, Malta's strategies are investigated. As these strategies enable each other to

be exploited for illegality due to its cross-sector nature, this chapter first explains the mechanism of each financialization strategy separately.

The Introduction of Individual Investor Program in 2014

The IIP was introduced as the Maltese version of CBI, whereby citizenship is granted for those who contribute to Maltese economic development. The condition of gaining citizenship through this scheme is straightforward, namely a one-off contribution/donation to Malta, government bonds and property purchase which totals circa €900,000 (MIIPA, n.d.). Citizenship for immediate family can also be bought through IIP (Maltese Citizenship Act (CAP.188), 2014). Besides financial and due-diligence requirements, there are barely other integration requirements. There is no naturalization exam, nor a Maltese and English language proficiency requirement. IIP applicants only need to reside in Malta for 183 days or visit Malta to buy/lease a property to satisfy the residential requirement (Malta Immigration, n.d.). Once these requirements are satisfied, citizenship can be granted within a year (ibid).

IIP is a carefully-crafted strategy, as both property and government bond purchased/lease are required to be held for at least five years, which act as an anchor for Malta to secure investment from each applicant for that period and to avoid the emergence of speculative investment that can lead to capital flight. This scheme is specifically targeted at high-net-worth individuals (HNWIs), as they are financially independent and might be able to further contribute to Malta financially, given Malta's healthy economic climate. IIP has attracted approximately €850 million from 1101 applicants, turning Malta's budget into a surplus (Bagnoli, 2018). This amount is equivalent to 40% of tax revenues and has partially contributed to Malta's GDP growth these years (Gold & El-Ashram, 2015, p.49; IMF, 2019). This scheme is strategic, as the capital generated can act as a fiscal buffer and build precautionary balances to offset any shocks (Xu et al, 2015, p.16), amongst other investments. This economic climate can boost employment, which might be the reason for Malta's low unemployment rate (IMF, 2019). Such great contributions would have not been possible in the case of naturalization through other means.

Low Taxation to Attract Investors

Based on the "impossible trinity", the only macroeconomic policy feasible in Malta is fiscal policy, as it renounces its monetary policy along joining the Eurozone. Therefore, taxation is

used as Malta's financialization instrument. According to Maltese Income Tax Law CAP 123, income tax is taxed progressively from 0-35%. However, due to the difference made between domicile and residence, foreigners generally benefit from this law. Article 4(g) states that:

Figure 4: Maltese Income Tax Law CAP 123 Article 4(g)

- (i) in the case of income arising outside Malta to a person who is not ordinarily resident in Malta or not domiciled in Malta, the tax shall be payable on the amount received in Malta;
- (ii) no tax shall be payable on capital gains arising outside Malta to a person who is not ordinarily resident in Malta or not domiciled in Malta or to a person who is charged to tax at the rate of fifteen cents (0.15) in the euro as laid down in article 56(11);
- (iii) in the case of any person who is charged to tax at the rate of fifteen cents (0.15) in the euro as laid down in article 56(11), the tax shall be payable only on any income or capital gains arising in Malta and on any amount of income arising outside Malta and received in Malta.

The attractiveness of this clause, for the HNWI, lies in the possibility of “passport-shopping” and obtaining citizenship through IIP (Henley, 2018). This is a great opportunity for tax-planning, as income earned abroad can be tax-free or taxed at a lower rate. There is also no inheritance tax, estate tax, wealth tax, capital acquisition tax, capital duty and real property tax (Deloitte, 2019), which is beneficial for fortune-transfers. For corporations, Malta imposes 35% corporate tax rate. However, foreign corporations that “are ordinarily resident but not domiciled in Malta are taxable in Malta on a source and remittance basis” (Ibid). Consequently, many foreign corporations pay only 0-10% effective tax rate, due to the possibility for tax refund and tax exemption. In this way, Malta has the lowest income tax in the EU (Grech, 2017a). Malta also runs a full imputation system and owns over 70 Double Tax Treaties agreements with other states that avoid double taxation (Finance Malta, n.d.).

These perks contribute to Malta's iGambling, blockchain and cryptocurrency industry's success. At first sight, these low tax rates might seem counter-intuitive due to lower tax revenue, but the inflow of HNWI and corporations can lead to increasing foreign direct investment (FDI). Plus, economic actors are *homo economicus* that seek profit-maximization, thus they usually move to where taxes are the lowest. By having these attractive tax rates, Malta becomes a reputable OFC and a top choice for over 74,000 entities to (re)locate their subsidiaries and intellectual property rights (Faccio, 2017, p.4).

Regulatory Support to the Expansion of the Banking Sector

Malta's banking system has grown from housing only four to 24 licensed banks today; only three of these are Maltese (EBF, n.d.). Since then, the Maltese banking sector has evolved from domestic-focused to international-oriented banking. To accommodate both local and international needs, Malta has undergone "innovation through regulation", by introducing both financial and non-financial institutions to stimulate a banking environment that facilitates other financialization strategies (Finance Malta, n.d.). First, the Malta Financial Service Authority (MFSA) was established to regulate and supervise banks under the MFSA Act 2002. All banks must be approved by the MFSA to operate in Malta, and they are obliged to submit statistical returns for risk management purpose (Ibid). Since 2014, this mechanism is further upgraded due to the supervision of the ECB and the implementation of the EU Banking Legislation (CRDIV/CRR) (Ibid). The same EU standard is also applied to Malta's AML mechanisms that is supervised by the Financial Intelligence Analysis Unit (FIAU). The FIAU has since received supervision, guidance and recommendation from EU institutions, including European Commission (EC), EP, ECB and European Banking Authority. This means that banks in Malta are frequently checked by several institutions at both national and supranational level. Malta's regulations, with the help of MFSA, go beyond the EU's Fifth AML to improve its AML mechanisms (Young & Ganado, 2019).

Overall, Malta has put much regulatory effort to expand its banking sector to become an internationally accredited banking center. This is important for its reputation for further financialization and to attract more investors.

Financialization through Digital Innovation

Malta is powered with digital innovation that enables it to explore financialization beyond traditional means, namely through iGaming, blockchain and cryptocurrency industry, to achieve its goal to become the "Silicon Valletta" – an initiative that was introduced in 2016 to advance its digital sector.

iGaming Industry

Malta is the first EU Member-State to regulate online gambling through Malta Gaming Authority in the 2000s. It now hosts the EU's biggest iGambling industry, housing over 513 online casinos (NexiaBT, 2019). Malta's booming iGaming business comes with its effort in building this empire. First, gaming tax rates are low for both players and corporations, which give great incentives for both to land in Malta. Second, Malta offers R&D tax credits and/or grants for companies that run industrial R&D (Ibid). Third, Malta widely encourages high-value adding start-ups in this industry by providing grants for relocation, professional and consultancy fees. Fourth, Malta's license is attractive due to the easiness to obtain it, its low price and its license grants online casino operation in both Malta and the EU. Plus, license fees are waived for new operators in the first year. To facilitate this industry, Malta constantly upgrades itself, by for example, establishing the European Gaming Institute of Malta to supply skilled workers in this sector, hosting SiGMA – the world's biggest annual iGaming Festival, attracting more potential global gaming companies to Malta (SiGMA, n.d.).

The iGaming industry plays a significant role in the Maltese economy today and this industry keeps growing over the years. It generates a total of circa €1.2 billion annually, which is approximately 12% of Malta's GDP (Civillini & Anesi, 2018). This growth continues, due to Malta's entrepreneurial spirit and further efforts in building its Blockchain Island and cryptocurrency hub.

Blockchain and Cryptocurrency Industry

Malta applies 'innovation through regulation' in these industries as well, namely through The Innovative Technology Arrangements and Service Acts, The Virtual Financial Assets Acts and The Malta Digital Innovation Authority Acts (Library of Congress, 2018). Such regulations provide certainty and security for blockchain-related companies, knowing that compliance to the regulations would grant their survival, especially because many states ban blockchain and cryptocurrency activities. For these reasons, the world's largest cryptocurrency companies like Binance, OKEx and ZBX have since moved their headquarters to Malta. Binance's entry to Malta is exceptionally significant, as it is the world's largest cryptocurrency exchange, and it even cooperates with the Malta Stock Exchange (Aitken, 2018). This move signals a meaningful recognition for Malta as a Blockchain Island and its potential to become a crypto-economy

giant, especially being described as “a global hub for blockchain technology through active and transparent crypto regulations” (Ibid).

Malta is very innovative in a way that blockchain is not simply used as another financialization strategy, but it helps to improve Malta’s iGaming and cryptocurrency sector. This kill-two-birds-with-one-stone strategy definitely helps to catch up with technology today and to diversify Malta’s financialization strategy.

In short, Malta’s financialization strategies showcase its comparative advantage – low taxation, its innovation and creativity in financialization strategies, and its willingness to regulate. As shown, these strategies are not limited to only the finance sector, but its non-finance sector-based strategies, namely IIP and digital innovation-based strategies, are also being used as financial instruments to accumulate capital. This again, portrays the quantitative and qualitative role of financialization.

Each of these strategies shows the success in Malta’s economic reform, as can be seen from the increase in the size of its finance sector and the intertwine of its finance sector and non-finance sector. The dependence on Malta’s economy on these strategies is also clear, proven by their contributions to Malta’s GDP, employment and current account surplus. All these strategies eventually help Malta to become one of the fastest-growing economies in Europe.

Malta, Finance Curse and Illegality

Malta shows impressive numbers in terms of economic growth, but this thesis’ emphasis lies on net economic growth which goes beyond these numbers. To examine the net contribution of Malta’s financialization strategies, this chapter is dedicated to map the field to decipher first, how Malta’s financialization strategies intertwine with illegality and second, its consequences on economic development in terms of the “unmeasurable cost” of Finance Curse – political, economic and societal risks.

Political Risk

Malta’s economic miracle was no longer a fairytale when the Maltese political turmoil 2019-2020 erupted. The political risk exposed by financialization in Malta has close co-relations with

its political institution, as Malta's smallness fosters clientelist/patronage relations (Veenendaal, 2019). Albeit corruption is present in almost all economies, the scandals that took place in Malta deteriorated its score on the Corruption Perception Index tremendously (Transparency International, 2019, p.23), suggesting a pattern that financialization shares correlation with illegality. As most scandals are connected with each other, this section maps out how Malta's financialization strategies bring clientelist/patronage relations closer that amplifies illegality and explains the political risk exposed as a whole.

The IIP was passed in 2013 despite strong opposition from the Opposition Party and the EC, because it is prone to crime (Vella, 2014). The IIP is perceived susceptible to crime because there is a lack of consistency in Malta's CDD process, as this process is done separately by 167 different IIP agents who only check on the IIP applicants they represent, from whom they receive high commission fees (Transparency International & Global Witness, 2018, p.30-32). With this double-role of marketer and CDD agent, there can be impartiality (Ibid). Besides, Legal Notice 24/2014 Article 6 states that under "special circumstances", those with criminal records can obtain Maltese citizenship through IIP. This clause was objected by the Opposition Party, as it is ambiguous what these "special circumstances" are, therefore the government receives "the power to grant citizenship to whoever has a criminal record or is a threat to national security" (Vella, 2014). It was revealed that personal connections with high-positioned politicians help in this process (EP, 2019b), proving how this Legal Notice gives the government more power. There is also no data released regarding the number and information of successful IIP applicants, as there is no distinction made in the annual naturalized citizens lists (EP, 2019a, p.21). Yet, this information is important, as more than 38% of Malta's naturalized citizens between 2014-2016 obtained their citizenship through IIP, most of them owning Russian and Azerbaijani citizenship (EP, 2018, p.18). Many IIP applicants are oligarchs and politicians who are suspected to be involved in financial crime by the US Treasury Department (Transparency International & Global Witness, 2018, p.31). For example, Russian billionaire Boris Mints and Pavel Melnikov are caught and suspected for committing fraud, money-laundering and tax evasion (Higgins, 2018). These evidences show the weakness of Malta's CDD process, the growing power of government from this strategy and the risks led by the IIP to Malta and the EU.

In an attempt to cater to the HNWI's needs, the Pilatus Bank was opened in 2014 – following a Maltese banking incentive for IIP recipients (Bernstein, 2019). Only after four years, its license was suspended by the ECB when its owner, Ali Sadr Hasheminejad, was charged with money-laundering, fraud and violation of a US economic sanction against Iran, as he used shell companies to transfer \$115 million to Iran (Osborne, 2018; US Department of Justice, 2020). It was found that Sadr is an Iranian who used illicit funds to register Pilatus Bank on Maltese soil (Reel, 2018). Given that the Financial Action Task Force (FATF) categorizes Iran as a high-risk country, the MFSA still granted an operating license to Pilatus Bank. The Pilatus Bank was notorious for being the hub of dirty transactions related to the IIP and shell companies owned by Muscat's aides (Reel, 2018), as can be seen by how it assisted Muscat's Chief of Staff – Keith Schembri, whose name also appeared on the Panama Papers, to launder €166,000 earned from Russians IIP recipients (EP, 2019a, p.10). This transaction was escorted by Schembri's auditor – Brian Tonna, Nexia BT's partner, who was often "bought" with lucrative income for public and private financial matters (Borg, 2019a; 2020). This scandal shows how financialization strategies strengthen clientelism and patronage relations, by bringing corrupted parties closer together, accelerating corruption practices in Malta.

Besides, Pilatus Bank provided the Azerbaijani's ruling elite a wealth hideout in Europe (Bernstein, 2019). It transacted the money extracted by Schembri and Konrad Mizzi – Malta's former Energy Minister, through the Electrogas scandal. This scandal concerns Malta's decision to buy gas from Electrogas – the joint corporation of Azerbaijani state oil company – SOCAR, and Siemens, because NexiaBT recommended that this deal is 20% "cheaper" (CoE, 2019b, p.13-15; Bernstein, 2019; Borg, 2018a). Consequently, the poorly-financed Electrogas cost Malta €450million and SOCAR profited over €40million from this deal, as the Maltese people are paying substantially more than they should for the Azerbaijani gas (Ibid). This incident shows how bad finance penetrated also into non-finance sector and how much power financialization gave to these two Ministers that they could approve such big deal even with due-diligence failure to consider cheaper options. Furthermore, Pilatus Bank was accused for assisting laundering money between Muscat's wife shell company – Egrant, and Azerbaijani elites (CoE, 2019b, p.15). This is no wonder why Azerbaijani and Russian Member of Parliaments at the CoE tried to defend the dirty acts conducted by the Muscat's aides and

Tonna (Borg, 2019b). It is also not surprising that the IIP's biggest clients are Azerbaijanis and Russians.

The use of Pilatus Bank for the transactions between offshore shell companies would not have been so popular without Malta's favorable taxation system and lenient regulations. The Maltese Income Tax Law adopts the domicile/resident-based taxation system, providing more tax-planning opportunities. This is because any foreign company registered in Malta is entitled to tax exemption, which provides them to evade tax in their home country. Besides, the law is shaped in a way that beneficial owners and shareholder of companies may remain confidential or could be hidden by using a nominee (Grey & Arnold, 2018). These laws show how the mechanisms of these financialization strategies create hurdles for investigations, resulting only two fines were issued out of 21 infringements found in 22 banks (Hornig & Morena, 2019).

These scandals illustrate how deeply Malta is captured by politics for the privilege of finance. To understand how this is possible, it is important to understand how financialization fortifies the power in the executive's hand in Malta, resulting in broken checks and balances. The PM of Malta has extensive powers of appointment, as he has the power to appoint judges, magistrates and the Commissioners of Police (CoE, 2019b), meaning that he has a double role of being the government executive and prosecutor. This power is amplified by financialization, as financialization strategies were placed high on Muscat's administration's agenda, which "allowed" Malta's executives the power to defend Malta's financialization strategies for "national competitiveness". However, this power went too far that the executives intervened in the prosecution of criminal offences related to these strategies to defend their aides. For example, whilst the FIAU is supposed to be established as an independent AML body, only "approved" investigators were allowed to investigate the mentioned scandals (Ibid, p.10). Besides, Muscat's appointed Commissioner of Police – Lawrence Cutajar, remained in office, despite being ordered to resign by the vast public after his poor performance during the Pilatus Bank and Egrant scandal (Times of Malta, 2020a). Not surprisingly, the whistleblower and Caruana-Galizia's source behind the Pilatus Bank scandal – Maria Efimova, faced prosecutions related to fraud quickly, whilst the proceedings against government officials in Panama Papers were blocked (EP, 2019a, p.7). Yorgen Fenech – the convicted murderer of Caruana-Galizia, is also not officially prosecuted until today due to his close relations with

Schembri and the investigator of this proceeding (Agius, 2020). Despite public pressure, Muscat had the power to keep Schembri and Mizzi in office and offered them lucrative governmental consultancy contracts after their resignations (Times of Malta, 2020b). These examples portray how much power financialization gave to the executives that resulted in the over-centralization of power to the extent that the rule of law is breached (CoE, 2019b).

The executive's power was not only limited in governmental institutions, but it penetrated deep in the society. Media was severely controlled, whereby journalists that revealed the ugly truths behind the government and its financialization strategies were often threatened or sued, together with their publications being removed (EP, 2018, p.9). This was possible because many private broadcasters are owned by political parties and the national broadcaster is also heavily influenced by the government (Ibid). Caruana-Galizia was also humiliated online with her private life and photos being published by the media adviser of Muscat's administration (CoE, 2019b, p.17-19). For those who are not directly under the state's control, the power that these financialization strategies give to the government is used. For example, when a representative from Chetcuti Cauchi – an IIP agency, got broadcasted by a French television for shaming the government and IIP, the agency's license got suspended (The Malta Independent, 2019a). Any party who had potential to reveal Maltese dark secret were all repressed with "punishments", and Caruana-Galizia's assassination is widely seen as the government's biggest warning. This is clearly a breach in the right to freedom of expression.

These corruption scandals cost Malta a fortune, because these strategies provide easy rents to the politicians and business elites, which give more incentives to these parties to be corrupted. It is estimated that corruption costs €725million annually, which amounts to 8.65% of Malta's GDP (The Greens, 2018, p.42). Corruption here acts as the informal form of tax to the economy. Should Malta be free from corruption, it will cost €1,671 per person less annually (Ibid). This is exactly the problem of over-financialization situation, whereby "finance turns away from its traditional role serving society and creating wealth" to wealth extraction (Shaxson, 2018, p.9).

These dirty stories make Malta the EU's next "problem child" (Ibid). Despite warnings to counter financial crimes, Malta did not change, but instead, continue to pursue its financialization strategies, even through digital innovation. This field is dangerous, as

blockchain and cryptocurrency are prone to financial crime due to “their anonymity, cross-borders nature and quick transferability” (Houben & Snyers, 2018). Even worse, Malta’s iGaming industry is often the target of the Italian Mafias, because gambling involves: (1) large cash-inflow and transactions that help to mask money-laundering, (2) no physical product, which complicates the tracking-process of the origin of money and (3) no tax in many jurisdictions (Fiedler, 2013). However, Malta turned a blind eye to rules and controls on these industries, because the economic benefits of facilitating these sectors are bigger than the benefits of legal compliance (Pauly, 2017). Simultaneously, despite external pressure, Malta took advantage of EU membership to enjoy economic privileges by functioning as a tax haven. When Malta assumed EU Presidency, despite EU finance ministers’ resistance, Malta used its power as EU Presidency to influence the EU agenda, e.g.: prevented itself from being listed as a tax haven by the EU, neglected the agendas of Anti-Tax Avoidance Directive and the relaunch of the Common Consolidated Corporate Tax Base way that it had promised, and avoided the amendment of AML laws (Vincenti, 2017). The over-centralization of power and the non-existing separation of powers in Malta angered the EU, especially regarding Caruana-Galizia’s assassination, because European values, the rule of law, press freedom and rules-based market economy were violated (Ibid). This was an EU-wide problem that Malta was facilitating financial crime and allowed the penetration of organized crime groups (OCGs) into the Union. These problems show the political conflict between the EU and Malta, as Malta degraded the EU’s regulation standards and the EU’s goal is definitely not breeding a “banana republic”.

The Muscat administration called for a snap election in 2017, hoping they could assure security before the government got on “fire” from all accusations. However, since Caruana-Galizia’s murder, there was an increasing public pressure on Malta, due to the increase in investigations conducted by independent investigative journalists and organizations who continue Caruana-Galizia’s work to fight for her justice and to expose the government. Governmental institutions and reports often defended the government, but such political oppression could not hold longer; resulting in a political crisis. Malta’s biggest demonstration since its dependence was held for weeks, demanding for Schembri, Mizzi and Muscat’s resignation (Ibid), as the public could no longer tolerate this newly-emerged Mafia State and definitely not its PM who was “awarded” as “2019 man of the year in organized crime and corruption” (OCCRP, 2019). Malta immediately plunged into a governmental crisis, following Malta’s Member of Parliament’s

call for an urgent debate regarding Malta's constitutional and institutional crisis, arising from the "hijack" of Malta by organized crime and "institutionalized" murder (Micalief, 2019). The EP also pressed Muscat for immediate resignation (Rankin, 2019). Although Muscat resigned in mid-January 2020, this late resignation is seen as a serious threat to the rule of law, democracy and fundamental rights of Malta.

In short, albeit there are no directly causality links, there is co-relation between financialization and corruption, because there are patterns that suggest these scandals went hand-in-hand with Malta's financialization strategies. This is mainly because the process of financialization gave more power to the executives, by either having legislation that consolidated more power and/or enabling Muscat's power that would not have been used if it was not to defend these financialization strategies. This is the double-fold political risk that is exposed: First, these strategies strengthen clientelism/patronage relations, because financialization brought (corrupted) economic elites closer together; Second, Malta's smallness eases the political oppression by the government, given the economic miracle led by the financialization strategies undertaken. In this situation, financialization no longer creates wealth for the aggregate economy, but leads to wealth extraction by the economic elites. These reasons show that financialization does amplify illegality in Malta, as finance and illegality intertwined and turned Malta into a Mafia State, which led to the ongoing political turmoil.

Economic Risk

According to the Dutch Disease, when foreign cash enters a state to exploit a booming sector, the exchange rate of the state will appreciate; Consequently, the deteriorated price competitiveness in exports and high spending level will leave negative economic impacts (Corden, 1984). Nevertheless, Malta managed to partially contain the effects of this Disease, as it has little influence on the value of the Euro. Besides, Malta smartly uses digital innovation to reinforce its already strong tourism sector through "blockchain tourism" (Ćirić & Ivanišević, 2018). For example, Malta actively hosts annual conferences and festivals like SiGMA and the Blockchain Summit. This strategy, together with friendly legislations, led to an influx of capital investment, business people, researchers and experts (Ibid). By doing so, crowding-out of the tourism sector is avoided. However, given the success of these financialization strategies, Malta put attention solely on these industries and no longer has interest to diversify the

economy and to address long-term challenges (Christensen et al, 2016). Such over-dependence on finance makes Malta running the risk of crowding-out, brain drain, damage to entrepreneurialism and long-term growth damage in the long-run. This is because finance-related industries will leech out skilled-workers from other industries – a form of brain drain within industries. Since most investments are directed to these industries, most entrepreneurs will focus solely on these areas and neglect the others, leading to the damage to entrepreneurialism.

The increasing international exposure of Malta's economy attracts financial crime and organized crime (CoE, 2019a, p.9), as over-financialization attracts mobile finance into the economy. This danger, originating from Malta's tax regime that attracts "hot money", is illustrated by FDI flows and non-financial corporate liabilities to foreign parent corporations that amount to 30% of Malta's GDP (IMF, 2018b), but the tax generated after refund is merely €247million in 2015 (Vella, 2016). This is possibly why Malta's Gross National Income (GNI) is higher than its GDP, as many multinational corporations set up subsidiaries in Malta. These subsidiaries are usually registered as limited liability entities – the equivalent of letterbox companies, which often combine company names that include "Finance" and "Holding" (Dahlkamp et al, 2017). This strategy is popular because it only costs €1200 and less than 24 hours (ibid). Not surprisingly, many of these corporations own small offices in Malta that are managed by the same staff (ibid). Their mere physical presence amplifies their intention to exploit Malta's tax regime and not to bring net contribution to Malta's economy. "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" is the way how these companies threaten Malta (Shaxson & Christensen, 2013, p.4), which shows how mobile they are and how little net contribution they give to Malta. The same applies to many HNWIs who exploit Malta's tax system. This leads to an increase from 30.4% to 48.3% in terms of GDP in offshore wealth, or tax evasion by individuals, in Malta between 2013-2016 (EC, 2019a, p.171). Such offshore wealth further increases mobile finance in Malta's economy.

Malta's tax regime also attracted OCGs, mainly the Italian Mafias, as the same logic applies – dirty money goes to where the highest return rate is, even better – with high opportunity to launder money and the perks of geographical proximity. Mafioso set up Maltese shell companies, for example, the 'Ndrangheta had previously set up Haru Pharma Limited in Malta

to transfer its cocaine money from its shell company in St. Kitts and Nevis (Winterbach, 2017). Besides, Malta's iGaming industry has become "an ATM for the Italian Mafia" since 2013-2014 (Civillini & Anesi, 2018). Many illegal betting shops owned by the Mafias used Maltese iGaming companies to cover-up their involvement in financial crime and abuse Malta's domicile/residence-based tax system by mixing legal and illegal bets, and submitting false tax returns (Ibid; Martin, 2019). This *modus operandi* further blurs the origin of dirty money. Consequently, these casinos are the Italian Mafia's alternative form of shell companies in Malta. Malta is the biggest loser in this scenario, because it has not only attracted bad finance that comes with OCGs' penetration in the economy, but it also suffers €53million loss in corporate taxes and €71million in betting duty that are supposed to be immobile finance which can be used to boost the local economy (Ibid).

These harmful tax practices have arguably made Malta the European version of Panama. This artificial profit shifting process is not directly harmful for Malta, as it operates the business model of "earning 5% is better than nothing", but this is a big problem for the EU. Many other EU Member-states with higher tax rates, like Germany, run relocation risks, having entities escaping to low tax states like Malta. This leads to states, including the Netherlands and Luxembourg, to engage in a tax war in the last five years (Eurodad, 2017, p.13). This is exactly what "competition" entails in the Finance Curse, whereby all states compete for their "competitiveness" that leads to a "race-to-the-bottom" on corporation taxation. The danger here is that tax-cutting is contagious, which leads to international contagion of tax-cutting across the region due to the international connectedness of the EU. Consequently, the EU loses €60billion in tax income annually and EU Member-states lose averagely 13% of public revenue (Sawulski, 2020, p.13), illustrating the economic risks Malta exposes to the EU in the long run.

The absorption of bad finance through financialization left damaging impacts on the housing market. Malta's property price increases at 17% annually in the last decade (Everett-Allen, 2018). There are also "signs of overheating" in the property rental market, by which the rental price increased by 47.7% between 2013-2016, because properties were rented "according to [one's] ability to pay" (Grech, 2017b). However, Malta's minimum wage only rose by 8.4%, from €702.82 to €761.97 (Eurostat, 2020), and average wage rose by 12.5% from €1,600 to €1,800 between 2013-2020 (Camilleri, 2019). The wage increase is unable to catch-up with

this speed of rising property prices, as one has to earn higher than the national average, namely at least €20,000 per annum, to be able to afford a cheap property in 2016 (Camilleri, 2019). This suggests the possibility of a housing bubble in Malta, yet the government refused to impose price controls (Ibid). The IIP is accused of causing soaring property prices, as due to the property purchase/lease obligation, most properties were built to cater the HWNIs (Foroudi, 2019). However, these properties are mostly left unoccupied (Sietsma & Mulder, 2019). Malta should be alert that real estate investment is the oldest “traditional” way for money-laundering (Remeur, 2019, p.2), and political land corruption is widespread in Malta (Caruana-Galizia & Caruana-Galizia, 2017). These phenomena cause a serious price distortion in the property market, resulting in relatively high private debt to gross disposable income (EC, 2020, p.5). These are all bad finances, as they are not aimed at boosting the local economy, but they are speculative and intertwined with illegality, and can lead to greater economic risk like the housing bubble and/or financial crisis.

As shown, the economic risk that resulted directly from over-financialization are partially contained by the government, given that “blockchain tourism” works well and the economic impacts of Malta’s tax regime are not exceptionally devastating to its economy. However, the economic risk exposed to Malta is mainly spilled over from its political risk. Financialization accelerates political corruption in Malta to the extent that it involves blood (Caruana-Galizia’s death) and political turmoil. Consequently, Malta’s attractiveness as an FDI destination has decreased since 2017, especially in terms of political, legal and regulatory stability and transparency (EY, 2019, p.20-21). The political turmoil happened only in January 2020, causing Valletta to be isolated and local businesses to be affected (Sansone, 2019). The Central Bank of Malta (CBM) predicted that Malta’s political instability poses a threat to its economy, as it can cause a negative impact on public finances that comes with postponement of private consumption and investment (Ibid). Many business associations and unions also worry that reputational damage could cause business uncertainties (Vella, 2019). All these factors can further lead to long-term economic damage.

Overall, one should not be blinded by the “glory” of financialization strategies, as they have attracted substantial amounts of bad finance. Not all bad finances are intertwined with illegality, but they can cause harmful economic impacts in the long-run. Another finding from this section is that the economic risks exposed are heavily influenced by the political risks that

Malta faced. Yet, due to short-term observation, the long-term economic impacts of Malta's political crisis still need to be followed. Nevertheless, these financialization strategies facilitated wealth extraction by the elites, while the society has to pay for the external costs.

Societal Risk

Malta's financialization strategies are promoted to make its finance sector more "competitive" for wealth creation, but the "competition" here is not the "perfect competition", whereby each participant is a winner. Contrarily, over-financialization occurred and left a range of external costs to the society, namely in terms of welfare and security risks.

First, Malta's tax regime gives privileges to the rich to become more "competitive", but this privilege cost Malta €5.2billion in tax evasion/avoidance (EC, 2019a, p.172). In this zero-sum economy, when some pay less tax, the government has to generate public revenue through other means, namely spending cuts and/or tax increase on others (Eurodad, 2017, p.15). These measurements impose burden on the non-privileged taxpayers. For example, while most financial services are free from VAT, VAT on other goods and services is applied. The former is used more by the rich, and the latter applies to all, yet daily household goods and services entail a larger share for the poor than the rich (Ibid). Second, Malta's informal tax on the society – corruption, cost the society €725million, which amounts to 65% of the national social expenditure budget (The Greens, 2018, p.41). Both taxes force the non-privileged taxpayers to end up paying "more" cost for public goods provision and this leads to a wider inequality gap.

Malta's Human Development Index (HDI) tops at 0.885, but when GNI rank minus HDI rank is used as an indicator to check whether the welfare is trickled-down, Malta's figure follows the suit of other resource/finance-dependent states, namely it has been declining closer and closer to a negative figure in the last decade (UNDP, 2018). This entails that less wealth being invested in true human development (Shaxson & Christensen, 2013, p.17). For this reason, the rate of those at-risk-of-poverty or social exclusion grew from 15.3% to 16.8% (Caruana, 2019). People from this group suffer from the inflation in the housing market due to the government's failure in price-controlling in properties and taxing property hoarders (Agius, 2018), thus many properties are left vacant for speculative activities (The Malta Independent, 2019b). Furthermore, there is a lack in social-housing and currently the real-estate industry

only develops high-end properties for the HNWI's (Agius, 2018; Grech, 2019). This explains why the percentage of Malta's homelessness increases, even among people who have a full-time or part-time job (Ibid).

To defend itself from the accusations that Malta is increasing poverty, Malta claims that its iGaming industry generates capital and shows "healthy increase in wages" (IMF, 2018a). However, only workers in this industry enjoy higher salary, because other sectors cannot compete with the salaries offered by iGaming industry. This is problematic, because approximately 67% of the employees in this industry are non-Maltese, which means that the Maltese people are not the biggest beneficiaries (Ibid). The same applies to the blockchain and cryptocurrency sector. This problem can be attributed to Malta's education sector. Whilst GDP has increased by 7.2% for the last decade, the spending on education dropped from 5.4% to 4.9% as a percentage of GDP (EC, 2019b, p.5). Although this number is still higher than the EU's average, the result of this investment is poorer in EU comparison. There is insufficient school infrastructure and although there is an expansion in education, Malta still hosts a high number of low-skilled workers and the skills produced do not match with the market needs (Ibid, p.8-12; EC, 2020, p.5). This indicates that the education sector is not given sufficient attention to "catch-up" with the financialization strategies that accelerate at a higher speed. Consequently, financialization through innovation actually increases the wage gap and contributes to higher inequality.

Although these welfare risks did not directly arise from the interconnection between Malta's financialization strategies and illegality, mobile finance from these strategies led to over-financialization and welfare cost. It is also financialization that leads to the over-centralization of power in the executive's hand that the people do not get voices to redistribute the welfare in the economy better.

Besides welfare risks, Malta's financialization strategies also led to security risks due to the Italian Mafia's infiltration in Malta's legitimate businesses. Originally, Malta had no historical presence of organized crime, but it has now become the Italian Mafia's destination to conduct illegal activities. Even worse, these Italian Mafias attract different OCGs, including the North African, Albanian and Balkan OCGs, to gather in Malta (Raineri, 2019; DIA, 2016). The presence of Italian Mafias turned Malta into a transaction point between the North Africa coast and Europe for illicit arms trade, illicit trafficking of tobacco products and human trafficking and

smuggling (Ibid). Since then, financial crime has escalated into violent crime as well. For example, there is an increasing number of explosives in Malta, namely 19 bomb attacks in the last decade (Pace, 2017). These explosives were sold or smuggled by the Italian Mafias, and most bombing cases are connected to the Mafias' oil-smuggling and drug-trafficking activities (Ibid). The common bomb attack involves detonating bomb(s) in the targeted person's car (Ibid), which is how Caruana-Galizia was killed. These assassins have indeed bought bombs from the Mafia (Harvey, 2019). These examples show that the society's security is compromised by Malta's financialization strategies.

Academic researches often state that a mafia and/or shadow state will end up becoming a failed state, as illegality can lead to a "decay of formal state institutions", conflict, civil war and state collapse (Reno, 1995,p.1; 2000; Naim,2012). Despite being labelled as a mafia state and shadow state, Malta is not a failed state, given its impressive economic achievements (Raineri, 2019). This provides the chance for the Maltese elites to de-securitize organized crime at national level, which allows them to portray organized crime as an opportunity instead of a threat for national "competitive" purpose (Ibid). This is a significant hazard to society, because without securitization, organized crime will never be a priority at the national agenda and even worse, Malta's national interest can possibly be influenced by the Mafias.

Despite Malta's passive attitude towards organized crime, the securitization of organized crime has been pressed by the EU, Europol and the FATF (Ibid). The network of Italian Mafias is big and their joint-business is worth €110billion annually in Europe itself (Times of Malta, 2019), which is why the Southern Spain and Eastern Cyprus have been highly securitized due to their proximity to the Mediterranean Sea (Gounev & Bezlov, 2010). However, Malta provides a new and better hideout for the OCG, as many illegal activities are condoned here. Malta has eased the operation of illegal activities and its toleration to the infiltration of the Mafias in its state is seen as the facilitation of the Mafias' expansion in the EU. This is a big threat to both Maltese and the European security, because organized crime is named the biggest threat to European internal security by Europol, whereby Cosa Nostra and 'Ndrangheta are Europe's biggest OCGs (Times of Malta, 2019).

In short, the welfare risks that are exposed are mostly due to the over-centralization of power in the politicians' hands given by the financialization strategies that hinders the redistribution of welfare. Whereas, security risks that are exposed are mainly due to the attraction of OCGs.

Here, it is Malta's financialization strategies that provide the OCGs a platform to turn all criminal activities into real. Both are equally seen as societal risks, because it is the society who has to take the burden of these external costs.

Conclusion

This thesis argues that Malta's economic development has to be studied by taking the net contribution of Malta's financialization strategies to its economy into account, namely not only its contribution to the GDP, but the wider impact on the Maltese economy and society, including the effect of illegality that is closely intertwined with the process of financialization. To do this, the thesis adapted the Finance Curse that outlines three major channels through which over-financialization can negatively affect a country: economic, political, and social.

The findings show that Malta's political channel is the main link that connects the risks of financialization and illegality. This means that in Malta's case, it is political risk that spills over to economic and societal risks. However, one must acknowledge that corruption exists in every economy, but there is a clear pattern that shows that financialization reinforced corruption in Malta, which arguably made it cursed by finance. This is because financialization leads to the over-concentration of power in the executive's hand and it brings clientelist/patronage political relations closer. Given Malta's smallness, the public can be easily oppressed, which eases the process of financialization, corruption and other financial crimes. This is the first type of bad finance: finance that is diverted to wealth extraction by the elites. This type of bad finance led to the Maltese political turmoil and distorted the EU standards, causing a political clash between Malta and the EU.

The second type of bad finance attracted by Malta's over-financialized economy is mobile finance that is speculative and not targeted at the aggregate welfare of the economy. In Malta, mobile finance is deceptive, because it makes Malta's GNI higher than in reality. This comes primarily from corporations, HNWI's and OCGs that are registered in Malta to legitimize their illegal intentions to commit financial crimes. Albeit Malta tried to mitigate economic risks (through blockchain tourism), other unintended impacts can be observed, e.g.: its skyrocketing housing price. The EU also bears the economic risks posed by Malta – the race-to-the-bottom of tax rates among EU Member-States and the loss of tax revenue. Besides, the

political risk that arose from wealth extraction will most certainly leave damaging effects on Malta's economy.

Both of these risks eventually leave societal impacts on Malta's economy in terms of welfare and security risks. The over-centralization of power in elites' hands made redistribution of welfare difficult, because privileges are given to the rich at the expense of society. Bad finance also led to the penetration of OCGs in Malta which threatened the society's security. These risks would not have been exposed and/or accelerated without financialization. Financialization strategies intertwined with illegality and ended up overshadowing Malta's economic performance. Taking these risks into account, this thesis emphasizes the importance of a more inclusive and holistic approach to study economic development, because these risks actually make Malta less affluent, as they lower the net contribution of financialization.

The findings of this thesis contribute to the Finance Curse in several ways. First, for theory-testing purpose, the case study of Malta shows that the Finance Curse can be applied to microstates, although Malta seems to be successful in financialization as an economic development model. An interesting finding here is that political risk is more detrimental to Malta, and it is political risk that spills over to economic and societal impacts. This means that different from the traditional Finance Curse theory, the root of Malta's Finance Curse is the political risk, instead of the economic risk. This is a new insight for further research on the Finance Curse, specifically: the inherent problem of a state (political structure in Malta's case) must be considered to understand how the spill-over effects of the Finance Curse work.

Second, for theory-building purpose, this thesis shows that illegality is strongly related to financialization, and makes it more likely to take place in other more weakly-regulated developing countries. Although Malta employs sophisticated national and supranational mechanisms to curb illegality, illegality is widely present and significantly impactful in all three risks. Illegality complicates financialization by inviting not just financial crime, but the penetration of OCGs in Malta. This means that illegality also adds another sub-category of societal risk – security risk, which further lowers the net contribution of financialization in Malta. For these reasons, illegality cannot simply be disregarded and be labelled as “unmeasurable cost”, but it has to be included in the Finance Curse to construct a more comprehensive analysis on economic development.

All these contributions ultimately show the shortcomings of the “more finance, more growth” model, and stress the need to study economic net growth. The inclusion of the Finance Curse and illegality in studying finance-based economic development models emphasize that there are other factors that define economic development, other than GDP. By taking all these factors and their short-term and long-term effects into account, this thesis addresses the danger of finance-based economic development models, especially to smaller developing states who are likely to embark on financialization as well. Academically, this is fruitful for GPE and Security Studies.

Nevertheless, there are several limitations that can be improved, if further research can be followed. First, the political turmoil in Malta took place very recently, which leads to limited short-term observation, especially on economic risks. Long-term impacts are vital to the study of the Finance Curse, therefore further research could strengthen the analysis of this thesis better. Second, illegality remains a difficult area to be studied, given the scarcity of sources, which is why this thesis relies on EU reports and independent investigation reports.

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