

## **ESTONIA TO EXPORT PUBLIC SERVICES USING DIGITAL IDENTIFICATION THEN CYPRUS?**

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Currently Cyprus tries to increase incoming foreign investments and to stabilize financial system. This short casual letter considers e-Residency started by Estonia in 2014 as a feasible option to invite investments, to stabilize financial system, and to increase tax revenue.

The e-Residency is a virtual residency system that enables virtual residents to obtain ID, access online public service, open bank account, having business, and paying tax in Estonia. The Estonian taxation system is very simple: the corporate tax is zero and the income tax 20%. In some sense, it is a mutant of tax heaven, but the critical difference from the ordinary tax heaven is the potential users of this scheme. For instance, tax heaven tries to attract affluent people while e-residency tries to attract any people that may benefit Estonia.

Bringing residents into the country induces many good things. New residents may have innovative ideas that create new businesses. If those businesses are successfully operated, Estonia will obtain tax revenues in exchange for providing governmental services. Additionally those businesses are providers of deposits and probably users of loans. Hence, e-Residency system expands the scale of the banking sector and that enables the banking sector to exploit the economy of scale. The expansion of the banking sector by new residents creates a stable financial system based on sufficient funding sources and profitability, so long as it remains healthy.

What are beneficial for e-Residency users other than the taxation scheme? If we look around the world, many countries have inferior property rights protection system. For now, most of e-residents are from EU (especially, from Finland and Germany) and US. However, assuredly there are lots of potential demands for obtaining e-Residency status from developing/emerging countries, where property rights are not better protected. Estonia needs to compete with tax heavens to attract such demands, but the competition is not hard if they focus on attracting non-superrich. Imagine that taking about 10% of BRICS citizens with 1,000 EUR that will amount circa three hundred billions for incoming funds.

When we invite offshore money, we always face additional risks of financial crises. For example, a huge decline in the national currency induces withdrawals of foreign depositor (bank running) and that further induce withdrawals of local depositors. Such a crisis could not have occurred if foreign depositors did not exist. In order to guarantee stable currency value, we may exploit one of the benefits of Euro even though there are several controversies.

In 2013, deposits were frozen in Cyprus. Cyprus then became the second country that implemented deposit freeze after Japan in 1946. The Japanese

crisis was created by the Second World War while the Cypriot crisis was created by excessively aggressive attitudes toward risks by banks that followed by very high leverage. Such kind of policy must not be implemented again, as protecting property rights is the most important thing for the Government.

To avoid the next crisis caused by greed, the Government needs to regulate the banking sector appropriately. This is of course not only for Cypriot Government, but also governments of all over the world. Yet, I believe in Economics. That means that we need to have an incentive compatible scheme to implement appropriate regulations for the financial sector. From the view point of attracting money using the e-Residency system requires transparent and healthy financial system. If incoming funds are induced by transparent and healthy financial system with strong property rights protection schemes, the Government and banks will have sufficient incentives to maintain such systems. Furthermore, if citizens believe in the Government and banks to maintain such systems to attract offshore money, they also believe in our monetary system to reinforce economic recovery and sustainable growth.

The e-Residency in Estonia has just started with currently a little bit more than 9,000 e-residents, so nobody knows if it succeeds as expected. However, it must be an innovation that enables small countries to export their public and financial services. By exporting such services, we may obtain offshore funds without relying on traditional foreign direct/indirect investments. The costs for inviting traditional investments are huge, as we have to provide several privileges for foreign firms. However, e-Residency imposes much less cost. Public and financial services are typical parts with large fixed costs, which means we can exploit larger profits from economy of scale. Exporting public services for virtual residents (e-Residency) will be a policy of low cost with larger positive externalities for Cyprus to be viable.