

5. Mauritius: An Economic Success Story

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There is no miracle. It is due simply to hard work, discipline, and will.

Sir Anerood Jugnauth, President of Mauritius

Mauritius is paradise. . .It is beautiful here and we all work together.

M. Rambonee, Mauritian taxi driver

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Abstract

In spite of its small economic size, low endowment of natural resources, and remoteness from world markets, Mauritius has transformed itself from a poor sugar economy into one of the most successful economies in Africa in recent decades, largely through reliance on trade-led development. Real GDP growth averaged more than 5 percent between 1970 and 2009, while GDP per capita has increased more than tenfold over the same period. Though its economic success has been the subject of considerable debate, several key factors were central in bringing about the Mauritian miracle: good macroeconomic policies, particularly fiscal prudence and a competitive exchange rate policy; strong public sector and private sector institutions, with exceptionally productive interaction between the two; a strong, pro-trade orientation and a liberal trade regime; and use of its ethnic diversity to forge a consensus between the different groups. In parallel to its economic growth, Mauritius has achieved significant improvements in key human development indicators.

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Introduction: Anatomy of the Mauritian Miracle

Defying the predictions of James Meade, a Nobel Prize recipient in economics who famously predicted a dismal future for Mauritius in 1961 due to its vulnerabilities to weather and price shocks and lack of job opportunities outside the sugar sector, the small island nation in the Indian Ocean of approximately 1.3 million people has transformed itself from a poor sugar economy into a country with one of the highest per capita incomes among African countries.¹ Mauritius' combination of political stability, strong institutional framework, low level of corruption, and favorable regulatory environment has helped lay the foundation for economic growth, while its open trade policies have been key in sustaining growth. The government functions as a parliamentary democracy, and the country has an efficient administration that is both technically competent and adaptive to changing global economic circumstances. Mauritius' financial sector sufficiently well developed, that the country has begun to position itself as a platform for investment linking East Africa with India and China.

Headline figures related to Mauritius' economic performance are impressive. Real GDP growth has averaged more than 5 percent since 1970 and real annual growth in per capita income, likewise, has been strong. GDP per capita increased more than tenfold between 1970 and [2010], from less than \$500 to more than \$6,000. Imports and exports have boomed; together, they have reached more than 100 percent of GDP during the late 1990s and 2000s. At the same time, efforts at economic diversification have been successful, allowing the country to move from sugar to textiles to a broader service economy. Mauritius' reliance on trade-led development has helped the country achieve respectable levels of export performance. Along the way, measures of human development have improved substantially.

Despite being a small island economy vulnerable to exogenous shocks, Mauritius has been able to craft a strong growth-oriented developmental path. Natural disasters and terms of trade shocks have never prevented the economy from having a strong and regular growth. Constrained at inception by a mono-crop sugar economy, low amounts of arable land, and a high population growth rate, Mauritius

¹ Careful empirical work by Subramanian (2003) shows how initial conditions in Mauritius—especially the level of income, geography, and commodity dependence—have hurt long-term growth, while there has been some mitigation due to favorable demography and high levels of human capital. For example, Mauritius is disadvantaged by being at least 25–30 percent more distant from world markets than the typical African country. Statistical analysis, however, shows that on balance, the disadvantages outweigh the advantages: initial conditions have slowed growth by about 1 percentage point per year relative to the average African country and by nearly 2 percentage points relative to the fast-growing developing economies of East Asia.

has emerged as a regional entrepot and tourism destination as well as the top-ranked African country in the World Bank's *Doing Business* (in 2009, it ranked xx out of xxx countries).

Though a variety of explanations have been developed to explain Mauritius' growth performance, there is no doubt that the country's focus on international trade has been a critical element of that performance.² Mauritius' preferential access to trading partners, particularly the European Union (EU), in the sugar, textile, and clothing sectors resulted in subsidies for the export sector and provided important foreign exchange for the economy. Preferential trading deals accounted a strong growth in Mauritius's total exports between the 1970s and the 1990s. Though imports tariffs in Mauritius were kept high, they have never been high enough to interfere with the overall trade regime. For example, the average tariff for manufacturing was 86.2% in 1980, but it did fall to 30.1% in 1994 (Wignaraja and O'Neil, 1999). Simultaneously, Mauritius pursued a very liberal investment regime and used incentives to attract foreign direct investment (FDI). Mauritius also offset the burdens on its exporters with tariff-free access for productive inputs and with tax incentive subsidies, and relaxed labor market regulations, in the export sector. Furthermore, it has used export processing zones (EPZs) to export key manufacturing goods, mostly apparel and textiles. Mauritius' overall trade and investment policy has been based on a managed embrace of globalization and cultivation of market access.

Aside from its trade and investment policy, Mauritius has benefited from prudent fiscal, exchange rate, and monetary policy, the latter of which has also been beneficial to export performance. To compensate for the myriad disadvantages of limited scale, Mauritius has also developed a plethora of strong institutions and good governance. Additionally, the public and private sectors maintain a vibrant partnership that manifests itself in a range of areas.

Finally, Mauritius has always displayed receptivity to new ideas and adaptability. At various points in its history, Mauritius has used intervention, subsidization, and targeting to adapt to the shifting economic circumstances by crafting imaginative public policy to adapt to shocks. Though Mauritius benefited from the sugar protocols, the government also recognized early on the advantages of diversification. As such, it relied heavily on EPZs but ensured that there was no antiexport bias. Mauritius also has proven very adept at embracing new sectors, particularly light manufacturing, offshore banking and financial services, and service-related information and communication

² See Sachs-Warner [1995, 1997], Meade (1961), Rodrik [1999], Romer [1993], and Subramanian and Roy[2001], among others.

technology (ICT). It has adapted and transformed its ethnic pluralism into a tangible economic force.³ It has forged a vibrant democracy with competing parties, a strong electoral system, and an open media.⁴ In sum, Mauritius' impressive economic performance has not been an accident, but rather the result of careful planning and policies. During and in the aftermath of the biggest exogenous shocks to its economy in recent times—the phasing out of the Multifibre Arrangement governing textiles, significant reductions in EU sugar protocol prices, the 2008 food and fuel crisis, and the 2008–09 global financial crisis—Mauritius's economy has displayed strong resilience.

The Growth Story

Since the 1970s, Mauritius has recorded very high growth rates and sustained increases in human development indicators due to a combination of good macroeconomic policies and strong institutions. With the advent of the sugar preferences and the EPZs in the 1970 and 1980s, Mauritian authorities have succeeded in transforming their economy and laying the foundation for stable growth in the future. Sugar and textile revenues have been used to facilitate service-sector development and contribute to socioeconomic progress and higher living standards.

A well-managed economic regime

Proper macroeconomic management—fiscal discipline during boom times, monetary management that kept inflation in the single digits and that produced interest rates that encouraged domestic savings, and an exchange-rate policy that maintained flexibility and competitiveness for exporters—have all been key to Mauritius' economic success. At the same time, flexible public policy, especially in the form of experiments creating EPZs in the 1980s and embracing the ICT industry in the 2000s, was also an important feature. Trade reforms, the development of a social welfare system, and policies that favored human capital development also played a part. The result has been respectable and stable growth rates, manageable fiscal and current account deficits, and high rates of private investment.

³ Mauritius has three ethnic groups: Mauritian Creoles, Indo-Mauritians, and Franco-Mauritians. The Creoles (African) were brought to Mauritius as slaves to work for owners of sugar cane fields. Indo-Mauritians came to Mauritius as indentured laborers after slavery was abolished in 1835 and eventually became the country's political elite. And Franco-Mauritians were the French who remained in Mauritius after the British took over in 1810 to look after their large sugar estates and other businesses, including trading and banking.

⁴ Mauritius' legislative system is based on a classic parliamentary Westminster system. Legislative power is vested in the National Assembly, which comprises 62 elected and up to eight designated representatives. The four main current political parties in Mauritius are the Labour Party (PTR), the Movement Mauricien Militant (MMM), the Mauritius Socialist Militant (MSM), and the Parti Mauricien Xavier Duval (PMXD).

	2006	2007	2008	2009
National income (%)				
Real GDP growth	3.9	5.4	4.2	1.5
Consumer prices	11.8	8.7	6.8	4.0
Unemployment	9.1	8.5	7.2	8.3
Fiscal (% of GDP)				
Revenue	19.3	22.0	22.5	21.1
Expenditure	23.6	25.7	26.1	25.6
Fiscal balance	-4.6	-4.0	-3.4	-4.5
Total external debt	6.1	4.6	6.1	8.0
Total domestic debt	46.6	45.6	43.8	42.0
External (%)				
Import	16.4	6.0	20.6	-24.5
Export	8.9	-4.7	7.3	-23.5
Current account (% of GDP)	-9.4	-5.6	-10.4	-8.1
Terms of trade	-5.8	-1.0	-1.1	1.6
Domestic investment (% of GDP)				
Public	6.9	6.4	5	6.1
Private	17.3	18.7	19.6	20.2
Nominal GDP (\$ billions)	6,507	7,521	9,321	8,527
<i>Source: IMF (2010); government of Mauritius.</i>				

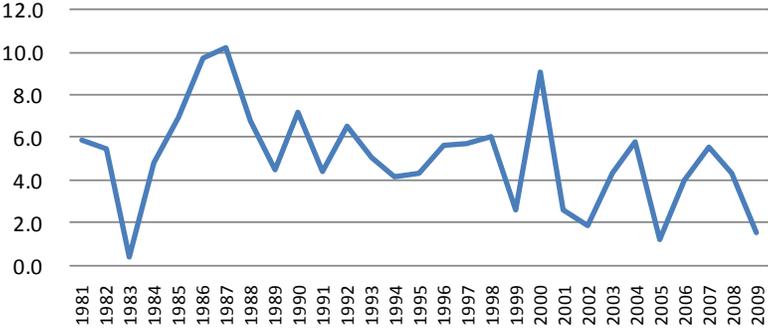
A very successful economic trajectory

Between 1977 and 2009, real GDP in Mauritius grew on average by 5.1 percent annually, compared with 3.2 percent for sub-Saharan Africa (figure 1 based on IMF and government data); this rate of growth is despite the volatility caused by exogenous shocks over those years. The acceleration of the growth rate in the 1980s is the result of the macroeconomic reforms in response to protracted balance of payments and fiscal troubles. Following the reforms, Mauritius experienced steady growth, low inflation, and increased employment. GDP per capita, meanwhile, increased approximately seven-fold between 1976 and 2008, from less than \$1,000 to nearly \$7,000 (figure 2). At the same time, consumer price inflation in Mauritius has remained in the low single digits through the 1990s and 2000s, and the country's debt stock has been manageable.⁵ Windfalls from sugar and textile preferences have been used wisely to

⁵ Although Mauritius' public debt is relatively high, at about 60 percent of GDP, most of it is held domestically by the National Pension Fund and commercial banks.

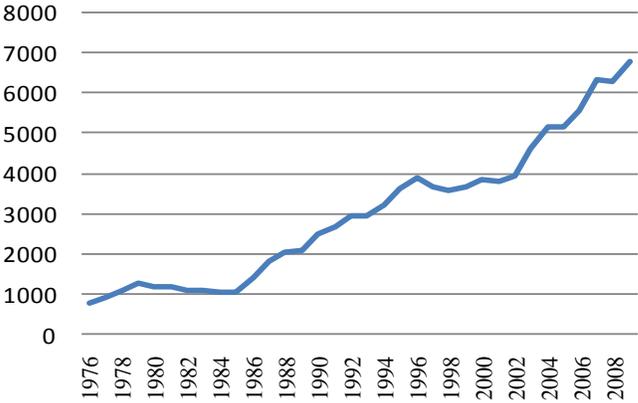
help promote diversification and boost growth. The structural transition away from agriculture and into manufacturing and services shows the success of the government’s efforts at economic diversification.

Figure 1. Real GDP Growth in Mauritius, 1981–2009 (percent)



Source: Government of Mauritius.

Figure 2. GDP per capita in Mauritius, 1976–2008, \$



Source: Government of Mauritius.

Favorable international comparisons

Both a cursory examination of economic indicators and detailed diagnostics show that Mauritius has been one of the best-performing and most stable economies in Sub-Saharan Africa in recent decades, even in the presence of terms-of-trade shocks and oil shocks. Using purchasing power parity (PPP) data for 44 Sub-Saharan African countries, Arbache and Page (2008), for example, examine country-level dynamics of long-run growth between 1975 and 2005 and conclude that Mauritius was one of the best performers, both in terms of per capita growth performance and in terms of low growth volatility, alongside Botswana, Cape Verde, Gabon, Namibia, the Seychelles, and South Africa. Decomposing the

standard deviation of GDP per capita and economic growth into within-country and between-country components, Arbache and Page (1999) find that Mauritius' growth stability was much higher than that of many oil economies, such as Nigeria and Angola, and of resource-poor economies, such as Burundi and Central African Republic, in Sub-Saharan Africa. While Mauritius was growing, much of SSA was not. In 1975–94 growth decelerations were twice as frequent as accelerations: 29 percent versus 14 percent of all country-year observations in the Arbache-Page dataset.

The role of total factor productivity

Empirical work decomposing total factor productivity (TFP) in Mauritius during different time periods shows the strong role of factor accumulation. As in many countries in East Asia, the principal driver of growth in Mauritius has been capital and labor accumulation, with TFP growth making a significant but varying contribution.

In a paper using a growth accounting framework analysis for Mauritius and highlighting the performance of the 1980s and 1990s, Subramanian and Roy (2001) uncover diverse performance in the two periods. In the first period (1982–90), economic growth was rapid and driven predominantly by the growth of inputs—capital and labor—which together accounted for more than 80 percent of the annual average rate of GDP growth of 6.2 percent. During this period, there was a stellar performance of employment growth, which averaged 5.2 percent per year, reflecting in a sharp decline in the unemployment rate from 20 percent of the total labor force in the early 1980s to 3 percent in the late 1980s. TFP growth was respectable at more than 1 percent, but capital accumulation was the main driver of growth. The authors find that economic growth from 1991 to 1999, however, was driven less by capital accumulation than in the past and to a greater extent by productivity growth, with TFP growth during this period averaging more than 1 percent per year.⁶

In another study, the analysis of Sawkut et al (2009) provides evidence that TFP gains in Mauritius have reached a plateau. TFP growth averaged 1.35 percent in the 1980s, 1 percent in the 1990s, and 0.7 percent in the 2000s, but the TFP contribution varies depending on the different growth rates (table 2). For the entire period 1980–2007, however, Sawkut et al. (2009) find that the TFP contribution to growth in Mauritius averaged 1 percent annually, considerably higher than the 0.28 percent average in Common Market for Eastern and Southern Africa (COMESA) countries over the same years. The TFP change in Mauritius was due to economic reforms and human capital improvements.

⁶ Note that TFP calculations are very sensitive to the start and end year.

Table 2. Total Factor Productivity Decomposition and Contribution to Growth

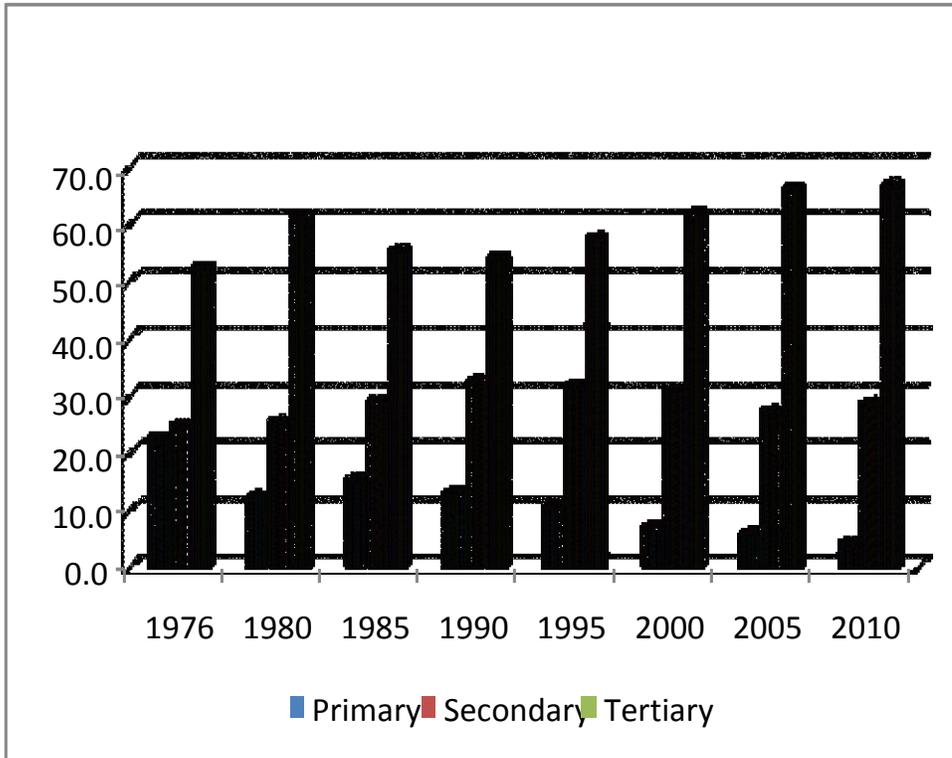
	Years	Growth rate (percent)	Capital (percentage points of growth rate)	Labor (percentage points of growth rate)	TFP (percentage points of growth rate)
Mauritius	1980–90	6.35	3	2	1.35
	1991–2000	5.6	2.5	2.1	1.0
	2001–07	4.1	2.5	0.9	0.7
	1980–2007	5.3	2.6	1.7	1
COMESA	1980–90	3.1	1.53	1.73	-0.16
	1991–2000	2.43	0.73	1.64	0.06
	2001–07	4.53	2.13	1.45	0.95
	1980–2007	3.35	1.5	1.6	0.28

Source: Sawkut et al (2009).

Structural transformation

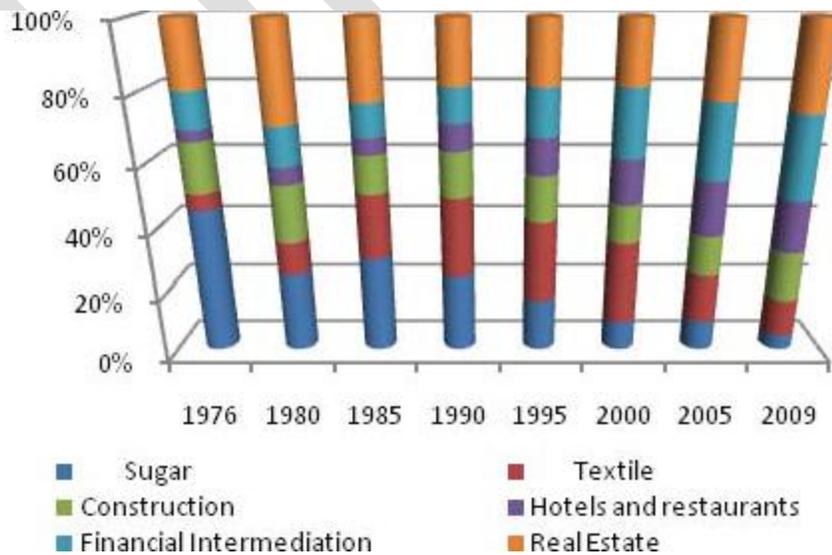
Over time, there has been a profound change in the sectoral composition of the Mauritian economy. Between 1976 and 2010, the share of primary-sector production declined from 23 percent of the overall economy to 6 percent, while the secondary sector (including manufacturing, electricity, water, and some construction) increased from about 23 to 28 percent (with manufacturing making an even bigger jump), and the tertiary sector, which includes tourism and financial services, grew from just over 50 percent to nearly 70 percent of GDP (figure 3). Projections by the Mauritian government suggest further expansion of the tertiary sector as a share of the economy in the future. In general, the share of manufacturing output increased in the 1980s due to the presence of EPZs but stagnated as the sector faced adjustment in the 1990s and 2000s. Table 3 shows patterns for specific industry groups and subgroups between 1990 and 2010. Sugar, which represented more than 20 percent of Mauritius' GDP in 1976, accounted for approximately 4 percent of GDP as of 2009. At a disaggregated sectoral level (whether at current prices or constant prices), there has been a strong structural change, with the decline in sugar, the rise of financial services and real estate, and the mixed performance of textiles as the service sector has strengthened (Figure 4). By the 2000s, the service sector is now the dominant feature of the economy in terms of contribution to output. This structural transformation has been noteworthy, and it has helped the country deal with decreasing returns to scale of capital accumulation at the sectoral level. The various economic pillars in Mauritius have thus contributed to growth and mitigated output volatility.

Figure 3. Sectoral Composition of GDP in Mauritius, 1976–2010, by Percent of GDP



Source: Mauritius authorities ; World Bank (2009)

Figure 4. Major Economic Sectors in Mauritius, 1976–2009, by Percent of GDP



Source: Mauritius authorities; World Bank (2009)

Table 3. GDP by Industry Group at Current Basic Prices, 1990–2010 (percent)

Industry group	1990	1995	2000	2005	2010 ^a
Agriculture, hunting, forestry, and fishing	12.9	10.4	7.0	6.0	4.3
Sugarcane	8.0	5.7	3.6	3.2	1.6
Other	4.8	4.6	3.4	2.8	2.7
Mining and quarrying	0.2	0.2	0.2	0.1	0.0
Manufacturing	24.4	23.0	23.5	19.8	19.1
Sugar	3.4	1.6	0.8	1.0	0.5
Food, excluding sugar	0.0	-	4.1	5.1	6.6
Textiles	0.0	-	12.0	6.7	5.2
Other	0.0	-	6.6	7.0	6.8
Electricity, gas, and water supply	1.5	2.4	1.7	2.1	2.5
Construction	6.7	6.4	5.6	5.6	7.1
Wholesale and retail trade; repair of motor vehicles, motorcycles, and personal and household goods	13.0	12.8	12.2	12.1	11.9
Wholesale and retail trade	12.6	12.3	11.7	11.4	11.1
Other	0.4	0.5	0.5	0.7	0.8
Hotels and restaurants	3.9	5.1	6.5	7.7	7.5
Transport, storage, and communications	10.4	11.4	13.0	12.6	10.8
Financial intermediation	4.9	6.5	9.7	10.3	12.3
Insurance	1.5	2.1	2.3	2.9	2.9
Banks ^b	0.0	4.4	6.6	6.2	8.0
Other	0.0	-	0.8	1.2	1.4
Real estate, renting, and business activities	8.9	8.5	8.9	10.2	11.9
Owner-occupied dwellings	6.4	5.3	4.5	5.0	5.0
Other	2.5	3.2	4.4	5.2	6.9
Public administration and defense; compulsory social security	6.4	6.7	6.7	7.1	6.5
Education	4.1	4.4	4.5	4.8	4.6
Health and social work	2.5	2.8	3.0	3.4	3.8
Other community, social, and personal service activities and private households with employed persons	2.0	2.8	3.3	3.7	4.7
Financial intermediation services indirectly	-1.8	-3.3	-5.7	-5.5	-7.0

measured (FISIM)					
GDP at basic prices	100.0	100.0	100.0	100.0	100.0
Manufacturing industries previously operating with an EPZ certificate	11.9	11.4	11.9	7.4	6.7

Source: CSO, Government of Mauritius.

Note: Figures may not add up to the totals due to rounding. Empty cells indicate data is not available. Data is at current prices.

a. Forecast figure.

b. For years 1991 to 1996, figures for other financial intermediation are included in banks.

Improvement in human development indicators

As opposed to many Sub-Saharan African and comparator economies, rapid economic growth in Mauritius has occurred in parallel with substantial improvement in human development indicators and a decrease in income inequality. Life expectancy at birth, for example, increased from 62 years in 1970 to 73 years in 2008, while infant mortality has dropped from 64 per 1000 in 1970 to 15 in 2008 (figure 5). The Gini coefficient, a measure of income inequality in which 0 represents perfect equality among households 1 represents perfect inequality, declined from 0.5 in 1962 to 0.37 in 1986–87 and was stable at 0.38 in 2008. Following heavy government investment in education improvements in the 1980s and 1990s, primary school enrollment rates have reached very high levels, averaging more than 90 percent in the 1990s and 2000s, although challenges remain.⁷

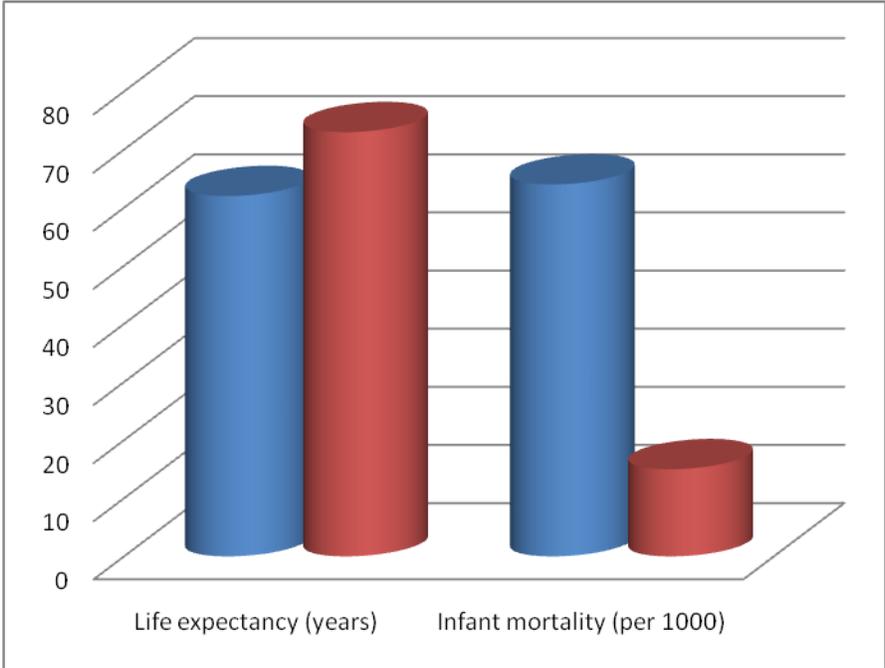
Poverty levels in Mauritius have also fallen significantly. In 1975, 40 percent of Mauritian households were below the presumed poverty line, according to the Central Statistics Office.⁸ By 1991/92, the proportion had fallen to 11 percent, and by 2010, absolute poverty was less than 2 percent. Significant improvements in gender equality have also occurred, due to the massive inflow of women into the labor market starting in the 1980s. The country recently ranked 11 out of 102 countries in the OECD Social Institutions and Gender Index. Mauritius' housing stock has also improved, both in

⁷ One challenge Mauritius faces is that a large proportion of young people are unable to access secondary education because of the very competitive system for moving from primary to secondary schools, and thus cannot contribute the skilled labor force required by the economy. At present, almost 35 percent of students fail to pass the completion-of-primary-education examination and drop out of the school system at the age of 12.

⁸ Mauritius does not have a national poverty line; poverty figures are derived by the Central Statistics Office using census and survey data.

terms of quality and quantity, as a result of government investment. Finally, Mauritius has developed a sophisticated pension system covering retirement benefits and general social security.

Figure 5. Social Indicators in Mauritius, 1970 and 2008



Source: WDI, UNICEF

Macroeconomic Management

Prudent, proactive fiscal policy

A hallmark of economic management in Mauritius in recent decades has been prudent fiscal policy, which has helped both maintain macroeconomic stability and contribute to growth. Fiscal policy in Mauritius has focused on ensuring that spending remains linked to the resource availability. While there have been fiscal imbalances, there is no history of the government borrowing from the central bank or from aid agencies. The strong growth in the 1980s led to a decrease in recourse to foreign financing. The budget deficit which was at 3 percent in 1983, turned into a budget surplus by 1987, as current expenditures shrank from 26 percent of GDP to 21 percent in 1987 while government revenues remained flat, around 24 percent over the same period. On the expenditure side, the government withdrew from subsidies on food items and kept the wage bill under control during that period.

Similarly, in the 2000s, the government built up reserves that allowed it the freedom to expand fiscal policy in the aftermath of the 2008–09 global financial crisis. Moreover, the stock of international and domestic debt has remained well below an unsustainable threshold (total public debt is projected to be 60.4 percent of GDP at the end of 2010). Mauritius' government expenditures have never much exceeded 20 percent of GDP and have been used mostly for wage policy, with a small amount devoted to food subsidies. Capital expenditures, which averaged less than 5 percent of GDP since independence to the present, but which have been increasing over the long term, have been used productively to invest in infrastructure—especially roads—and provide a necessary operating environment for EPZs.⁹ In sum, fiscal policy has helped lay the foundation for management of volatility and robust growth.

In terms of both revenue management and expenditures, fiscal policy in Mauritius has been proactive. On the revenue side, international trade taxes anchored the system's revenue system, accounting for close to 50 percent of GDP during the 1970s, 1980s, and 1990s. High import tariffs and export levies on sugar helped give the government resources during the early years, though the introduction of value added tax (VAT, which replaced the sales tax) in 1998 has played an important role in improving tax buoyancy at the level of direct and indirect taxes and has allowed the fiscal system to evolve. As a result, the tax system has not been impacted by import tariff liberalization in recent years. In addition, in 2007—the implementation of a flat tax of 15 percent on corporate and personal incomes—streamlined tax administration. By 2008, tax revenue amounted to 19 percent of GDP, of which 20 percent came from income tax, more than 35 percent from the VAT, and slightly less than 5 percent from international trade taxes. The diversified stream of revenue helped the fiscal system absorb shocks and provide stable revenue flows to the government.

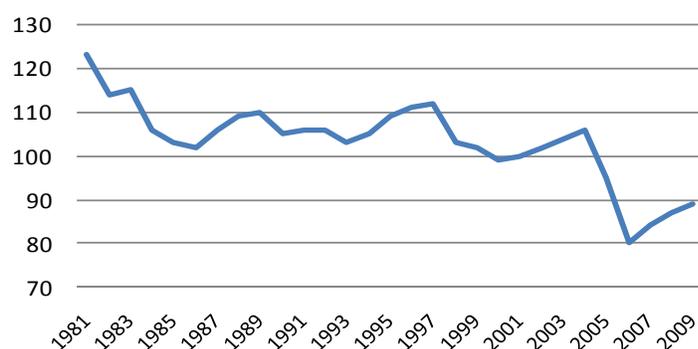
Monetary policy as an anchor for economic growth

In tandem with fiscal policy, monetary policy in Mauritius has helped anchor economic growth and ensure competitiveness. Since its creation in 1967, the Bank of Mauritius has been concerned with ensuring the competitiveness of the country's export sectors and, secondarily, with price stability. In important ways, a series of exchange rate decisions early on had ripple effects on economic activity. As part of the liberalization program, in 1979, the Mauritian rupee (MUR) was devalued by 30 percent, and readjusted by 20 percent in 1981 when the rupee was officially delinked from the IMF's Special Drawing

⁹ It should be noted that capital expenditures are underestimated in the Mauritian budget, since many public investments take place through parastatals, while expenditure classifications are detailed for the central government. As a result, some capital expenditures may be classified as current expenditures.

Right (SDR) and pegged to a trade-weighted basket of the currencies of its major trading partners. By the mid- 1980s, the Bank of Mauritius was intervening to smooth currency fluctuations, and the country has maintained a managed float since the mid-1990s. Figure 6 shows the path of the real effective

Figure 6. MUR Real Effective Exchange Rate, 1981–2009



Source: IMF

exchange rate (REER) of the rupee (base year is 1970 = 100). The results of managed float exchange rate regime have been favorable to the economy, with the trade-weighted real effective exchange rate (REER) depreciating on average every year by more than 5 percent from the 1981 to 2007.¹⁰ Though inflation has been higher in other Sub-Saharan African countries than in Mauritius, the central bank allows the accommodation of these inflation differentials by letting the nominal exchange rate slide in order to keep the REER competitive. The policy has worked well in terms of being flexible and being sensitive to the country's export sector.

As inflation fell in other parts of the developing world in the 1990s, Mauritius adopted an informal inflation targeting approach. Over time, monetary policy in Mauritius has evolved from a strong reliance on direct monetary instruments, such as credit ceilings, to a gradual introduction of market-based instruments such as weekly auctions of Treasury and Bank of Mauritius bills. In practice, monetary management has been oriented to ensure a positive interest rate differential relative to major currencies while reacting to domestic inflation when it is above a certain level. Interest rate

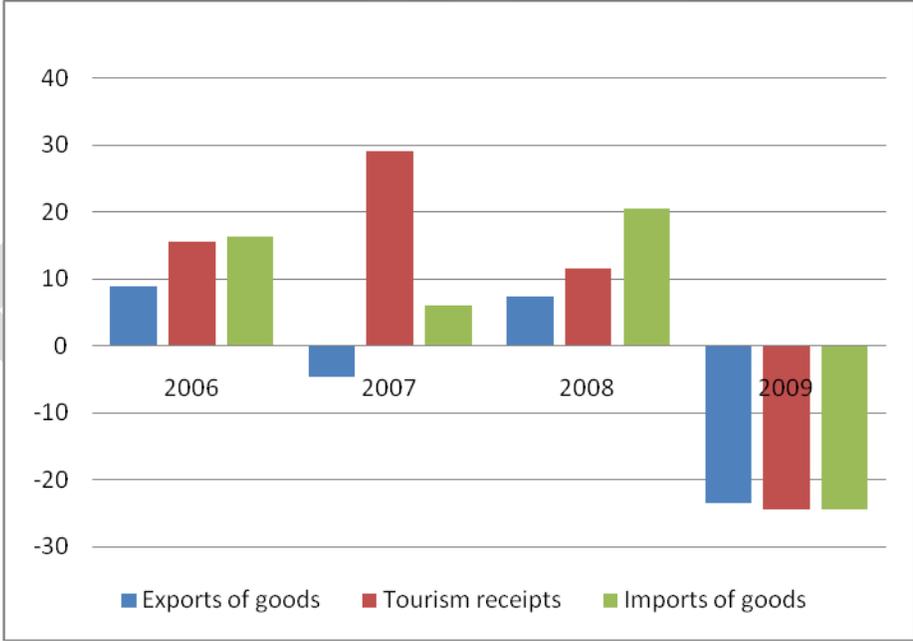
¹⁰ The IMF (2008) finds that using the macroeconomic balance approach and the single-equation equilibrium exchange rate approach, the real exchange rate at the end of 2007 was broadly in line with its equilibrium value (as determined by economic fundamentals).

policy has been used successfully to provide savers with positive real rates of return in order to mobilize domestic capital and to help sterilize excess liquidity. As a result, since the mid-1980s, national savings has consistently exceeded investment expenditure.¹¹

Effective response to economic shocks

A tribute to Mauritius’ successful macroeconomic management can be seen in the response to the crisis and the various preceding shocks. The combination of the phasing out of the Multifiber Arrangement starting in 2004, the reduction in sugar price guarantees from the EU starting in 2006, and dramatic increases in world commodity prices (especially for food and fuel) had already started to act as a brake on the country’s growth trajectory and current account and fiscal positions when the global financial crisis began. As a small, open economy, the financial crisis hit Mauritius hard. The country experienced a sharp decline in demand for tourism and textile exports (Figure 7) . There was a contraction of the labor-intensive sectors, especially construction and textiles, as the crisis made its way to Mauritius.

Figure 7: Trade and Tourism Growth (%): 2006-2009



Source: IMF (2010)

¹¹ Since the mid 1980s, private sector investment has also exceeded private sector savings.

As a result of the crisis, growth slowed to 4.2 percent in 2008 and then to less than 2 percent in 2009, while unemployment increased by from 7.2 percent in 2008 to 7.7 percent in 2009. Due to prudent macroeconomic management, however, international reserves continued to expand and the fiscal deficit was kept below 5 percent of GDP. Morisset, Bastos, and Rojid (2010) find that the country's resilience to the shocks was a combination of four factors: reforms to sustain long-term growth, which accelerated in 2006; timely, targeted, and temporary short-term response to the crisis; institutional arrangements to face the crisis that promoted private sector collaboration; and strong relationships with development partners.

In response to the global financial crisis, Mauritius passed a fiscal stimulus and monetary easing package of about 5 percent of GDP over 2009–10. The plan focused on infrastructure spending, providing financial relief to the firms hit hardest by the global crisis, and social and job protection measures. At the same time, the government introduced offsetting measures that are expected to bring the primary budget into surplus by the end of 2011, and a public debt management act was passed limiting public sector debt to 60 percent of GDP, with a goal of reducing it to 50 percent by 2013. The government has also been using special “rainy day” funds to help finance the stimulus. These funds have been prudently put aside in previous financial years (to the tune of 3 percent of GDP), reducing current debt financing needs. Monetary policy in Mauritius was also loosened, the key repo rate was cut by 250 basis points, and reserve requirements were reduced.

In addition to easing fiscal and monetary policy, Mauritius introduced measures to assist the private sector in the wake of the crisis. Firms facing liquidity difficulties were given temporary financial relief (conditional on credible restructuring plans), with costs shared by banks, the government, and the firm's shareholders.¹² A tax suspension program was also introduced for the labor-intensive and vulnerable tourism, construction, and real estate sectors.

¹² Technically, the Mechanism for Transitional Support for the Private Sector (MTSP) under the Additional Stimulus Package (ASP) was a combination of: equity support, liquidity/working capital (including guarantees for bank support), and asset purchases and swaps. from the mechanism began functioning in mid-December 2008. As of September, 2010 11 companies have received assistance under the MTSP, to which the government has contributed MUR 140 million (36 percent of the total MTSP support for these companies; the remainder has been provided by banks and shareholder equity) in the form of debentures at 5 percent interest.

Dynamic Institutions and Adaptability to Change

Aside from its success in macroeconomic management, one of the keys to Mauritius' economic success has been its rich web of trade links, effective institutions, and history of public collaboration. In surveys of institutional quality, Mauritius repeatedly ranks high vis-à-vis comparator countries, particularly in terms of governance, rule of law, and control of corruption (table 4). The combination of political stability, democratic legacy, rule of law, and quality of judicial institutions sets Mauritius apart from many Sub-Saharan African countries. Moreover, a set of informal and formal mechanisms guide the interaction between the public and the private sector, with the result that the private sector plays a seminal role in the policy formulation process (all Mauritian delegations to international organizations, for example, have a private sector member). Indeed, cooperation between the public and private sectors has a long history in Mauritius.¹³

For decades, Mauritius served as a trade hub for Chinese and Indian traders and an entrepot for shipping across the Indian Ocean, and its inhabitants known for their entrepreneurship. Over time, those trade links coalesced into formal trade associations and entities, some of which came to be represented at the political level. At the same time, Mauritius has been quite effective at promoting its trade links on the international level.

The importance of forging consensus

The search for consensus is one of the remarkable features of the Mauritian political economy. Essentially, the Mauritian State is modeled on the British system of government, with a cabinet headed by a prime minister and a legislative assembly serving as the law-making body. As in the United Kingdom, the system of government in Mauritius is based on the principle of separation of power between the legislature, the executive, and the judiciary. Gulhati and Nallari (1990) argue that since no single political party has ever secured a majority in the assembly, which would allow it to form a government on its own, there has always been a need to work together across party lines, putting a distinctive stamp on economic policy process. Despite being based on loose agglomerations of ethnic and economic interests, political parties in Mauritius have not been vehicles for ethnic separation. To

¹³ The fact that Mauritius was, at different times, colonized by both the French and the British left it with a British-based public administration and a French-based private sector, which coexisted and worked together for the benefit of both parties for more than a century, setting in play a policy of consensus building that continued after independence in 1968.

the contrary, political parties in have long recognized that building consensus is necessary to avoid adverse economic effects in a small economy.

The nexus between the public and private sectors

A paramount role in state-business relations in Mauritius is played by the Joint Economic Council (JEC), JEC occupies a central place in the country's institutional landscape and represents an umbrella association of a number of sector-specific groupings.¹⁴ As such, it carries a certain amount of institutional weight, meeting with the prime minister on a regular basis and providing input on major policy decisions. Being funded entirely by the private sector, it also has a degree of financial autonomy. The overarching goal of the JEC is to ensure private sector representation in all key government economic decisions. It also ensures that its members' ideas are conveyed to political leaders.

Another example of public-private sector cooperation in Mauritius is the establishment of the EPZs, which would not have been possible without support from several key public sector institutions. Central among these were the Mauritius Export Development and Investment Authority (MEDIA), the Export Processing Zone Authority (EPZDA), and the Development Bank of Mauritius. MEDIA was formed in 1985 a public trade and investment promotion agency (with some private sector membership) and was a pivotal institution behind country's drive for export growth and industrial upgrading. Providing overseas marketing support for exports and arranging buyer seller meetings, it helped explore niches for Mauritian garments in European and American markets. Formed in the early 1970s, the EPZDA helped represent the interests of firms in the EPZs, while the Development Bank of Mauritius provided much of the credit and start-up capital for the economy as it was taking off from its narrow monocrop base. Finally, more recently, the Board of Investment has played a role in helping to promoting Mauritius as an international investment, business, and service centre and provides counseling on investment opportunities in Mauritius and helps in setting up businesses.

A Tale of Three Sectors: Sugar, EPZs, and Tourism

At various times in Mauritius' history, sugar, EPZs, and tourism each has been a mainstay of the economy, and the interaction among the three sectors has been essential for the country's economic

¹⁴ The JEC of Mauritius is funded entirely by its private sector members, which include: Mauritius Chamber of Commerce and Industry, Mauritius Chamber of Agriculture, Mauritius Employers' Federation, Mauritius Sugar Producers' Association, Mauritius Exports Association, Mauritius Bankers' Association, Mauritius Insurers' Association, Association des Hôteliers et Restaurateurs de l'Île Maurice, and Association of Mauritian Manufacturers.

takeoff. As a small, open economy with a high ratio of trade of goods and services to GDP (averaging more than 50 percent of GDP from 1970 to 2010), Mauritius has long been well positioned to embrace globalization. Over the years, Mauritius has used trade policy as both a means to protect domestic industry and a means to launch export growth.

The sugar sector

In its heyday in the 1970s, the sugar sector in Mauritius accounted for close to one-third of employment, one-third of export earnings, and one-quarter of GDP. Through smart negotiations and building on a preexisting relationship with the United Kingdom, Mauritius succeeded in obtaining preferential treatment from the European Economic Community (EEC) through the Sugar Protocol of the Lomé Convention in 1975, under which it received more or less free access for its sugar exports to the EEC.¹⁵ Mauritius sold its sugar to the EEC at a premium—three times the international market price, on average. For years, Mauritius' export quota was fixed at more than 500,000 metric tons annually, and it had the largest quota share among African, Caribbean, and Pacific (ACP) countries. Even with these international trade agreements in place, however, the collapse in international sugar prices in the mid-1970s hit Mauritius' sugar sector hard, leading to balance of payments difficulties and recourse to external assistance. Nevertheless, by 2005, in the aftermath of the WTO's ruling that the above-market prices paid to sugar producers constituted unfair trade, the EU began end the preferential deals by slashing sugar prices.

Import substitution industrialization and restrictive trade policies following the colonial period

Following on the establishment of a development certificate scheme by colonial authorities in 1964 to promote import substitution industrialization and provided incentives for local manufacturers through concessions and tariffs, Mauritius invoked a series of protectionist measures in an effort to develop local industry. Besides providing government with some revenue and helping to incubate entrepreneurial talent, these policies had a marginal impact on the local economy as the EPZ regime was much more important. Subramanian and Roy (2003) find that Mauritius' trade policy was highly protective in during the 1970s and 1980s. In 1980, average effective protection exceeded 100 percent, although this fell to 65 percent by the end of the 1980s. During the 1970s and 1980s, there were extensive quantitative restrictions in the form of import licensing, which covered nearly 60 percent of imports, and an

¹⁵ The Sugar Protocol was negotiated as a condition of the United Kingdom's membership in the EEC to protect the developing countries from which it had traditionally imported sugar to under the Commonwealth Sugar Agreement.

extensive system of exemptions and concessions. Protection was especially high in the clothing, footwear, furniture, and rubber sectors, all of which had tariffs above 50 percent, while tariffs for electronics and plastics averaged more than 40 percent. Corporate taxes were also very high, and bureaucracy was quite heavy. Protectionism faded through the course of the 1980s, however, and by the early 1990s import licensing was eliminated on all but a limited list of items subject to health, sanitary, or strategic controls, while export licensing was abolished for most products.

The rise of EPZs in the 1970s and 1980s

Having studied the success of export processing zones (EPZs) in East Asia, a group of visionary policy makers in Mauritius put forth the idea that the country's small economic size and distance from large developed markets presented a potential opportunity to develop an export-oriented textile industry. In 1970, Mauritius passed the Export Processing Zone Act, which provided powerful incentives to manufacturers catering to foreign markets. Key components of the new legislation included protective import duties and quotas for infant industries, suspension of import duties on materials and equipment for industrial use and not locally available, rebates of import duties on other raw materials and components for specified industries, duty drawback schemes, and favorable long-term loans. The granting of duty-free inputs for manufactured exports was key in expanding Mauritius' export competitiveness on world markets, while tax incentives provided to the export firms helped subsidize exports. Firms within EPZs also benefited from the availability of relatively cheap labor, drawn from unemployed workers and women who were outside the labor force at the time. According to interviews with textile executives located in the EPZ, (80 percent of workers in the EPZs in the 1980s were women). The rate has decreased somewhat in the 1990s and 2000s, but women continue to be more than 60 percent of the workers in the zones. The lower wages that were paid to the workers in the EPZs in the early years allowed the firms to accumulate capital and reinvest the earnings into the firm's expansion.¹⁶ However, over time the wages in the EPZ zone became higher than the non-EPZ economy. Also important was that Mauritius did not restrict EPZs to one geographical location, and that the government invested heavily in the infrastructure needed to set up EPZs.

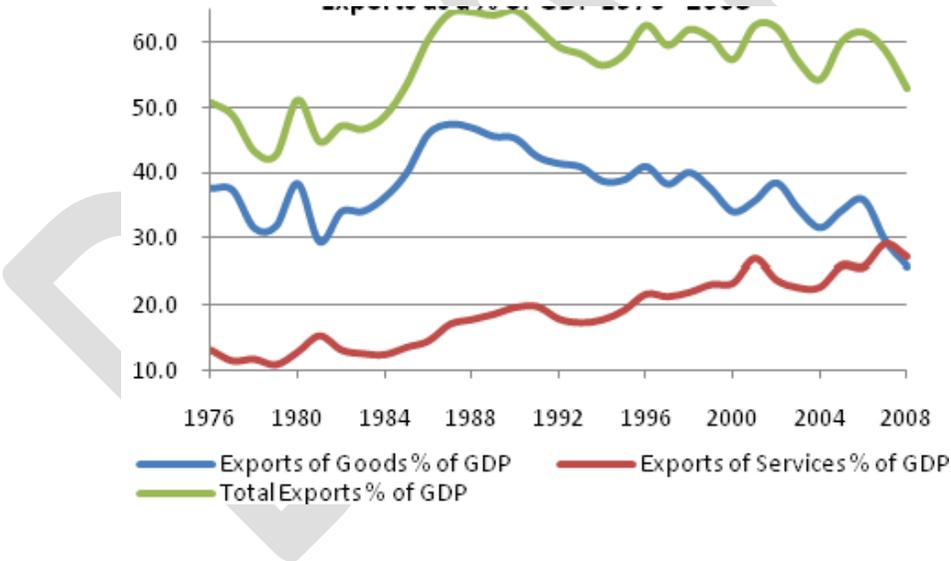
By the 1980s, EPZs had exceeded the expectations of even visionary policy makers in Mauritius. EPZs accounted for more than 60 percent of Mauritius' gross export earnings and employed one-third of the Mauritian labor force. In terms of share of GDP, goods produced in EPZs more than tripled between

¹⁶ Firms within EPZs were subject to general labor laws (including minimum wages) but were free to fire workers, to demand compulsory overtime work, and to penalize workers heavily for absenteeism.

1980 and 1988, from 4 percent to more than 14 percent. More people worked in EPZs than in the agricultural sector by the end of the 1980s. The growth rate of the EPZs value added was close to 30 percent annually between 1983 and 1988. Most of the goods produced in EPZs were exported to the EU under a preferential regime. Notably, there was significant interaction between sugar sector and EPZs. Much of the start-up capital for EPZ firms, as well as technical and managerial expertise, came from the well-established sugar companies in the aftermath of the sugar boom in the 1970s. Together with the sugar sector, the textile sector provided the capital accumulation that allowed Mauritius to decrease reliance on foreign capital and start down the path to becoming a middle-income economy.

Several additional factors contributed to Mauritius’ success with EPZs. First, the country took advantage of the depth of demand for textiles and apparel in the EU and United States, which provided a solid base for expansion. Second, Mauritius’ timing was good, as its initial entry into the U.S. market got a boost from investors based in Hong Kong who were seeking to move capital and factories out of Hong Kong in anticipation of 1997 reunification with China.

Figure 8. Value of Mauritian Exports, 1976–2008 (percent of GDP)



Source: IMF, World Bank (2009)

Third, quotas on Asian textile exports into Western markets led investors to look alternate production countries. Those investors brought capital, marketing networks, and technological know-how to Mauritius’ nascent textile sector. (Greenaway and Milner [1989], however, find that the OECD decision to grant Mauritius trade preferences in garments through the Multifiber Arrangement was more

important in giving Mauritius privileged access to developed markets relative to established Asian producers.) Fourth, EPZs benefited from the inflow of local capital and of indigenous managerial capacity, which had partly been incubated under import substitution policies. Bheenick and Schapiro (1989) find that local participation in EPZ equity in Mauritius was roughly half, a much higher ratio than in EPZs in other developing countries. And fifth, Mauritius benefited from a strong entrepreneurial class and a trainable labor force. In turn, the job opportunities offered by EPZs played a significant part in unemployment falling from 20 percent to less than 5 percent between the mid-1970s and 1990.

Post-EPZ economic drivers: tourism, business process outsourcing, and financial services

Though EPZs brought dramatic economic improvements to Mauritius, the textile and apparel sectors have met challenges in more recent years, not least of which was the phasing out of the Multifiber Arrangement starting in 2004. This led to a contraction of 30 percent in value added of the products produced in EPZs and a reduction in the number of Mauritians employed in the EPZ by about 25,000 people between 2005 and 2010.¹⁷ In parallel, the EU's reduction of sugar prices by more than 50 percent starting in 2005 and continuing onto 2010 was a significant blow to the Mauritian economy given that from 1975 to 2005, about 90 percent of its sugar production has been exported to the European market. The EU's decision to end price guarantees on raw sugar for all countries has thus been a shock for the \$ 10 billion Mauritian economy. In short, both the sugar and textile and apparel sectors are in the process of adjustment in order to remain globally competitive, with the textile sector making inroads into fully integrated activities (for example, spinning and weaving) and higher end manufacturing and the sugar sector increasing its focus on refined sugars.

As the sugar and EPZ sectors in Mauritius have struggled in recent years, the tourism sector has expanded rapidly, backed by a master plan reflecting the government's dislike for mass tourism and high-rise buildings. Public sector efforts to expand tourism have been complemented by the promotional activities of the hotels and by Air Mauritius. Indeed, Mauritius' combination of beautiful beaches, a multiethnic society, and excellent hotels dotting the coastline has been quite effective in attracting tourists. According to the Mauritius Chamber of Commerce, tourist arrivals reached 240,000 in 1988, 400,000 in 2000, and 900,000 in 2008. The estimate is about 1 million tourists visiting the

¹⁷ Despite the challenges, the government has supported the restructuring of EPZ textile firms in order to avoid a possible collapse of the sector. These efforts include establishing the Textile Emergency Support Team (TEST) initiative in July 2003 and encouraging the National Productivity and Competitiveness Council (NPCC) to carry out a diagnostic study of textile firms to assess their cost structure and point to areas in need of improvement.

country in 2010. Tourism is also been among the strongest foreign exchange-earning sectors of the Mauritian economy.

In addition to tourism, the government of Mauritius has also made encouraged diversification of the economy into Business Process Outsourcing (BPO), financial services, and information technology. According to Government figures, the BPO industry in Mauritius has been growing 70 percent a year and is currently worth \$1.6 billion, employing more than 100,000 people. Offshore banking was introduced in 1988 as a first step toward developing Mauritius into an international financial center, and the offshore sector is playing an increasingly important role in the financial services sector and emerging as a growth vehicle for the economy.¹⁸ Development of the information technology sector, meanwhile, is intended to transform Mauritius into “ a cyber island” by creating a high-tech multi-storeyed tower with strong technological capabilities that provides a home to companies from all over the world to set up operations, manage data, facilitate e-commerce, and establish call centers. The government has also encouraged use of Mauritius as a transshipment center and a re-export base and, more recently, as an international medical hub and a regional knowledge center. As a result of all of these efforts, the Ministry of Finance finds that the services sector showed consistent growth over 2006–09, with financial intermediation growing by 10.1 percent in 2008.

Lessons of the three sectors

The story of the three sectors in Mauritius has a number of lessons. Most importantly, the constant search for new drivers of economic growth reflects a desire by policy makers to adapt to the future rather wait and respond to shocks. The central lesson here is that the public sector can effectively formulate and implement sectoral policies to stimulate the private sector. In the case of sugar, the protocols were signed and the private sector rushed into the activity. In the case of EPZs and tourism, a well-articulated policy framework led to a strong private sector response. And in all cases, the government acted as a facilitator of private sector expansion.

¹⁸ At the end of October 2002, the number of companies registered in the offshore sector reached 20,111. The Mauritius Freeport, the duty-free zone in the port and airport, aims at transforming Mauritius into a major regional distribution, transshipment, and marketing center.

Business Climate and Investment

Alongside successful trade policy and adaptability, another major reason for Mauritius' economic success has been its business climate and incentives for foreign companies to locate there. Mauritius has no capital controls, a relatively stable currency, a low flat corporate tax rate of 15 percent, and a large number of double taxation avoidance agreements; together, these attributes sometimes make Mauritius more attractive than larger financial sectors for businesses. International rankings consistently give Mauritius high marks for business and investment climate. In contrast to many developing countries, Mauritius has never had a government advocating confiscation and nationalization policies. The main lesson from Mauritius in this regard is that geography is not destiny and that policies to improve investment climates can have large positive multiplier effects.

Business climate improvement in recent years

The World Bank's *Doing Business 2010* ranks Mauritius as the best country in which to do business in Africa. Overall, Mauritius is ranked 17th out of 183 countries ranked in the 2010 survey, up from 24th out of 183 in 2009. Currently, Mauritius is among the top-performing developing countries in starting a business, paying taxes, and protecting investors, and it has been a consistent reformer since it began being included in *Doing Business* in 2005. More broadly, Mauritius has taken steps to improve business facilitation since the late 1990s. In earlier years, while the private sector was thriving in certain sectors such as sugar and textiles, the climate for domestic firms in the non-EPZ sector was unfavorable. A study by Lall and Wignaraja (1998) found several major obstacles for enterprises operating in Mauritius at the time: high interest rates; heavy bureaucratic procedures resulting in delays in obtaining foreign investment approvals; difficulty getting loans approved by the Development Bank of Mauritius, delays in receiving refunds on import duties; difficulty obtaining work permits for foreign technical staff; lack of access to finance for small enterprises; and high sea freight costs. Government reforms have helped alleviate all of these obstacles in the years since.

One major piece of legislation, the Business Facilitation Act 2006, provided a new, streamlined legal framework for business operations in Mauritius. The legislation facilitates doing business and acquisition of properties by foreigners and, among other things, enables small enterprises to start business activities within three working days. As a result, the private sector and foreign investors can continue to venture into new sectors, such as real estate and financial services, in which growth rates are eclipsing traditional sectors. Between 2006 and 2010, the share of private sector investment has grown, mainly due to investment in infrastructure projects such as commercial and office buildings,

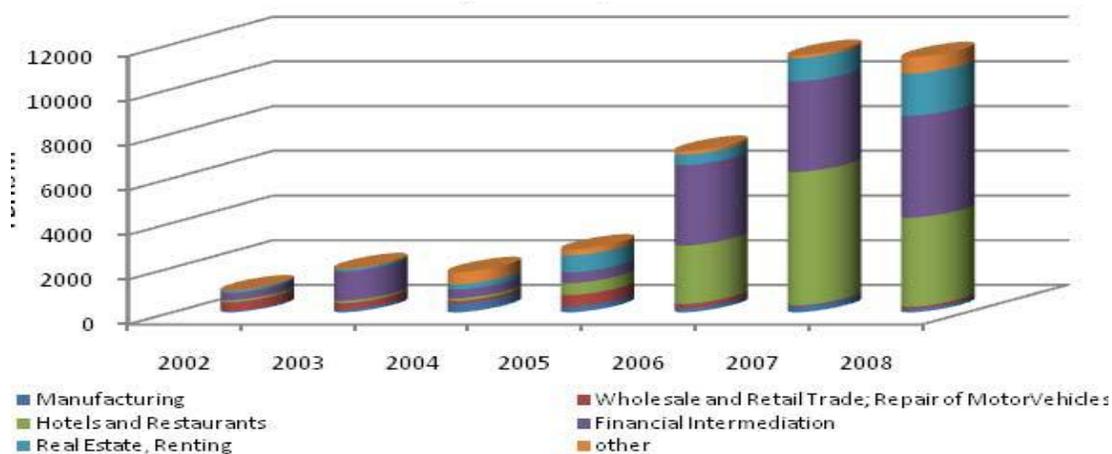
hotels, and resorts, to account for more than 80 percent of gross domestic capital formation. While infrastructure deficiencies and difficulties obtaining credit remain for small firms and there is still a lack of skilled labor available for larger firms, the thrust of the reforms has been to alleviate these constraints.

The role of foreign direct investment

Following reforms such as the removal of the tax on capital account transactions and the waiving of the requirement that foreign investors need approval of the Bank of Mauritius to carry out activity, in addition to a low corporate tax rate of 15 percent (although foreign firms receive a subsidy of close to 10 percent leading to an effective tax rate of 5 percent), FDI inflows to Mauritius have increased rapidly in the past several years. In fact, the country attracted more FDI during 2004–07 than the cumulative stock of FDI during the 25 years before that (figure 9). Importantly, FDI inflows are accompanied by new business ideas, technologies, and managerial skills. Most FDI inflows have gone to the hospitality and tourism, property and real estate, banking and finance, information technology, health, and education sectors. The main FDI source countries are France, South Africa, and the United Kingdom, though total FDI inflows are equally divided between developed and emerging countries. Interestingly, Mauritius has also been a beneficiary of a high inflow of FDI into India. Due to special tax treatment given to investments that come through Mauritius to India,¹⁹ there has been a surge in recent years as companies register themselves in Mauritius. Mauritius has been a quasi- tax haven for foreign funds invested in India, and currently, about 80% to 90% of foreign direct investment into India flows through Mauritius via private-equity, hedge funds and mutual funds. Under the current double taxation treaty between India and Mauritius, capital gains on Indian shares that are held by a Mauritian company are not subject to Indian tax laws and rates, an issue which has been vexing to Indian regulators and policymakers. Simply put, Mauritian companies are taxed according to Mauritius tax laws, which are extremely favorable, compared to Indian laws. There is some chance that the treaty will be amended by India in 2011 to try to capture more of the revenue from this activity. Nevertheless, FDI from Mauritius to India, which has been mostly in the electrical equipment, cement, telecommunications, and financial sectors, has helped Mauritius establish the attributes needed to compete globally in high-value service sectors.

¹⁹ India has a double taxation avoidance agreements with approximately 65 countries, including France, Germany, Japan, the United Kingdom, and the United States, though Mauritius is the most preferred route for FDI inflows.

Figure 9. Foreign direct investment inflows to Mauritius, 2002–08 (MUR millions)



Source: World Bank (2009)

The Economic Future of Mauritius

The long-term challenge for the government of Mauritius is to maintain its unique combination of resilience in the face of changing economic circumstances and adaptability to new paths toward achieving growth. A number of key lessons can be learned from Mauritius' experience. First, the forging of consensus between the Franco-Mauritian business elite and the Indian political elite has provided the bedrock for economic growth. Consensus building was mapped into the management of ethnic interests while the country opportunistically moved forward with growth strategies. Even an occasionally contentious political environment has not jeopardized the continuity of state policies and administrative stability. The combination of adaptable institutions and a rich interface between the public sector and private sectors has ensured effective economic policy. The important role the private sector plays in the formulation of economic policy, especially through the Joint Economic Council, is relatively unparalleled in Africa.

Second, Mauritius benefited from very good macroeconomic management that was pragmatic and supportive of long-term growth aspirations. The rents generated within the system during the 1970s and 1980s were used to finance capital accumulation rather than consumption. The real exchange rate

was kept competitive, fiscal discipline was maintained, and debt burdens were kept at respectable levels, while there was a willingness to correct external and internal imbalances when needed.

Third, Mauritius recognized the benefits of economic openness at an early stage, implementing effective sectoral policies and building a good investment climate. The policy framework was used to facilitate private and foreign investment, particularly in the textile and tourism industries. The interplay between the relatively closed import substitution industrialization on one hand and export-driven initiatives on the other (particularly the EPZs) provides a fascinating tale. In general, though, Mauritius' openness, which allowed it to successfully penetrate developed markets through exports, has been unrivalled by countries in Africa and the Middle East. Through smart tax policy, it has become a source of a large portion of FDI flows into India. Throughout, the country has demonstrated a capacity to capitalize on good international relationships.

While its future success is not guaranteed, Mauritius has proven that it has the right instruments to weather a range of economic shocks. The history of Mauritius is one of adaptability, innovation, and anticipating global changes. Its combination of good leadership, consensus building, sound macroeconomic management, and positive policies for the private sector will serve it well in the future.

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