CHAPTER 5

Mauritius: An Economic Success Story

Ali Zafar

In 1961 James Meade, a Nobel Prize recipient in economics, famously predicted a dismal future for Mauritius because of 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 defied those predictions, transforming itself from a poor sugar economy into a country with one of the highest per capita incomes among African countries.[1] Mauritius's 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's financial sector is sufficiently well developed that it has begun to position itself as a platform for investment linking East Africa with India and China.

Headline figures related to Mauritius's economic performance are impressive. Growth of real gross domestic product (GDP) has averaged more than 5 percent a year since 1970, and annual growth in real per capita income has likewise been strong. GDP per capita increased about sevenfold between 1976 and 2008, from less than $1,000 to roughly $7,000. Imports and exports have boomed; together, they reached more than 100 percent of GDP during the late 1990s and early 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's 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 strong and regular growth. Constrained at inception by a monocrop sugar economy, low amounts of arable land, and a high rate of population growth, Mauritius has emerged as a regional entrepôt and tourism destination as well as the top-ranked African country in the World Bank's Doing Business survey (in 2010, it ranked 20th of 183 countries).

Although a variety of explanations have been advanced to explain Mauritius's growth, the country's focus on international trade has been, without doubt, a critical element of that performance.[2] Mauritius's preferential access to trading partners, particularly the European Union (EU), in the sugar, textile, and clothing sectors resulted in subsidies for

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the export sector and provided important foreign exchange for the economy. Preferential trading deals accounted for strong growth in Mauritius's total exports between the 1970s and the 1990s. Although 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 percent in 1980, but it fell to 30.1 percent 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, 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's 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 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, subsidies, and targeting to adapt to shifting economic circumstances. Although Mauritius benefited from the sugar protocols, the government also recognized early on the advantages of diversification. As a result, it relied heavily on EPZs but ensured that there was no anti-export bias. Mauritius has also proven very adept at embracing new sectors, particularly light manufacturing, offshore banking and financial services, and service-related information and communication 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's 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 through a combination of good macroeconomic policies and strong institutions (table 5.1). With the advent of the sugar preferences and the EPZs in the 1970s and 1980s, Mauritian authorities have succeeded in

Table 5.1 Major Economic Indicators for Mauritius 2006–09

Indicator	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

Source: IMF (2010); Government of Mauritius.

transforming the 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's 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 manageable fiscal and current account deficits, high rates of private investment, and respectable and stable growth rates.

A very successful economic trajectory

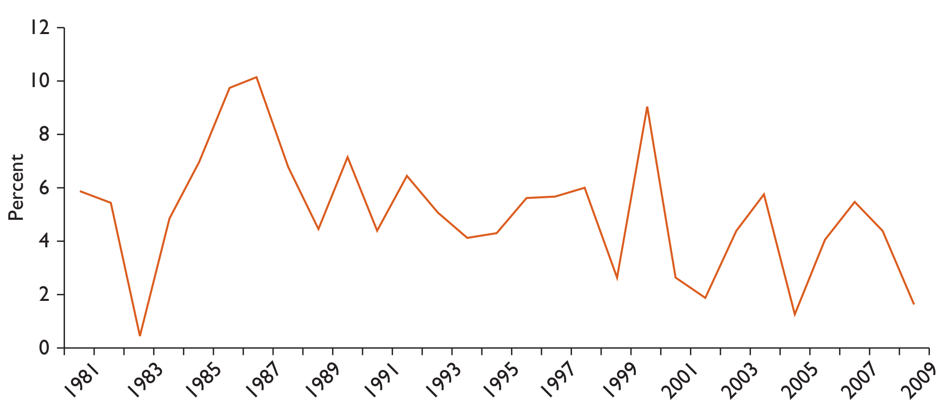
Between 1977 and 2009, and despite the volatility caused by exogenous shocks during those years, real GDP in Mauritius grew on average by 5.1 percent annually, compared with 3.2 percent for Sub-Saharan Africa (figure 5.1). The growth rate accelerated in the 1980s as a result of the macroeconomic reforms instituted 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 sevenfold between 1976 and 2008, from less than $1,000 to nearly $7,000 (figure 5.2). At the same time, consumer price inflation in Mauritius has remained in the low single digits through the 1990s and early 2000s, and the country's debt stock has been manageable.[5] Windfalls from sugar and textile preferences have been used wisely to 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.

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 and oil shocks. Using purchasing power parity (PPP) data for 44 Sub-Saharan African countries, Arbache and Page (2008) examine country-level dynamics of long-run growth between 1975 and 2005 and conclude that Mauritius was one of the best performers, both in per capita growth performance and in low volatility of growth, alongside Botswana, Cape Verde, Gabon, Namibia, the Seychelles, and South Africa.

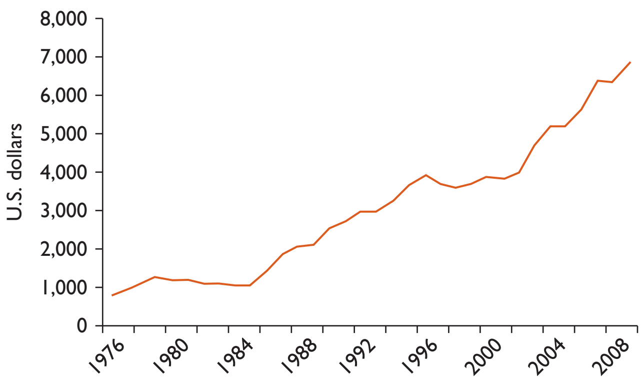
Decomposing the standard deviation of GDP per capita and economic growth into within-country and between-country components, one finds that Mauritius's growth stability was much higher than that of many oil economies, such as Angola and Nigeria, and of many resource-poor

Figure 5.1 Real GDP Growth in Mauritius, 1981–2009



Source: Government of Mauritius.

Figure 5.2 GDP per Capita in Mauritius, 1976–2008



Source: Government of Mauritius.

economies, such as Burundi and Central African Republic, in Sub-Saharan Africa. While Mauritius was growing, much of Sub-Saharan Africa 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 drivers of growth in Mauritius have 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. For the period 1982–99, productivity growth in the EPZ sector was 3.5 percent, substantially more than double the 1.4 percent for the economy as a whole. 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, employment growth averaged 5.2 percent a year, reflecting 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 a year.[6] Their estimates suggest that in the EPZ sector, TFP grew by 5.4 percent from 1991 to 1999.

In another study, Rojid and Seetanah (2009) provide evidence that TFP gains in Mauritius have reached a plateau. TFP growth averaged 1.4 percent in the 1980s, 1.0 percent in the 1990s, and 0.7 percent in the 2000s, but the TFP contribution to overall growth varies depending on the different growth rates (table 5.2). For the entire period 1980–2007, TFP contribution to growth in Mauritius averaged 1.0 percent annually, considerably higher than the 0.3 percent average in Common Market for Eastern and Southern Africa (COMESA) countries over the same years. The TFP change in Mauritius resulted from economic reforms and human capital improvements.

Structural transformation

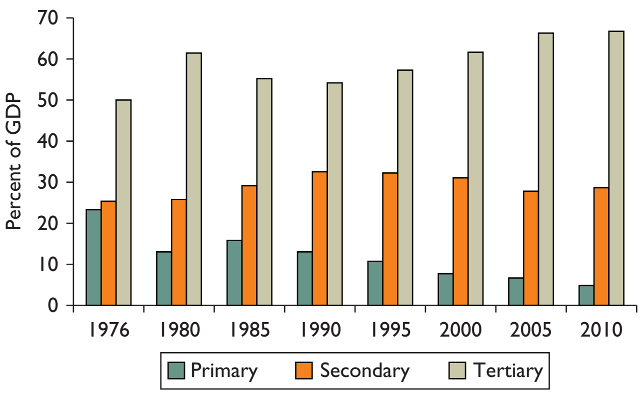
Over time the sectoral composition of the Mauritian economy has changed profoundly. Between 1976 and 2010 the share of primary-sector production declined from 23 percent of the overall economy to 6 percent, while the secondary sector (including manufacturing, electricity, water, and some construction) increased from about 23 to 28 percent (with manufacturing making an even bigger jump). The tertiary sector, which includes tourism and financial services, grew from just over 50 percent to nearly 70 percent of GDP (figure 5.3). 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 because of the presence of EPZs but stagnated as the sector faced adjustment in the 1990s and 2000s. Table 5.3 shows patterns for specific industry groups and subgroups between 1990 and 2010. Sugar, which represented more than 20 percent of Mauritius's GDP in 1976, accounted for approximately 4 percent of GDP in 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, a rise of financial services and real estate, and a mixed performance of textiles as the service sector has strengthened (figure 5.4) By the 2000s the service sector had become the dominant feature of the economy in terms of contribution to output. This noteworthy structural transformation 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.

Table 5.2 Total Factor Productivity Decomposition and Contribution to Growth

Economy/	Years	Growth rate (percent)	Contribution to the Growth Rate: Capital (percentage points)	Labor (percentage points)	TFP (percentage points)
Mauritius	1980–1990	6.3	3.0	2.0	1.3
	1991–2000	5.6	2.5	2.1	1.0
	2001–2007	4.1	2.5	0.9	0.7
	1980–2007	**5.3**	**2.6**	**1.7**	**1.0**
COMESA	1980–1990	3.1	1.5	1.7	–0.2
	1991–2000	2.4	0.7	1.6	0.1
	2001–2007	4.5	2.1	1.5	0.9
	1980–2007	**3.3**	**1.5**	**1.6**	**0.3**

Source: Rojid and Seetanah 2009.
Note: Percentages are rounded to nearest tenth.

Figure 5.3 Sectoral Composition of GDP in Mauritius, 1976–2010



Source: Mauritius authorities; World Bank 2009.

Improvement in human development indicators

In contrast 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 dropped from 64 per 1,000 live births in 1970 to 15 in 2008 (figure 5.5). The Gini coefficient, a measure of income inequality in which 0 represents perfect equality among households and 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 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 government's Central Statistics Office.[8] By 1991/92 the proportion had fallen to 11 percent, and by 2010 absolute poverty was less than 2 percent. The poverty decline was achieved with no exacerbation of inequality. Significant improvements in gender equality have resulted from the massive inflow of women into the labor market starting in the 1980s. The country recently ranked 11th of 102 countries in the OECD Social Institutions and Gender Index. Mauritius's housing stock has also improved, both in quality and quantity, as a result of government investment. Finally, Mauritius has developed a sophisticated pension system covering retirement benefits and general social security.

MACROECONOMIC MANAGEMENT

Prudent, proactive fiscal policy

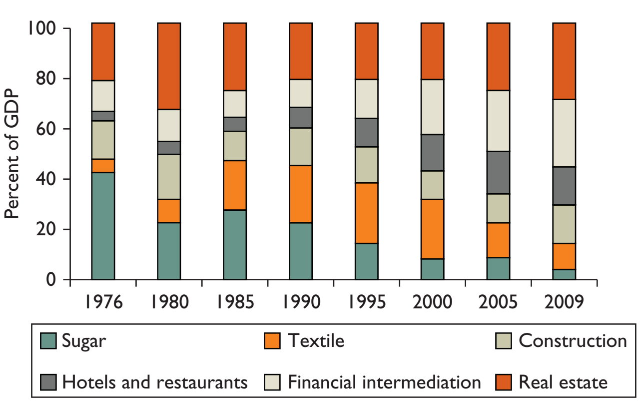
A hallmark of economic management in Mauritius in recent decades has been prudent fiscal policy, which has helped maintain macroeconomic stability and contributed to growth. Fiscal policy has focused on ensuring that spending remains linked to resource availability. While there have been fiscal imbalances, 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.

Table 5.3 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 measured (FISIM)	**–1.8**	**–3.3**	**–5.7**	**–5.5**	**–7.0**
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: Central Statistics Office, Government of Mauritius.
Note: Figures may not add up to the totals due to rounding. — = not available. Data are at current prices.
a. Forecast figures.
b. For years 1991 to 1996, figures for other financial intermediation are included in banks.

Figure 5.4 Major Economic Sectors in Mauritius, 1976–2009



Source: Mauritius authorities; World Bank 2009.

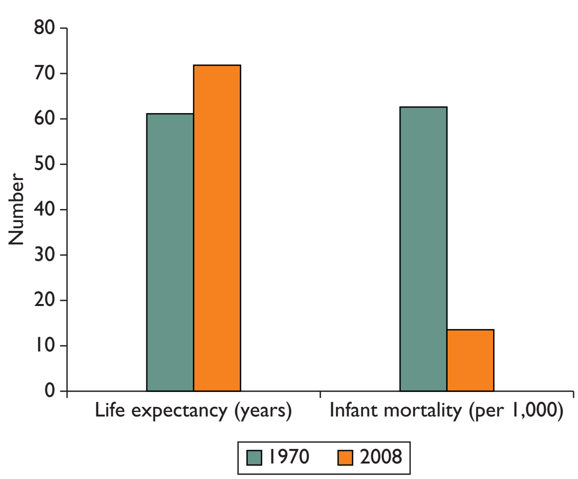
Similarly, in the 2000s, the government built up reserves that allowed it the freedom to expand fiscal policy in the aftermath of the 2008–09 global financial crisis. Moreover, the stock of international and domestic debt has remained well below an unsustainable threshold (total public debt was projected to be 60.4 percent of GDP at the end of 2010). Excluding a period in the early 1980s, current 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. Taken together, the composition of current expenditure has been mostly oriented in recent decades to the outlays for wages and subsidies, but there has been little expansion of the federal apparatus as a share of GDP because fiscal profligacy has been an anathema to the Mauritian policy makers. In the first four years of the 1980s, the ratio of current expenditure to GDP was close to 25 percent but it steadily dropped to around 20 percent by the mid 1980s, and that ratio has stayed relatively constant, in contrast to that of many developing countries. Capital expenditures, which have averaged less than 5 percent of GDP since independence, have been used productively to invest in infrastructure—especially roads—and to provide a necessary operating environment for EPZs.[9] Mauritian policy makers have been remarkably fiscally prudent to avoid any macroeconomic instability. 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. 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, although the introduction of a 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.[10] As a result, the tax system has not been affected 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 taxes, 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

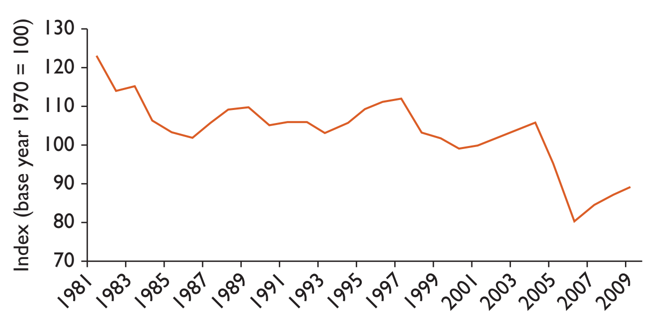
In tandem with fiscal policy, monetary policy in Mauritius has helped anchor economic growth and ensure competitiveness. Since its creation in 1967, the Bank of Mauritius has been concerned with ensuring the competitiveness of the country's export sectors and, secondarily, with price stability. In important ways, a series of exchange rate decisions early on had ripple effects on economic activity. As part of the liberalization program, the Mauritian rupee (MUR) was devalued by 30 percent in 1979 and readjusted by 20 percent in 1981, when the rupee was officially delinked from the IMF's special drawing right 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 5.6 shows the path of the real effective exchange rate (REER) of the rupee (base year is 1970 = 100). The results of the managed float exchange rate regime have been favorable to the economy, with the trade-weighted REER depreciating on average by more than 5 percent a year from 1981 to 2007.[11] Although 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.

Figure 5.5 Social Indicators in Mauritius, 1970 and 2008



Source: World Bank 2010, UNICEF.

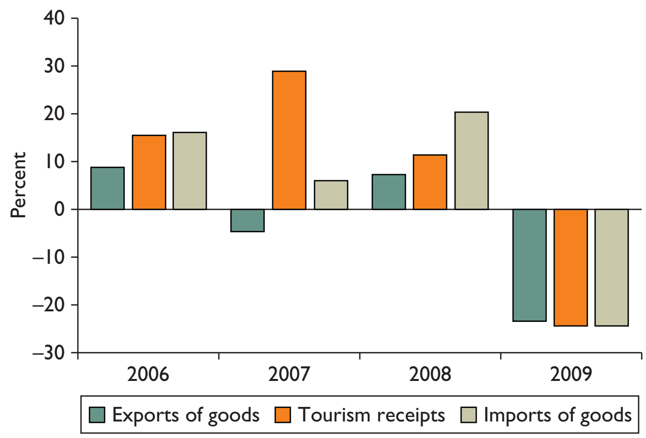
Figure 5.6 MUR Real Effective Exchange Rate, 1981–2009



Source: IMF.

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 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, national savings has consistently exceeded investment expenditure since the mid-1980s.[12]

Figure 5.7 Trade and Tourism Growth, 2006–09



Source: IMF 2010.

Effective response to economic shocks

A tribute to Mauritius's successful macroeconomic management can be seen in the response to the global financial crisis and the various shocks that preceded it. The combination of the phasing out of the Multifibre Arrangement starting in 2004, the reduction in sugar price guarantees from the European Union 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 financial crisis began. The financial crisis hit the small, open economy of Mauritius hard. The country experienced a sharp decline in demand for tourism and textile exports (figure 5.7). Labor-intensive sectors, especially construction and textiles, contracted as the crisis made its way to Mauritius.

As a result of the crisis, growth slowed to 4.2 percent in 2008 and to less than 2 percent in 2009, while unemployment increased from 7.2 percent in 2008 to 7.7 percent in 2009. Through 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 derived from a combination of four factors: reforms to sustain long-term growth, which accelerated in 2006; a 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 had 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 discount rate at the central bank 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.[13] A tax suspension program was also introduced for the labor-intensive and vulnerable tourism, construction, and real estate sectors.

A TALE OF THREE SECTORS: SUGAR, EPZs, AND TOURISM

At various times in Mauritius's history, sugar, EPZs, and tourism each have been a mainstay of the economy, and the interaction among the three sectors has been essential for the country's economic take-off. As a small, open economy with a high ratio of trade of goods and services to GDP (averaging more than 50 percent from 1970 to 2010), Mauritius has long been well positioned to embrace globalization. Over the years Mauritius has used trade policy as a means both to protect domestic industry and 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.[14] Mauritius sold its sugar to the EEC at a premium—three times the international market price, on average. For years Mauritius's export quota was fixed at more than 500,000 metric tons annually, 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's sugar sector hard, leading to balance of payments difficulties and recourse to external assistance. Nevertheless, by 2005, in the aftermath of the World Trade Organization's ruling that the above-market prices paid to sugar producers constituted unfair trade, the European Union ended the preferential deals by slashing sugar prices.

Import substitution industrialization (ISI) and restrictive trade policies following the colonial period

Following the establishment of a development certificate scheme by colonial authorities in 1964 to promote import substitution industrialization and provide 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, which were concentrated in the EPZs, had a marginal impact on the local economy. Subramanian and Roy (2001) find that Mauritius's trade policy was highly protective 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 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 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 that catered to foreign markets. The EPZ was not restricted to one physical location but was envisaged as a fiscal regime that encompassed the entire island, and the idea was to develop a fast-track approval for all administrative procedures in the EPZ. Ambitious and well-crafted legislation provided the underpinnings for the new regime. 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 that were 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's export competitiveness on world markets, while tax incentives 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 EPZs, 80 percent of workers in the EPZs in the 1980s were women. The rate has decreased somewhat in the 1990s and 2000s, but more than 60 percent of the workers in the zones are women. 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 firms' expansion.[15] However, over time the wages in the EPZ became higher than those in the non-EPZ economy.

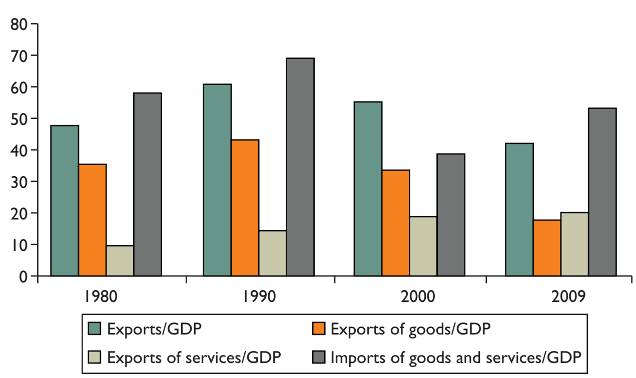
Also important, Mauritius did not restrict EPZs to one geographical location, and the government invested heavily in the infrastructure needed to set up EPZs. Finally, it is important to note that the government provided strong institutional support for marketing EPZ products.

By the 1980s EPZs had exceeded the expectations of even visionary policy makers in Mauritius. The zones accounted for more than 60 percent of Mauritius's gross export earnings and employed one-third of the Mauritian labor force. Goods produced in EPZs more than tripled as a share of GDP between 1980 and 1988, from 4 percent to more than 14 percent (figure 5.8). 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 Europe under a preferential regime. Notably, there was significant interaction between the 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's success with EPZs. First, the country took advantage of the depth of EU and U.S. demand for textiles and apparel, which provided a solid base for expansion. Second, Mauritius's timing was good, as its initial entry into the U.S. market got a boost from investors based in Hong Kong SAR, China, who were seeking to move capital and factories out of Hong Kong SAR, China, in anticipation of the 1997 reunification with China. Third, there was a strong political stability, proper governance, and a clear legal and institutional demarcation between the ISI and the EPZ regimes.

Fourth, quotas on Asian textile exports into Western markets led investors to look to alternate production countries. Those investors brought capital, marketing networks, and technological know-how to Mauritius's nascent textile sector. Greenaway and Milner 1989, however, find that the decision to grant Mauritius trade preferences in garments through the Multifibre Arrangement was more important in giving the country privileged access to developed markets relative to established Asian producers. Fifth, 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 finally, Mauritius benefited from a strong entrepreneurial class and a trainable labor force, that together with the political class, had a strong ownership in the success of the EPZs. 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. Over time the EPZs have helped the country's exports match the imports, although the proportion of service exports has increased in recent years as the economy has changed (see figure 5.8).

Figure 5.8 Value of Mauritian Exports and Imports, 1980–2009



Source: Mauritian authorities.

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

Although EPZs brought dramatic economic improvements to Mauritius, the textile and apparel sectors have met challenges in more recent years. Not least of these was the phasing out of the Multifibre Arrangement, which started in 2004 and led to a contraction of 30 percent in value added of the products produced in EPZs. The number of Mauritians employed in EPZs fell by about 25,000 people between 2005 and 2010.[16] In parallel, the European Union'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 was exported to the European market. The European Union'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's 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. An estimated 1 million tourists were expected to visit the country in 2010. Tourism is also among the strongest foreign exchange–earning sectors of the Mauritian economy.

In addition to tourism, the government of Mauritius has also encouraged diversification of the economy into business process outsourcing (BPO), financial services, and information technology. According to government figures, the BPO industry 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 now emerging as a growth vehicle for the economy.[17] Development of the information technology sector, meanwhile, is intended to transform Mauritius into "a cyber island" by creating a high-tech, multi-story tower that provides a home to companies from all over the world to set up BPO operations, including data management, e-commerce, and 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 regional knowledge center. As a result 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 offers a number of lessons. Most important, the constant search for new drivers of economic growth reflects a desire by policy makers to adapt to the future rather than wait for 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.

DYNAMIC INSTITUTIONS AND ADAPTABILITY TO CHANGE

Aside from its success in macroeconomic management, one of the keys to Mauritius's 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 relative to comparator countries, particularly in measures of governance, rule of law, and control of corruption. 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.

For decades, Mauritius served as a trade hub for Chinese and Indian traders and an entrepôt for shipping across the Indian Ocean, and its inhabitants were 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 the contrary, political parties 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), which occupies a central place in the country's institutional landscape and represents an umbrella association of a number of sector-specific groupings. 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 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 (DBM). MEDIA was formed in 1985 as a public trade and investment promotion agency (with some private sector membership) and was a pivotal institution behind the 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. More recently, the Board of Investment has played a role in helping to promote Mauritius as an international investment, business, and service center, providing counseling on investment opportunities in Mauritius and helping in setting up businesses.

BUSINESS CLIMATE AND INVESTMENT

Alongside successful trade policy and adaptability, another major reason for Mauritius's 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. 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 20th of 183 countries included in the 2010 survey, up from 24th 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 loan approvals from 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 more easily 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, mainly in infrastructure projects such as commercial and office buildings, hotels, and resorts, grew to account for more than 80 percent of gross domestic capital formation. While infrastructure deficiencies and difficulties obtaining credit remain for small firms, along with a lack of skilled labor for larger firms, the thrust of the reforms has been to alleviate these constraints.

The role of foreign direct investment

FDI inflows to Mauritius have increased rapidly in the past several years, attracted by 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 while the corporate tax rate is a low 15 percent, foreign firms receive a subsidy of close to 10 percent, leading to an effective tax rate of 5 percent. The country attracted more FDI during 2004–07 than the cumulative stock of FDI during the previous 25 years (figure 5.9). 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, although 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. Because of special tax treatment given to investments that come through Mauritius to India,[18] Mauritius has become a quasi-tax haven for foreign funds invested in India, and currently, about 80–90 percent of foreign direct investment into India flows through Mauritius through private equity, hedge, 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 that has been vexing to Indian regulators and policy makers. Simply put, Mauritian companies are taxed according to Mauritius tax laws, which are extremely favorable, compared to Indian laws. There is some chance that India will try to amend the treaty 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.

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 for growth. A number of key lessons can be learned from Mauritius's experience. First, the forging of consensus between the Franco-Mauritian business elite and the Indian political elite has provided a sound foundation for economic growth. Consensus building was mapped into the management of ethnic interests while the country opportunistically moved forward with growth strategies.

Figure 5.9 FDI Inflows to Mauritius, 2002–08

Source: World Bank 2009.

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 pragmatic macroeconomic management that was 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 polices 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's openness, which allowed it to successfully penetrate developed markets through exports, has been unrivaled by countries in Africa and the Middle East. Through smart tax policy, the country has become a source of a large portion of FDI flows into India. Throughout, Mauritius 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. Its history 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.

NOTES

1. Careful empirical work by Subramanian (2009) shows how initial conditions in Mauritius—especially the income level, geography, and commodity dependence—have hurt long-term growth, while favorable demography and high levels of human capital have been mitigating factors. For example, Mauritius is disadvantaged by being at least 25–30 percent more distant from world markets than the typical African country. Statistical analysis shows that on balance, the disadvantages outweigh the advantages: initial conditions have slowed growth by about 1 percentage point a year relative to the average African country and by nearly 2 percentage points relative to the fast-growing developing economies of East Asia.

2. See Sachs and Warner 1995, 1997; Meade 1961; Rodrik 1999; Romer 1993; and Subramanian and Roy 2001, among others.

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's legislative system is based on a classic parliamentary Westminster system. Legislative power is vested in the National Assembly, which is composed of 62 elected and up to 8 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).

5. Although Mauritius's 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.

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

7. One challenge Mauritius faces is the large proportion of young people who are unable to access secondary education because of the very competitive system for moving from primary to secondary schools and who thus cannot contribute to the skilled labor force required by the economy. 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.

9. It should be noted that capital expenditures are underestimated in the Mauritian budget, because 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.

10. The VAT was introduced in Mauritius in September 1998, close to six months ahead of schedule, and its performance has exceeded expectations.

11. 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).

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

13. 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. Between mid-December 2008, when the mechanism began functioning, and September 2010, 11 companies had received assistance under the MTSP, to which the government contributed MUR 140 million (36 percent of the total MTSP support for these companies; the remainder was provided by banks and shareholder equity) in the form of debentures at 5 percent interest.

14. 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 under the Commonwealth Sugar Agreement.

15. 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.

16. 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 initiative in July 2003 and encouraging the National Productivity and Competitiveness Council to carry out a diagnostic study of textile firms to assess their cost structure and point to areas in need of improvement.

17. 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.

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

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