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MAURITIUS

SELECTED ISSUES

December 2017

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November 6, 2017

Approved By
David Owen

Prepared by Torsten Wezel, Mookameli Fuma, Salifou Issoufou, Cameron McLoughlin and Mounir Bari (all AFR).

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IMPLICATIONS OF INTERNATIONAL TAX TRANSPARENCY AND ANTI-TAX AVOIDANCE INITIATIVES FOR MAURITIUS[1]

A. Background

1. An international financial center with low tax rates, Mauritius has been scrutinized by international bodies promoting fair tax competition and is liaising with them. The Mauritian authorities speak of being a "fully cooperative and responsible" financial center. They point to recent initiatives that Mauritius has been participating in—inter alia, the Common Reporting Standard (CRS) for automatic exchange of financial account information; FATCA with the U.S., and the Multilateral Instrument (MLI) of the OECD-G20's Base Erosion and Profit Shifting (BEPS) package. After assessing the legal and regulatory framework for information exchange and actual practices, the OECD Global Forum[2], in August 2017, rated Mauritius as a compliant jurisdiction. In a welcome step, the authorities, in July 2017, signed the BEPS Multilateral Convention[3]—also known as the Multilateral Instrument—that 67 countries had already signed the previous month.

2. Mauritius is currently dealing with two separate tax transparency and anti-avoidance initiatives, one by the OECD-G20 and one by the European Union. Under the BEPS initiative, Mauritius has committed to including minimum standards and possibly other BEPS-compliant features into its domestic laws and bilateral double taxation avoidance agreements (DTAs). Treaty revisions will be undertaken partly within the framework provided by the Multilateral Instrument and partly in somewhat more flexible bilateral negotiations outside the MLI. At the same time, Mauritius has been facing a complaint by the European Union, as represented by the European Commission (EC), about the tax regime for the offshore company sector: The EU objects specifically to Mauritius' Deemed Foreign Tax Credit (DFTC), which does not require proof of tax payment abroad and is available only to so-called Global Business Companies (GBCs). The authorities are considering eliminating the DFTC and introducing instead a partial exemption system that would exempt from taxation in Mauritius a certain share of qualifying income earned abroad.[4]

[1] Prepared by Torsten Wezel.

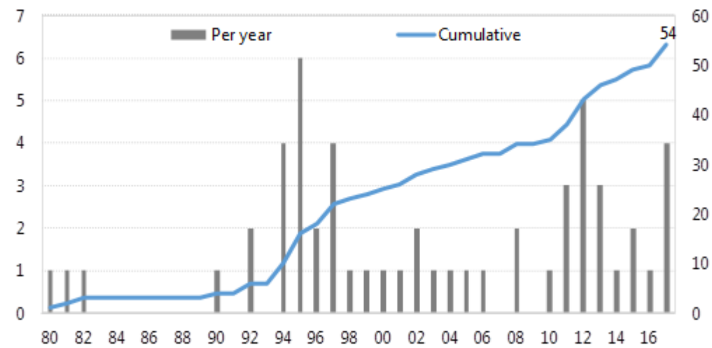
[2] Global Forum on Transparency and Exchange of Information for Tax Purposes.

[3] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

[4] Countries with such territorial systems generally exempt only foreign income subject to tax in the source country (i.e. corporate earnings). Forms of income not taxed in the source country, such as interest and royalty payments, are usually taxed in the residence country. A few countries operate a "pure" territorial system that exempts all forms of foreign income.

3. Mauritius has been involved in intensive DTA negotiations and re-negotiations. Sixteen DTAs have been added in the past 6 years (Figure 1). The most important treaty re-negotiation was the one with India, which was signed in May 2016 and is being phased in through end-March 2019. India is the single largest destination for outbound investment from Mauritius, accounting for 45 percent of the total in 2015.[5] Under the revised treaty, India will have the right to tax capital gains from sales of shares of Indian companies by Mauritian investors, which were previously exempt, at the domestic capital gains tax rate (currently 15 percent).[6] The exemption from withholding tax on bank interest will also be eliminated.[7] On the other hand, proceeds from debt instruments will be taxed at a preferential rate of 7.5 percent so that investment flows to debt instruments are likely to grow.

Figure 1. Mauritius: Double Tax Conventions

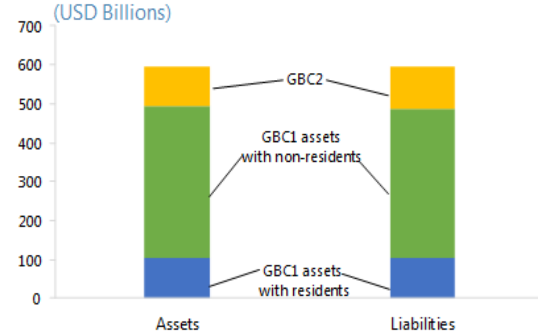


Sources: Global Forum on Transparency and Exchange of Information for Tax Purposes; and IMF staff.

B. The GBC Sector as Recipient of Tax Benefits

4. Thanks to Mauritius' favorable business environment, GBCs have become a pillar of the economy. The latest available balance sheet data for GBCs, which were created in the 1990s, show that at the end of 2015 they had assets of US$594 billion—or roughly 50 times domestic GDP (Figure 2). In that year, they contributed about 6 percent to GDP and 6.5 percent to tax revenue. Total direct and indirect employment in the GBC sector is estimated to be 15,000-20,000 employees, or about 3 percent of total employment. Major factors in the development of the sector have been a beneficial environment featuring political stability and legal certainty as well as high-quality professional services provided by the bilingual workforce. Furthermore, for many years, reporting and substance requirements were rather limited.

Figure 2. GBC Sector Balance Sheet, 2015
(USD Billions)



Source: FSC.

[5] IMF CDIS database: http://data.imf.org. India also accounted for 8.4 percent of inbound investment.

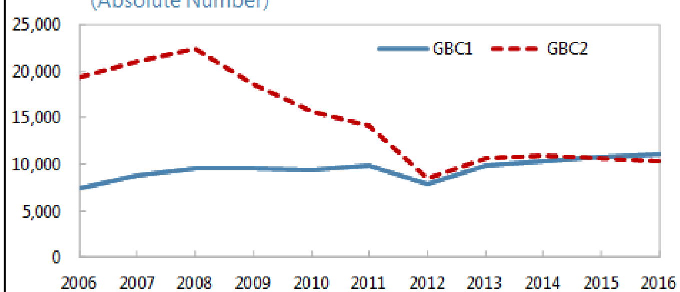
[6] During the phase-in period, this tax is applied at half the regular rate. Shares held longer than a year are exempt from tax in India. The exemption for capital gains on shares purchased before April 2017 is grandfathered.

[7] The exemption for interest on bank debt incurred before April 2017 will also be grandfathered.

5. **Arguably even more important for investors has been the favorable tax framework offering benefits that are in part being challenged.** Mauritius currently has a 15 percent corporate income tax (CIT) rate and a "worldwide" system that taxes foreign earnings but allows for foreign tax credits (FTCs), including the contested Deemed Foreign Tax Credit. FTCs are granted not only for foreign withholding taxes, but also for underlying tax (e.g. corporate income tax) on companies in which the Mauritian investor holds an at least 10 percent stake. In addition, there are a number of additional favorable characteristics of the tax framework.[8] Some of these benefits are now at risk under the international tax transparency and fairness initiatives, making prospects for a continued expansion of the GBC sector uncertain and likely prompting reforms towards an updated business model for the offshore sector.

6. **There are two types of GBCs with different legal status and purpose.** GBC1s are often used for channeling investments, both direct and portfolio investment, into emerging markets, particularly India that so far has offered attractive after-tax returns under the old DTA. As tax residents of Mauritius, GBC1s can claim a tax credit for foreign tax on dividends, royalties, interest and capital gains. A special provision is the Deemed Foreign Tax Credit (DFTC)—the bone of contention for the EC—allowing GBC1s to reduce their domestic tax liability by 80 percent without furnishing proof of actual tax payment in the exterior.[9] The DFTC thus reduces the effective CIT rate on foreign income from 15 to 3 percent. When producing verifiable FTCs, up to 100 percent of the Mauritian tax liability can be offset. GBC2s, which are often used for marketing purposes as well as trust and estate planning, are treated as non-residents. They are tax-exempt (and thus not entitled to FTCs) and are also subject to less stringent substance and publication requirements than GBC1s. Although almost equal in number, GBC1s are on average much larger than GBC2s, holding nearly 80 percent of total GBC assets (Figures 2 and 3).[10]

Figure 3. Number of GBCs
(Absolute Number)



Source: FSC.

[8] FTCs are also granted in the case of source country tax sparing. There is no capital gains tax, and there are no withholding taxes on outbound capital flows and no thin capitalization, transfer pricing, or controlled foreign corporation (CFC) rules. Furthermore, its extensive network of 42 DTAs makes Mauritius an attractive investment hub—for international investors, the after-tax return to some projects is higher when investments are channeled through Mauritius.

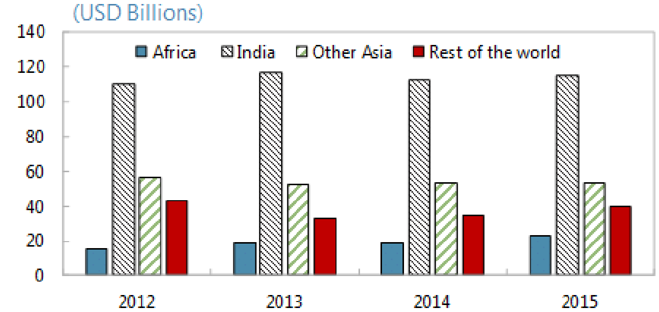
[9] Proponents of the DFTC posit that this arrangement is a convenient way to avoid double taxation in cases where obtaining supporting tax documentation is difficult.

[10] The GBCs are licensed and supervised by the Financial Services Commission (FSC). They are represented by about 165 Management Companies (MCs) that assume management functions in the GBCs, provide accounting and legal services, and conduct due diligence.

7. Important macro-financial linkages between the GBC sector and the financial sector present vulnerabilities that need to be managed carefully. The GBC sector is a major provider of inexpensive funding to banks, but by nature of the GBC investment pattern, these deposits are potentially highly volatile. Typically, GBCs receive capital inflows from source countries for investing in a third country, albeit with a certain lag. Thus, a certain stock of GBC deposits persists, and banks routinely estimate what share of the stock can be considered stable. However, the stock masks the volatile in- and outflows. In single cases, banks have reportedly lost as much as 15 percent of their GBC deposits within one month, which may also be attributable to a bank's characteristics. Banks also increasingly lend to GBCs, with the sector by now accounting for one-sixth of bank credit to the private sector. Still, bank-by-bank analysis shows that banks typically lend to the GBCs only a fraction of what they receive from the sector in funding. Generally, they keep most of the GBC deposits as liquid assets at other banks, at home or abroad.

8. A secular decline in GBC activity amid removal of tax benefits could have spillovers to the economy unless the sector transitions to higher value-added activities. It is not unreasonable to assume that GBC investments into India will recede in the long run after full expiry of the grandfathered tax shield on income from equity investment, at least in terms of the share of total GBC investment abroad. If, in addition, changes to the tax regime, as prompted by international tax transparency and fairness initiatives, made channeling investments through the GBC sector less attractive, there would be a measurable impact on the Mauritian economy. Apart from lower bank deposits, spillovers could include a fall in employment at both management companies and other associated service providers. Therefore, the sector may have to move gradually to higher value-added activities such as consulting services and tap new markets such as Africa, a region that has received an increasing amount of direct investment by GBC1s during the last years (Figure 4). Although still dwarfed by FDI going into India, Africa is generally viewed as a promising destination for GBC investment and services.

Figure 4. Direct Investment – Outward
(USD Billions)



Sources: FSC Mauritius GBC1 Surveys 2012, 2013, 2014, and 2015; and IMF staff calculations.

C. Implementing the OECD-G20 Tax Initiatives

9. The BEPS initiative, commissioned by the G20 in 2013, aims to address the weaknesses in the international tax system, enabling countries to protect their revenue base. The OECD elaborated the BEPS initiative within two years and opened participation to non-members in July 2016 under the Inclusive Framework on BEPS, whose goal is a broad and consistent implementation of the BEPS package (OECD, 2017a and 2017d). A central purpose of the G20-OECD BEPS Project is avoiding the uncertainty arising from fragmented or unilateral action by achieving greater cooperation and coordination in international tax matters (IMF-OECD, 2017). Hence, the initiative's measures were designed to be implemented in a coordinated manner and supported by targeted monitoring involving a peer review mechanism and strengthened transparency.

10. As a member of the Inclusive Framework, Mauritius has been supporting the BEPS initiative. Mauritius has committed to implementing these actions, and has also participated in technical working groups, for example, on the Limitation-on-Benefits (LOB) rule under BEPS Action 6 that restricts the benefits to qualifying entities via substance and other requirements that Mauritius prefers to enshrine in new and re-negotiated DTAs. As mentioned, Mauritius has also participated in the Multilateral Convention.

11. In July 2017, Mauritius signed the Multilateral Instrument (MLI) establishing a common framework for including minimum standards in bilateral tax treaties. The MLI offers a synchronized framework for enshrining Actions 6 and 14 in existing DTAs in a time-efficient manner. Treaties subjected to this process are referred to as "covered tax agreements" (CTAs). Currently, 23 of Mauritius' DTAs with other MLI signatories—mostly European countries—have been submitted to the OECD. Some of Mauritius' CTA partners have not yet signed the Multilateral Convention.

12. There are 15 BEPS actions, among them four minimum standards that must be implemented by all Inclusive Framework members. The minimum standards are aimed at addressing (i) harmful tax practices (including special intellectual property regimes); (ii) treaty shopping; (iii) issues in transfer pricing; and (iv) mutual agreement procedures (see Box 1 for more detail on the minimum standards). Not all of these 15 BEPS actions pertain to bilateral treaties.

13. Combating treaty abuse under BEPS Action 6 relies on two basic instruments. A Principal Purpose Test (PPT) stipulates that a treaty benefit shall not be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of a transaction, except when granting the benefit would be in accordance with the object and purpose of the treaty provisions (OECD, 2016). In addition, a Limitation-on-Benefits (LOB) rule restricts treaty benefits to entities that meet certain substance requirements within a treaty signatory's jurisdiction. The BEPS Action 6 final report (OECD, 2015) envisioned three types of provisions to combat treaty abuse (at times referred to as "treaty shopping"): (i) the PPT on a stand-alone basis; (ii) the PPT together with a simplified LOB provision; or (iii) a detailed LOB provision without a PPT and supplemented by specific rules targeting conduit financing arrangements. However, as the Inclusive Framework's partners could not agree on the language, the detailed LOB option is not available under the current MLI. Therefore, countries like Mauritius seeking to curb treaty abuse by detailed LOB rules will need to engage in bilateral negotiations.

14. Generally speaking, the LOB and PPT rules have strengths and weaknesses. The use of LOB can provide more certainty than the PPT rule, in that the anti-treaty-shopping provisions of the LOB are based on objective criteria such as legal nature, ownership in, and general services of, certain entities. On the other hand, the LOB rule does not address treaty shopping through conduit financing arrangements and other forms of treaty abuse. The PPT represents a case-by-case analysis based on the motive of a transaction, and so introduces a certain degree of subjectivity (OECD, 2015). The PPT rule, however, has the advantage of efficiently producing assessments of compliance with the anti-abuse provisions of the BEPS framework, particularly when complemented with an arbitration process as laid out in BEPS Action 14.

Box 1. The Four BEPS Minimum Standards

The OECD has designated four of its actions as "minimum standards" that must be adopted by members of the Inclusive Framework. Members commit to rapid implementation of the minimum standards and also to undergoing peer review to ensure consistent implementation (OECD, 2017d):

- *BEPS Action 5:* This action sets out a minimum standard based on an agreed methodology to assess whether there is substantial activity in a preferential regime, requiring such regimes, e.g. intellectual property (IP) regimes, to limit the tax benefits to the underlying R&D activities, thereby stopping profit shifting on IP income. It also provides a framework to exchange rulings related to transfer pricing, permanent establishments (PEs), and conduits. The OECD's Forum on Harmful Tax Practices (FHTP) now focuses on requiring substantial activity for PEs and improving transparency through exchange of rulings;

- *BEPS Action 6:* This action includes a minimum standard on preventing abuse through treaty shopping and new rules providing safeguards to prevent treaty abuse. It aims at eliminating ubiquitous treaty-shopping structures that use special-purpose vehicles in certain hubs and instead seeks to ensure, including by an explicit statement in the preamble to the DTA, that the treaty serves only the intended purpose of preventing double taxation, without creating opportunities for double non-taxation. As mentioned, Mauritius has signed the MLI and will thus update its DTAs accordingly;

- *BEPS Action 13:* This action contains a standardized approach to transfer pricing, including a minimum standard on country-by-country reporting on where a multinational enterprise (MNE) records profits and sales, employs staff, holds assets and pays taxes. Mauritius has already implemented an obligation for relevant MNEs to file country-by-country reports and signed the Multilateral Competent Authority Agreement designed to operationalize the exchange of reports (to be prepared by the ultimate parent of a group and shared by its tax authority with those abroad);

- *BEPS Action 14:* This action aims at making dispute resolution mechanisms more effective through dispute prevention, access to mutual agreement procedures and the resolution of such cases. Several countries, among them Mauritius, went further, committing to introduce arbitration if the dispute is not resolved within a certain period.

The Multilateral Instrument itself was developed under BEPS Action 15.

15. **For its covered tax agreements under the MLI, Mauritius must apply a PPT—at least in the near term.** Mauritius has notified the OECD that it will apply the stand-alone PPT as an interim measure for treaty negotiations under the MLI, but it retains the right to pursue the LOB approach if

counterparties so agree in bilateral negotiations.[11] The Mauritian authorities are concerned that applying the stand-alone PPT could cause uncertainty among non-residents using Mauritius as an investment hub. The risk is that the tax authority of the claimant, say in Europe, could deny the tax benefit if an arrangement or transaction does not pass the PPT as administered by that authority. The relatively vague wording in the MLI framework constituting the PPT could lead to uncertainty among investors, particularly if the LOB option that would establish more objective criteria for eligibility cannot be used, as is currently the case for Mauritius' treaties under the MLI.

16. For the 19 DTAs that Mauritius will renegotiate outside the MLI, the authorities plan to use the option of a detailed LOB rule rather than the PPT. The Mauritian authorities believe that the LOB approach offers sufficient flexibility to tailor DTAs to the signatories' needs in the bilateral negotiations. The LOB rule, as already used by the U.S. and a few other countries, aims to address a large number of treaty-shopping situations based on the legal nature, ownership in, and general activities of certain entities resident in a treaty partner country. A detailed LOB provision may be appropriate when a country already has domestic anti-abuse rules or may prefer a more restricted form of the LOB, possibly adapted to reflect certain constraints or policy choices concerning other aspects of a bilateral tax treaty (see OECD, 2015, including for a comparison of the legal provisions of the simplified LOB and the detailed LOB). Indeed, according to the authorities, the detailed LOB approach (without use of the PPT) may help anchor specific provisions in the treaty that would otherwise have been wiped out under the MLI. Depending on the outcome of its bilateral negotiations, Mauritius may be able to include more detailed LOB provisions in combination with grandfathering clauses which limit the scope of new provisions to newly established firms. Renegotiating the non-MLI treaties will need to commence within 18 months, and the revised agreements would likely be vetted by the OECD for consistency with the MLI.

17. The GBC2 sector has also come under scrutiny of the OECD. Potential issues already identified by the OECD's Forum on Harmful Tax Practices (FHTP) include the ring-fencing of the GBC2 sector from the domestic economy and insufficient substance requirements. The FHTP has yet to examine the tax system in more detail and then to determine whether this preferential regime—and also Mauritius' freeport regime—are indeed harmful. On the other hand, Mauritius' preferential regimes for global headquarters administration, global treasury activities, shipping, and investment banking[12] have been found by the FHTP not to be harmful (OECD, 2017d). The authorities have indicated that they will address the remaining concerns within the revision of the DFTC framework

[11] While Mauritius accepts the application of the PPT under Article 7(1) of the Multilateral Convention alone as an interim measure, the authorities intend where possible to adopt a limitation on benefits provision**,** in replacement of the PPT through bilateral negotiation. It is certainly possible that a jurisdiction does not agree with the preferred detailed LOB approach, which is a case that needs to be distinguished from failure to modify the treaty altogether (OECD, 2017c).

[12] The regimes for global headquarters administration and global treasury activities were introduced in the Financial Services Act in 2012, while the regime for investment banking was added therein in 2016. Firms subject to the three regimes are regulated by the Financial Services Commission. Provision of services under the regimes is not limited to GBCs.

and the Financial Services Sector Blueprint that was announced in the last budget and is currently being elaborated.

18. Going forward, Mauritius will also have to devise a strategy for the GBC2 sector beyond tax reforms. The future of the GBC2s appears uncertain considering the explicit scrutiny by the OECD on the GBC2 sector's framework. This thrust may foreshadow a wider clampdown on this type of GBC that features lower substance and reporting requirements, including limited information on ultimate beneficial owners. It remains to be seen whether the attractiveness of the GBC2 license for certain investors (e.g. trusts and estates relying on confidentiality of ownership and detailed financial information) will persist after any substantial changes to the GBC2 framework. Policy options include phasing out the GBC2 license or creating a unified GBC license.

D. Complying with the EU Tax Initiative

19. Mauritius also needs to address the demands of the European Union, as represented by the European Commission (EC) and its member states. This concerns measures to adhere to "minimum standards of good governance in tax matters" (EC Communication on an External Strategy for Effective Taxation (COM (2016) 24), as endorsed by the European Council. The EU's minimum standards target "harmful tax regimes", which the EC sees manifest in Mauritius and has notified the country accordingly.

20. It is understood that the EC specifically takes issue with Mauritius' Deemed Foreign Tax Credit. As that tax is deemed paid, the DTFC provides a tax shield that, as mentioned, lowers the effective CIT tax rate considerably. The system shares this characteristic with those of other countries enacted at the time. This does, however, not alleviate the matter as such. The EC, in its early 2016 letter to the Mauritian government, indicated that it would assess the GBC tax regime as harmful unless the GBCs are systematically taxed at 15 percent like other companies that do not enjoy such a tax credit. Therefore, if the GBC taxation were not adjusted, the EC and EU member states might adopt defensive measures that act as sanctions.[13] Intended revisions to the tax regime would have to be communicated to the EC before the list of non-cooperative jurisdictions is published towards the end of 2017.

21. The authorities indicated that they would meet the demands of the EC. Compliance would be achieved by abolishing the DFTC and introducing instead a partial exemption system aimed at eliminating double taxation by exempting from taxation in Mauritius most of the foreign-sourced income, especially dividends received abroad as well as profits from foreign permanent establishments of companies' resident in Mauritius. Such a system would be along the lines of the EU Parent-Subsidiary Directive except for no minimum shareholding being required. The less-than-

[13] Such measures include: (i) the EU putting Mauritius on a blacklist requiring, inter alia, EU member states to renegotiate DTAs; (ii) EU members' taking other defensive measures such as imposing punitive withholding taxes on or denying deductions of payments to Mauritius; and (iii) the European Investment Bank's refraining from structuring investments using a GBC. Sanctions would be felt more in the balance of payments that in the fiscal accounts, given that the tax receipts from GBCs are a small fraction of government revenue.

full exemption reflects the possibility of some deductible costs reducing the tax liability abroad. It would, however, be granted only in cases where an arrangement for the exchange of information with the source country allows for verification of claims. Moreover, the new system could include certain substance and anti-avoidance measures to avoid granting the benefit in inappropriate circumstances. There would still be the choice of a regular foreign tax credit in cases where the foreign tax paid exceeds the tax liability in Mauritius so that there is no double taxation of the same income. This new regime would apply to GBCs and other domestic firms alike and would therefore address the concern that the DFTC was available only to GBC1s ("ring-fencing").

22. The EC has indicated that it will follow the judgment of the Forum on Harmful Tax Practices. This position reportedly aims to avoid a double assessment given that the FHTP of the OECD is tasked with reviewing measures related to BEPS Action 5 on such practices (OECD, 2017b). The authorities are working closely with the FHTP and will present their reform measures to the Forum in due course.

23. The necessary changes to the tax framework may be designed to be revenue-neutral. Although details of the reform to the tax framework are still under consideration, the authorities indicated to the mission that the legal changes should ideally be revenue-neutral. To this end, among the options originally contemplated one is to offset revenue losses arising from extending the tax benefit to all firms under the partial exemption system, though presumably minor, by specific compensatory measures (such as broadening the tax base for certain companies). A more detailed proposal for reforming the Mauritian tax framework will be included in the Financial Services Sector Blueprint.

E. Conclusions

24. The authorities are devising ways to meet the challenges from the international tax transparency initiatives. Meeting the OECD-G20 BEPS requirements will be done partly within the internationally-agreed framework of the Multilateral Instrument, and partly outside the MLI to incorporate special arrangements. While much work will need to be carried out within a relatively short period, the rules for the upcoming negotiations are established. Similarly, the authorities have shed light on how they intend to address the concerns of the European Commission about the current preferential tax framework while not materially changing the tax burden for the GBC sector and making the necessary changes ideally revenue-neutral.

25. Despite the current efforts to comply with these demands, in the medium-term a deeper reform of the GBC sector may be needed to preserve its competitiveness. While the forthcoming tax reform and changes to the DTAs may preserve the status quo for the GBC sector for now, more fundamental changes to the GBC framework are likely needed to maintain the sector's international competitiveness. Removing certain tax benefits—such as exemption of taxation of capital gains from sales of shares in India, possibly making some other DTAs somewhat less favorable under the BEPS initiative, and upgrading the substance requirements (particularly for the GBC2s)—may lessen the attractiveness of the GBC sector for current and prospective investors. It may take a concerted effort by the authorities and the industry to revisit the business model of the

GBC sector and devise measures to move the sector gradually towards higher-value activities such as consulting services, and also to redirect the geographical orientation towards destinations with high potential such as African countries. More work could also be done on measuring the competitiveness of the GBC sector vis-à-vis other offshore centers offering a similar framework to foreign investors.

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MODERNISATION OF THE MONETARY POLICY FRAMEWORK IN MAURITIUS[1]

A. Introduction

1. **In recent years, most emerging market and developing economies have been refining and upgrading their monetary policy frameworks to align with the rapidly changing policy environment**. More recently, through a series of initiatives, the Bank of Mauritius (BOM) has signaled its intention to modernize and enhance its monetary policy framework by moving to a forward looking monetary policy to anchor inflation expectations.

2. **Consequently, Mauritius has made significant efforts in recent years to modernize its monetary policy framework**. Several initiatives have been recently undertaken by BOM to strengthen its monetary policy framework. The liquidity forecasting framework has been strengthened despite liquidity absorbing operations not being calibrated in line with liquidity forecasts. The BOM has also embarked on a project to upgrade its macro modeling capacity and strengthened its internal analytical capacity with assistance from the IMF. These efforts were further complemented by the development of a comprehensive set of data to support the analytical work of the BOM.

3. **However, significant reforms will be needed to align the BOM's de facto conduct of monetary policy with the principles that characterize an effective monetary policy framework and accelerate the transition towards a forward looking monetary policy**. At the moment, the liquidity management framework is not functioning properly. There is a persistent disconnect between the monetary policy stance decided by the Monetary Policy Committee (MPC) and the *de facto* stance as reflected in the money market due to the persistent structural excess liquidity. Additionally, the overall monetary policy framework is also not well articulated which has the potential to undermine the credibility of monetary policy conduct in Mauritius.

4. **This note discusses Mauritius's monetary policy in the context of the principles of an effective monetary policy framework and suggests actions to further improve the modernization of the country's monetary policy framework.** The rest of the note is organized into 3 sections. The first section discusses the evolution of monetary policy framework in Mauritius and recent efforts to modernize that framework. The second section discusses Mauritius' compliance with some of the principles of an effective monetary policy framework. The third and last section proposes recommendations on how to proceed with the monetary policy framework modernization agenda in Mauritius.

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[1] Prepared by Mookameli Fuma and Salifou Issoufou.

B. The Evolution of Monetary Policy Framework and Modernization Efforts

5. Like other central banks, the de jure objective of the BOM is to achieve and maintain price stability. As stipulated in the BOM Act of 2004, ''the primary objective of the Bank of Mauritius shall be to maintain price stability and to promote orderly and balanced economic development.'' Inflation has mostly been single-digit in the context of wide-ranging regimes and economic policies adopted by the BOM over the years (Figure 1).

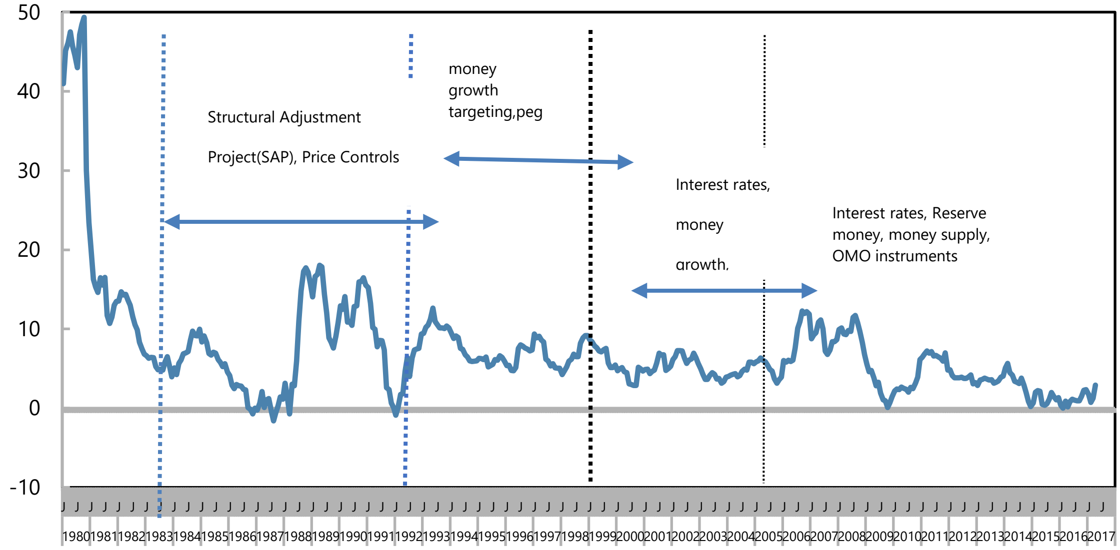
6. The conduct of monetary policy by the BOM has evolved with economic and financial developments over the years. Prior to the early 1980s, the BOM relied mostly on money growth targeting and pegging of the rupee to a basket of currencies to control inflation. Subsequently, the monetary policy framework focused on direct monetary control. With financial liberalization, the removal of exchange controls in the mid-1990s, a more flexible exchange rate gradually replaced the peg to a basket of currencies and reserve money became the operating target of monetary policy. In 1999, with the introduction of the Lombard rate, reserve money was abolished as an operating target while broad money served an intermediate target.

7. The process towards modernization of monetary policy picked momentum in 2006. Following the enactment of the BOM Act of 2004, the repo rate was introduced to replace the Lombard rate as the key policy rate signaling the stance of monetary policy. Additionally, a monetary policy committee (MPC) charged with the responsibility for formulating monetary policy was set up. Additional instruments of monetary policy with a wide range of maturities were subsequently introduced. The BOM also reviewed the cash reserve requirement from 4 percent in 2006 to 9 percent presently, and lengthened the cash reserve requirement maintenance period from 1 to 2 weeks.

8. In recent years, the BOM has put in place additional building blocks to strengthen the monetary policy framework. With the assistance of AFRITAC South, the BOM recently embarked on a comprehensive and ambitious effort to upgrade its macro modeling capacity. A comprehensive set of statistical data has been developed to support the analytical work and macro-modeling. Considerable progress has been achieved in enhancing communication on monetary policy in Mauritius. A press release is issued after each MPC meeting and the Governor holds a press conference on the following day. The minutes of MPC are published with a 2-week lag, which also discloses the voting of each member of the Committee. A combined inflation and financial stability report is published twice each year.

9. Despite the efforts to modernize monetary policy in Mauritius and a track record of single-digit inflation in recent years, the conduct of monetary policy does not appear to be in line with international best practice. While *de jure* the BOM's central objective is price stability, *de facto* it appears to pursue several other conflicting goals with potential to lead to policy inconsistency and undermine BOM's credibility. In addition, the liquidity management framework presents challenges that hinder the conduct of monetary policy. The BOM has a wide range of liquidity management instruments but most of them are underutilized due to likely risks to its financial strength. This has contributed to a build-up of excess liquidity.

Figure 1. Inflation Rate 1980 -2017
(Percent)



Sources: Bank of Mauritius and IMF Staff Calculations

C. BOM's Compliance with the Principles of Effective Monetary Policy Conduct

10. Monetary policy frameworks in Low and Lower Middle-Income Countries (LLMIC) often suffer from many drawbacks. These drawbacks encompass opacity regarding policy objectives and decision processes, weak liquidity management and policy analysis capacity, and poor communication strategies. As a result, most central banks in these LLMIC do not have a well-articulated forward-looking framework for assessing how policy should respond to shocks, or a coherent strategy that effectively maps objectives to monetary operations. Moreover, a pursuit of multiple objectives complicates policy formulation and reduces policy effectiveness. Against this background, the IMF developed seven principles that serve as a guide for an effective monetary policy framework (Box 1).

11. Despite efforts to improve its monetary policy framework, Mauritius does not appear to abide by most of the core principles that characterize an effective monetary policy framework. Monetary policy in Mauritius could benefit from further improvement in the following five areas: clarity regarding monetary policy objectives, having an explicit or implicit inflation objective to anchor inflation expectations, putting in place an effective operational framework, and articulation and communication of the monetary policy framework.

12. BOM's de facto pursuit of multiple objectives complicates monetary policy conduct. Most of the successful central banks around the world have price stability as the overarching objective of monetary policy both in the Law and in practice. While de jure the BOM cites price stability as its core objective, de facto BOM seems to pursue multiple objectives with potential to conflict with the price stability mandate. Although the pursuit of other objective may by coincidence be complementary to price stability, it can also come into conflict with price stability. In practice, the BOM's other objectives appear to include exchange rate management and avoidance of central bank losses.

13. Additionally, the BOM's systematic intervention in foreign exchange market confirms pursuit of multiple objectives. Large and unsterilized operations in the FX market suggest pursuit of additional objectives by BOM (see Figure 2). While BOM's purchase of foreign exchange is intended to build a buffer for reserves, the systematic one-way intervention may reflect a desire to lean against appreciation and to preserve competitiveness of the export sector.

14. Mauritius does not have a clearly defined inflation objective to anchor expectations. Although the BOM has put in place an implicit inflation objective to anchor inflation expectations, there is presently no firm commitment to a specific numerical inflation objective.[2] Formation of inflation expectations and an assessment of the success of monetary policy in Mauritius are therefore hindered.

15. Mauritius' monetary policy framework in not clearly articulated and communicated. While the ultimate objective is enshrined in the Law, the nominal anchor is not clearly articulated and communicated. In practice, the exchange rate seems to be playing an anchoring role given that Mauritius is a small and open economy. However, in the articulation of the monetary policy framework, the role of the exchange rate regarding the monetary policy framework is not referenced.

16. Lack of clarity about the role of the exchange rate has a potential to lead to policy inconsistencies. As the impossible trinity posits, it is difficult to pursue an independent monetary policy in the context of an inflexible exchange rate under an open capital account. The domestic liquidity injection by the BOM due to unsterilized FX interventions aimed at managing the exchange rate, exerts a downward pressure on interest rates, which would complicate monetary policy conduct in an event of a build-up in inflationary pressures. Lack of clarity on the monetary policy objective or pursuit of multiple inconsistent objectives poses a risk of not achieving those objectives.

17. The functioning of BOM's operational framework is hindered by excess domestic currency liquidity in the money market. Liquidity accumulated over the past few years, mostly due to the conversion of government's external borrowing into domestic currency, and to the accumulation of reserves through unsterilized intervention. In early 2015, the authorities ramped up efforts to mop up the excess liquidity, which peaked in April 2015. Excess liquidity declined on average between end-2015 and end-2016, achieved through the issuance of BoM bonds and Treasury bills, as well as sterilized interventions in the foreign exchange market. However, excess liquidity has recently been on the rise. The buildup in excess liquidity over the years has handicapped the interest rate transmission channel of monetary policy.

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[2] The various economic reports by BOM cite varying numerical inflation objectives.

Box 1. Principles of an Effective Monetary Policy Framework[1]

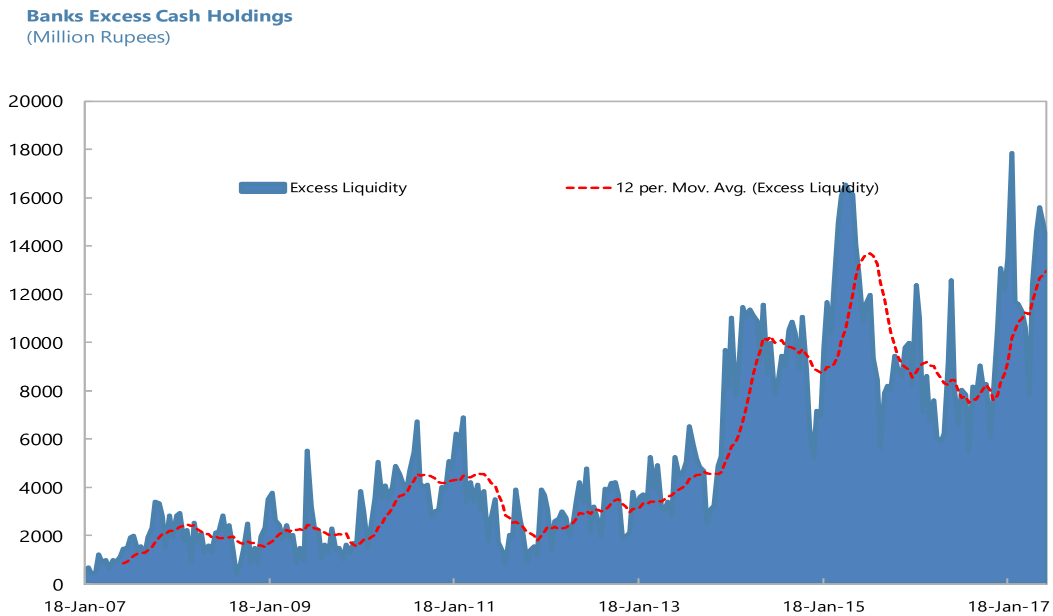
The Fund has developed seven-core principles that characterize an effective monetary policy framework for any country intending to adopt a forward looking monetary policy framework and these include:

(a) The central bank should have a clear mandate in terms of goals, and operational independence to pursue these goals, within the context of public accountability. Most importantly, these should be enshrined in the law and an effective governance and organizational structure should also be put in place.
(b) Price stability should be the primary or overriding objective of monetary policy over the medium-term as monetary policy cannot be expected to deliver on multiple inconsistent objectives.
(c) Consistent with the primacy of price stability, the central bank should have a medium-term inflation objective that serves as the cornerstone for its monetary policy actions and communication. A transparent and credible inflation objective helps anchor inflation expectations and serves as a benchmark against which to measure performance of the central bank.
(d) In determining the magnitude and pace of monetary policy adjustments warranted by the inflation objective, the central bank should carefully take into consideration the implications for macroeconomic activity and financial stability. However, this should not be done at the expense of undermining the role of inflation objective for policy formulation as this can unhinge inflationary expectations.
(e) The central bank should have a clear and effective operational framework and it should align market conditions with its announced policy stance. It should choose an operating target, with the policy stance being set and announced in terms of a specific level for this target. The operating target should facilitate the communication of the policy stance and its setting should be linked to the attainment of the inflation objective.
(f) The central bank should have a transparent forward-looking monetary policy strategy that reflects timely and comprehensive assessment of the monetary policy transmission mechanism.
(g) The central bank's communication should be transparent and timely, because clear communication enhances the effectiveness of monetary policy. Effective communication, helps reduce uncertainty, improves monetary policy transmission, facilitates accountability and thereby building credibility.

[1] Source: The IMF Board paper on Evolving Monetary Policy Frameworks in Low and Lower Middle-Income Countries (LLMICs)

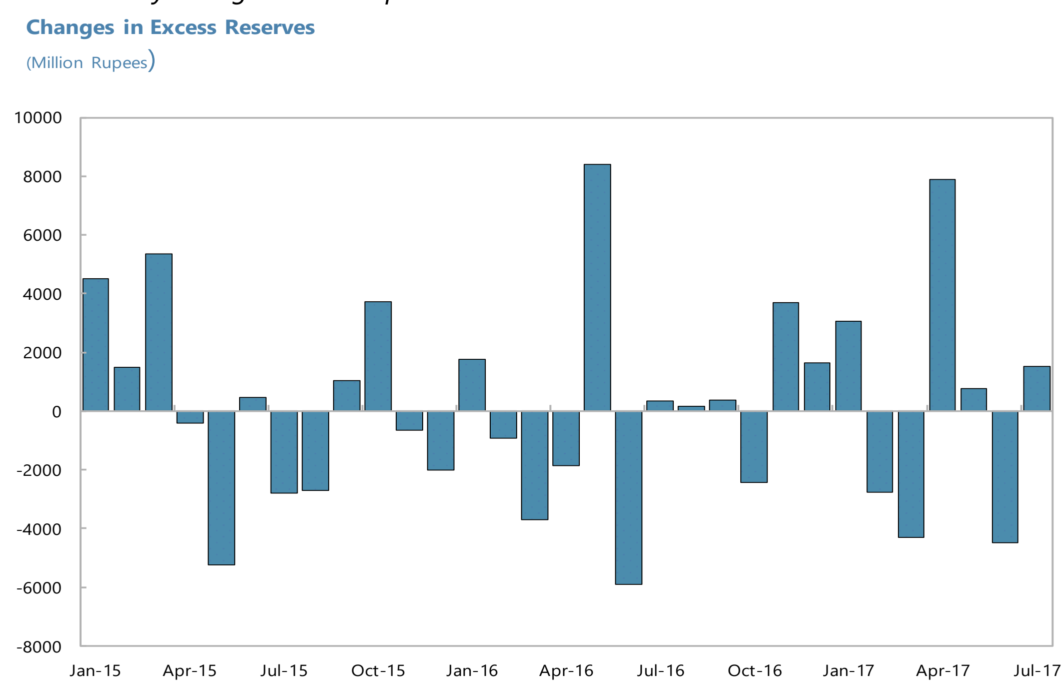
Figure 2. Major Drivers of Excess Liquidity in Mauritius

Bank's excess cash Holdings remain high….



Sources: Bank of Mauritius and IMF staff Calculations

Cumulative monthly changes over the period show a net increase in Excess reserves ….

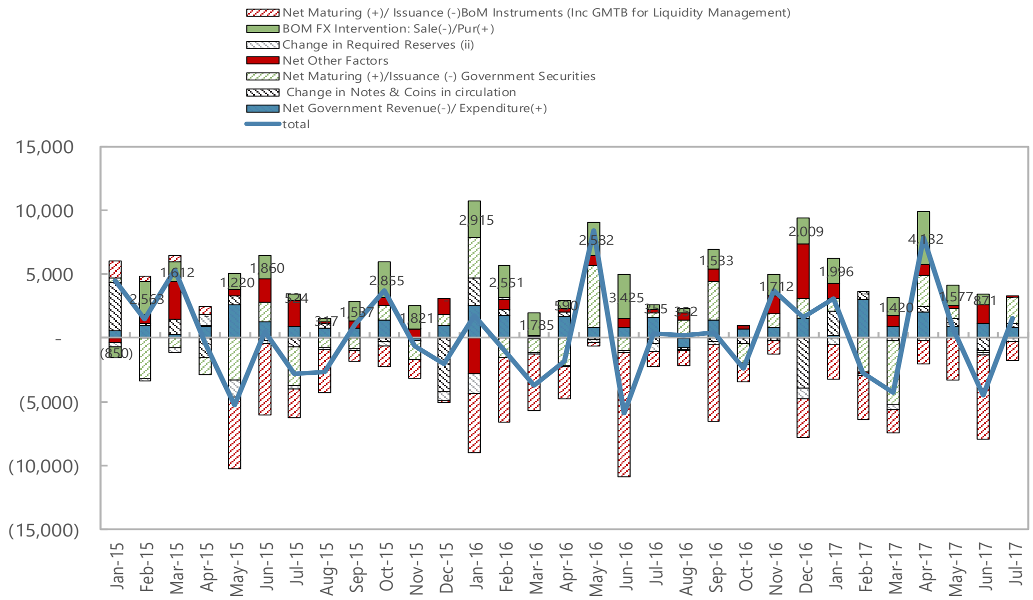


Sources: Bank of Mauritius and IMF staff Calculations

Figure 2. Major Drivers of Excess Liquidity in Mauritius (continued)

FX interventions and Government Operations fuel excess liquidity….

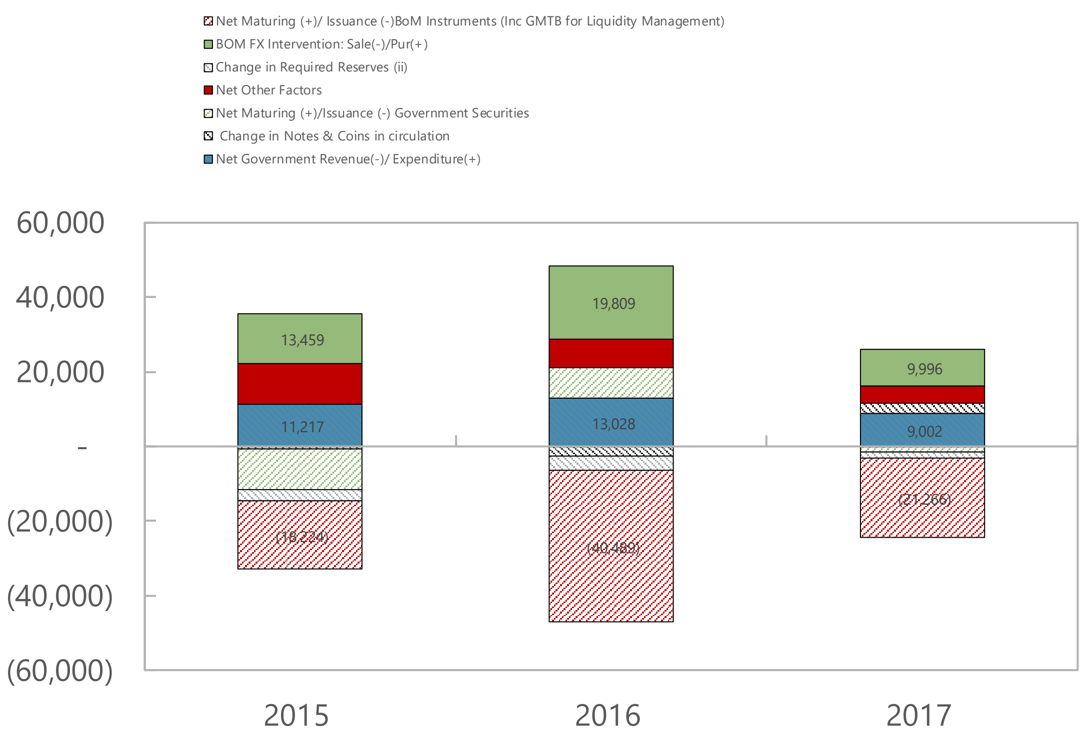
Excess Reserves and Autonomus Sources (Mil. Rupees)



Sources: Bank of Mauritius and IMF staff Calculations

FX Interventions and Government Operations fuel excess liquidity despite efforts by BOM to drain liquidity….

Autonomus Sources of Excess Liquidity (Million Rupees)

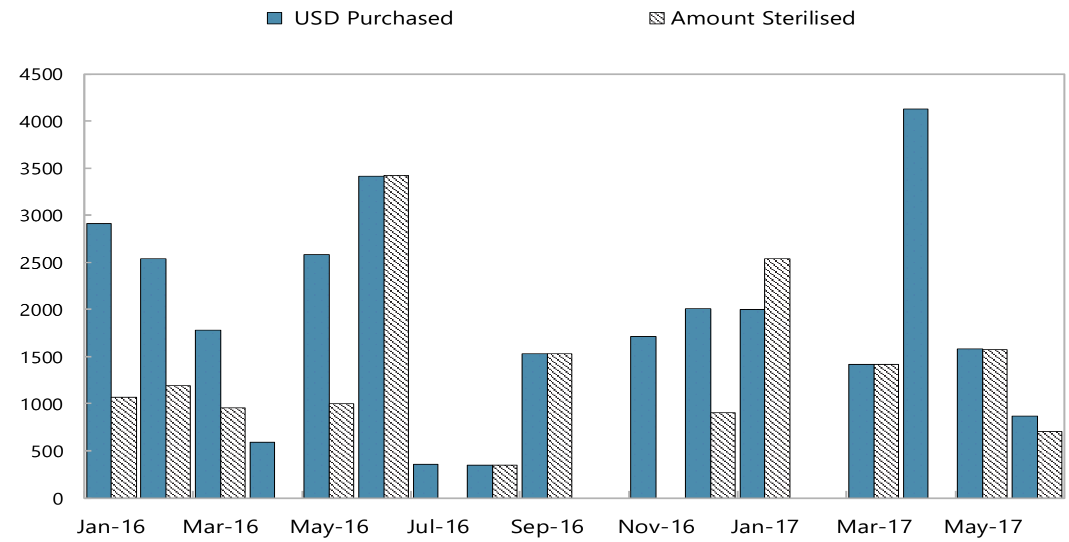


Sources: Bank of Mauritius and IMF staff Calculations

Figure 2. Major Drivers of Excess Liquidity in Mauritius (concluded)

BOM does not fully sterilize FX interventions…

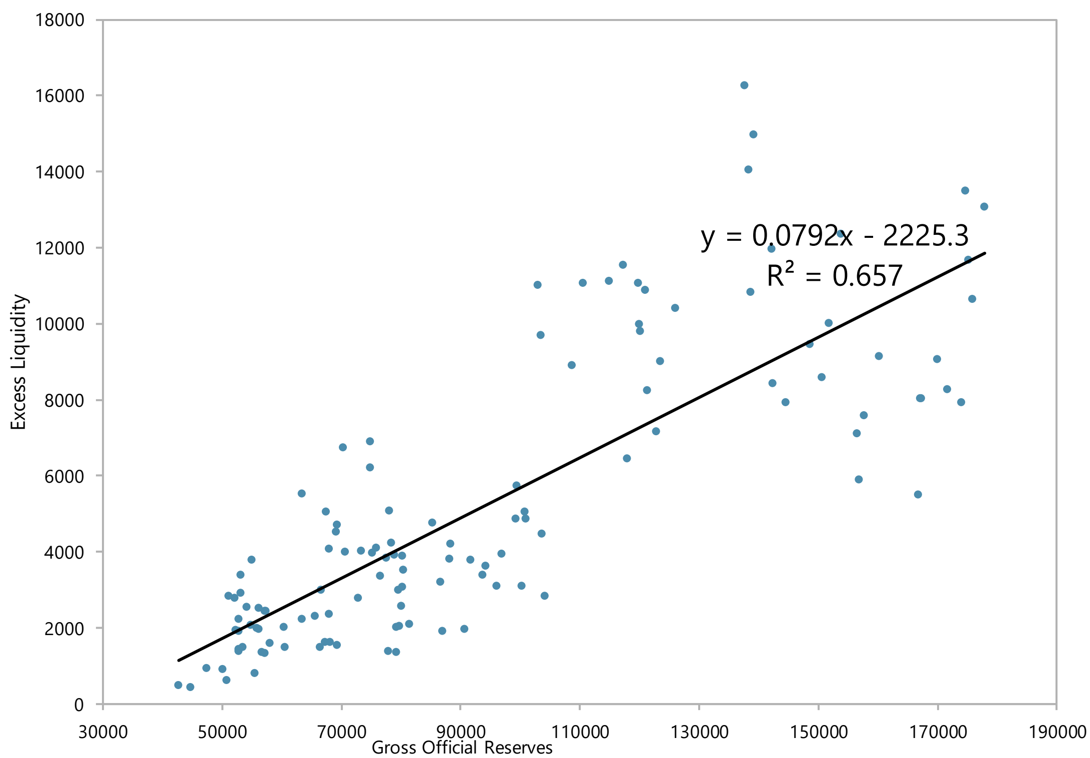
Forex Puchases and Amount Sterilised
(Million Rupees)



Sources: Bank of Mauritius and Staff Calculations

There is evidence of strong relationship between official Reserves and Excess liquidity….

Gross Official Reserves and Excess LIQUIDITY

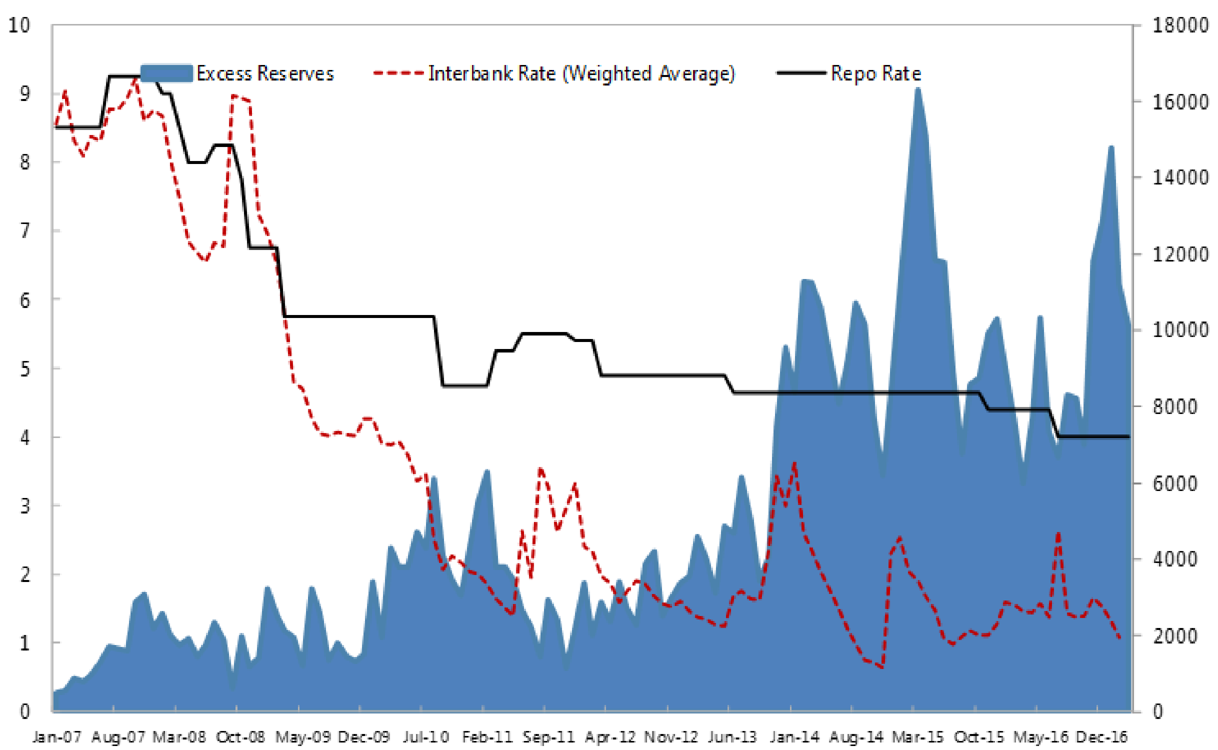


Sources: Bank of Mauritius and IMF staff Calculations

18. Autonomous supply factors suggest that unsterilized foreign exchange interventions are one of the major drivers of excess liquidity (Figure 2). Excess liquidity remains high as the BOM continues to intervene in the foreign exchange market with a view to stabilizing the rupee and building-up foreign exchange reserves. Despite increased efforts by the BOM since March 2015 to sterilize excess liquidity, it remains high and it continues to thwart the monetary policy transmission mechanism. Sterilization efforts by the BOM do not fully offset domestic liquidity injection that stems from foreign exchange interventions. Concerns about sterilization costs of removing liquidity and its effect on BOM's balance sheet have led to passive liquidity management strategy. While BOM has enough instruments to mop up excess liquidity, concerns about balance sheet constraints have constrain sterilization efforts.

19. The chronic excess liquidity causes interbank rate to persistently diverge from policy rates severely weakening the interest rate transmission channel of monetary policy. During the period of moderate excess liquidity, both the policy rate and the interbank rate were closely moving together (Figure 3). However, as excess liquidity mounted the wedge between the policy rate and the interbank rate widened reflecting the impact of excess liquidity on interest rates. The divergence between the interbank rate and the policy rate continues to distort monetary policy signals and undermines the overall credibility of the monetary policy. On the contrary, the co-movement between the policy rate and deposit and lending rates partly achieved through moral suasion (Figure 4).

Figure 3. Excess Liquidity and Interest Rates



Sources: Bank of Mauritius and IMF staff Calculations

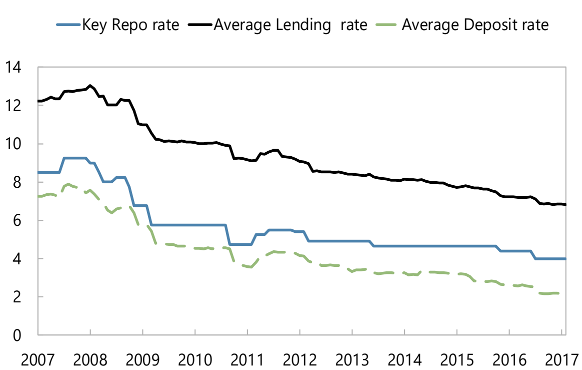
20. Inactive secondary bond market and some restrictions on access to lending facilities by BOM also contribute to banks' need to maintain large excess reserve balances. Limited trading in the secondary market and limited access to the lending facilities further contribute to higher excess reserves as it leads banks to hold further precautionary reserves.

21. Constrained access to the standing facilities renders the "indicative" corridor system ineffective. Currently the ''indicative'' corridor is set at 125 bps around the key repo rate and is operated at the initiative of the BOM instead of commercial banks. The corridor system is only indicative as there is currently no permanent standing lending and deposit facilities. It is ineffective in controlling the interbank rate and consequently, market rates continue to move outside this indicative corridor.

Figure 4. Interest Rate Dynamics

The Key Repo Rate moves in tandem with lending and deposit rates...

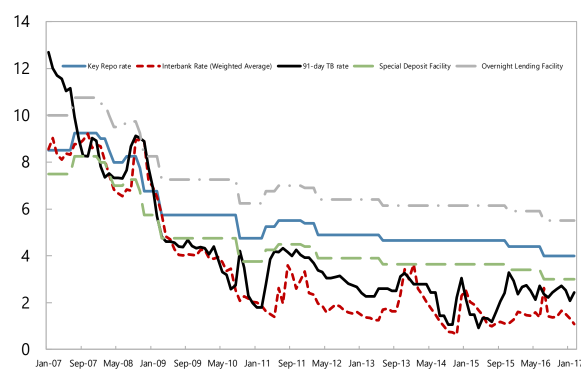
Key Repo Rate, Lending and Deposit Rate



Sources: Bank of Mauritius and IMF Staff Calculations

The Key Repo rate and Interbank rate are misaligned ...

Key Repo Rate and Money Market Rates



Sources: Bank of Mauritius and IMF staff Calculations

22. A skewed distribution of liquidity in the banking system continues to affect the efficiency of the interbank market. The Mauritius domestic banking system is dominated by a few highly liquid large banks and several small banks. Market segmentation implies that the large banks are reluctant to lend to the smaller banks which are short of liquidity due to credit risk considerations and this also contributes to the inefficiency of the interbank market.

23. Despite being equipped with a variety of absorption tools BOM has not effectively use them to resolve the excess liquidity problem, due to balance sheet constraints. BOM has several liquidity absorption instruments including reverse repo, deposit facility and BOM bills and bonds. However, it has not been able to use them due to balance sheet constraints. Despite introduction of sterilized interventions by BOM in 2015, excess liquidity remains high as sterilization is handicapped by the associated costs of monetary policy.

D. Conclusions and Recommendations

24. In recent years, the BOM has undertaken several initiatives to strengthen its monetary policy framework. These include, amongst others, an improvement of the liquidity forecasting framework and the macroeconomic model. Nevertheless, in line with BOM's plans to put in place an effective forward looking monetary policy framework, additional reforms along the lines of the following recommendations could be considered**:**

- Emphasize price stability as the primary monetary policy objective and have a clearly defined nominal anchor, along with a numerical intermediate target. Additionally, BOM should clarify the role of the exchange rate as it relates to monetary policy objectives and the strategy for intervention in the foreign exchange market.

- Slow down the pace of unsterilized accumulation of foreign reserves which is a major source of excess liquidity. Foreign reserves have grown significantly and could be deemed adequate, as reflected by the various reserve adequacy measures. However, should the need for further reserve accumulation arise, BOM could clearly communicate its plan to purchase foreign currencies at the market rate, and for reserve buildup only, thereby not affecting the exchange rate.

- Introduce a 7-day Certificate of Deposit (CD) and link it directly to the policy rate. Currently, the policy rate is linked to a liquidity injection facility – the repo facility - which appears to not function properly given excess liquidity and therefore policy actions taken by BOM tend to not be transmitted to the market rates. Additionally, autonomous supply factors should be used in calibrating monetary policy operations.

- Put in place an effective interest rate corridor. Introducing a standing overnight facility without restrictions (subject to provision of sufficient collateral) and a deposit facility at fixed rates would ''corridor'' for the interbank rate.

- Strengthen coordination between liquidity management and debt management. Given structural excess liquidity and costs involved in sterilization operations, coordination between BOM and MOFED should be strengthened. Development of a MoU between the BOM and the MOFED provides a useful tool to specify a cost-sharing arrangement of monetary operations.

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BOOSTING INTERNATIONAL COMPETITIVENESS[1]

A. Introduction

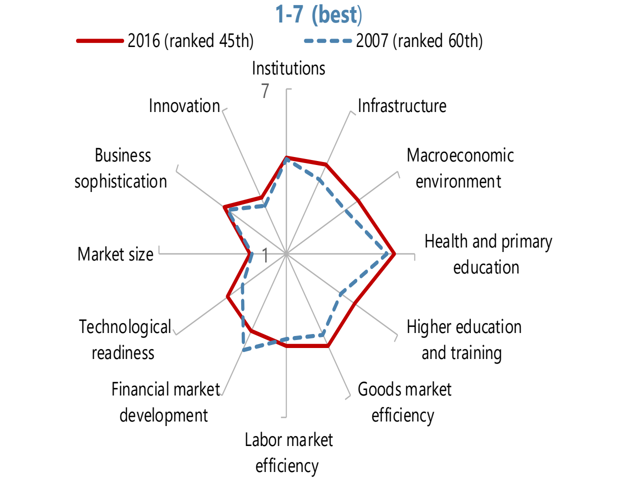
1. Boosting international competitiveness is an integral component of the Mauritian authorities' 'Vision 2030', which foresees Mauritius joining the ranks of higher-income countries before 2030. The authorities' ambitious economic development strategy seeks to transform Mauritius into an inclusive high-income economy by 2030. The plan involves a fundamental transformation of the economy and a move up the economic value chain to boost growth and position Mauritius as a services and investment hub for mainland Africa. Boosting Mauritius' international competitiveness and business environment to attract new high value-added industries is a key component of this strategy.

2. In this light, this paper analyses three key issues. First, we present recent developments pertaining to Mauritius' international competitiveness, in a regional and global context. Secondly, we highlight the competitiveness challenges facing Mauritius. Thirdly, we propose policies that may be adopted to boost Mauritius' international competitiveness and help the country graduate to the next level of economic development.

B. Recent Competitiveness Developments

3. The latest available international benchmark data on international competitiveness show that Mauritius is the most competitive economy in SSA. Per the latest edition of the World Economic Forum's Global Competitiveness Report (2016-2017), Mauritius ranked 45th out of 138 economies in terms of overall competitiveness, two places ahead of South Africa. The aspects of competitiveness on which Mauritius tops the region are the provision of infrastructure, health and primary education and training, higher education and training, and goods markets efficiency.

Figure 1. Mauritius: Global Competitiveness Index, 2007 vs. 2016
1-7 (best)



Sources: World Economic Forum; and IMF staff calculations.

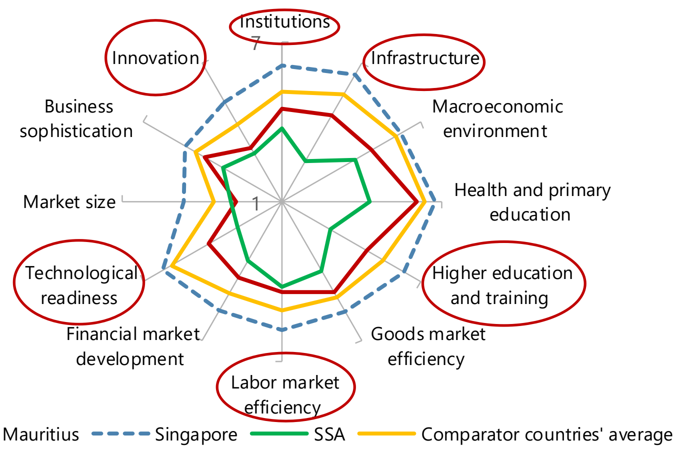
4. Much progress with respect to competitiveness has been made over the last decade to bring Mauritius to the top of SSA's competitiveness rankings (Figure 1). A suite of reforms was put in place over the last decade, which have accompanied and facilitated Mauritius' structural economic transition, allowing the country to climb 15 places on the competitiveness ranking within a decade. Apart from rapid improvements in the areas in which

[1] Prepared by Cameron McLoughlin and Mounir Bari.

Mauritius currently leads the SSA region, Mauritius' overall competitiveness position has also benefited from improvements in the macroeconomic environment and the readiness to adopt new technologies, particularly the more widespread usage of internet and mobile-broadband. Although the offshore financial sector is of large economic significance, Mauritius has regressed in the competitiveness rankings on certain aspects of financial market development, chiefly related to trustworthiness and confidence.

5. Despite the impressive gains of the last decade, competitiveness gaps vis-à-vis comparators remain in several areas (Figure 2). Although Mauritius is streets ahead of the SSA region in the competitiveness rankings, the country is lagging in certain areas *vis-à-vis* emerging market peer countries.[2] Competitiveness gaps are especially apparent in relation to innovation, institutions, infrastructure, higher education and training, labor market efficiency and technological readiness.

Figure 2. Mauritius: Global Competitiveness Index, 2016 1-7 (best)



Sources: World Economic Forum; and IMF staff calculations.
Note: Comparator countries include Singapore, Panama, Malta, Hong Kong, and Iceland.

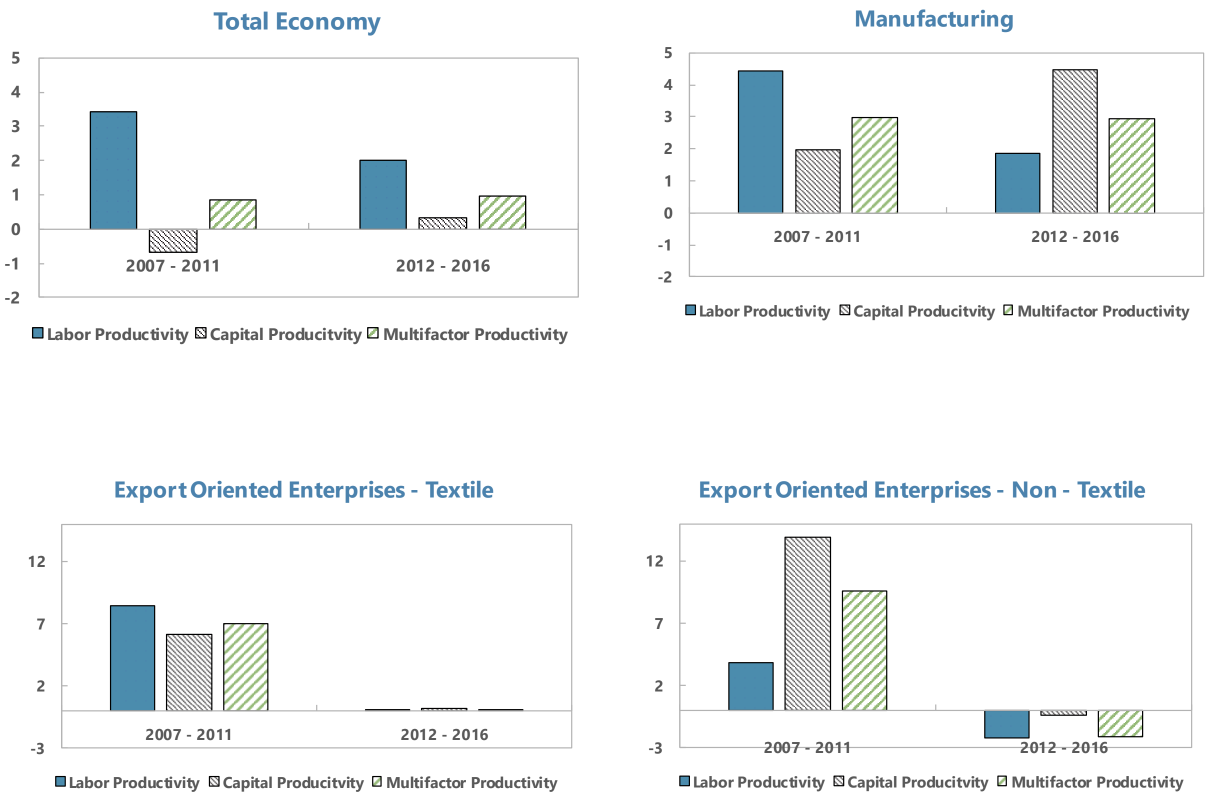
6. Symptomatic of emerging competitiveness gaps is the recent stagnation in productivity across sectors, which may undermine the hard-won competitiveness gains of the last decade (Figure 3). For the overall economy, growth in average labor productivity declined in the second half of the last decade. This trend was evident both in the manufacturing sector, as well as by firms operating in the Export Processing Zone sector. While at the same time capital productivity in manufacturing picked up, export oriented enterprises (EOEs) experienced declines in both capital and multifactor productivity (even negative in the case of non-textile EOEs).

7. The above unfavorable productivity trends have, alongside rising wages, induced increases in economy-wide unit labor costs (Figure 4). Data show an increasing disconnect between pay and productivity outcomes. Average compensation exceeded productivity, especially in the latter half of the last decade, leading to increased unit labor costs.[3] This is especially the case for export-oriented enterprises in the non-textile sector.

[2] Comparator countries are Singapore, Panama, Malta, Hong Kong and Iceland.

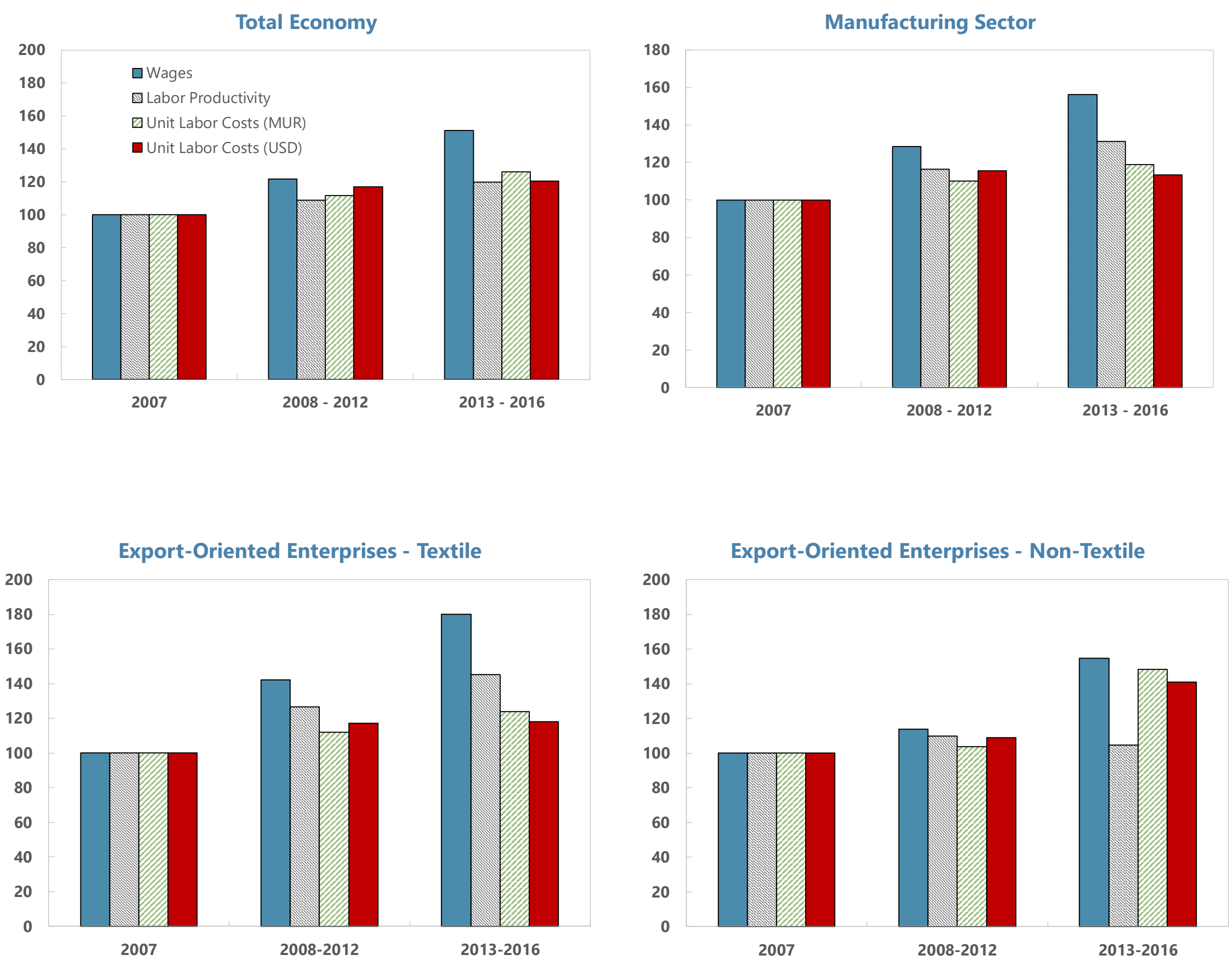
[3] The increase in unit labor costs is less pronounced in some sectors when they are expressed in $US.

Figure 3. Mauritius: Trends in Average Productivity Growth
(Percent)



Source: Statistics Mauritius and IMF staff estimates.

Figure 4. Mauritius: Wages, Labor Productivity and Unit Labor Costs
(Average Index, 2007=100)



Source: Statistics Mauritius and IMF staff estimates.

8. **A contributing factor to the unfavorable trends in productivity and unit labor costs may be inefficiencies in the labor market resulting from the complex wage-setting mechanism (Box 1).** The wage-setting mechanism is complex, consisting of several competing systems that review wages and conditions in the public and private sectors. While productivity considerations do to some extent figure in wage negotiations, recent trends in unit labor costs reflect the importance of a tighter linkage between pay and productivity outcomes**.**

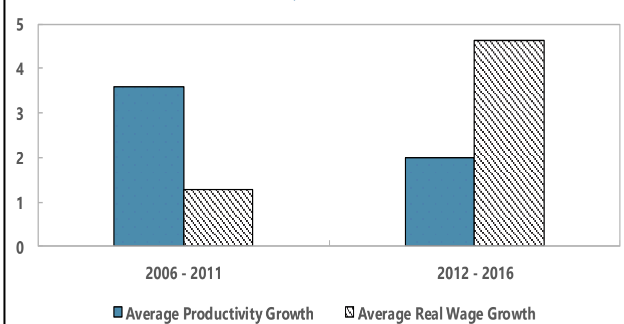
Box 1. The Wage-Setting Mechanism in Mauritius

The complex wage-setting mechanism for the private and public sectors in Mauritius is characterized by several competing processes. In the private sector, enterprise-level collective bargaining applies to a small fraction (about 6 percent) of the workforce. This is due to structural economic shifts reducing the relative share of unionized jobs in the total, and a relative absence of collective-bargaining practices in firms in the large Export Processing Zone sector. Minimum pay and conditions for non-unionized and lower-paid workers in certain industries (currently about 30, covering about 70 percent of the private sector workforce) are covered by so-called Remuneration Orders (ROs). These are ministerial orders made on the recommendation of a quasi-judicial wage-fixing body called the National Remuneration Board (NRB). The NRB undertakes extensive consultations with government, unions, employers and the public regarding potential wage increases.

In the public sector, a government agency (Pay Research Bureau) reviews the ceiling on salaries and working conditions every 5 years. Finally, wages in both the public and private sector are subject to annual cost of living adjustments by the so-called Tripartite Committee, which is composed of high-level representatives of government, trade unions and employers. Such adjustments are usually triggered when the average inflation rate exceeded 5 percent in the previous year, although the threshold has not been strictly adhered to in the past.

Although productivity considerations form part of wage-setting negotiations, some sectors of society e.g. labor unions have argued that wage increases are not granted solely on economic and social merits (Fashoyin 2010). Indeed, data suggest that in recent years, real wage increases in Mauritius have run well ahead of productivity (Box Figure 1).
Simplifying the wage-setting mechanism and more explicitly linking wages to productivity may alleviate Mauritius' competitiveness concerns. Lessons drawn from similar economies may help in this respect. For example, in Singapore, the tripartite National Wage Council (NWC) –comprising representatives of labor, employers and the government– issues wage guidelines. These wage guidelines are not sector-specific and are only mandatory for the public sector.

Box Figure1. Wages and Productivity
(percent)



The pending introduction of the national minimum wage in 2018 may play an important role in labor market reform in Mauritius. The national minimum wage aims to provide a living wage to lower-paid workers in both the public and private sectors and will be set by the National Wage Consultative Council (NWCC). Indications are that competitiveness, along with other socio-economic considerations, will be a key consideration in setting the minimum wage.

C. Competitiveness Challenges

9. **Part of Mauritius' competitiveness challenge is to address the most problematic aspects for doing business in the country (Figure 5).** Per the 2016 Executive Opinion Survey, the most pervasive problems for doing business in Mauritius are an inefficient government bureaucracy (about 17 percent of respondents), followed by insufficient capital to innovate (16.1 percent), an inadequately educated workforce (13.7 percent), followed by corruption (11.1 percent). Recent

reforms introduced in the Business Facilitation Act of 2017 are a step in the right direction and may address some of these concerns, through eliminating regulatory and administrative bottlenecks.

10. That an inadequately educated workforce is an important hindrance for business in Mauritius reflects concerns surrounding the 'skills mismatch' problem. Mauritius rates well in international comparison regarding secondary education enrollment rates (Figure 5). However, it is not clear that the fragmented technical and vocational education and training (TVET) system, characterized by a range of private providers, produces the right skills for the economy (World Bank 2015). At the tertiary level, enrollment rates are comparatively low, and the proportion of students enrolled in science and technology related degrees forms a relatively small share of the total. The share of graduates in industries associated with the offshore financial sector (e.g. accounting, law) is comparatively high.

11. There also appears to be a negative correlation between corruption perceptions and competitiveness (Figure 5). Data suggest that perceptions of corruption are strongly negatively correlated with a country's overall competitiveness ranking. It has been shown that depending on its pervasiveness, corruption affects factors such as total factor productivity, public and private investment, and human capital accumulation (IMF 2016a). These factors tend to also be associated with competitiveness outcomes.

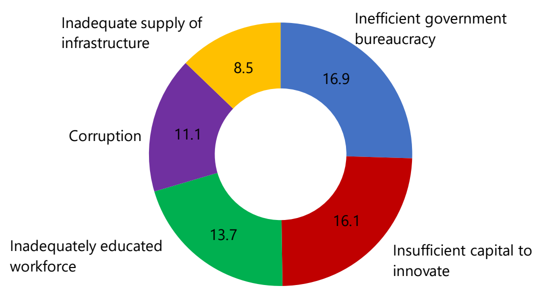
12. Female participation in the labor force is also comparatively low (Figure 5). Mauritius ranks poorly in international comparison on female participation in the labor force (108th out of 138 economies). Closing the gender gap in labor force participation is not only an important factor for boosting growth in Mauritius (IMF 2016b), but also an efficient mechanism to optimize deployment of the economy's labor resources necessary to boost the country's global competitiveness.

13. Foreign Direct Investment (FDI) in Mauritius has been skewed towards real estate, rather than more productive investments (Figure 5). Over time, FDI has been concentrated in the real estate sector, rather than in research and development and innovation. This trend has limited the opportunities for technological transfer, and helps explain Mauritius' challenges related to a weak capacity for innovation. Moreover, the above-mentioned labor market rigidities and skills mismatches may also have kept investors in more productive sectors at bay and skewed investment away from more productive sectors and into those sectors where qualified talent is available (e.g. the financial sector).

Figure 5. Mauritius: Aspects of Competitiveness

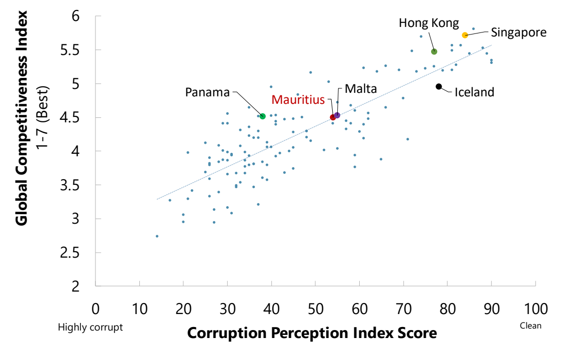
Most Problematic Factors for Doing Business in Mauritius

(Executive Opinion Survery 2016)



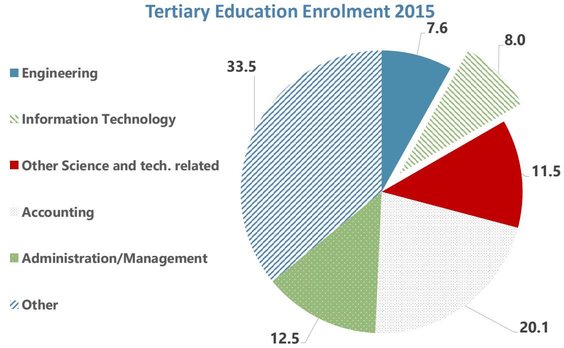
Sources: Word Economic Forum 2016.
Note: The score corresponds to the responses weighted according to their rankings.

Global Competitiveness and Perception of Corruption, 2016



Sources: World Economic Forum; and Transparency International.

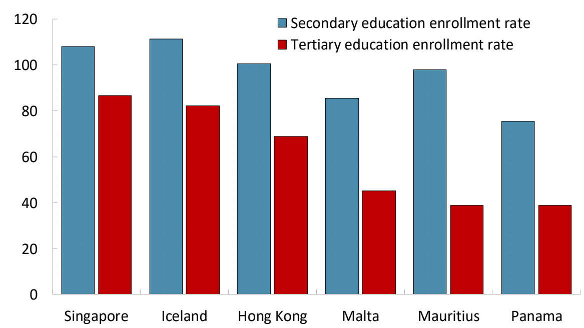
Tertiary Education Enrolment 2015



Source: Statistics Mauritius

Education Enrollment

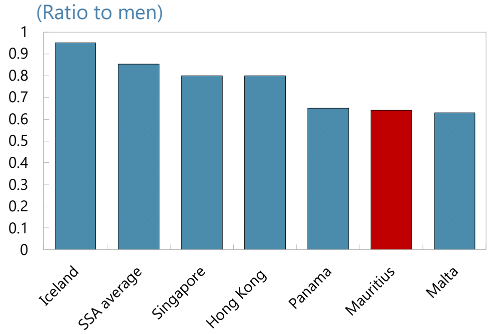
(Percent of total enrollment)



Source: Global Competitiveness Index 2016.

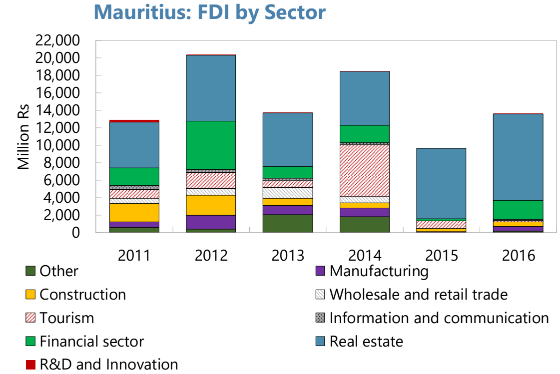
Female Participation in the Labor Force, 2016

(Ratio to men)



Source: Global Competitiveness Index 2016.

Mauritius: FDI by Sector



Sources: Bank of Mauritius; and IMF staff calculations.

D. Policies to Boost International Competitiveness

14. A new wave of economic reforms is necessary to meet the key economic task of graduating to a higher level of economic development. Boosting competitiveness and moving up the economic value chain are key economic tasks currently faced by Mauritius. Some sectors, for example the offshore financial sector, are being remodeled to deal with external challenges, with for example a greater emphasis on encouraging companies to put down concrete roots (creating 'substance') in the country through tax incentives (see Annex on BEPS).

15. Recent reforms aimed at enhancing the business climate contained in the Business Facilitation Act of 2017 are an important welcome step in the right direction. The reform package contained in the Business Facilitation Act (2017) is designed to create a more hospitable business climate, through for example streamlining official procedures and tax administration via a one-stop e-licensing platform, and facilitating international trade and commerce.

16. Moreover, creating the National Economic Development Board (NEDB) and adopting the draft Financial Sector Services Blueprint will help coordinate the strategic vision needed to guide Mauritius' economic transformation. The NEDB has three core functions: i) export marketing and business development, ii) coordinate licensing and regulatory activities, and iii) guide the future strategic economic direction. In addition, the draft Financial Sector Services blueprint will guide the transition of the GBC sector from a system based largely on tax incentives to one that provides higher value added services.

17. However, further action is also needed to address bottlenecks in areas where Mauritius is lagging compared to higher income peers in the global competitiveness rankings (Figure 6). Areas in which further reforms are required are the relatively rigid labor market (57th place in labor market efficiency); skills mismatch (a relatively low tertiary education enrollment rate of 38.7 percent, or 73rd rank); and a relatively weak capacity for innovation.

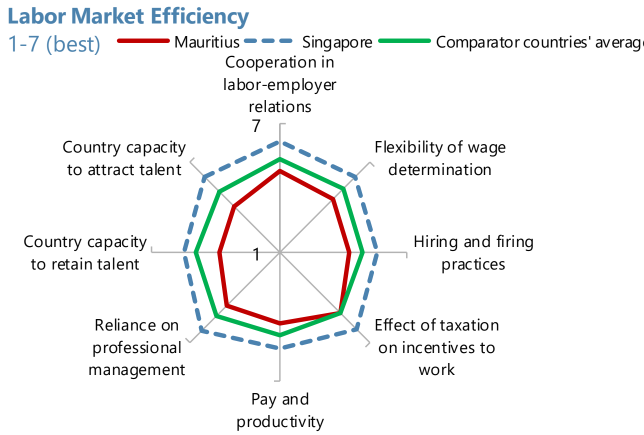
18. Making progress on reforms to the labor market and wage-setting mechanism. To arrest the unfavorable trends in productivity and unit labor costs that are negatively affecting Mauritius' cost competitiveness, attention needs to be paid to reforming Mauritius' labor market and wage-setting mechanism (Figure 6). Currently, Mauritius' labor market is characterized by, amongst other things, a lack of flexibility in wage determination by companies (102th rank). Care should be taken to avoid backsliding on previous reform efforts. Moreover, the wage-setting mechanism could be altered to more tightly link wages to productivity outcomes in individual sectors, for example by increasing the coverage of collective agreements in the total workforce.

19. The pending introduction of the National Minimum Wage in 2018 should be carefully managed and form part of a holistic approach to labor market reform. Implementation of the National Minimum Wage, which will be calculated as a proportion of the median wage, is scheduled for 2018. It is not yet clear whether the minimum wage would lead to an overall simplification of the already complex wage-setting mechanism. Also, while negotiations regarding the minimum-wage level are still underway, caution should be taken to ensure that its introduction does not adversely affect enterprise competitiveness, job creation, and induce sectoral wage spill overs by distorting wage relativities. Introducing the minimum wage may also provide a window of opportunity to streamline the labor market architecture and ensure that the wage-setting process contributes to enhanced competitiveness outcomes. At the same time, it is important that the new scheme also safeguard social objectives. In this context, current efforts to close gender gaps and reduce inequality by boosting the labor supply of youth and women could be bolstered.

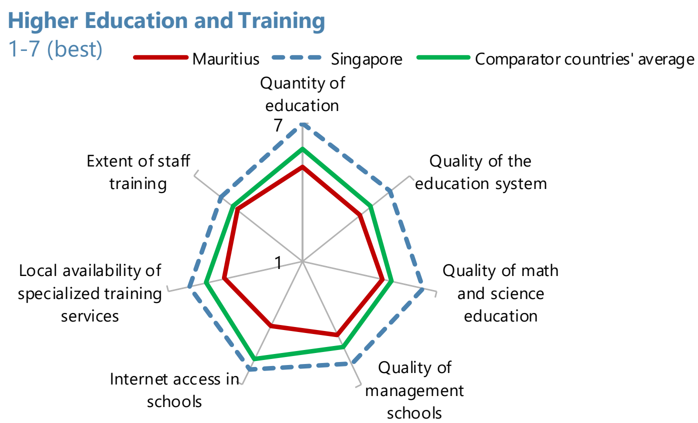
20. Addressing the skills mismatch. Both the quality and quantity of education need to be **improved** to better serve the industries of today and encourage the development of those of the future (Figure 5). While overall secondary education enrollment rates are high, the portion of TVET enrollments in the total is small (World Bank 2015). A more active and comprehensive approach by government to the delivery, monitoring and evaluation of technical training programs could ensure that market demands for skills are better fulfilled. Furthermore, encouraging tertiary enrollment in STEM subjects, and encouraging foreign skilled labor where necessary, will help to develop a pipeline of human capital suited to working in higher value-added sectors in the future, also complementing innovation policy (see below).

21. A comprehensive innovation policy, which could follow comparator country experiences in the area, would promote economic diversification and enhance growth over the medium-to longer term (Figure 6). A more active innovation policy could, in concert with higher education reforms, boost the availability of scientists and engineers, while also allocating more tertiary education funds towards the development of research. To boost technology absorption in the economy and facilitate the growth of new industries, greater incentives for R&D could be offered to companies, while government could also foster greater collaboration between universities and industry on R&D. A revamped innovation policy could for example adopt the approach of Singapore, which promotes technology transfer through attracting multinational corporations, and has an emphasis on building domestic R&D capacity, also with strong government support for promoting venture capital.

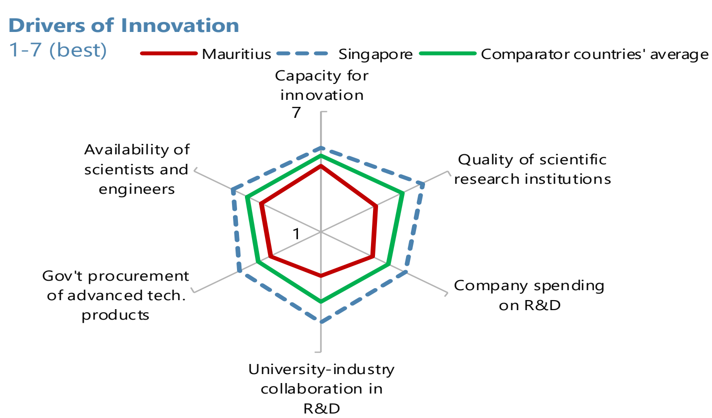
Figure 6. Mauritius: Aspects of Competitiveness



Sources: Global Competitiveness Index 2016.



Sources: Global Competitiveness Index 2016.



Sources: Global Competitiveness Index 2016.

E. Conclusions

22. Mauritius' progress in improving competitiveness over the last decade has been nothing short of remarkable, however some areas of concern have emerged. During the last decade, Mauritius has jumped 15 places in the international competitiveness rankings, and is now the most competitive economy in SSA. However, stagnating productivity in some sectors and recent associated increases in unit labor costs have signaled growing cost competitiveness concerns.

23. To propel Mauritius to the next level of economic development, further reforms are necessary to address the competitiveness gaps emerging *vis-a-vis* emerging market comparator countries. While Mauritius is leading the pack in SSA on international competitiveness, data also suggest that competitiveness gaps are opening *vis-à-vis* emerging market comparator countries (Singapore, Panama, Hong Kong, Iceland, and Malta).

24. Areas to be urgently addressed are the labor market, skill mismatches, and innovation policy. Chief concerns of labor market reform are to tighten the linkage between pay and productivity through simplifying the complex wage-setting mechanism, and closing the gender gap in labor market participation. The current mismatch between demand and supply of skills in the economy could be addressed through unifying the TVET system and encouraging tertiary enrolment in STEM subjects. The latter would also contribute to the implementation of a more comprehensive innovation policy, that would focus on leveraging collaboration between university and industry on R&D and technology adoption to facilitate development of new generation growth sectors.

25. A bold strategic vision is required to achieve Mauritius' ambitious development agenda; initial reform steps, as well as Mauritius' strong track record of reform implementation, both bode well for the future. Mauritius' transformation from an agriculture to a services-based economy is nothing short of remarkable. This shift was facilitated by, among other things, a suite of economic reforms that catapulted the country to the top of the competitiveness rankings in SSA. Attaining the next level of economic development will not be easy and will require enhanced efforts to overcome the variety of policy challenges outlined above. Considering Mauritius' track record of reinventing its economic model, there are grounds for optimism that the country will successfully manage the reform process.

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