CHAPTER

6 Fiscal Developments

Over the past 25 years, Mauritius's public finances have experienced three distinct phases: large fiscal deficits in the early 1980s, followed by a period of fiscal consolidation and discipline during the late 1980s and early 1990s, and finally the reemergence of fiscal imbalances from the second half of the 1990s to date (see Table 6.1).

As described below, the authorities have shown a strong determination to prevent public finances from becoming a cause of macroeconomic instability. The deficits of the early 1980s were quickly reduced, and both the external

Table 6.1. Summary of Government Finances, 1980/81–2003/04 [1]

(Period averages; in percent of GDP)

	1980/81–1984/85	1985/86–1989/90	1990/91–1994/95	1995/96–1999/00	2000/01–2003/04
Total revenue and grants	21.6	22.8	21.3	19.7	19.5
Total revenue	21.1	22.2	21.1	19.5	19.2
Tax revenue	18.7	20.1	18.9	16.9	16.7
Nontax revenue	2.4	2.1	2.2	2.6	2.5
External grants	0.5	0.6	0.2	0.2	0.3
Total expenditure and net lending	30.2	24.9	23.8	24.5	25.3
Current expenditure	24.4	20.0	19.5	20.6	20.9
Capital expenditure and net lending	5.8	4.9	4.3	4.0	4.4
Overall balance after grants	-8.6	-2.1	-2.5	-4.9	-5.8
Primary balance	-2.8	2.2	0.7	-1.4	-1.8

Sources: Mauritian authorities and IMF staff estimates.

[1] Fiscal year from July to June.

debt and the overall government debt were maintained within very prudent bounds. While the rise of the public debt has become a source of concern in recent years, requiring the adoption of corrective actions, the limited size of the external debt is an important element of stability. However, the authorities should not be complacent, and should pursue steadfastly a policy of deficit reduction.

Phase 1: Fiscal Imbalances

The fiscal problems of the early 1980s had their roots in the lax fiscal policies of the mid-1970s, when sugar prices reached record highs and the government embarked on large spending programs. By the turn of the decade, a drop in sugar prices, combined with the steep rise in international petroleum prices and a number of severe cyclones, significantly weakened the Mauritian economy. Public finances deteriorated, too, as tax revenues declined and expenditures rose, including spending on reconstruction and relief efforts. By 1980/81 (July to June), the overall fiscal deficit peaked at about 14 percent of GDP.

With the support of the World Bank and the IMF, the Mauritian authorities responded forcefully to these economic and weather-related shocks by adopting comprehensive macroeconomic adjustment measures. A key element of the authorities' adjustment efforts was the reestablishment of fiscal discipline, which was achieved primarily by reining in expenditures, as revenues increased only marginally. The turnaround was quite impressive. Within five years, total expenditure and net lending as a proportion of GDP dropped from an average of about 30 percent during the first half of the 1980s to about 25 percent in the second half of the decade, while revenues increased modestly by about 1½ percent during the same period. As a result, the overall fiscal deficit shrank from about 8½ percent of GDP during 1980/81–1984/85 to just over 2 percent of GDP in the late 1980s.

Phase 2: Fiscal Consolidation and Trade Tax Reform

The Mauritian economy experienced enviably robust growth during the second half of the 1980s, with average annual output expanding at about 8 percent. Economic growth continued at a vigorous annual rate of about 5 percent in the early 1990s, despite severe cyclones that damaged sugar output and infrastructure in 1993/94. The strong economic performance and the authorities' tight fiscal policies helped to limit the country's fiscal deficit to less than 3 percent of GDP during the 10-year period from the mid-1980s to the early 1990s. During this period, expenditures as a proportion of GDP declined by about 1 percent, led by lower spending on wages, on domestic and external interest, and on capital projects and net lending. While revenues also weakened by about 1 percent of GDP, significant structural changes took place that affected the composition of taxes. As a proportion of GDP, taxes on property and on domestic goods and services increased by about 1 percent of GDP, while taxes on income and profits remained constant, and those on international trade dropped by about 2⅓ percent of GDP.

In 1994/95, important trade tax reforms were implemented, which aimed at abolishing export taxes, simplifying the taxation of imports, and reducing excessive trade protection. The tax on sugar exports that amounted to about 0.7 percent of GDP was abolished, and the country's import duty system was rationalized. The three previous types of import taxes—the customs duty, the fiscal duty, and the import levy—were consolidated into one duty, and the number of nonzero duty rates was reduced from 60 to 7.[23] The maximum rate of import duty was reduced from 600 percent to 100 percent, and import duties on about 4,000 items, mainly foodstuffs, raw materials, and capital goods, were lowered. While the above reforms simplified the import tax regime, the tariff reductions, in the absence of compensating increases in domestic taxation, entailed a significant loss of tax revenue, estimated at about 1½ percent of GDP.

Phase 3: Reemergence of Fiscal Imbalances Despite VAT Introduction

The tariff reductions, compounded by the reconstruction costs following the 1993/94 cyclone season, contributed to a sharp deterioration in Mauritius's public finances, with the fiscal deficit widening from about 3½ percent of GDP in 1994/95 to about 7¼ percent of GDP in 1995/96. Faced with this fiscal challenge, the new government that took office in December 1995 committed itself in the medium term to consolidating public finances, while at the same time pushing ahead with tariff reform. The momentum for further tariff reform was provided by Mauritius's participation in a number of regional trade arrangements that called for the removal of taxes on intraregional trade and the harmonization of external tariffs at lower levels.[24] As tariff reforms progressed, the need to strengthen the domestic taxation of goods and services to offset the loss of revenue from lower tariffs became more and more evident.

In mid-1997, the IMF supported the authorities' request to assist in the design and introduction of a value-added tax (VAT) system to replace the then existing sales tax of 8 percent and the hotel and restaurant tax of 10 percent. The VAT was introduced on September 7, 1998, which was almost six months ahead of its

[23]In 1998, an eighth nonzero rate of 10 percent was introduced.

[24]Mauritius belongs to the Common Market for Eastern and Southern Africa (COMESA), the Regional Integration Facilitation Forum (RIFF, formerly known as the Cross-Border Initiative), and the Southern African Development Community (SADC).

Table 6.2. Tax Revenue, 1997/98–2003/04 [1]

(In percent of GDP)

	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04 Est.
Tax revenue	16.7	16.9	18.1	16.1	15.7	17.4	17.8
Taxes on goods and services	6.4	7.5	8.3	7.6	7.9	9.4	9.6
Of which: value-added tax	...	4.4	5.0	4.7	5.1	6.6	6.8
Taxes on international trade	6.5	5.6	6.2	5.1	4.3	4.4	4.5
Other taxes	3.7	3.7	3.6	3.5	3.5	3.6	3.7

[1] Fiscal year from July to June.

original schedule. While the law implementing the VAT closely maintained its key design features—a comprehensive single-rate tax on goods and services, with very few exemptions—under intense political pressure from the business community and the opposition, revisions were made soon after its enactment that significantly widened the scope of exemptions. In particular, the import and provision of goods and services to the main export sectors, namely the EPZ and the sugar industry, enjoyed preferential treatment. Moreover, the VAT was introduced at the rate of 10 percent, as opposed to the 12 percent that its designers considered necessary to offset revenue loss from past and future import tariff reductions.

Despite these modifications, the performance of the VAT with respect to compliance and revenue generation exceeded its initial expectations. In 1998/99, more than 90 percent of taxpayers filed their returns on time. Revenues from the taxation of goods and services rose from 6.4 percent of GDP in 1997/98 to 8.3 percent of GDP in 1999/2000, the VAT's first full year of implementation (Table 6.2). Also, Mauritius's VAT system is considered highly efficient by international comparison, including comparison to small islands, which by their nature demonstrate high VAT efficiency (see Table 6.3).

However, as the liberalization of import tariffs progressed, revenues from trade taxes continued to decline and reached a low of 4⅓ percent of GDP in 2001/02, down from 6½ percent of GDP in 1997/98. Moreover, the new government that took office in September 2000 embarked on an ambitious program of investing in education and new information technologies, which entailed considerable capital outlays for infrastructure. Between 2000/01 and 2002/03, capital spending and net lending almost tripled, from just under 2 percent of GDP to 5⅔ percent of GDP. Faced with mounting deficits, the new government, which had vigorously opposed the introduction of the VAT in its

Table 6.3. Value-Added Tax Efficiency Ratios

	Mauritius [1]	Sub-Saharan Africa	Asia and Pacific	Americas	European Union [2]	Small Islands
Efficiency ratio [3]	50	27	35	37	38	48
C-efficiency ratio [4]	80	38	58	57	64	83

Sources: Ebrill and others (2001) and IMF staff estimates.
[1] Data for 1999/2000, when the VAT rate was 10 percent.
[2] Including Norway and Switzerland.
[3] Defined as the ratio of VAT revenues to GDP, divided by the VAT rate.
[4] Defined as the ratio of VAT revenues to private consumption, divided by the VAT rate.

days in opposition, decided to raise the VAT rate to 12 percent in July 2001 and again to 15 percent in July 2002. The latter rate increase particularly succeeded in reversing the decline in tax revenues, which rose by 2 percentage points of GDP in 2002/03.

Challenges Ahead

Mauritius faces a number of challenges in the fiscal area. First, growing fiscal imbalances over the past decade have increased public debt to a level that threatens to trigger unfavorable debt dynamics. Second, the need for urgent and credible fiscal consolidation will necessitate difficult choices with regard to boosting revenue collection and realizing sustainable expenditure savings. Finally, the structure and maturity profile of domestic debt will need to be improved in order to minimize the market risk associated with the rollover of government debt.

Debt Sustainability

An analysis of Mauritius's total public debt (government and parastatal entities), which reached the equivalent of 73 percent of GDP at the end of the 2003–04 fiscal year, of which 58 percent of GDP is accounted for by central government debt,[25] reveals that under plausible assumptions fiscal sustainability can be achieved provided that corrective fiscal policies (see Table 6.4), that would bring the fiscal deficit to below 3 percent of GDP by 2006/07 are implemented

[25]The public sector debt, other than central government debt, is constituted by borrowing by public sector corporations such as Air Mauritius, the Central Electricity Board, the Central Water Authority, the State Trading Corporation, and other smaller corporations; this borrowing is mainly in the form of bank loans.

Table 6.4. Public Debt Sustainability Framework, 2003/04–2007/08[1]
(In percent of GDP)

	2003/04 Projected	2004/05 Projected	2005/06 Projected	2006/07 Projected	2007/08 Projected
Baseline scenario					
Primary balance	-1.5	-0.7	0.6	1.8	1.2
Public sector debt	72.8	71.5	69.7	67.0	63.9
Public sector debt assuming lower GDP growth[2]	72.8	78.0	76.4	73.8	70.7
Public sector debt assuming combined shocks[3]	72.8	87.2	84.1	80.2	75.7
Real GDP growth (in percent)	4.4	4.8	3.8	4.0	4.1
Average real interest rate (in percent)	0.5	2.0	2.1	2.7	1.2
No-adjustment scenario					
Primary balance	-1.5	-1.9	-1.7	-1.7	-1.7
Public sector debt	72.8	73.8	74.8	75.7	76.4
Public sector debt assuming lower GDP growth [2]	72.8	84.2	85.6	86.9	86.6
Public sector debt assuming combined shocks[3]	72.8	93.0	92.9	92.6	112.3
Real GDP growth (in percent)	4.4	4.8	3.8	4.0	4.1
Average real interest rate (in percent)	0.5	3.0	3.0	2.8	2.2

Source: IMF (2003b).

[1] Fiscal year from July to June.

[2] Assumes GDP growth falls from its historic average by two standard deviations in 2004/05 and 2005/06.

[3] The assumed shocks are (1) the real interest rate increases from its historic average by two standard deviations in 2004/05 and 2005/06; and (2) the primary balance falls from its historic average by two standard deviations in 2004/05 and 2005/06.

immediately.[26] With such adjustment, the public sector debt would fall from about 73 percent in mid-2004 to close to 64 percent in mid-2008. In addition, the interest charges on government debt, which in 2003/04 absorbed the equivalent of 4 percent of GDP, would gradually decline. However, in the absence of a credible and immediate fiscal adjustment that would be sustained over the medium term, the debt situation could become very worrisome, with the debt-to-GDP ratio increasing further. The debt dynamics would become very vulnerable to shocks, as slower economic growth accompanied by a sudden rise in real interest rates could very quickly result in an unsustainable debt burden,

[26]See Appendix I in IMF (2003b) with an update in the Staff Report for the 2004 Article IV Consultation. For this exercise, fiscal sustainability was defined as a situation whereby, over the medium term, the debt-to-GDP ratio first stabilizes and thereafter starts to fall. The debt simulations were conducted on the estimated total public debt of Mauritius, which included domestic central government debt as well as government and parastatal external debt.

approaching 100 percent of GDP. In particular, an increase in interest rates could not be ruled out, if confidence in the government's resolve to manage its debt problem were weakened.

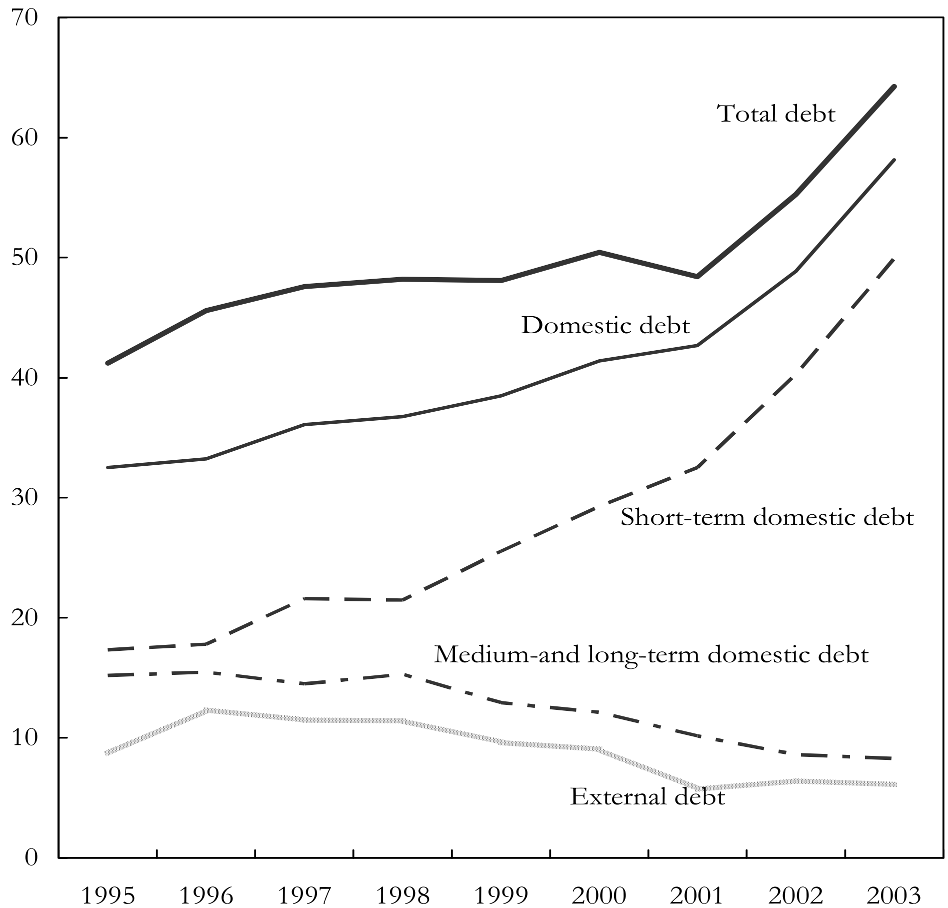
Fiscal Consolidation

Fiscal consolidation will best be achieved through efforts on both the revenue and expenditure sides. *Tax revenue* today is about 2 percent of GDP lower than during the boom years of the late 1980s. Looking ahead, there is room for enhancing tax collections in Mauritius without raising tax rates. In particular, the VAT tax base could be enlarged, exemptions in the area of import duty could be reduced substantially, and taxes on income and profits could be reformed. Based on data for 1999, it has been estimated by an IMF technical assistance staff team that taxes forgone as a result of exemptions on import duties alone amounted to almost 7 percent of GDP and exceeded the import duties that were actually collected. While not all of these exemptions can be removed immediately–diplomatic exemptions, for example, are subject to international conventions–their sheer magnitude provides sufficient room for improvement.

Corporate and personal income tax collections (at about 2½ percent of GDP) are also very low by international standards, especially given Mauritius's level of economic development. The corporate income tax is marred by a narrow base, a varying treatment of investment income, and a range of exemptions and preferential rates. The personal income tax also has a narrow base—the result of a variety of exemptions, allowances, and deductions—with a taxpaying population of less than 60,000 out of a total population of about 1.2 million. About 85 percent of the population who pay personal income tax are salaried employees, while higher-income groups pay little or no taxes, reflecting the generous exemptions, particularly on financial instruments and on fringe benefits, and inadequate enforcement. Corporate and personal income tax collections could be significantly increased if tax incentive schemes were phased out, exemptions and allowances were reduced, and tax administration and enforcement were strengthened. During 2004, tax administration was strengthened through the establishment, by act of parliament, of an independent revenue authority. Among the key priorities of the authority is to increase tax compliance by the self-employed, and to strengthen compliance with the taxation of investment income, which is marred by significant underreporting.

On the *expenditure side*, it would be important to review and prioritize the large capital investment projects that are being undertaken in the areas of education, health, and information technology, to ensure that the pace of their execution does not exert undue pressure on wages and prices. It would also be important to adjust expenditure spending to what can be financed prudently, so as to ensure that an unfavorable debt dynamic does not develop.

Figure 6.1. Central Government Debt, 1995–2003 [1]
(In percent of GDP)



Source: Bank of Mauritius.

[1] End-of-period stock as of June 30.

Debt Management

The rise in the government's fiscal deficit, particularly since the mid-1990s, has contributed to a steady increase in central government debt, not only nominally, but more importantly as a proportion of GDP (Figure 6.1). While external debt has been gradually decreasing from about 12 percent of GDP in 1996 to about 6 percent in 2003, domestic debt has almost doubled during the same period from 33 percent to 58 percent. Particularly noteworthy is the steep rise in short-term domestic debt, even as medium- and long-term domestic government indebtedness has fallen. At mid-2003 only 14 percent of the government debt

Table 6.5. Maturity Composition of Government Debt, 1998/99–2002/03

(As of end of fiscal year, in millions of Mauritian rupees)

	1998/99	1999/00	2000/01	2001/02	2002/03
Long Term					
Treasury certificates	0.0	0.0	0.0	0.0	0.0
Tap loan stocks	0.0	0.0	0.0	0.0	0.0
Development loan stocks	11,340.0	11,590.0	12,710.0	11,807.8	11,408.0
Anonymous bearer bonds	0.0	0.0	0.0	0.0	0.0
8-year savings bonds	0.0	0.0	0.0	0.0	0.0
4-year independence bonds	296.4	0.0	0.0	0.0	0.0
5-year republic bonds	2,078.5	2,078.5	0.0	0.0	0.0
Treasury bearer bonds	0.0	0.0	0.0	0.0	0.0
5-year GOM bonds	0.0	0.0	0.0	0.0	866.3
Sub-total	13,714.9	13,668.5	12,710.0	11,807.8	11,408.0
In percent of GDP	12.9	12.1	10.2	8.6	7.7
Short Term					
Treasury bills (nominal)	24,097.4	32,188.2	41,034.9	55,607.0	74,662.2
1-month	860.4	0.0	0.0	0.0	0.0
3-month	3,299.0	4,018.0	1,582.9	2,051.3	911.9
6-month	4,484.1	6,875.5	3,414.3	3,887.4	3,521.8
12-month	6,339.0	8,153.8	16,070.0	14,807.2	14,700.0
24-month	9,114.9	13,140.9	19,967.7	34,861.1	55,528.5
Advances from BOM	3,161.5	1,089.4	0.0	0.0	0.0
Tax reserve certificates	0.5	0.4	0.4	0.4	0.4
Sub-total	27,259.4	33,278.0	41,035.3	55,607.4	74,662.6
In percent of GDP	25.7	29.5	32.8	40.5	50.1
Total	40,974.3	46,946.5	53,745.3	67,415.2	86,070.6
In percent of GDP	38.6	41.7	43.0	49.1	57.8

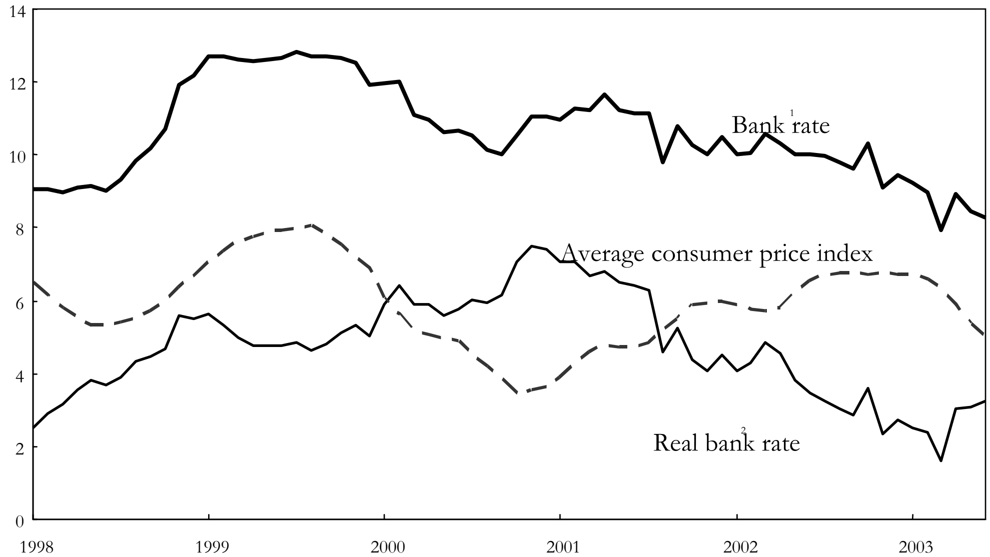
Source: Bank of Mauritius and Ministry of Finance.

Note: BOM=Bank of Mauritius, GOM=Government of Mauritius.

carried a maturity longer than two years, the rest being constituted by treasury bills issued with maturities between 3 and 24 months and by central bank advances (Table 6.5). The significantly larger borrowing requirements that resulted from loose fiscal policies in the run-up to the September 2000 elections and from the new government's spending priorities have contributed to a marked pickup in the growth of domestic indebtedness since 2001/02. Between 2001/02 and 2002/03, interest payments on the public debt increased by almost 40 percent, with interest payments on the total government domestic debt reaching 19.7 percent of total current expenditure in 2002/03.

Figure 6.2. Bank Rate and Inflation, January 1998–June 2003

(In percent)



Source: Bank of Mauritius.
[1]The bank rate is the weighted average of 1-, 6-, and 12-month treasury bill rates.
[2] Discounted by the annual average consumer price inflation rate.

As Figure 6.2 shows, the government's cost of domestic borrowing, as reflected in the bank rate, has remained fairly high over the past five years.[27] While in real terms the bank rate has come down from a peak of about 7½ percent at end-2000 to about 3⅓ percent in mid-2003, the decline has been mainly attributable to a rise in average consumer price inflation, and only marginally to a fall in nominal interest rates, despite significant declines in nominal interest rates during this period in industrial economies.

The level and underlying trend in central government indebtedness is a challenge that needs to be addressed with determination. The rapid rise in domestic debt and the growing reliance on shorter-maturity government securities increase the so-called rollover risk. This is the risk that an unfavorable swing in market sentiment (specifically the private sector's willingness to hold Mauritian government obligations) could lead to a sudden and large increase in the cost of

[27]The Bank of Mauritius's bank rate is the weighted average of 1-, 6-, and 12-month treasury bill rates. It is used for central bank advances to the government.

Table 6.6. Savings and Investment, 2000/01–2003/04

(In percent of GDP)

	2000/01	2001/02	2002/03	2003/04
Gross national savings	26.6	26.7	25.5	27.0
Gross domestic investment	23.2	21.3	22.9	24.3
External current account balance	3.4	5.4	2.6	2.6

Sources: Mauritian authorities and IMF staff estimates.

borrowing, and even to the inability of the government to raise the needed funds to repay the maturing debt obligations. In 2004/05 the amount of maturing treasury bills is extremely high, equivalent to 16.4 percent of GDP.

This point was highlighted as a source of concern in the recently published Financial System Stability Assessment (FSSA) of Mauritius, which was jointly prepared by the IMF and the World Bank.[28] The FSSA recommended that the authorities improve the strategic planning, organization, and operation of public debt to better manage the significant rollover risk. The authorities were advised to seize the fortuitous opportunity of an unfulfilled demand for longer-term government securities, particularly among institutional investors such as pension funds and insurance companies, to extend the maturity structure of domestic debt. While steps in this direction have been taken in 2003–04 with the issuance of four series of Five-Year Government of Mauritius bonds between September 2003 and June 2004, the total amount issued of MUR 2 billion compares with almost MUR 40 billion of maturing treasury bills in that fiscal year. Extending the maturity of the outstanding government debt will therefore require a protracted effort.

Mauritius, unlike a number of other emerging markets, is somewhat fortunate in that it is shielded from the vagaries of international capital markets, thanks to its remarkably robust national savings rate. This could be seen as a mitigating factor in the otherwise difficult debt situation. Over the past three years, gross national savings have averaged about 27 percent of GDP. During the same period, gross domestic investment averaged about 22½ percent of GDP. As a result, Mauritius has run a healthy current account surplus of about 3½ percent of GDP (Table 6.6).

[28]See the chapter on " Vulnerabilities Facing the Financial System" in IMF (2003a).

Table 6.7. Holders of Domestic Debt, 2002
(In percent of total domestic debt)

Residents	99.5
Bank of Mauritius	1.6
Commercial banks	39.5
Institutional investors	51.3
Others	7.1
Nonresidents	0.5
Total	100.0

Source: IMF (2003b, p. 29).

Consistent with Mauritius's relatively high savings rate, government domestic debt is held primarily by residents, and only about 0.5 percent is held by nonresidents (Table 6.7). However, Mauritius has an open capital account, and nominal interest rates on its government debt have maintained a substantial positive margin over U.S. treasuries. Meanwhile, the exchange rate of the Mauritian rupee vis-à-vis the U.S. dollar has remained fairly stable. In such an environment, it is quite likely that Mauritius would have attracted short-term foreign capital inflows, which would be seeking to benefit from the interest rate differential. These would be rather difficult to identify, especially if they were placed in term deposits at banks, which would in turn invest in domestic government securities.