

4 Policy and Procedural Regime for SMEs

4.1 Introduction

This chapter analyses the nature of macroeconomic, trade and industrial policies in Mauritius pertaining to the fostering of competitiveness in individual SMEs and SME clusters. For convenience, the relevant policy regime issues are considered under three broad headings: policy impediments, procedural impediments and infrastructure impediments. The first concerns incentive policies that affect the relative attractiveness of domestic market production and exporting, the second concerns bureaucratic procedures/regulations that affect transaction costs involved in small enterprise start-up and operation, and the third affects small enterprise production costs and country reputation. The aim of the chapter is not to be exhaustive but to focus on those aspects of the policy regime, which in the Commonwealth mission's view, pose the biggest constraints to small firms.

4.2 Policies and Procedures: SME Views

In terms of its trade, industrial and macroeconomic regime; Mauritius is an outlier from other African developing economies. Unlike many African developing economies, the country did not subscribe to the prevailing orthodoxy of inward-oriented, state dominated development strategies of the 1960s and 1970s that emphasised stringent import substitution coupled with heavy state intervention in the economy. Instead in the 1970s, Mauritius followed a mixed trade policy of import substitution coupled with incentives for exports through the Export Processing Zone (EPZ).¹ These two trade regimes co-existed, influencing enterprises producing for the small home market and those producing for export. Furthermore to its credit, Mauritius began trade liberalisation in 1983 as a part of its 1981 structural adjustment loan agreement with the World Bank.

Three distinct phases of trade liberalisation and industrial reforms can be identified since the mid-1980s, each with a different rate of reform and coverage.

- The first episode, between 1983-85, consisted of the rapid elimination of most quantitative restrictions on imports and their replacement by tariffs. Existing incentives for exporting – granted via the EPZ since 1970 – were maintained. Repeated attempts were made to attract export-oriented foreign investment. Moreover, macroeconomic stability in the form of low inflation

¹ Woldekidan (1994), Milner and McKay (1996) and Lall and Wignaraja (1998).

and competitive interest and exchange rates became an explicit policy objective. Despite these early market-oriented reforms, the domestic manufacturing sector remained relatively highly protected and the private sector was restricted by a plethora of bureaucratic regulations.

- The second, between 1986-1993, tried to gradually reduce the dispersion of effective protection among industries and to promote exports more vigorously by providing exporters with overseas marketing support, preferential interest rates on development loans and tax concessions. Export and foreign investment promotion was greatly strengthened by the creation of a specialised agency, the Mauritius Export Development and Investment Authority (MEDIA) in 1985. Emphasis was also placed on maintaining macroeconomic and price stability. There were also useful cuts in bureaucratic procedures and regulations affecting imports, exports, foreign exchange allocations etc. The net result of these reforms was that the economy became more outward-oriented and private-sector focussed than in the past.
- The third episode, from 1994 to date, attempted to cut protection further by reducing import tariffs and attempting to develop new areas of comparative advantage. Although the government reduced the number of tariff bands and made a cut in maximum import tariff rates in 1995, no specific targets seem to have been set to achieve a low uniform rate of effective protection. The development of new exports was recognised as a pressing issue and new institutions were established to achieve this end. In particular, the Mauritius Productivity and Competitiveness Council was conceived in 1998 to provide strategic guidance in fostering new skill-intensive exports. Plans were drawn up for a separate Board of Investment to facilitate the entry of high skill inward investment as well to streamline approval procedures. Corporate taxation was reduced for EPZ firms.

The results from the survey of 34 randomly selected small and medium enterprises (SMEs) in the garments, printing and information technology (IT) sectors helps identify specific policy areas, which require immediate reform to accelerate SME competitiveness in Mauritius.² The firm-level interviews indicate that the trade and industrial reforms (implemented in 1986-1993 and accelerated from the mid-1990s onwards) have led to considerable improvements in the business environment for the private sector – including SMEs. The trade and industrial regime in Mauritius in 1998/1999 is much more liberal than in the past and is one of the most open and market-friendly in Africa. The country has emphasised export promotion policies and given incentives to expand exports. Many enterprises detect increasing sensitivity and responsiveness of the Government to the concerns of the small firm sector. These are creditable achievements

² These were surveyed through postal questionnaires and face-to-face interviews. Of these, about 25 enterprises provided quantitative data for this chapter. The enterprise survey is described in Appendix

even by the standards of many middle-income Asian developing economies.

Nevertheless, the SME survey showed that there are some important policy and procedural impediments, which hamper the growth and competitiveness of small firms in 1998/1999. The aggregate results for 25 small enterprises are shown in Figure 4.1. The sample firms scored the major obstacles on a scale of 1 to 5 according to their degree of negative impact on business. The enterprise scores on a particular variable were then summed-up and averaged for the whole sample. A score of 1 is regarded as the least negative impact and 5 as most negative impact.

The survey suggests that on average small firms believe that macroeconomic issues – high interest rates, high taxation/VAT level concerns and (to a lesser extent) exchange rates movements – are among the strongest obstacles to operating their business and moving into exports. Conversely, however, policy uncertainty (in the sense of unpredictable, and non-transparent implementation of government policies and rules that affect a small firm's daily business) does not generally rank as a major issue.

The concern with high interest rates is also closely related to an important financial sector problem for small firms: a lack of access to bank finance. Interestingly, our subsequent interviews with enterprises suggests there is little difference in the conservative approach of private commercial banks and the state-owned Development Bank of Mauritius (DBM) as suppliers of short-term working capital (or long-term investment finance) to small firms.

Following these macroeconomic and financial sector concerns, small firms report being badly impaired by some cumbersome bureaucratic regulations and procedures on business start-up and operation. In this regard, procedures affecting access to imported raw materials and equipment show up as a significant impediment (see Section 4.3.2.1). Other bureaucracy is also mentioned as a problem. Disaggregation of the survey data suggested that this concern is largely due to rules governing small business start-up (see Section 4.4.2). With the exception of a few persistent impediments, firms suggest that the degree of bureaucratic control of business activities has declined over time.

In the area of labour market impediments, the main concern arises from strict rules governing the hiring foreign workers and technicians. Other issues impairing labour market flexibility include the level of the minimum wage and stringent regulations on laying-off workers.

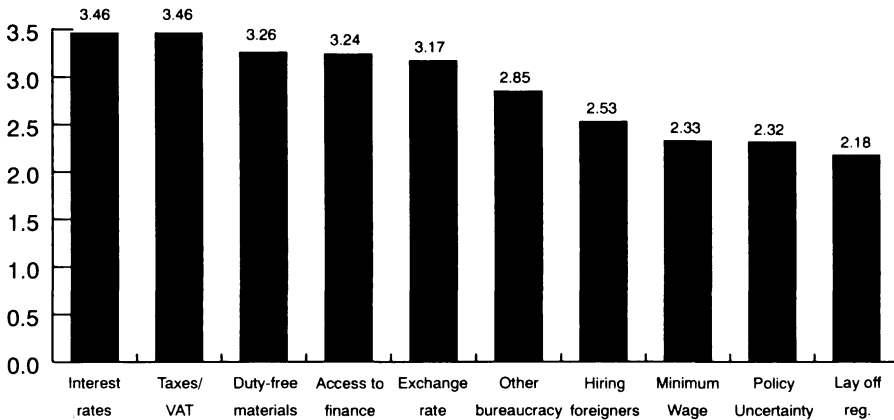
Apart from the principal concerns listed above, a few small firms also pointed to dumping of goods by EPZ firms on the local market, harassment by customs officials and the limited size of the local market.

It is interesting to note that some of our findings were echoed in a mid-1998 May survey of 55 SMEs commissioned by SMIDO and carried out by a local accounting firm. The SME survey by De Chazal Du Mee (1998) highlighted the bureaucratic problems experienced in small enterprise business start-up and operation, fears about the administrative burden of VAT introduction and the lack of duty exemption on equipment purchase and raw materials. However, the De Chazal Du Mee survey shed no light on impediments to small firms stemming from the lack of policy reform and

macroeconomic stability or labour market impediments.

As in the case of all firm-level surveys, the results of our survey should not be regarded as definitive indicators of key issues of small enterprise development in Mauritius. Rather it provides evidence of how the business environment appears from the important but subjective perspective of the private sector. To obtain a wider perspective on these issues, the Commonwealth mission spoke to government officials, economists, representatives of financial institutions and business associations, and visited enterprises.

Fig 4.1: Policy Obstacles to SMEs



4.3 Selected Policy Impediments

4.3.1 TARIFF STRUCTURE

As we have seen, Mauritius has been gradually moving from a mixed trade policy of import substitution coupled with incentives for exports through the Export Processing Zone (EPZ) in the 1970s to a more open, export-oriented economy in the 1980s and 1990s. Several episodes of import liberalisation have been attempted – last actions were in 1995 when the number of tariff bands were reduced and maximum import tariff rates were cut. By the mid-1990s, substantial progress was made in reducing tariffs and non-tariff barriers to imports in Mauritius. One indication of greater openness is that the average tariff for manufacturing fell from 86.2% in 1980 to 30.1% in 1994.³

The main changes include: quantitative restrictions have been mostly eliminated and the few that remain are largely on health, sanitary and security grounds; there are few

³ WTO (1996); Lall and Wignaraja (1998)

import prohibitions (with the exception of commodities such as second hand motor vehicle spares and explosives); the level of nominal tariffs has fallen as well as its dispersion (the number of rate bands were cut from 60 to 8 and the maximum rates were reduced); there are no local content programmes to assist local suppliers; and public procurement policies are minimal. In July 1998, the country had an 8 band tariff system as follows: 0%, 5%, 15%, 20%, 30%, 40%, 55 & 75%, and 80 & 100%. Despite this progress, the process of tariff reform seems to have faltered and remains far from complete in achieving the desirable goal of a low uniform rate of effective protection. Far more serious is that the Government seems not to have any plans for further tariff reductions.

At present, some industrial sectors are still quite highly protected by tariff barriers to trade while others are completely open. Table 4.1 provides the latest tariff rates for finished goods in selected manufacturing and service activities: software, information technology, printing and textiles receive no tariff protection; metal products and machinery receive medium-levels of protection; and clothing, food, footwear and furniture receive high levels of tariff protection. Chapter 2 (Table 2.4) illustrates the SME intensity of manufacturing establishments by industrial branch. Some sectors with a large population of SMEs (including food products, footwear and furniture) are very highly protected while the remainder receives negligible protection.

Table 4.1: Tariffs on Finished Goods, July 1998

Item	Tariff Rate
Food products	55-80%
Textiles (fabrics)	Mostly 0%
Clothing	80%
Footwear	30% or 80%
Furniture	80%
Printing	0%
Metal Products (iron and steel)	20-55%
Machinery	15-40%
Information technology	0%
Software	0%

Source: Ministry of Finance Database, August 1998.

In general, international experience points to free trade as superior to protection because of better resource allocation according to comparative advantage; the realisation of economies of scale; access to new technologies, skills and markets; and the spur of competition to cut costs, improve productivity and achieve technical efficiency. Moderate protection is sometimes justified on “infant industry” grounds by the need for industrial latecomers to gain sufficient breathing space to learn to absorb new and

complex technologies. However, the existing pattern of protection granted to particular activities in Mauritius does not seem to escalate according to skill and technology intensity (and hence learning costs and infant industry grounds).⁴ Nor does it relate to increasing presence of small firms, which may have less industrial experience relative to large firms and multinationals. As such, there seems little economic rationale for the existing pattern of tariff protection. In addition, Mauritian membership of the WTO means that the country has signed up for sweeping import liberalisation in accordance with the Uruguay Round Agreements and a reduction in subsidy-based methods of export promotion. Thus, further liberalisation is the optimal policy option for SME growth and competitiveness.

4.3.2 EXPORT PROMOTION

In the short term, to cope with the situation of incomplete import liberalisation in the short-term and to reduce the anti-export bias of the trade regime, the Government of Mauritius provides some general measures to assist its exporters. The principal means of support which affect SMEs are:

- providing export-oriented firms with access to raw materials and equipment at world prices for export production;
- providing overseas marketing support for actual and potential SME exporters.

4.3.2.1. Access to Duty Free Imported Inputs

Under the scheme, EPZ firms can import a list of goods exempt from duties and sales taxes while non-EPZ firms are entitled to a duty drawback on the proportion of imported inputs used in making exports. The refunds to non-EPZ firms must be claimed from Customs within a six-month period of importing. This situation can pose impediments for sub-contractors and suppliers in general. The Government is aware of this situation and is attempting to alleviate some of the problems this has caused. Nevertheless, substantial problems remain. These can be illustrated by reference to three possible cases:

(1) *An EPZ textile and clothing firm is in a Cut, Making and Trimming (CMT) sub-contracting arrangement with an SME.* A practical route for the SME to gain duty-free access to imported inputs is by obtaining an EPZ certificate. Even in textiles and clothing where CMT arrangements are common, firm-level interviews suggested that approval for an EPZ certificate could take between 1-2 months from submission of the paperwork to the relevant administrative committee. Although approval times have improved significantly (down from 3-6 months previously), the delay and element of administrative discretion causes unnecessary business uncertainty for

⁴ For instance, metal products, machinery and printing, usually regarded as medium to high skill activities, receive modest or no protection while simple activities – like food products, footwear and furniture – are very well protected.

SMEs and possible cancellation of orders. The firm-level interviews in industrial sectors with no CMT arrangements, further suggested that approval times may be longer than for textiles and EPZ certificates may be harder to obtain for SMEs. As the Mauritian industrial base grows and diversifies, this may pose a bottleneck to SME expansion.

(2) *An EPZ firm makes an ad hoc order to an SME and provides it with the raw materials duty-free.* The problem is wastage provision. Factory production usually involves an element of raw material wastage, which often cannot be accounted for. In order to ensure smooth functioning of duty-free raw material access, governments normally provide for a wastage ratio in a given order. Such wastage ratios are thought to exist for textiles and clothing but not for other industries. In turn, this can penalise ad hoc sub-contracting and cluster formation in new areas.

(3) *An EPZ firm makes an order to a non-EPZ SME.* Here the non-EPZ firm is entitled to a duty drawback on the proportion of imported inputs used in making exports. However, this process of re-claiming duty drawback is subject to variable administrative delays. A recent study found that processing times could vary between 4-24 weeks in Mauritius in comparison with only 2 weeks in Sri Lanka and 2-6 weeks in Indonesia.⁵ This constraint discourages non-EPZ SMEs from the benefits of engaging in indirect exporting activities and forming clusters.

The analysis suggests that urgent action should be taken to reduce the transactions costs to small business in procedures affecting the duty-free access to imported inputs. This is one area where relatively painless reform can have immediate payoffs to SME growth. Streamlining, using paperless communications systems, and setting maximum processing times would form elements of a coherent solution. Raw material wastage provisions should also be extended to all potential export sectors to facilitate intermittent sub-contracting and intra-firm relations.

4.3.2.2 Overseas Marketing Support

In the past public policy did not seem to pay much attention to the overseas marketing needs of SMEs in Mauritius. However, this has changed since the mid-1990s. The Government has encouraged MEDIA and SMIDO to work more closely to identify and develop capable SMEs to become export-oriented. At present, a variety of MEDIA's overseas marketing services have been actively targeted to encourage SMEs to export (particularly to African markets such as Mozambique). The full range of MEDIA's services are available to SMEs including buyer-seller meets, contact promotion programmes, one-to-one meetings, industry-level market surveys and general and specific trade information. Some of these are provided free of charge to SMEs and others are part-subsidised. These services and enterprise viewpoints on them are

⁵ Lall and Wignaraja (1998), p. 63.

examined in more detail in Chapter 5 (Section 5.5).

Most unfortunately, no aggregate data was available on the beneficiaries of MEDIA's services over time by firm size, industry membership and export history. During our interviews, MEDIA officials suggested that, historically the take-up rate of overseas marketing services among SMEs has been quite low. MEDIA estimates that only about 40-50 SMEs on SMIDO's list can meet the rigorous demands of overseas markets (in terms of price, quality and delivery deadlines) and even fewer have approached MEDIA for assistance during the last year. In our view, this may be owing to several inter-related reasons:

- MEDIA and SMIDO have not sufficiently publicised these services to potential SME exporters (and sought them out for tailor-made assistance);
- MEDIA has too many responsibilities (export promotion, investment promotion and managing industrial estates) and has insufficient time to devote to the specialised needs of SMEs, particularly first time exporters;
- MEDIA does not have adequate financial and human resources to allocate to the expensive business of overseas promotion of SMEs;
- The risky, costly business of producing for export markets deters individual SMEs from participating.
- SMEs have weak manufacturing capabilities by international standards and are thus forced to produce for the captive home market.

Without further study of this issue, it is extremely difficult to say which of these is the most relevant explanation. However, all of them point to the pressing need to enhance the overseas marketing capabilities of individual and clusters of SMEs, to devote more resources to doing this, and to provide more focussed institutional support. Several policy options seem to present themselves: to create an export development fund for individual and clusters of SMEs, to refocus the role of MEDIA to support them and to encourage the entry of foreign marketing agents around clusters.

The refocusing of MEDIA's role is currently in progress. A consultancy study was recently undertaken on MEDIA's effectiveness by International Development Ireland Ltd.⁶ Recently the Government announced its intention to create a specialised Board of Investment to facilitate inward investment. In effect, this means detaching the investment promotion function from MEDIA. Similarly, the industrial estates of MEDIA and DBM could be hived off to the private sector to create an export development fund for SMEs marketing efforts. Large business houses in Mauritius already run industrial estates and the private sector could profitably expand in this direction. Some of the proceeds from future privatisation of public enterprises could be added to increase the size of the export development fund. In contrast with other initiatives, however, little policy attention has been given to date to attracting private sector marketing agents for specific clusters.

⁶ Murphy and Suttle (1998).

4.3.3 EXCHANGE RATE MANAGEMENT

Between 1983-1993, Mauritius pursued a managed exchange rate policy under which the Bank of Mauritius intervened on the foreign exchange market to smooth out irregular fluctuations of its currency. An undisclosed basket of currencies of major trading partners is used to determine the value of the Mauritius rupee. The managed float was accompanied by foreign exchange controls. In 1994, foreign exchange controls were fully liberalised. The Exchange Control Act was suspended and free movement of foreign exchange was permitted. Moreover, the Bank of Mauritius stopped setting rates and the rupee was floated with the creation of a new inter-bank foreign exchange market.

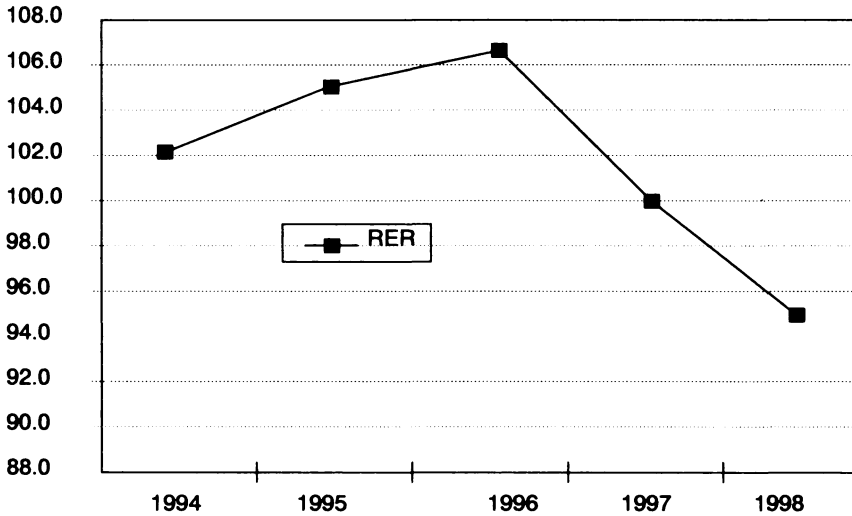
In general, private sector analysts have been mixed about the behaviour of the Mauritius currency since the 1994 liberalisation and its influence on exports. One recent report argued that “the rapid depreciation of the rupee over the last year against the major international currencies has certainly lent support to our export industries: but at the same time it has given a blow to our aspirations of becoming a regional and financial business centre” (MCCI, 1998, p. 27). Another recent report argued that “the rupee maintained its downward trend, depreciating sharply vis-à-vis most major currencies ...It is certainly true that Mauritius has a limited capacity to influence international fluctuations. However, it is noteworthy that owing to the inelastic nature of our imports, such a fluctuating rupee is already impacting negatively on our balance of trade” (MEF, 1988, p. 38).

MCCI (1998) and MEF (1998) have focussed on nominal exchange rate changes in their analysis. For our purposes, however, the relevant concept is the real effective exchange rate, which takes into account nominal exchange rates as well as inflation rates between Mauritius and its principal trading partners. Figure 4.2 shows our estimates for the trade weighted real effective exchange rate for Mauritius vis-à-vis its three major trading partners – UK, France and USA – for 1994-1998 using IMF data with 1990 as the base year.⁷ A fall in the index indicates a real effective exchange rate depreciation and a rise an appreciation. Overall, the rupee depreciated by 6.8% against its major trading partners over 1994-1998. Disaggregation of the data indicates that the rupee appreciated by 4.3% during 1994-1996 and then depreciated sharply by 10.6% during 1996-1998.

In the aftermath of the 1994 liberalisation of the foreign exchange market, the Mauritian real effective exchange rate behaviour was worrying as the country is reliant on labour-cost sensitive export industries like textiles, clothing and footwear. Although a period of sustained real exchange rate appreciation can spur exporters to invest in new equipment and upgrade quality, on balance it seems to have imposed penalties on price sensitive items operating at low margins. In this regard, the real appreciation seems to have negatively affected both established SMEs trying to compete in overseas

⁷ Figure 4.2 uses the method normally employed by the IMF to determine trading partner weighted real effective exchange rates for Mauritius. The data are from 1994 up to end-June 1998. Yearly average nominal exchange rates are used along with the consumer price index to derive relative prices. Mauritius's three major trading partners are felt to be relevant for the analysis as they accounted for 66% of total exports in 1997. Germany is excluded because it only accounts for a small share of Mauritian exports. Adjusted destination of exports data for 1997 gave the trade weights which were: UK (48.9%), France (29.0%) and USA (22.1%).

Fig 4.2: Trade-Weighted RER, 1994-98



markets and new SME exporters trying to venture out for the first time. Breaking into export markets is a costly and risky undertaking and adverse exchange rate movement adds to uncertainty about future profit streams. In some cases, this may have acted as a net disincentive to exporting and forced a concentration on the home market. This trend was corrected in 1996 and a real depreciation ensured. The significant improvement in incentives to exports is a positive development as far as export-oriented firms in general (and SMEs in particular) are concerned.⁸ Experience elsewhere indicates that exports normally respond with a time-lag of one or two years before an improvement occurs in the real exchange rate (as resources take time to shift away from home market based activities into exports). The future challenge for Mauritius is to ensure a period of sustained stability on the foreign exchanges based on a mildly depreciated real exchange rate *vis-à-vis* its main trading partners.

4.3.4. ACCESS TO FINANCE

The Mauritian financial system is reasonably well-developed, liberal and market-oriented. Capital market imperfections in the form of financial repression, arbitrary allocation of credit and other interventions in the allocation of resources are minimal by developing country standards. The government seems to adhere to a liberal approach

⁸ Some analysts in Mauritius argue that a depreciated real exchange rate makes imports more expensive and that this causes adjustment problems to highly import dependent local industries. However, this is typically a short-term issue and a depreciated real exchange rate is a net benefit to the economy. In the medium-term, a competitive real exchange rate provides incentives for import substitution in raw material and component industries and stimulates the formation of industrial clusters and networks in industries like textiles and clothing.

to interest rate determination and rates are responsive to market forces. The financial system is properly regulated by a rejuvenated central bank, the Bank of Mauritius and overly strict rules and procedures do not hamper foreign banks. There are several sources of industrial finance including a network of domestic and offshore financial institutions as well as a fairly active stock market.

The growing offshore financial sector is outward-oriented and typically does not do business with local SMEs. The burden of servicing the credit needs of SMEs falls on the domestic financial sector which consists of about 10 commercial banks (local and foreign-owned), a leasing company and the Development Bank of Mauritius (DBM).⁹ The Development Bank of Mauritius – whose operations are examined in more detail in Chapter 5 (Section 5.7) – is the principal public sector provider of concessionary credit to the SME sector. Unfortunately few local SMEs appear to access the stock market or the international capital market which may offer cheaper and more flexible financing than the domestic sector. The country's status as a middle-income country also excludes its firms from accessing the "soft term" small and medium enterprise lending windows of multilateral organisations like the World Bank and the African Development Bank. As in other developing countries, there are many informal sources of finance for small firms in Mauritius such as moneylenders, pawnbrokers, traders, equipment suppliers, friends and relatives.

Despite a liberal financial policy environment and positive institutional developments, there are several problems with industrial finance for SMEs in Mauritius. The Commonwealth mission's interviews with small firms and the Small Scale Entrepreneurs Association of Mauritius (SSEAM) revealed small firms attitudes to (and involvement with) their banks. Some of these issues have been documented in the De Chazal Du Mee (1998) survey of small firms and the SMIDO organised conference on SMEs in 1996 (SMIDO, 1996).

⁹ Bank of Mauritius (1997) and DBM (1997).

Table 4.2 Commercial Bank Loans and Lending Rates to Small Scale Industries (SSI) , 1995-1997 (a)

Year	A	B	C	D	E
	Commercial bank Credit to SSI (US\$ million)	Total commercial bank credit to private sector (\$ million ¹⁰)	A as a % of B	Nominal SSI Lending Rate (%)	Real SSI Lending Rate (%) (b)
1995 June	25.4	1751	1.5	11 to 20	4.9 to 13.9
1996 June	13.9	1605	0.9	11.5 to 20	5.7 to 14.2
1997 June	10.8	1794	0.6	11.5 to 20	3.6 to 12.1
1998 June	10.2	2041.2	0.5	11.5 to 19.5	6.1 to 14.1

Notes: (a) Data refer to SSI engaged in manufacturing, services and trade.
(b) Nominal interest rate adjusted for inflation.
Source: Calculated from Bank of Mauritius (1997 and 1998).

First, on the whole small firms complain about a dearth of commercial bank credit that severely impedes SME start-up, operation, expansion and exporting in Mauritius. This view is borne out by the available data. Table 4.2 provides the latest available information on commercial bank lending to all SMEs (short and long term loans) and the total private sector during mid-1995 to mid-1998. Bank credit to the private sector declined slightly between mid-1995 and mid-1996 but recovered thereafter to exceed \$ 2 billion by mid-1998. However, SME credit more than halved from a negligible \$25.4 million in mid-1995 to only \$10.2 million in mid-1998 (or equivalently from 1.5 % of total bank lending to the private sector to 0.5%). The mid-1998 figure for SME credit translates into an average commercial bank loan size of only \$396 to each SME in the country (this is based on the projection in Chapter 2 of an SME and micro-enterprise population of 25,761 establishments). The net result is that SMEs are dependent on non-bank sources for the bulk of their capital requirements.¹¹

Second, firms argue that interest rates are very high which, in turn, raises the cost of conducting business and reduces competitiveness. Table 4.2 also shows nominal and real interest rates on commercial bank lending since mid-1995. During the short period, nominal interest rates have been stable, but on the high side (ranging from 11 to 20%). Far more serious is that real interest rates have been high. At the top end of real interest rates, figures have ranged from 12.1% to 14.2%. Our interviews with firms in textiles, printing and IT suggested that the most SMEs were paying at the higher end of real interest rates rather than at the lower end. These are very high by international standards and have constituted a serious drag on SME activity, especially by firms that were

¹⁰ Total commercial bank credit to the private sector includes credit to both (formerly) priority and non-priority sectors and credit in the form of investments.

¹¹ The De Chazal Du Mee (1998) Survey of SMEs found that all firms relied heavily on their own savings, some also obtained loans from friends and relatives and used leasing of equipment and motor vehicles.

unable to tap lower interest sources.¹² The sample SMEs also complained that other non-interest related bank charges were high and few firms saw bank charges as providing good value for money.

Third, firms argue that the other terms of bank loans (repayment periods, guarantees and collateral requirements) were excessive. It indicates that banks are less willing to lend to high-risk/high-return borrowers (reflecting a conservative approach to SME lending by banks). For instance, the De Chazal du Mee (1998) survey reported that 55% of SMEs want few guarantees and 20% want longer repayment periods. Our interviews with SMEs further suggested that there are cases where banks only lent against collateral or that the amount of collateral required to cover a loan is excessive. Moreover, there is a tendency for banks to close down a business “too early” if it gets into difficulties. The nature of banking statistics is such, however, that no hard data is available to back up these claims.

Fourth, firms argue that banks have an “attitude problem” and do not understand small firms. There is little evidence of equity and loan participation by banks, or of systematic provision of business advice by the lender. With notable exceptions, the relationship between banks and SMEs is characterised as an arms-length, detached relationship rather than an intense financial and advisory partnership. The experience of developed economies like the UK suggests that an intense financial and advisory partnership has mutual benefits for borrower and lender alike.¹³ For the small business sector many UK banks have appointed specialist advisors in their branches, have implemented extensive programmes of staff training, have sought to improve their communications, and more loan officers have taken to visiting clients in their premises than was the case in the past.

The difficulties faced by SMEs in accessing bank finance and the higher interest rates charged by banks are classic examples of capital market imperfections, which stem from banks and smaller firms having different types of information (the “asymmetric information” problem).¹⁴ Thus, there is a tendency for “large firm bias” in credit allocation by the banking sector. The Government of Mauritius is aware of the problems faced by small firms in accessing bank finance and two proposals were under consideration at the time of the Commonwealth mission:

- Establishment of the Venture Capital Fund to provide long-term risk sharing capital for SMEs and the Mutual Guarantee Fund to act as a guarantor for bank loans to SMEs with insufficient collateral. A detailed plan of action for

¹² According to World Bank (1998a), in 1996 Mauritian real interest rates for commercial bank lending were 14% compared with Bangladesh (8%), Sri Lanka (4.8%), India (8.4%), Malaysia (0.8%), Singapore (4.8%), UK (2.8%) and Germany (8.9%). Only African competitors like South Africa (10.3%), Zimbabwe (9.9%) and Madagascar (9.8%) were approaching Mauritian levels. The World Bank defines real interest rates as nominal lending rates adjusted for inflation using the GDP deflator.

¹³ See Story (1994) and DTI (1996) for an analysis of the UK experience in this regard.

¹⁴ See Story (1994) for a detailed explanation. In brief – the owner of a small firm has more/better information about the firm than the bank. The existence of asymmetric information, when this favours the SME owner makes the bank more wary of lending to this type of firm. If it does lend, the bank would charge higher interest rates, demand more collateral and have shorter repayment periods than for larger more established firms.

both institutions is contained in a consultancy report prepared by Global Financial Services Ltd (Global Financial Services, undated).

- Creation of a National Entrepreneurs Bank to provide direct financial support to SMEs. This was announced in the 1998 Budget of the Minister of Finance (but no information was available to the Commonwealth mission on its mandate, lending portfolio and operational procedures).

In our view, the Venture Capital/Mutual Guarantee Funds are both valuable institutional additions to SME financial sources and will spur the financial market to deepen and develop in Mauritius. The experience of new financial institutions and services can also be exported as a consultancy service to the African region and other small states. The lack of an intermediary guarantor for SME bank lending is a pressing issue and its creation should receive the highest priority because of its ready impact on the supply of SME finance. Venture capital may take longer to influence the supply of SME finance and may not be available to most SMEs or micro-enterprises. Experience suggests that venture capital is particularly relevant to the high-tech enterprise start-up and growth that is absent in Mauritius. Most of the SME population in Mauritius, however, is confined to the low technology end of manufacturing and services.

Depending on how it is set up, the new National Entrepreneurs Bank is likely to increase the supply of SME finance but, in this market, it will take time for its impact to be felt. Other public action would have a more immediate effect on the supply of SME finance. The state-owned Development Bank of Mauritius (DBM) has long been a concessionary lender to SMEs. It has many strengths including committed staff, a new chief executive, an established brand and a reasonably sized loan portfolio. The DBM's SME lending experience is analysed in Chapter 5 (Section 5.7). Suffice to say, that our enterprise survey and the De Chazal Du Mee (1998) survey suggest that SMEs are dissatisfied with the cumbersome, bureaucratic nature of DBM loan procedures.¹⁵ During our interviews, DBM officials suggested that delays occur because many SMEs do not know how to fill in the loan forms (nor can they provide adequate supporting documents at the onset). The DBM also suggested that as a public sector institution, it has to adopt a cautious lending posture because it is dealing with public money, subject to public sector rules and regulations. The short span of fieldwork in Mauritius meant that the Commonwealth mission was unable to verify either set of claims. However, these claims and counter claims suggest that there may be weaknesses in the public sector provision of concessionary finance to SMEs.

This points to commercialisation of the DBM to improve operational and loan processing efficiency (see Chapter 6 for the details). Our suggestion for the DBM is to remain in the public sector but under different management. A rejuvenated, business-like DBM could play a lead role in promoting exports from individual and clusters of

¹⁵ In these surveys a high proportion of enterprises claimed that they have never applied for a DBM loan usually because of lengthy procedures (it can take between 4-6 weeks for processing of loan applications) and a small number said that their applications had been rejected owing to a lack of guarantees.

SMEs. A second option is to stimulate the creation of credit unions in SME associations. This would permit access to small but significant amounts of credit at difficult times.

4.3.5. OTHER POLICIES TO FOSTER LOCAL LINKAGES AND CLUSTERS

Little is known about the nature of intra-firm linkages and clusters in Mauritius. On the issue of supplier linkages, an earlier study undertaken by the Commonwealth Secretariat found that “the local supply base in key industries is weak. As expected, the average local content is high in natural resource based industries like food products (26-50%) but very low in others like textiles and garments (1-25%), electronics (1-10%), and chemicals (1-10%)” (Lall and Wignaraja, 1998, p. 107). The study also found that “there is some sub-contracting activity in the sample. Of the 34 sample firms, about one third seemed to undertake intermittent sub-contracting to SMEs. In textiles and garments, sub-contracting included activities like dyeing of fabrics, embroidery and sewing. In electronics, it included the manufacture of some parts... in food products, some firms get their labels printed locally” (Lall and Wignaraja, 1998, p. 107). As Chapter 5 shows, the enterprise survey (covering clothing, printing and IT) in the present study confirms the findings of Lall and Wignaraja (1998) that the extent of intra-firm linkages is limited in the Mauritian manufacturing sector.

The few intra-firm linkages between large local firms and SMEs seem to have occurred spontaneously in response to market forces. Until the late 1990s, there were no government policies to encourage sub-contracting, supplier relations or other forms of intra-firm linkages in the Mauritian industrial sector. Import protection based measures like local content rules and public procurement – which were common in East Asia in the 1960s and 1970s to stimulate the local supply industry – are absent in Mauritius. So too are UK or Singapore-style technological upgrading schemes to develop SMEs into efficient industrial suppliers for multinationals/large local conglomerates.

The first time in public policy that some emphasis was given to the issue of intra-firm linkages was in September 1997. A sub-contracting exchange (SUBEX-M) was established with technical assistance from UNIDO along the lines of a model implemented by the UN agency in other developing countries. The Government of Mauritius provided the bulk of the funding for the Mauritian SUBEX but there was also some private sector financing. The main objectives of SUBEX-M are to: (a) create a data bank on potential sub-contractors and customers; (b) provide information on outsourcing possibilities in response to enquires; and (c) provide technical assistance to improve manufacturing capabilities in SMEs on an occasional basis. At the time of the Commonwealth Mission, it had about 80 firms in its data bank and had undertaken a promotional fair in 1997 involving 112 exhibitors as well as 2500 local and international participants. SUBEX had not formally tracked business outcomes from the fair but claims that it resulted in several Mauritian SMEs establishing contracts with Madagascar and the Seychelles.

It is still too early to make a comprehensive evaluation of the success of SUBEX-M.

However, the following preliminary observations can be made about its focus and operations to date:

- ✓ Operations began after a slow start, (there were delays in obtaining funding and hiring qualified engineers) and has yet to make a measurable impact on sub-contracting relations between large firms and SMEs in Mauritius.¹⁶ Also its future was in some doubt at the time of the Commonwealth mission (that in part explains its relatively low take-up rate within the private sector).
- ✓ It has focussed on a group of high skill engineering industries (metal working, plastics, electronics and electrical activities) in which Mauritius has no obvious short or medium-term comparative advantage *vis-à-vis* world markets. Low skill industries, in which the country has an existing and medium-term comparative advantage, as well as some valuable intra-firm linkages are excluded: such as, textiles and clothing, leather products and footwear, and food products. The lack of emphasis given to comparative advantage considerations may in part reflect the agenda of inward-oriented international agencies.
- ✓ It seems to over emphasise *ad hoc* information provision and “match-making” between firms and promotion fairs. The major gap with SUBEX-M is the lack of focussed technical assistance to upgrade existing supplier-relations between large export-oriented enterprises and their suppliers within geographical or sector-specific industrial clusters. In part this may reflect a lack of specialised in-house engineering and technical expertise and inadequate service partnerships with public technology institutions.

The experience gathered from best-practice linkage creation, such as the UK and Singapore, would be valuable for Mauritius. Best practice suggests that focussed assistance, within existing (realistic) marketing chains, is the most efficient means of developing a deep and diverse supplier base in a developing country like Mauritius.¹⁷ By definition such a chain makes products that are in demand in international markets and firms in that chain have reasonable manufacturing capabilities. However, in a world of rapid technological progress and intense competition, survival depends upon technological improvement, quality upgrading and cost-reduction in the SME sector. Best-practice also suggests that success can be achieved when a linkage scheme is private sector driven (supplemented with appropriate inputs from public technology institutions), rather than bureaucrat-led.

In this context, it would be a mistake to shut down SUBEX-M as this would dissipate a valuable learning experience with fostering infra-firm relations. It would also be a mistake to subsidise SUBEX-M to survive independently from the rest of the country's

¹⁶ There was a long time lag between the feasibility study that was done in 1994 and implementation of SUBEX-M in Sept. 1997.

¹⁷ Humphrey and Schmitz (1996) and DTI (1996).

technology infrastructure. One option might be to absorb it within SMIDO (this merger would require little restructuring as SUBEX-M is already housed in the SMIDO building in Mauritius). This should be followed by the development of a more focussed linkage programme based on existing marketing chains, a strong private sector orientation and inputs from public technology institutions. SMIDO would need to work with its new partner, MEDIA, to realise success. MEDIA has direct contact with international buyers and knowledge of the price, quality and delivery requirements of international markets while SMIDO knows the characteristics of the SME population.

4.4 Selected Procedural Impediments

4.4.1 THE STATE OF PROCEDURAL OBSTACLES

Previous studies of the Mauritian trade and industrial regime in the 1980s and early 1990s highlighted businesses' transactions costs arising from administrative procedures of the public sector. They documented the reality of a excessive bureaucratic procedures (concerning imports, exports, foreign exchange allocation, foreign investment, taxation and business entry and exit) and its cost to the private sector.¹⁸ Procedures have raised operating costs above optimum levels, wasted valuable management time, employment of additional staff to deal with redundant paperwork, acted as an obstacle to achieving quick response practices, and provided incentives for rent-seeking behaviour by public officials.

To its credit, in the 1990s, the Government of Mauritius began promoting manufacturing efficiency by streamlining and abolishing unnecessary procedures/documents. In 1991 import licensing was abolished. This was soon followed by the elimination of foreign exchange controls in 1994 (foreign exchange transactions no longer needed Bank of Mauritius approval) and a streamlining of foreign investment approvals in 1998 (normal FDI approvals which are eligible for "fast track" processing have a target of 4 weeks while others, a maximum of 12 weeks). There has also been a reduction in processing times for EPZ certificates (from 3-6 months to 1-2 months) and long-term work permits for expatriate technical staff.

Moreover in 1990, in an environment of gradual procedural reform, a One Stop Shop was created within the Ministry of Industry and Commerce to help firms obtain permits/clearances for business start-up and operation. The One Stop Shop operates through a system of liaison officers who are responsible for sorting out enterprises' problems with government departments. Difficult cases are referred to an inter-ministerial committee chaired by the Permanent Secretary or the Minister of Industry and Commerce. In early 1998, SMIDO started a separate One Stop Shop to provide SMEs with information on business start-up and to assist in obtaining permits. SMIDO's

¹⁸ World Bank (1994) and WTO (1995).

One Stop Shop works with the Ministry of Industry and Commerce to provide a follow-up service with specific government departments.

Clearly progress has been achieved in several areas of procedural reform, generally benefiting SMEs. However, the available evidence seems to indicate that procedural reform has not gone far enough even compared to competitors in Africa. A recent survey by the World Economic Forum's *African Competitiveness Report 1998* provides data about the percentage of senior management's time spent negotiating with officials or obtaining licenses, regulations, permits and tax assessments for several African economies including Mauritius. Out of 20 African economies, unexpectedly Mauritius is ranked 14th by this measure of procedural inefficiency. Mauritian enterprise senior management spends up to 13% of their time dealing with permits/other regulatory issues compared with only 3% in Namibia, 4% Botswana, 7% South Africa, 10% Tunisia, 11% Uganda and 12% Cote d'Ivoire. Although cross-country comparisons of procedural inefficiency are often subjective and difficult to make, they can provide a useful perspective.

4.4.2 SMALL BUSINESS START-UP PROBLEMS

One important area, which seems to have escaped serious procedural reform in Mauritius, is regulations on business start-up.¹⁹ Regulatory costs are much more damaging to small businesses than to large firms. Focused on an owner/manager, small firms lack specialist staff to obtain multiple permits/clearances. They have less political influence than large firms to by-pass bureaucratic obstacles. Compared to large firms, they can ill afford the foregone output associated with delays to project execution or to pay rents connected with multiple clearances.

Our survey of SMEs suggests it takes an average of 7 months to overcome the bureaucratic hurdles to start a small business in Mauritius.²⁰ The removal of a few outliers (with processing times in excess of 24 months) reduces the average to 4.2 months. These averages mask a wide variation in bureaucratic processing times for small firm start-up in the sample. The detailed results show that at best, it takes between 0-3 months while at worst it can be more than 10 months (see Figure 4.3). The 0-3 month processing times is probably an acceptable delay to small firm start-up. However, the worst case results are very high processing times by international standards and can retard the rate of SME start-up in the country. These results are a central concern for policy action.

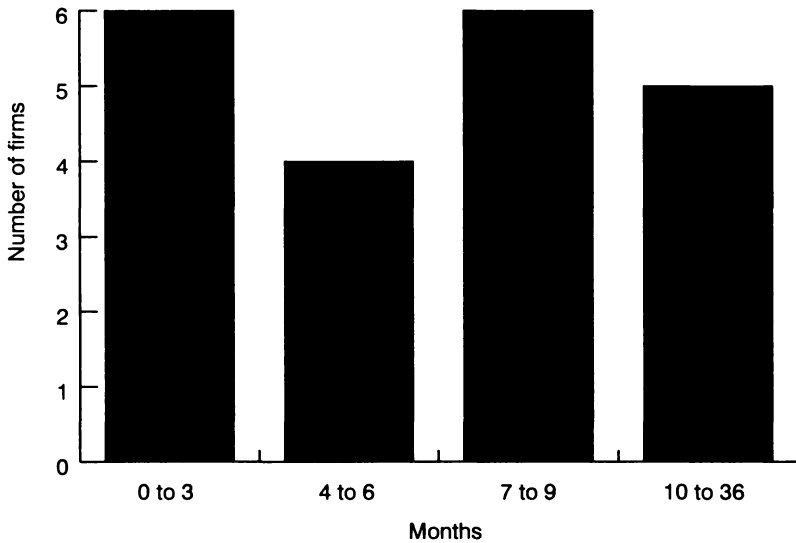
The cost of procedures associated with new firm start-up is difficult to estimate in monetary terms but the opportunity costs are clear: *the owner/senior manager of a typical*

¹⁹ For instance, data provided by SMIDO shows that its One Stop Shop dealt with about 200 enquiries from small firms during February-July 1998. Many of these requested information on establishing businesses (e.g. where to get loans, what to produce or where equipment to buy) but a significant share (9%) concerned problems with getting start-up permits from national/local government organs.

²⁰ Results from the first set of 17 responses received suggested a 7.8 months figure but adding the results from an additional 8 responses recently received, the figure fell to about 7 months.

small firm spends about 8.5% of his/her time each month dealing with taxes and other government regulations/officials.²¹

Fig 4.3: Time to Obtain All Permits to Start-up



The list of permits/clearances required for setting up an enterprise in Mauritius including an SME is contained in Appendix 2. A plethora of permits/clearances are required for start-up including: development/buildings permits, local authority permits, electric motor permits, applications for foreign investment, work permits, residence permits, water supply applications, electricity supply applications, telephone/fax applications and national pension fund registration.²² It is worth remembering that once a firm is established there are many regulations governing business operation (these range from labour laws and environmental standards to accessing duty-free raw materials and payment of taxes).

Figure 4.4 provides enterprise impressions of relative difficulties faced in obtaining 11 different start-up permits for small firms from the Commonwealth SME survey. A score of 5 indicates the most difficult permits to obtain and 1 indicates the least difficult. The following picture emerges from the survey data and detailed interviews with the two One Stop Shops and small firms:

²¹ Estimate from the Commonwealth SME survey for this study. It is the Mission's judgement that this may be closer to the real situation than the figure for Mauritius in the African Competitiveness Report 1998. However, our figure remains higher than the most efficient African economies.

²² Ministry of Industry and Commerce (1998).

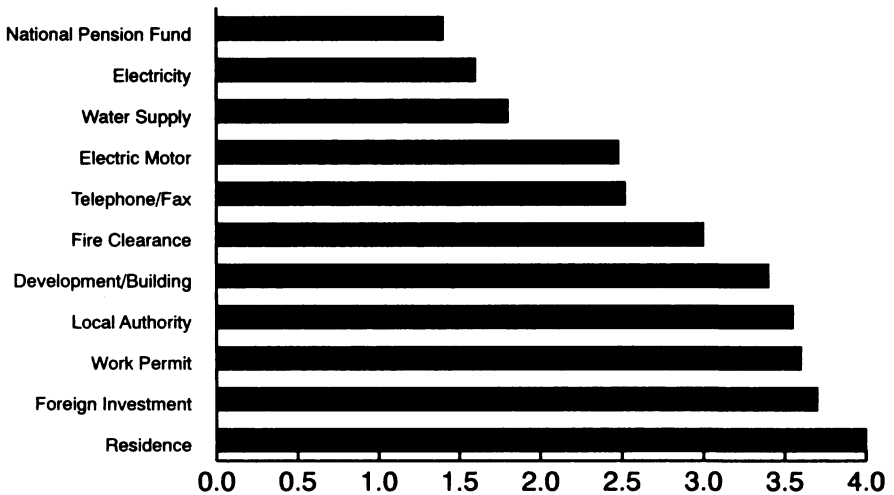
- The most difficult permits are those affecting residence and work. This is paradoxical because Mauritius has an open door policy towards foreign investment but has traditionally discouraged the import of foreign workers (or engineering technical staff) in favour of local employment. There is an assumption that the requisite (right quality) skills are available locally which may not be so for high-level engineering and technical skills. For a small island, these approvals are gained within a cumbersome structure. Residence permits, for expatriate staff and foreign investors, are granted by the Passport and Immigration Office and work permits by the Ministry of Education & Human Resource Development. An inter-ministerial committee is usually involved and approval is required from the Prime Minister's Office. The process can take from 1-3 months. Approval times are faster for EPZ firms than for non-EPZ firms. Expatriates are normally granted a two-year permit and the firm has to pay a financial bond of Rs. 50,000 and produce a return ticket. Extensions are difficult and workers are sometimes sent home, only to be brought back later. All of this adds to the transactions costs of firms, particularly SMEs.²³
- A close second is foreign investment applications. This finding is supported by a previous Commonwealth Secretariat study which found that it can take between 9-32 weeks to obtain foreign investment approval in Mauritius because of a multi-stage approval process with excessive documentation requirements.²⁴ Falling inward investment in the mid-1990s resulted in an overhaul of these procedures. A powerful Board of Investment was announced in 1998 along with targets for processing times for FDI approvals. However, at the time of the Commonwealth mission, the Board of Investment had not yet been established and it was unclear whether the targets for processing times had come into effect. This may continue to be a problem for small firms seeking joint ventures with foreign investors.
- Obtaining local government permits (e.g. development/building, local authority and fire services) is also very time consuming and bureaucratic. Three separate permits are required for construction, building and business operation from the same local authority. Before the issue of the operating permit, the local authority requires further clearance from five different government departments (Ministry of Health, Ministry of the Environment, Ministry of Labour and Industrial Relations, Fire Services and Police Department). All these steps are compulsory and the documentation requirements are excessive. Co-ordination between the different departments

²³ Our interviews with the One Stop Shop suggest that work permits for foreign production managers had become easier than in the past. Today One Stop Shop can assist a firm to get a temporary entry visa, which is granted in 3 days. After processing by an inter-departmental committee, the work permit is issued within 2-3 months.

²⁴ Lall and Wignaraja (1998).

is weak and the process, from start to finish, can take from 2 -12 months. Particular problems seem to arise when a firm is located in a residential zone but somewhat less difficult for firms which are in designated industrial zones. The application of health, environmental and fire safety standards seem to be particularly slow and restrictive.

Fig 4.4: Start-up Permit Problems



- Compared with many other developing countries, utility applications (telephones, water supply and electricity) are relatively easy to process in Mauritius. A major improvement has occurred in telephone application processing times, which range from only 1-4 weeks. In any case, easy access to mobile telephones has diffused this problem. Water and electricity applications are usually processed in three weeks but small firms in geographically remote areas can face delays of 3-4 months. This is more of a problem of infrastructure gaps rather than cumbersome bureaucratic procedures *per se*.
- National Pension Fund registration with the Ministry of Social Security poses the least problems to small firms.

Quite apart from the transactions costs involved in business start-up due to excessive administrative procedures, an important problem concerning administrative obstacles in Mauritius is the uncertainty of the outcome. Small firms begin processes without knowing how and when they will end. The time and cost vary from firm to firm depending on contacts, familiarity with bureaucratic processes, financial resources

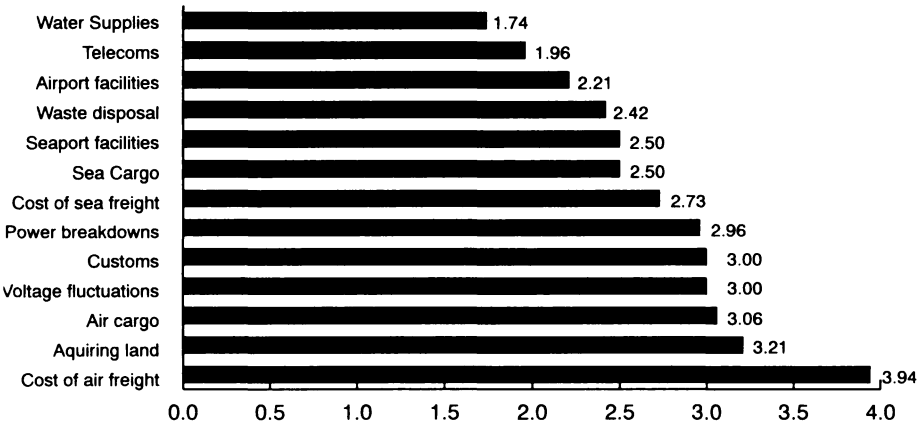
available for payments to bureaucrats and linkages with political groups. Experience from developed and developing countries suggests that entry procedures are an important influence on the rate of small business start-up. Where bureaucratic barriers to start-up are significant, they can act as a disincentive to new small firm creation and growth.

4.5 Infrastructure Impediments

The influence of infrastructure impediments on private sector activity has been considered by several recent studies and the Government of Mauritius is well aware of the nature of the problem.²⁵ Few further insights can be added to existing knowledge by this study. Figure 4.5 shows small firm perspectives on the degree of difficulty caused by different aspects of infrastructure in Mauritius from the Commonwealth enterprise survey. A score of 5 indicates the most difficult permits to obtain and 1 indicates the most straightforward.

The data reinforce previous findings that the cost and availability of air freight is a major barrier to small firm exporting in Mauritius. This is closely followed by firms having difficulties in acquiring land or industrial space and weaknesses in electricity supply, in the form of both voltage fluctuations and breakdowns. Customs clearance is also regarded as a problem by some small firms, but in contrast with concerns about air freight, sea freight cost and availability this does not pose a serious problem. Other aspects of Mauritian infrastructure are considered quite efficient by small firms (e.g. water supply and sewage, airport facilities and telecommunications reliability).

Fig 4.5: Infrastructure Problems



²⁵ World Bank (1994), MEDRC (1997); Lall and Wignaraja (1998); De Chazal du Mee (1998).

4.6. Conclusions

This chapter examined the influence of the Mauritian macroeconomic, trade and industrial policy environment on small firm operation and the attainment of international competitiveness. Following a ranking by small firms of the degree of obstacle presented by individual policies and procedures, the analysis examined selected policy, procedural and infrastructural impediments to competitiveness in more detail.

The overall conclusion is that the present policy environment is now more favourable to small firms than it was previously due to two decades of gradual liberalisation and deregulation of government controls. The country was fortunate to have escaped a strong or prolonged inward-orientation, which hampered many developing countries since the 1960s and 1970s. The Mauritian policy environment is more open and small business-friendly than those of many competitors in Africa and the Indian Sub-Continent. Economic policy is generally well managed and more predictable than most. The private sector is consulted before major policy initiatives are implemented and their views often shape policy. Major areas of policy success include switching from quantitative restrictions to tariffs (and cuts in tariffs), the lack of public procurement and local content rules, maintaining a depreciated real exchange rate, removal of exchange controls, maintaining a liberal and market-oriented banking system, the introduction of VAT, and streamlining some administrative procedures. This is an impressive record and makes Mauritian enterprises more poised than others to reap future gains from globalisation of trade and investment.

However despite past successes in policy reform, there is still room for improvement, which in turn will benefit small firms as well as the rest of the Mauritian private sector. Tariff reform is far from complete and the existing protective structure discriminates against small firms, particularly those in the non-EPZ sector. The future agenda on tariff reform is unclear. Small firms lack ready access to duty-free imported inputs to offset an anti-export bias in the trade regime. Until relatively recently, there was little effective overseas marketing support for small firms. MEDIA has improved service delivery in this regard but the take-up rate among small firms has been quite low. This raises questions about the quantity and quality of the services provided. Small firms face higher real interest rates, more restrictive terms and less access to commercial bank finance than large firms (which indicates a “large firm bias” in the allocation of finance). There is an absence of effective policies to develop linkages and industrial clusters among small firms. SUBEX-M – the only scheme which provides information about potential intra-firm production linkages – started very recently but has run into difficulties with the phasing out of technical assistance from an international donor. There are serious administrative barriers to small firm start-up which raise SMEs’ transaction costs above those of competitor economies. Start-up procedures have raised operating costs above optimum levels, wasted scarce management time, employment of additional staff to deal with redundant paperwork, acted as an obstacle to efforts to adopt quick response practices, and provided incentives for rent-seeking behaviour by public officials. Long processing delays arise from a multi-stage approval process involving contact with numerous public agencies.