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EXPORT OF SERVICES: HYPE OF HIGH POTENTIAL?
IMPLICATIONS FOR STRATEGY- MAKERS

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Export of Services: Hype or High Potential – A Seller's Perspective?

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Introduction

Over the last forty years, Mauritius has succeeded in developing a modest financial services export industry.

Success grew out of a number of factors, the most important of which has perhaps been the existence of a pool of educated professionals, the presence of international professional networks, and the preparedness of the private sector to take advantage of opportunities when Government adopted the relevant policies.

The first phase was a gradual evolution, largely related to providing auditing, financial consultancy and related services to the African region. This had perforce to be linked to the funding of projects by international agencies, such as the World Bank and the IMF, which guaranteed payment in foreign exchange. This business grew steadily, spurred by the local presence of the large accounting firms acting as a catalyst, providing the comfort that the work would be carried out to internationally-accepted norms, but at lower cost.

The second phase, which started in 1989, and accelerated in 1992, was based largely on the positioning of Mauritius as an offshore jurisdiction, servicing the region. Offshore banks started their activity in 1989, and targeted regional deposit-taking and lending. However, that in itself could not constitute an important pillar of development, as Africa has always struggled to attract large investment flows, especially from private sector sources.

Development of the sector received an important boost in 1992, with the passing of enabling legislation aimed at attracting non-banking offshore activities. The model was probably inspired from the fact that most continents were services by one or more offshore island jurisdictions on their doorsteps, and Africa did not have its own. The time zone, allowing the island to do business with Asia in the morning, and the United States late in the afternoon, was also an important consideration.

Whatever the motives, expectations were modest, and it was believed more in the rhetoric that the sector would develop into an important pillar of the economy within a short time span.

Reality was to prove much more rewarding.

1 The Experience

The main driving force in the early stages was the double taxation treaty with India, which had been signed some ten years previously, and which achieved its full relevance when the Indian Government of the early nineties embarked on major reforms to the economy.

This led to a considerable inflow of funds, either as portfolio investments, or FDI, a tide which continues to this day, albeit with some fluctuations.

Given that diplomatic and bilateral relationships are often based on cultural affinities, the special relationship which the island enjoys with India by virtue of the composition of its population, must have played a part in enabling the country to position itself as a gateway to India from an investment perspective.

However, the take-off would not have been as successful if there had not been a pool of labour, already qualified, if not actually trained in the specific business of offshore work, and waiting to take up the challenge. Again, the presence of the large accounting firms with their worldwide network, made not just for a ready system of referrals into the Mauritius jurisdiction, but gave the confidence and comfort required before international operators would take the plunge to use a hitherto unknown jurisdiction.

It also helped that the island had a real economy, and was not just a “rock in the ocean” on which the Government had slapped a few laws. The first bank goes back to 1838, the Chamber of Commerce to

1850, as does the *Chambre des Courtiers,* and the first Companies Act was passed in 1913. The country also had built solid credentials as an exporter of agricultural products and manufactured goods to Europe and the United States, and as a tourist destination of excellence.

International law firms, who often drive international structures, quickly seized on the Mauritius story, and the rest, as they say, is history. The process of knowledge transfer was greatly enhanced by the Mauritians who were already working in the field, overseas, and returned to contribute their skills.

As in most pioneer or emerging areas of economic activity, the ability of foreign nationals to obtain work and residence permits was another catalyst to the sector, and furthered the transfer of skills. However, Mauritius has always had a mixed record in this respect. Whilst paying lip service to the need to attract foreign nationals when the skills are not available locally, the administrative burden imposed on foreigners wishing to work here is often a disincentive.

Side by side with treaty work, and the establishment of funds, there developed a small market for offshore vehicles, largely based on trusts on the Anglo Saxon model, and private investment holdings. This market segment was, however, not on the same scale in terms of added value as the treaty related structures. The lack of asset management capabilities, the island's as yet unproved credibility as a domicile for private wealth, and the fact that even the larger local financial institutions did not have the asset backing needed to act as Trustees, meant that the take-off in this segment was slower.

As usual in many development scenarios, success often contains the seeds of its own destruction. The success of the India treaty distracted attention from other treaties, lulled the authorities into a false sense of satisfaction and well-being, and may have led the island to put all its offshore eggs in one basket. This over-concentration of its export market was to lead to fragility in its current client base, and some measure of criticism in the Indian press.

Not enough effort has thus been deployed to look for alternatives to diversify the product base. For a long period, and even at this moment, three years after having established a Financial Services Promotion Agency, the island has yet to carry out a proper survey of competing jurisdictions, and of the services which can be provided out of Mauritius, with the attendant legal and regulatory provisions which are required to promote such activity. This delay could prove costly.

Nevertheless, the jurisdiction developed strongly during the mid nineties, only to hit the wall about five years ago, when growth in the number of entities being set up in the jurisdiction was probably negative, owing to a number of reasons. The crisis in the Far East and the decline in international investment flows, the downturn of the Indian stock markets, meant that few promoters, apart from the hardiest emerging markets specialists, were willing to commit funds to these jurisdictions. FDI flows also slowed down, to resume only recently.

This was accompanied by the wave of attacks against "offshore tax havens", "unfair tax competition", launched by the OECD in 1998. The success of the India treaty led to its own problems, as the impression was created that Mauritius was somehow getting very rich on the back of the Indian tax payer, leading to a spate of press articles in India which aimed at throwing doubt about the sustainability of the treaty provisions. Actions in the Delhi High Court, although subsequently reversed by the Supreme Court,

For the past two years, investment flows to Far East countries has resumed in a significant way, and the offshore jurisdiction has resumed a growth pattern, partly because of the double taxation treaty with China which is amongst the best in the world.

Taking stock at present, one can claim that Mauritius has achieved, in a very short time, a reputation as an "India funds specialist". Without detracting from the vision of the Government of the nineties, and of the operators who gave flesh and substance to its policies, this achievement can be described as "opportunistic", since success on this scale would not have been possible without the double taxation treaty which had been signed ten years previously, and without the wave of economic reforms in India. The time difference of 1.5 hours, a population largely composed of people who trace their origins to the Indian sub-continent, aided the process. The island has today developed a real capability being developed in the area of fund administration.

However, Mauritius will have to rethink its model going forward. Before addressing this, it would be useful to list the obstacles facing similar jurisdictions which try and adopt this model of development. The list contains raises many of the questions which need to be addressed by any country wishing to go down that route.

2 Main Obstacles

A high literacy rate and a pool of qualified professionals largely educated to European standards, facilitated the take-off of the Mauritius initiative. Although, as in most sectors, qualified does not necessarily mean able to do a particular and specialist job, the learning curve was sharp, and within a few years, tax structuring skills and fund administration expertise became well established. This is a *sine qua non* for any country aspiring to compete.

Training facilities are often inadequate, particularly in specialist areas, where trainers may not be available locally. Whilst these can be brought in, sometimes at considerable expense, which can be alleviated through Government assistance, the speed at which new technologies, tax and other laws, evolve, means that training becomes a continuous imperative. Distance, and the absence of a clustering effect, would make take-off more difficult for a newcomer.

Access to the latest IT systems, for purchase and maintenance, and delivery mode to the end customers, is not always available.

Whilst the accounting profession has effectively networked, thus facilitating cross border referrals, the Mauritius experience is that legal services often lag behind. Whilst the main financial centres are well served with international law firms and representative offices, the medium and smaller jurisdictions may be at a disadvantage. The process is certainly slower.

The legal and regulatory framework needs to be adequate. Provisions would depend on the sectors involved, but the protection of investors across borders is a vital consideration. Countries, and operators, are reluctant to allow financial services to be imported unless the degree of regulation in the exporter's domestic economy is adequate. As a corollary to this, whilst the legal framework may be adequate in theory, certain clients are concerned about the lack of jurisprudence. For many jurisdictions, the first test case in dispute resolution may well prove to be a make-or-break experience.

Concentration within the financial services sector is now an inevitability. Banks, insurance companies, custodians, administrators, have been, and will continue to be, in a state of consolidation. This makes it hard to grow to any extent in financial services without external support from, or partnership with, internationally established players.

There are many features of the financial services markets, besides a worldwide reach and network, which favour the larger transnational operators. Custodians have to have minimum balance sheet size, precluding all but the largest banks from offering the service. Sophisticated and expensive IT platforms require a high volume of activity for amortization. Liability insurance is increasingly a further requirement, and not always accessible to emerging players.

Disaster recovery is becoming the norm in this sector. Certain countries have enacted legislation requiring full-fledged business continuation provisions, and even those which have yet to do so require this service as best practice. The larger operators can put in place disaster recovery platforms across borders. The small local operator would have difficulty doing the same. As an exporter, this will have to be part of the product offering.

Geographical proximity will become increasingly important. Whilst companies would go to great length to set up entities in far away jurisdictions, particularly where the advantages can be quantified, and there is differentiation between jurisdictions, the tendency would be to stick close to home.

With regard to small offshore jurisdictions, all the continents are well served with their own offshore centres, with the US using the Caribbean, Europe relying on the Channel islands, Luxembourg, and others, and the Far East using the Singapore and Hong Kong hubs. The established jurisdictions thus have a first mover advantage which will be difficult to dislodge in the absence of any other competitive arguments in favour of the newcomers.

The cluster effect is important in any industry to achieve critical mass. Besides the need to achieve international standards, which are becoming increasingly difficult unless partnerships are established, one needs to attract sufficient operators with this profile to achieve the cluster effect.

3 Protectionism & Double Standards

The main obstacles however, for this model of development has been the major initiative which aimed at targeting low tax jurisdictions. From a Mauritian perspective, the omission of a number of OECD member countries with low or zero tax regimes from the OECD's target list smacked of double standards. The outcome was inevitable, and confirmed the theory that "might is right". Under threats of being black-listed, some countries initially abandoned their fiscal sovereignty, and caved in.

The same can be said about regulatory provisions. The need to adopt FATF recommendations against money-laundering is not contested, but what may be a case of double standards is that most of the small island economies are perhaps now better regulated than developed jurisdictions, which for some reason may not have been subject to the same searching enquiries.

4 The way forward

The above list is formidable, and one is tempted to reach the conclusion that the window of opportunity which existed for small economies to transform themselves in this manner has already closed. Even for medium-sized economies to try and enter the field from a very low base will not be an easy proposition.

The relatively unregulated areas such as the provision of consultancy services across borders will need to remain a major thrust and should be strengthened. Mauritius can build on its already acquired expertise in this regard.

Development and especially growth of the current model as a treaty jurisdiction could be difficult to sustain. The increasing harmonization of tax practices includes the elimination, gradual or otherwise, of capital gains tax, making the choice of jurisdiction less critical. On the other hand, this development may call for a complete overhaul of the country's taxation system, possibly towards the territorial basis of taxation which is adopted by some countries. A major policy decision is thus required going forward.

The harmonization of regulatory practices also means that no one country can hope, going forward, to leverage on a competitive advantage based purely on regulatory provisions.

The option for Mauritius lies increasingly in shifting to a BPO mode. The expertise which has been accumulated, particularly in fund administration, can be built upon to provide quality services at better price, as the reliance on purely fiscal advantages may prove to be unsustainable.

For those countries which have not built any capacity in this respect, the choices are limited. The strategic debate is then whether policy makers should cast aside export possibilities and concentrate on domestic markets. There appears to be a logical, although superficial, attraction to develop one's own internal capabilities and then go and conquer the world.

However, it is not clear that this is the only model. The island offshore jurisdictions, including others like Singapore and Hong Kong, have driven growth through services to the hinterland, unable to rely on domestic market to build capacity first. In a way, gearing one's services to what is internationally saleable would then, by ricochet, benefit the local market, usually less demanding.

Regional proximity is likely to become more important as fiscal and regulatory issues confer aspects are harmonized, and national strategy should concentrate on developing regional services.

Policy making should also address the question as to whether to target specialist areas for development. No country would be able to be all things to all people. Jersey has become known as a trust jurisdiction ; Guernsey, Luxembourg and Dublin are well known for fund administration. Cayman Islands has a thriving fund domiciliation work, as well as a well developed offshore banking industry, whilst the Bahamas made a name for itself in insurance. Mauritius has become an India specialist. Whether a country can decide, from the outset, the particular niche where it wants to be, will depend on skills inherent in its economy, and the relative strengths of its components.

Targeting more precisely the right products and markets needs to be accompanied by incentives to attract the larger players. As mentioned above, any country is unlikely to be able to make a mark on its own, and a strategic of encouraging strategic alliances with foreign players becomes an imperative.

In conclusion, it can be said that the barriers to success to new entrants appear formidable. The inability to leverage on fiscal or regulatory competitive advantages, and the need for size, and for international networking, makes for an enormous challenge.