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Seychelles: Selected Issues

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SEYCHELLES

Selected Issues

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October 31, 2008

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I. LARGE FISCAL ADJUSTMENT IN SMALL STATES: LESSONS FOR SEYCHELLES[1]

A. Introduction

1. **One of the major objectives of the Seychelles authorities' strategy for 2017 is to reduce public debt to 60 percent of GDP from 146 percent of GDP at the end of 2007.** For this to be achieved a large and sustained fiscal adjustment will be needed, as well as a public debt restructuring with a substantial relief component (not discussed here). Following on the 2007 Selected Issues paper,[2] this study analyzes the experience of small states in order to highlight the benefits of sound fiscal policies and to derive some lessons for Seychelles from successful large fiscal adjustments.[3] Compared to large countries, a flexible fiscal policy is more important in small states for two reasons: first, there is a greater need for countercyclical policy since small states are more prone to shocks, and second, most small states have fixed exchange rate regimes which leaves fiscal policy as the main tool for adjustment. This paper addresses four main questions:

i. What is the link between size of government and growth?

ii. How does a large fiscal adjustment impact the economy?

iii. How should the adjustment be done?

iv. How long are primary surpluses sustainable?

2. **The paper first argues that sound fiscal policies and smaller governments can be conducive to growth and help reduce a country's economic vulnerability**. Government in small states tends to be much larger as a share of GDP than in larger countries owing to the fixed cost of providing public services. This poses a policy challenge of containing the burden of government on the economy. Small states that contain the size of government tend to perform better. The paper shows that a large fiscal adjustment underpinned by an economic reform program can support economic growth and the development of the private sector. After analyzing how large adjustments can best be achieved and showing they are frequently frontloaded, the paper demonstrates, based on cross-country experience, that though not common, large-scale fiscal adjustment can be sustained for an extended period (3-10 years). The final section highlights some policy conclusions for Seychelles.

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[1] Prepared by Stephanie Medina Cas (AFR).

[2] This paper builds on work from Working Paper 08/39 which should be referred to for more information on the size of government and debt in small states.

[3] For an overview and definition of small emerging-market and developing states and large countries used in this paper, see Appendix I.

B. Benefits of Smaller Governments and Sound Fiscal Policies

3. **There is some evidence that growth is higher in small states with smaller government and lower public debt** (Figure 1.1). During most of the period from 1990 through 2007, high-growth small states on average had lower revenues and grants, lower expenditures, and lower public debt than low-growth small states.[4, 5] Except for 1993–96, high-growth small states also tended to have equal if not stronger fiscal balances for most of the period.[6]

4. **High-growth states also tend to have a more favorable expenditure mix,** with relatively less current expenditure and more capital expenditure. High-growth states on average managed to contain expenditure on goods and services, wages and transfers, and subsidies.

5. **Seychelles' growth and fiscal performance does not compare very favorably to other small states.** Growth in Seychelles has been volatile and underperformed most small states from 1998 to 2005. Seychelles' revenues, expenditures, and total public debt are higher; after an improvement in 2003, its fiscal balance has worsened and has been weaker in comparison to most small states for most of the period. Moreover, its expenditure composition is most similar to that of low-growth small states.

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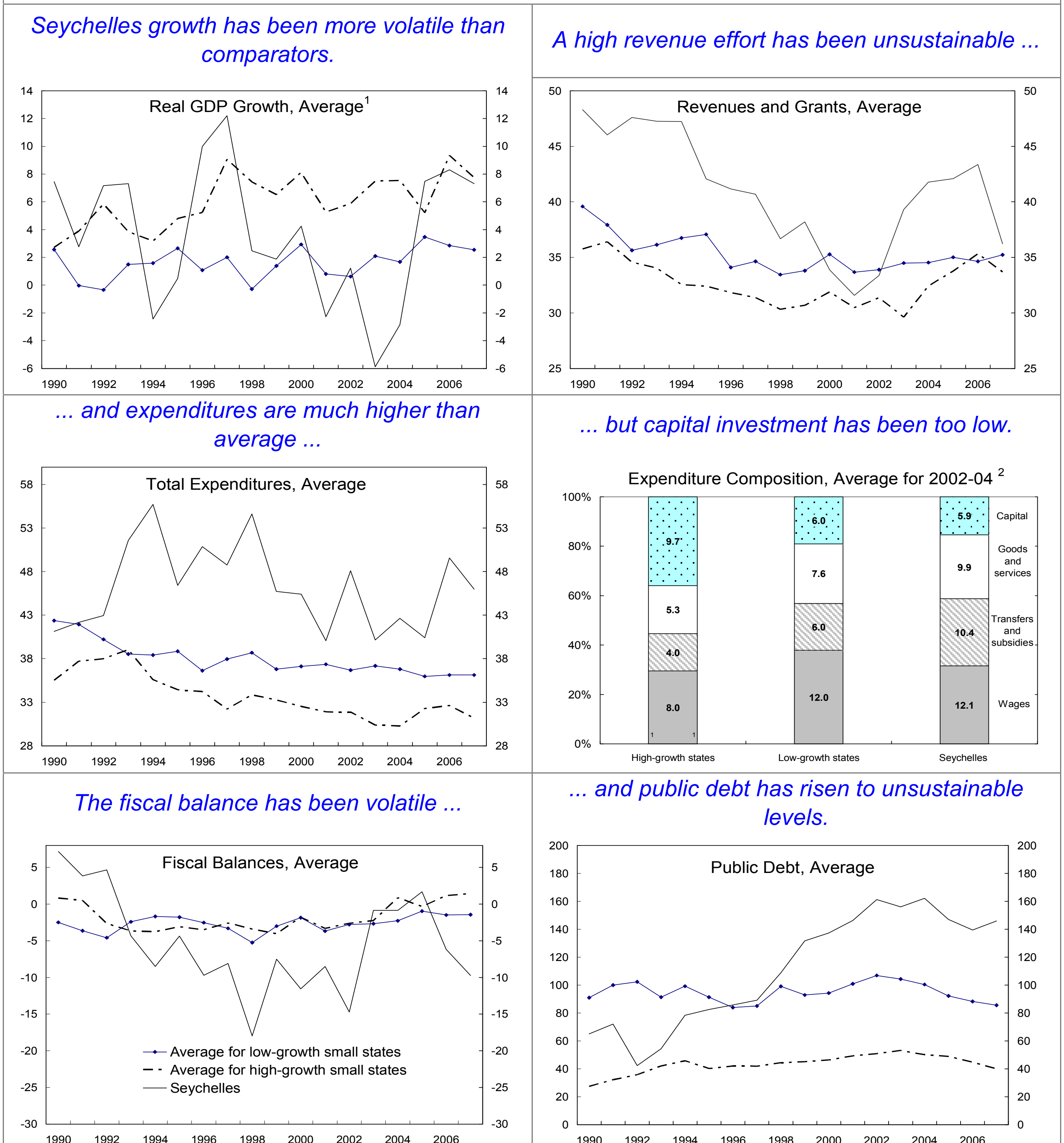
[4] High-growth small states as a group have seen a rise in average revenues and grants from 2004 to 2006, but this was largely due to the Maldives, where revenues and grants rose from about 34 percent of GDP in 2004 to 60 percent in 2006 after the Indian Ocean tsunami mostly due to large official grant inflows.

[5] High-growth small states in the sample are defined as the 11 countries that enjoyed the highest growth rates on average from 1990 through 2006. They are Bahrain, Belize, Bhutan, Botswana, Cape Verde, Equatorial Guinea, Estonia, Maldives, Mauritius, Qatar, and Trinidad and Tobago.Low-growth small states are the 11 countries that had the lowest average growth rates for the same period. The low-growth states are the Bahamas, Barbados, Comoros, Djibouti, Dominica, Gabon, Guinea Bissau, Jamaica, Micronesia, Slovenia, and Tonga.. The 20 states in the middle include Seychelles.

[6] Further statistical analysis suggests that the correlation between growth and contemporaneous or lagged expenditure and public debt is negative and significant; while the correlation between growth and contemporaneous and lagged government balance is positive and significant.

Figure 1.1 Growth and Fiscal Indicators in Small States and Seychelles, 1990—2007
(Percent of GDP)



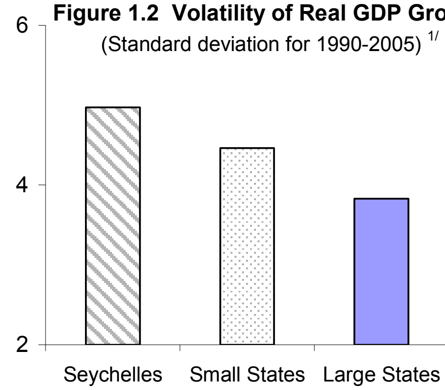
Sources: National authorities; and IMF staff estimates.

[1] High-growth small-state growth average excludes Equatorial Guinea due to large data swings.

[2] Values in columns are percent of GDP.

6. **Lower fiscal deficits and public debt should make fiscal policy more adaptable for responding effectively to negative shocks.** Small states in general tend to be more vulnerable to economic shocks, and their growth is more volatile than in larger countries (Figure 1.2). Because many small states, like Seychelles, have had a fixed exchange rate, fiscal policy is one of the few tools available to respond counter-cyclically to shocks. Moreover, in small states with limited nontradable sectors, the scope for adjustment from exchange rate changes through import substitution and export development is much more limited than in large countries. Small open economies such as Seychelles that have a high essential goods content of imports also tend to have a high pass-through from the exchange rate, so a nominal exchange rate depreciation would largely be transmitted into higher inflation and erode all potential competitiveness gains.[7]

Figure 1.2 Volatility of Real GDP Growth
(Standard deviation for 1990-2005) 1/



Source: IMF staff estimates
1/ Weighted by nominal GDP

C. Experience with Large Fiscal Adjustment

7. **There is some cross-country evidence that a fiscal adjustment, especially a large one, may have an expansionary impact on the economy by improving private investment and consumption** (Tsibouris and others, 2006). Expansionary fiscal contractions have been found to be particularly connected with high-debt countries because the risk premium on interest rates declines and confidence rises when government default risk is lower and there is less probability that taxes will go up (Perotti, 1999).

8. **This study of episodes of large fiscal adjustment in small states confirms that in most cases growth actually rose** (Table 1.1). An episode of large fiscal adjustment is defined as occurring when the average primary balance as a percent of GDP for a three-year period was at least 10 percentage points of GDP greater than the average primary balance for the previous three-year period.[8] To limit the impact of exogenous events, adjustment episodes involving oil exporters were excluded starting in 1999, when oil prices began to rise. During the period examined, 1990 to 2004, there were 12 episodes involving nine small states, one of them Seychelles.[9] In 67 percent of the episodes of large fiscal adjustment, economic growth increased and the average change in growth was 1.3 percent.

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[7] Using data from 2004 to early 2008 for Seychelles, econometric models estimate a pass-through range of the nominal effective exchange rate (NEER) of -0.7 to -1.0. In other words, a 1 percentage point NEER depreciation is associated with a 0.7 to 1.0 percentage point increase in inflation.

[8] Two of the episodes were for two-year periods.

[9] See Appendix II, Table A2, for the list of countries that experienced large fiscal adjustment and for more details of the episodes.

In only one episode was average growth negative—in Seychelles during 2003–04—although this coincided with the introduction of the goods and services tax in 2003, which brought a steep rise in the tax burden. Fiscal adjustment is often part of a comprehensive reform effort. In some cases, changes in the political and social environment may have also impacted growth.[10]

Table 1.1 Episodes of Large Fiscal Adjustment in Small States
(Percent of GDP, unless otherwise indicated)

	Primary Balance	Fiscal Balance	Revenue	Expenditure	Growth[1]
Average	2.6	-4.3	41.7	46.1	3.3
Median	1.0	-1.0	42.2	45.4	3.9
Average change	15.2	12.3	2.6	-9.9	1.1
Median change	11.7	12.1	3.4	-6.5	0.5

Number of Cases[2]...

Where Primary and Fiscal Balances Improved	Where Revenues Rose	Where Expenditure Fell	Where Growth Rose
100 percent	58 percent	92 percent	67 percent

Source: IMF staff estimates

[1] Annual percentage change.
[2] There are 12 cases of large fiscal adjustment.

9. **The most effective way to achieve a durable fiscal adjustment appears to be to reduce spending.** The majority of episodes of large fiscal adjustment in small states involved hefty cuts in both current and capital spending; a rise in revenue was less common and of less magnitude. Moreover, there is evidence that curtailing current spending, especially transfers and subsidies, while holding capital spending steady supports more sustainable and durable adjustments (Daniel and others, 2006).

10. **Small-state fiscal data also suggest that reducing current expenditures in goods and services, transfers and subsidies, and wages is associated with higher growth.** High-growth small states tended to spend less in these three categories and more on capital projects than medium and low-growth small states.[11]

11. **The experience of large fiscal adjustments in small states reveals a significant amount of the fiscal effort is often front loaded** (Figure 1.3). Most of the fiscal adjustment, as illustrated by the improvement in the median primary balance, occurred in the first year of the adjustment, with less in the second year.

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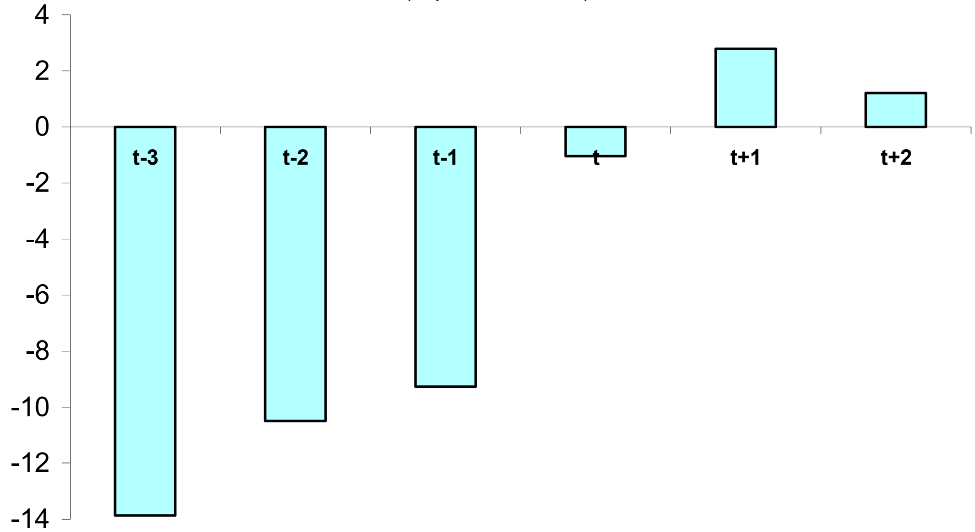
[10] For example, during 2003-04 in the Solomon Islands the fiscal adjustment coincided with an improvement in security, which had a positive impact on the large pickup in growth.

[11] Note that we did not test for causality; many of the high-growth small states are resource-rich countries. However, there are studies that suggest there may be a resource curse on growth (for example, Sachs and Warner, 1995).

Figure 1.3 Median Primary Balance During Episodes of Large Fiscal Adjustment in Small States[1]
(In percent of GDP)



Source: IMF staff estimates.

[1] t=the first year of the adjustment.

D. Sustainability of Fiscal Tightening

12. **An examination of periods of sustained primary surpluses in small states shows that, though rare, they can be maintained over a number of years** (Table 1.2). Episodes of sustained fiscal tightening are defined as a minimum period of three years during which a country maintained a primary surplus of at least 7 percent of GDP each year.[12] During the period examined, 1980 to 2007, there were nine episodes of sustained sizable fiscal tightening involving seven small states, one of them occurring in Seychelles from 1987 to 1992. Moreover, during that adjustment growth in Seychelles averaged 6.3 percent compared to 1.5 percent in the previous six-year period.

[12] Again, to minimize the effect of exogenous events, adjustment episodes involving oil exporters were excluded starting in 1999 when oil prices began to rise.

Table 1.2 Episodes of Sustained Sizeable Fiscal Adjustment in Small States

Country	Period	Years	Average Primary Balance [1]
Botswana	1980-82	3	25.8
Botswana	1984-93	10	13.4
Dominica	1986-88	3	8.0
Gabon	1995-97	3	9.3
Guyana	1991-96	6	14.3
Jamaica	1986-95	10	12.8
Jamaica	1998-07	10	10.2
Lesotho	2004-07	4	9.5
Seychelles	1987-92	6	12.9
Average		6.1	12.9
Median		6.0	12.8

Source: IMF staff estimates.

[1] Percent of GDP.

13. **The experience of Jamaica illustrates that sustained fiscal adjustments may not be sufficient to reduce public debt significantly.** In its second period of sustained fiscal adjustment, from 1990 to 2006, public debt in Jamaica rose by about 30 percentage points of GDP because high real interest rates and sluggish growth had a negative impact on debt dynamics. In addition, the durability of the fiscal impact was undermined by weak revenues and spending pressures on the high wage bill and on security. More structural reforms were needed to broaden the tax base, and reform public enterprises to limit the debt burden emanating from off-budget entities.[13]

E. Policy Conclusions

14. **A large adjustment is often frontloaded, can be sustained for a number of years, and can underpin growth especially if it is embedded in a comprehensive reform program.** Low debt and a healthy fiscal position will give policymakers the flexibility to react effectively to shocks. Small states that have relatively smaller governments and lower public debt tend to grow faster. By crowding in private sector investment in small states, fiscal adjustment can thus support growth.

[13] See Staff Report on Jamaica for the 2005 Article IV Consultation (IMF Country Report No. 06/158, May 2006).

15. **The analysis above suggests several implications for Seychelles**:

- Its own experience in the late 1980s suggests that a major fiscal consolidation to reduce public debt is achievable and can be accompanied by higher growth, though other external and socio-political factors will also have an impact.

- Much of the adjustment should come from cuts in expenditure, particularly current expenditure. In Seychelles, total expenditures are estimated to fall from nearly 50 percent of GDP in 2006 to about 38 percent in 2008. In terms of expenditure composition, the largest declines will be in transfers and subsidies, followed by wages, and then capital though further cuts here should be avoided in order not to stifle growth.

- Seychelles' negative growth during the 2002–04 adjustment period, which involved a steep rise in revenue, suggests that adjustments that rely too much on raising revenues may not be sustainable. After a decline in revenues of almost six percentage points of GDP to 35.9 percent in 2007, the revenue-to-GDP ratio is expected to stabilize at about 35.5 percent from 2008.

- A sound and flexible fiscal policy is crucial because is it is one of the key instruments available to ensure the sustainability of the exchange rate regime and to respond counter-cyclically to economic downturns and shocks, given the limited role that exchange rate adjustment can play in small states.

APPENDICES

Appendix I.I: Details of Small States and Large Countries

Table I.I.1 Small Country Categories

Country	Region	Income level[1]	External Indebtedness[1]	Other	Geography	Population (millions, 2004)	Exchange rate regime[1] Type	Details
Antigua & Barbuda	WH	upper middle income	less		island	0.08	monetary union	ECCU, peg to US dollar
Bahamas, The	WH	high income	less		island	0.32	fixed	peg to US dollar
Bahrain, Kingdom of	ME	high income	less		island	0.78	fixed	peg to US dollar
Barbados	WH	upper middle income	less		island	0.27	fixed	peg to US dollar
Belize	WH	upper middle income	severely		mainland	0.26	fixed	peg to US dollar
Bhutan	AP	low income	severely		landlocked	0.75	fixed	peg to Indian rupee
Botswana	AFR	upper middle income	less		landlocked	1.59	fixed	peg to basket
Cape Verde	AFR	lower middle income	moderately		island	0.47	fixed	peg to euro
Comoros	AFR	low income	severely	HIPC	island	0.59	fixed	peg to euro
Cyprus	EUR	high income	less		island	0.83	fixed	peg to euro, ERM2 +/- 15% bands
Djibouti	AFR	lower middle income	less		mainland	0.78	fixed	peg to US dollar
Dominica	WH	upper middle income	severely		island	0.07	monetary union	ECCU, peg to US dollar
Equatorial Guinea	AFR	upper middle income	less		mainland	1.11	monetary union	CEMAC, peg to euro
Estonia	EUR	upper middle income	severely		mainland	1.35	fixed	peg to euro
Fiji	AP	lower middle income	less		island	0.85	fixed	peg to basket
Gabon	AFR	upper middle income	severely		mainland	1.33	monetary union	CEMAC, peg to euro
Gambia	AFR	low income	severely	HIPC	mainland	1.47	managed float	ERM2 of WAMZ +/-15% bands
Grenada	WH	upper middle income	severely		island	0.10	monetary union	ECCU, peg to US dollar
Guinea Bissau	AFR	low income	severely	HIPC	mainland	1.54	monetary union	WAEMU, peg to euro
Guyana	WH	lower middle income	severely	HIPC	mainland	0.75	managed float	
Jamaica	WH	lower middle income	moderately		island	2.69	managed float	
Lesotho	AFR	low income	less		landlocked	2.32	fixed	peg to South African rand
Maldives	AP	lower middle income	less		island	0.32	fixed	peg to US dollar
Malta	EUR	high income	less		island	0.39	fixed	peg to basket, mostly euro
Mauritius	AFR	upper middle income	moderately		island	1.23	managed float	
Micronesia	AP	lower middle income	less		island	0.11	monetary union	US dollar is legal tender
Namibia	AFR	lower middle income	less		mainland	2.01	fixed	peg to South African rand
Papua New Guinea	AP	low income	moderately		island	5.76	independently floating	
Qatar	ME	high income	less		mainland	0.76	fixed	peg to US dollar
Samoa	AP	lower middle income	severely		island	0.18	fixed	peg to basket, +/-2% bands
São Tomé & Príncipe	AFR	low income	severely	HIPC	island	0.16	managed float	
Seychelles	AFR	upper middle income	severely		island	0.08	fixed	peg to basket
Slovenia	EUR	high income	less		mainland	2.00	fixed	ERM2 of EMU +/-15% bands
Solomon Islands	AP	low income	moderately		island	0.47	fixed	peg to basket
St. Kitts and Nevis	WH	upper middle income	severely		island	0.04	monetary union	ECCU, peg to US dollar
St. Lucia	WH	upper middle income	moderately		island	0.18	monetary union	ECCU, peg to US dollar
St. Vincent & Grens.	WH	upper middle income	moderately		island	0.11	monetary union	ECCU, peg to US dollar
Suriname	WH	lower middle income	less		mainland	0.50	managed float	previously peg before mid-2004
Swaziland	AFR	lower middle income	less		landlocked	1.09	fixed	peg to South African rand
Tonga	AP	lower middle income	less		island	0.10	fixed	peg to basket
Trinidad & Tobago	WH	upper middle income	less		island	1.29	fixed	peg to US dollar
Vanuatu	AP	lower middle income	less		island	0.21	fixed	adjustable peg

Sources: IMF; and World Bank.

[1] As of mid-2005.

Table I.I.1 presents an overview of the 42 small emerging-market and developing states used in this study. The regional groupings are Africa (AFR), Asia Pacific (AP), Europe (EUR), the Middle East (ME), and the Western Hemisphere (WH). Small states are defined as countries with a population of two million or less, except for Jamaica and Papua New Guinea, which have higher populations but many of the economic and physical characteristics of small states. This definition is a bit broader than that of the World Bank and Commonwealth Secretariat, which use a population threshold of 1.5 million but which also include Jamaica, Lesotho, Namibia, and Papua New Guinea. Although other measures of economic size have been proposed, they have been generally found to rank countries in much the same way as population, and population data are more readily available.

Table I.I.2 Large Country Categories

Country	Region	Income level	External Indebtedness[1]	Other	Geography	Population (millions, 2004)	Exchange Rate Regime[1]
Argentina	WH	upper middle income	severely		mainland	38.37	managed float
Bolivia	WH	lower middle income	moderately	HIPC	landlocked	9.01	fixed
Brazil	WH	lower middle income	severely		mainland	183.91	float
China, P.R.: Mainland	AP	lower middle income	less		mainland	1307.99	fixed
Colombia	WH	lower middle income	moderately		mainland	44.92	float
Côte d'Ivoire	AFR	low income	severely	HIPC	mainland	17.87	fixed
Ecuador	WH	lower middle income	severely		mainland	13.04	fixed
Egypt	ME	lower middle income	less		mainland	72.64	managed float
India	AP	low income	less		mainland	1087.12	managed float
Indonesia	AP	lower middle income	severely		island	220.08	managed float
Jordan	ME	lower middle income	severely		mainland	5.56	fixed
Lebanon	ME	upper middle income	severely		mainland	3.54	fixed
Mexico	WH	upper middle income	less		mainland	105.70	float
Nigeria	AFR	low income	moderately		mainland	128.71	managed float
Pakistan	ME	low income	moderately		mainland	154.79	managed float
Peru	WH	lower middle income	severely		mainland	27.56	managed float
Philippines	AP	lower middle income	moderately		island	81.62	float
Poland	EUR	upper middle income	moderately		mainland	38.56	float
Russia	EUR	upper middle income	moderately		mainland	143.90	managed float
South Africa	AFR	upper middle income	less		mainland	47.21	float
Thailand	AP	lower middle income	less		mainland	63.69	managed float
Turkey	EUR	upper middle income	severely		mainland	72.22	float
Ukraine	EUR	lower middle income	less		mainland	46.99	fixed
Uruguay	WH	upper middle income	severely		mainland	3.44	float
Venezuela, Rep. Bol.	WH	upper middle income	moderately		mainland	26.28	fixed

Source: IMF; and World Bank.
[1]As of mid-2005.

Table I.I.2 shows the 25 large emerging-market and developing countries used in the study. A large country is defined as one country with a population of two million or more.

Appendix I.II: Details of Large Fiscal Adjustment in Small States

Table I.II.1. Details of Episodes of Large Fiscal Adjustment in Small States
(Period averages, percent of GDP, unless otherwise indicated)

						Expenditure Subcategories				
Country	Years	Primary Balance	Fiscal Balance	Revenue & Grants	Total Expenditure	Capital	Wages & Salaries	Transfers & Subsidies	Goods & Servicies	Growth[1]
Cape Verde	2002-04	0.5	-2.1	31.1	33.2	12.0	11.2	4.7	1.2	4.7
Previous Period	1999-01	-10.4	-12.2	27.2	39.4	12.5	9.7	8.2	0.9	8.4
Guinea Bissau	1994-96	-1.1	-7.4	25.8	33.2	16.8	2.0	2.3	3.8	3.8
Previous Period	1991-93	-12.5	-17.9	28.0	45.9	26.0	4.0	1.9	5.1	2.7
Malta	1997-99	-1.3	-2.4	45.1	47.5	7.2	n.a	n.a	n.a	4.0
Previous Period	1994-96	-11.8	-14.6	33.3	47.9	7.1	n.a	n.a	n.a	5.2
Malta	1998-00	3.0	-0.2	45.3	45.5	6.8	n.a	n.a	n.a	2.1
Previous Period	1995-97	-9.4	-12.3	35.7	47.9	7.1	n.a	n.a	n.a	5.2
Micronesia	2002-04	4.3	3.6	67.7	64.1	9.7	25.2	3.4	25.0	0.8
Previous Period	1999-01	-7.0	-8.4	69.8	78.2	16.1	24.8	4.3	31.6	2.0
Samoa	1994-96	-0.2	-1.1	44.3	45.4	16.6	11.6	n.a	n.a	6.7
Previous Period	1991-93	-15.2	-16.7	57.0	73.7	29.7	10.9	n.a	n.a	1.1
Samoa	1995-97	2.7	1.9	41.6	39.7	14.6	10.6	n.a	n.a	4.9
Previous Period	1992-94	-12.3	-13.6	53.1	66.6	25.5	11.7	n.a	n.a	4.1
São Tomé& Príncipe	1997-99	-16.0	-27.7	38.8	66.5	38.6	5.0	1.6	3.5	2.0
Previous Period	1994-96	-26.5	-37.5	35.9	73.4	46.0	1.7	1.2	3.6	1.9
São Tomé& Príncipe	1998-00	-9.1	-19.2	34.4	53.6	26.9	5.8	1.3	3.7	2.7
Previous Period	1995-97	-21.0	-32.1	40.1	72.2	45.8	2.3	1.6	3.5	1.5
Seychelles	2003-04	7.1	1.0	49.9	48.7	2.7	12.5	9.9	11.2	-4.4
Previous Period	2001-02	-5.5	-11.6	39.1	53.1	6.3	11.8	11.1	9.6	-0.5
Solomon Islands	2003-04	40.3	2.7	42.8	40.1	16.7	8.1	2.5	6.9	7.3
Previous Period	2001-02	-9.5	-11.8	21.2	33.0	6.0	11.3	1.6	5.0	-5.4
Suriname	2001-03	1.5	-1.0	34.2	35.2	3.0	14.2	6.9	8.1	5.1
Previous Period	1998-00	-9.9	-10.8	29.4	40.2	7.3	14.0	5.9	11.7	0.2

Sources: National authorities; and IMF staff estimates
[1] Average annual percentage change.

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II. Seychelles: Securing High FDI and Benefiting More from It[1]

A. Background

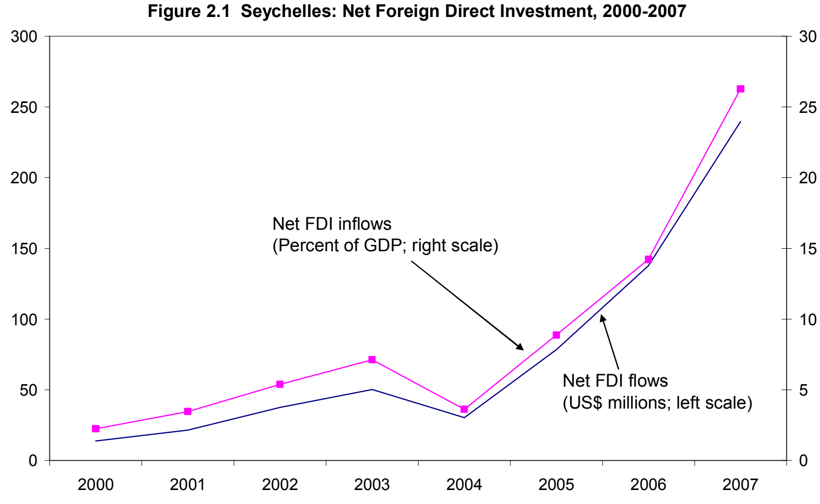
1. **Foreign direct investment (FDI) is critical to Seychelles growth strategy.** FDI is expected to continue to promote the development of the tourism sector and help exploit new sectors. This raises several policy questions:

- How do FDI inflows to Seychelles compare to flows to its major comparators?
- What explains the high inflows of FDI, and what needs to be done to sustain the momentum?
- How can Seychelles best benefit from FDI?

B. FDI Inflows into Seychelles

2. **Seychelles attracts more FDI than other-upper middle-income countries, small states, and island economies**. For 2004–07 average net FDI inflows into Seychelles amounted to 13 percent of GDP, compared with 7 percent of GDP for small states and 3 percent of GDP for upper-middle-income countries.[2] FDI inflows have increased to an estimated US$225 million in 2007 (about 25 percent of GDP). Since 2005 tourism has attracted some 97 percent of total foreign investments, though a small amount has gone to industry and commercial fishing projects.

Figure 2.1 Seychelles: Net Foreign Direct Investment, 2000-2007



Source: World Economic Outlook

[1] Prepared by Rainer Köhler (AFR).

[2] See for analysis of capital flows to sub-Saharan African countries the *Regional Economic Outlook: Sub-Saharan Africa,* Section III, April 2008 (Washington: International Monetary Fund).

Table 2.1 Seychelles: Foreign Direct Investment			
	1995-1999	2000-2004	2004-07
FDI Inflows (Percent of GDP)			
Seychelles	**6.5**	**5.5**	**13.2**
Upper middle-income countries	2.6	2.9	3.0
Small states	7.2	6.0	7.2
Of which: small island economies	5.9	5.7	6.8

Sources: World Development Indicators; and IMF staff estimates.

3. **More FDI is expected**. New projects approved in 2007 are estimated to exceed US$1 billion,[3] but the investments are likely to be spread over several years. Most are large hotels. Thus, FDI is expected to promote tourism, which in 2007 accounted for over 60 percent of the country's foreign exchange earnings and 21 percent of GDP.

Table 2.2 Seychelles: FDI Projects by Sector, Approved in 2007			
	Project count	Value (SR thousands)	Share of total FDI (percent)
Sectors			
Tourism	8	9,455,394	98.9
Large hotels (≥ 25 rooms)	5	9,404,400	98.4
Small Hotels (< 25 rooms)	3	50,994	0.5
Industry/manufacturing	4	80,946	0.8
Commercial fishing	2	13,515	0.1
Other	2	6,810	0.1
Total	16	9,556,665	100.0

Source: Seychelles Investment Bureau (February 2008)

C. An Explanation

4. **In general FDI inflows to a country are determined by the relative rates of return at home and abroad and the relative risks of the investments** (Bhattacharya, Montiel, and Sharma, 1997). Since no set of indicators describes these factors well, empirical studies typically identify broad categories of macroeconomic, institutional, and policy variables as proxies. In a cross-country comparison, the findings for Seychelles are mixed:

- Inflation was generally lower than in average competitor countries.

[3] Given the small size of the economy, one or two projects could change the figures significantly. With estimates for 5-star hotels to be built between 2008 and 2012 ranging from US$58 million to US$1,300 million, starting up just one more project could cause total single-year FDI inflows to more than double.

- However, Seychelles trails in terms of fiscal discipline and since 2000 also in growth. Moreover, current account restrictions persist, and shortages in foreign exchange may render the repatriation of profits difficult.

Table 2.3 Seychelles: Selected Macroeconomic Indicators

	1995-1999	2000-2004	2004-07
GDP growth (percent change)			
Seychelles	5.3	-1.1	5.0
Upper middle income countries	2.5	3.3	5.9
Small states	4.4	3.9	5.0
Of which: small island economies	3.6	2.7	4.5
Inflation (Percent change)			
Seychelles	1.0	3.9	2.3
Upper middle income countries	7.9	5.5	6.4
Small states	8.0	5.4	5.5
Of which: small island economies	3.9	3.6	4.5
Fiscal balance (Percent of GDP)			
Seychelles	-11.5	-8.7	-3.5
Upper middle income countries	n.a.	n.a.	n.a.
Small states	-3.7	-3.9	-1.5
Of which: small island economies	-4.2	-4.8	-2.3
Current account balance (Percent of GDP)			
Seychelles	-11.6	-6.1	-15.7
Upper middle income countries	n.a.	n.a.	n.a.
Small states	-7.3	-7.7	-10.9
Of which: small island economies	-7.4	-10.4	-17.5

Sources: World Development Indicators; and IMF staff estimates.

- Seychelles achieves overall high scores in international good governance surveys.[4] It came in third place in the *Foreign Direct Investment—African Countries of the Future* 2007/08 rankings, behind only South Africa and Mauritius, and scored consistently well on such criteria as economic potential, FDI deals, best FDI strategy, and development, best human resources, and best infrastructure.[5] In the Control Risks annual study of global political and security risks, Risk Map 2008, Seychelles is the only African country whose security risk is rated as "insignificant."[6]

[4] Seychelles ranks fifth in Africa in the *Transparency International 2008 Corruption Perceptions Index* (www.transparency.org/policy_research/surveys_indices/cpi) and the *2008 Ibrahim Index of African governance* (www.moibrahimfoundation.org) puts Seychelles second only to Mauritius.

[5] Produced by the Financial Times group, fDi magazine is a publication for global business (www.fdimagazine.com/news/fullstory.php/aid/2098/African_Countries_of_the_Future_2007_08_html). According to fDi's analysis, Seychelles also has the highest level of adult literacy, one of the best government-initiated professional skills programs, and one of the best telecommunication networks in Africa.

[6] *Control Risks* is an independent, specialist risk consultancy (www.control-risks.com).

Table 2.4 Seychelles: Selected FDI Determinants

	Seychelles	U-M-I[1]	Small States[2]
"Protecting Investors"			
Rank: 49 (out of 181 countries)			
Investor Protection Index [3] (2007)	5.7	5.4	4.9
"Trade Openness"			
Trade (ratio of imports and exports/GDP) (averages, 2004-07)	244.9	59.1	119.6
"Quality of Infrastructure"			
Proxy: Number of (fixed) telephones per 100 people (2007)	115	106	98

Sources: World Bank; and IMF staff estimates.
[1] U-M-I means upper-middle income countries.
[2] "Small states" are defined as countries with a population of two million or less.
[3] Higher value indicates better investor protection.

- Yet, Seychelles is just average on many doing business indicators and lags behind key competitors in access to credit and closing a business.[7] Allocative inefficiencies brought about by the foreign exchange controls are compounded by labor market rigidities and significant government interventions in private sector activity. Seychelles overall Doing Business 2009 rank has thus worsened compared to the 2008 rank.

Text Table 2.1 Seychelles: Development of Selected Doing Business Indocators, 2008-2009

Ease of …	Doing Business 2009 rank	Doing Business 2008 rank	Change in rank
Doing Business	104	93	-11
Starting a Business (Challenges launching a business, etc.)	68	51	-17
Employing Workers (Difficulties in hiring and firing workers, etc.)	120	101	-19
Getting Credit (Access and quality of credit information, etc.)	163	161	-2
Protecting Investors (Transparency of transactions, etc.)	53	49	-4

Source: World Bank (http://www.doingbusiness.org/ExploreEconomies/?economyid=165)

5. **The natural endowments of Seychelles seem to be a major factor in attracting FDI.** The physical environment is pristine, the weather pattern is cyclone-free, and there are no endemic diseases. Social harmony and minimal crime also support tourism. These factors contribute to the country's popular image of an island paradise, which the tourism marketing board's campaign has promoted.

6. **The authorities have in place an enabling framework for FDI.** In July 2004 the authorities established the Seychelles Investment Bureau (SIB) as the first point of contact for

[7] See Staff Report on Seychelles for the 2008 Article IV Consultation (www.imf.org), Figure 2.

all matters relating to investment and business in Seychelles. SIB's objectives are to promote the country for investment and make Seychelles the ultimate environment for business development and expansion in an investor-friendly setting (Box 2.1). A new Investment Code was passed in December 2005 and the Tourism Incentives Act was amended in December 2007. Both provide new investment incentives, such as waivers for import duties for construction materials and exemptions for employer social security contributions for expatriate staff.

Box 2.1. Why Seychelles?—Advantages to Investors

- A stable political environment and government policies that welcome and support local and foreign investment
- An investment code that ensures a legal climate that is conducive to a greater flow of investment and business
- An ideal location in the Indian Ocean, midway between the largest trading and manufacturing blocs of Asia and Europe and a business stepping stone into Africa
- A favorable time zone where working hours overlap with those of major financial centers
- A labor force fluent in English, French, and Creole
- Excellent sea and air links with Europe, the USA, Asia, and Africa
- A telecommunications system that compares favorably with that of many countries in the developed world
- Port Victoria, which is at the heart of the Seychelles economy with two deepwater berths, extensive space for container handling, and modern cargo-handling equipment
- Well-developed electricity infrastructure, water supplies, and roads.
- An attractive package of incentives for investment in different sectors to enhance cost-competitiveness
- Residence and work permits for foreign investors
- A good educational system and a peaceful environment to bring up families
- A strategic location outside the cyclone belt.

Source: Seychelles Investment Bureau (www.sib.gov.sc).

D. FDI Benefits and Bottlenecks

7. **FDI can bring substantial benefits to the host country and promote economic development.** In general, it is expected to create jobs, improve the skills of the labor force, generate government revenue, and more generally support growth.

8. **However, employment in Seychelles is already close to capacity.** In Seychelles, the FDI-driven economic boom created many new jobs in tourism and construction, which brought the unemployment rate down to a historic low of 1.9 percent in December 2007. Increases in tourism-related construction have led to greater use of expatriate workers, mainly from China, India, Philippines, and Madagascar. The new Seychelles Tourism Academy has

signed agreements with the overseas academies of internationally renowned hotel chains and is becoming an important facility for producing a pool of local hotel talent.

9. **FDI may stimulate infrastructure development, but it can also create new bottlenecks.** FDI in tourism generates a demand for water, power, and sanitation, telecommunication, and financial services. Seychelles is aware of these challenges; for hotel projects on the "Outer Islands," investors must finance basic infrastructure to support the operations of the hotel (roads, sewage system, and power and water supply) and contribute to the Environmental Preservation Fund.

10. **Though FDI is potentially a source of government revenue, generous tax incentives erode the benefit.** Revenues from tourism activities could be generated through a variety of taxes, on sales or value added, rooms, corporate income, payroll, import duties, and property. It is estimated that in Seychelles the contribution of tourism to GDP in 2007 is 46½ percent, but its contribution to total tax revenues is only 11 percent (about 4 percent of GDP).[8] The tax concessions Seychelles has been actively promoting to entice new investors (Box 2.2) have impacted the tax base.[9] The tax system in Seychelles gives some discretion to the Minister of Finance to grant special concessions. Hotels are exempt from business tax up to SR250,000 of taxable profit, but pay a reduced flat rate of 15 percent above that threshold, and are also exempt from many of the provisions of the Social Security Act, the Business Tax Act, the Goods and Services Act, and the Tourism Incentives Bill.[10]

11. **In Seychelles the shortage of foreign exchange has been the greatest operational challenge for enterprises**, as well as an obstacle to attracting FDI to sectors other than tourism.[11] Since tourism contributes over 60 percent of foreign exchange earnings, the government favors especially five- or even six-star hotel investments through incentives. However, when these big hotel projects are being built, essentially all capital equipment, raw materials, and other inputs must be imported. This requires foreign exchange in the magnitude of 80-90 percent of the FDI inflows. Once a luxury hotel is completed, it must import almost everything it uses;[12] for most hotels the only significant local expenditures are staff salaries, utilities, and fuel.[13] While the direct impact of tourism contributes only modestly to the domestic economy, the income and tax streams from the rest of the economy are ultimately supported by the foreign exchange derived from the tourism industry.

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[8] Moreover, the government spent almost 1 percent of GDP on subsidizing the Seychelles Tourism Board.

[9] Chai and Goyal (2006) found that in the Eastern Caribbean Currency Union, where tourism is also strong, reliance on tax concessions is high and tax revenues forgone range from 9½ to 16 percent of GDP annually.

[10] *Seychelles—Administrative Barriers Study* (International Finance Corporation and World Bank, May 2005).

[11] According to the Seychelles Investment Code (2005), investors have the right to convert all payments in Seychelles rupees relating to their investments in Seychelles into convertible currency through financial institutions. However, in practice, given shortages of convertible currency, foreign companies that accumulate foreign exchange earnings may not be able to repatriate them..

[12] Apart from some fish, beer, and soft drinks, bottled water, and local fruit, all food and beverages are imported.

[13] Utilities and fuel are now required to be paid for in hard currency.

E. Policy Conclusions

12. **Prospects for FDI to Seychelles appear broadly favorable.** Although the global slowdown and credit crunch could delay some projects and cause others to be cancelled, the pipeline of projects, mostly hotels, is strong. External debt payment problems and associated ratings downgrade may also impact project financing and underscores the importance of moving ahead expeditiously with a negotiated public debt restructuring agreement. Further, projects include hotels by large middle-eastern airline and tourism groups that are already fully financed. Over the medium-term, the comprehensive reforms that the authorities are now embarking on should ensure continued strong FDI inflows and underpin growth.

13. **In particular, the removal of exchange controls will eliminate an important administrative barrier to investment.** Together with a more competitive exchange rate, availability of foreign exchange for imports, and unhindered repatriation of profits should help attract more FDI and encourage diversification.

14. **The current review of the incentive schemes for investors, together with the review of the tax regime, will help create a level playing field for investors and enhance transparency and governance.** Not only should these measures encourage new investment, they would also increase its direct economic benefits.

Box 2.2. Seychelles: Investment Incentives Through Fiscal Concessions

Background

Seychelles has territorial taxation; thus only locally sourced income is taxed at up to 40 percent, and social security contributions amount to an income tax at up to 40 percent for individuals for all sectors other than the International Trade Zone (SITZ). There is a goods and services tax (GST). Import duties have been reduced substantially in recent years.

Fiscal incentives predominate. They consist mainly of concessions on social security and business (profits) taxes, often through lower rates; special exemptions or deductions; accelerated depreciation, and tax credits. Legislation for international business companies, offshore banks, insurance companies, mutual funds, trusts, and extensive programs of investment incentives is well-drafted. Companies established in the SITZ are basically free of taxes. All foreign-source income is tax-free.

The tourism sector

Taxes in the tourism sector are determined by the Tourism Incentives (Amendment) Act 2008 (TIA). The TIA gives, for example, licensed accommodations (hotels), yacht and live board operators, as well as dive, tour, cruise ship, and helicopter services operators a variety of tax concessions, such as:

- *Trades tax and GST concessions:* Trades tax rates range from 0 to 225 percent; the average GST is 15 percent. For licensed accommodations and restaurants trades tax and GST comprise 0 percent on construction materials and capital equipment. On minor operating equipment and hotel and guest consumables trades tax is 0 percent and GST at concessionary taxable value (calculated on c.i.f. prices applying a 12 percent tax rate before the retail mark-up). The GST on hotel services was raised from 7 to 10 percent effective November 1, 2008.
- *Business tax concessions:* The TIA specifies a reduced business tax rate for tourism businesses. Taxable income under SR250,000 is exempt; higher income is taxed at 15 percent. Depreciation is accelerated on capital investment. The allowable deduction from taxable income for marketing and promotion expenditures income is 200 percent (to a maximum of 5 percent of turnover). The allowable deduction for expenditure on training certified by the Seychelles Tourism Board (STB) is up to 150 percent for all tourism businesses. Furthermore additional business tax deductions of 200 percent are applicable on salaries paid to qualified graduates of local Technical Colleges for the first 12 months of employment. A deduction of 150 percent are applicable on part-time students of the above colleges during the period of attachment. Both of the above are subject to social security contributions.
- *Social security concessions:* Employer social security contributions are reduced for qualified tourism businesses: (i) employer's contributions are capped at 50 percent of the applicable rate for licensed accommodations, restaurants, dive centers, yacht/live board, and car hire operators; and (ii) upon certification of STB and approval of SIB, product enhancement specialists and foreign experts/consultants pay no social security contributions.
- *Gainful occupation permits (GOP) fees:* The number of maximum allowable foreign workers depends on the total number of employees and the size of the hotel and its location (island resort or not); the payable GOP fees stand at 35 percent of the specified rates per person/per month.

Source: Tourism (Incentives) Amendment Act 2008.

15. **The sustainability of a growth strategy based on large FDI flows will however require addressing infrastructure and labor market bottlenecks**.[14] Basic infrastructure needs to be upgraded and extended, particularly regarding water and energy supply. The authorities' civil service reform should help alleviate some of the labor shortages, provided it is combined with adequate re-training opportunities.

16. **In the future, the authorities could also consider trying to attract foreign investment for high technology enterprises and activities requiring a skilled but relatively small workforce.** The strategy might have three approaches: developing science and technology, increasing productivity and quality, and enhancing education. The government already plans to diversify the economy and sees scope for development of eco-, sports, and medical tourism; recreational facilities; and marine infrastructure (facilities to service ships and yachts). Seychelles might also want to capitalize on several other positive factors, especially the perception that the country is safe and politically stable.

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[14] A joint IFC/World Bank study recommended that procedures for dismissing inadequately performing workers should be shortened and simplified (*Seychelles—Administrative Barriers Study* [International Finance Corporation and World Bank, May 2005]).

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