

The Unfinished Revolution

Bringing Opportunity, Good Jobs
And Greater Wealth To All Tunisians



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May 2014

Development Policy Review



THE WORLD BANK

Report No. 86179-TN

TUNISIA: DEVELOPMENT POLICY REVIEW

The Unfinished Revolution

Bringing Opportunity, Good Jobs
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May 24, 2014

Poverty Reduction and Economic Management Department
Middle East and North Africa Region



Currency Equivalents

(As of May 1, 2014)
Currency Unit = Tunisian Dinar (TND)
USD 1 = TND 1.6305

Acronyms and Abbreviations

ACRLI	Arab Center for the Rule of Law and Integrity	CNUC	Commission Nationale de l'Urbanisme
ADSL	Asymmetric Digital Subscriber Line	CSI	Commission supérieure d'investissement
AfDB	African Development Bank	CTN	Compagnie Tunisienne de Navigation
AFI	Industrial Property Agency	DCTFA	Deep and Comprehensive Free-Trade Agreement
ALMPs	Active Labor Market Policies	DPR	Development Policy Review
AMC	Asset Management Company	DRC	Domestic resource cost
AMU	Arab Maghreb Union	ECA	Europe and Central Asia
ANETI	Tunisian National Employment Agency	ECN	European Competition Network
API	Agency for Industrial Promotion	ENE	Enquête National des Entreprises
APIA	Agency for Agricultural Investment Promotion	ETAP	Entreprise Tunisienne d'Activités Pétrolières
APII	Agence de Promotion de l'Industrie et de l'Innovation	EU	European Union
BASA	Bilateral Air Service Agreements	FAMEX	Fonds d'Accès aux Marchés d'Exportation
BFPME	Banque de Financement des Petites et Moyennes Entreprises	FAO	Food and Agriculture Organization of the United Nations
BH	Banque d'Habitat	FCPR	Fonds Commun de Placement à Risque
BIAT	Banque Internationale Arabe de Tunisie	FDI	Foreign Direct Investment
BNA	Banque Nationale Agricole	FIPA	Foreign Investment Promotion Agency
BoP	Balance of Payments	FOPRODEX	Fonds de Promotion des Exportations
BPO	Business Process Outsourcing	FOPRODI	Fonds de Promotion et de Décentralisation Industrielle
BT	Banque de Tunisie	FSAP	Financial Sector Assessment Program
CAs	Collective Agreements	FTA	Foreign Trade Agreement
CBT	Central Bank of Tunisia	GCC	Gulf Cooperation Council
CCSP	Coopérative Centrale de Semences et de Plantes	GDP	Gross Domestic Product
CDC	Caisse des Dépôts et Consignations	GIFF	Growth Identification and Facilitation Framework
CEPEX	Centre de promotion des exportations	HC	Human Capital
CGE	Computable General Equilibrium	HS	Harmonized System
CMI	Center for Mediterranean Integration	ICT	Information and Communications Technology
CNEA	Centre National des Etudes Agricoles	IFAD	International Fund for Agricultural Development
CNICM	Commission nationale d'investigation sur la corruption et la malversation	IFC	International Finance Corporation
CNRPS	Caisse Nationale de Retraite et de Prévoyance Sociale	IIC	Investment Incentives Code
CNSS	Caisse National de Sécurité Sociale	ILO	International Labor Organisation
		IMF	International Monetary Fund

INS	Institut National de la Statistique
IRR	Internal Rate of Return
ITCEQ	Institution Tunisien de la Compétitivité et des Etudes Quantitatives
KPO	Knowledge Process Outsourcing
LAC	Latin America and the Caribbean.
LBS	Location-Based Services
LFS	Labor Force Survey
LPG	Liquid Petroleum Gas
LSCI	Liner Shipping Connectivity Index
MAT	Alternative Minimum Tax
MC	Marginal Cost
MCC	Millennium Challenge Corporation
MDCI	Ministère du développement et de la coopération Internationale
MENA	Middle East and North Africa region
METR	Marginal Effective Tax Rate
MFN	Most Favoured Nation
MICs	Middle-Income Countries
MVNO	Mobile Virtual Network Operator
NAFTA	North American Free Trade Agreement
NPL	Non-Performing Loans
NPV	Net Present Value
NTB	Non-Tariff Barriers
NTM	Non-Tariff Barriers
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
ONTT	Office National du Tourisme Tunisien
PAFTA	Pan Arab Free Trade Area
PAM	Policy Analysis Matrix
PCM	Price Cost Margin
PCMs	Price Cost Margins
PIT	Personal Income Tax
PMR	Product Market Regulation
PS	Products Space
R&D	Research and Development
RAM	Royal Air Maroc
RCA	Revealed Comparative Advantage

RNE	Repertoire National des Entreprises
ROAC	Return On Average Capital
SICAR	Societe d'Investissement à Capital Risque
SMEs	Small and Medium Enterprises
SMIG	Salaire minimum interprofessionnel garanti
SOBs	State-Owned Banks
SOEs	State-Owned Enterprises
SOTUGAR	Société Tunisienne de Garantie
SPLT	Société pour la Promotion du Lac de Tunis
STAM	Société tunisienne d'acconage et de manutention
STB	Société Tunisienne de Banque
STEG	Société Tunisienne de l'Electricité et du Gaz
STIR	Société Tunisienne des Industries de Raffinage des produits pétroliers
STRI	Services Trade Restrictiveness Index
TACT	Association Tunisienne Pour la Communication et la Technologie
TAF	Technical Assistance Funds
TFP	Total Factor Productivity
TIMSS	Trends in International Mathematics and Science Studies
TND	Tunisian Dinar
TT	Tunisie Telecom
TTR	Total Tax Rate
TVET	Technical and Vocational Education and Training
UGTT	Union Générale Tunisienne du Travail
UHT	Ultra-high temperature
U-MICs	Upper Middle-Income Countries
UNCTAD	United Nations Conference on Trade and Development
UTICA	Union Tunisienne de l'Industrie, du Commerce et de l'Artisanat
VAT	Value-Added Tax
VC	Venture capital
VET	Vocational Education and Training
VNO	Virtual Network Operator
WDI	World Development Indicators
WITS	World Integrated Trade Solution
WTO	World Trade Organization

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Acknowledgments

This Development Policy Review was prepared by Antonio Nucifora (Lead Economist, World Bank) and Bob Rijkers (Economist, World Bank) under the guidance of Bernard Funck (Sector Manager, World Bank).

The team includes a large number of World Bank Group staff and Tunisian experts and academics—not all of whom are mentioned below. Although each of them has contributed to specific parts of the report, they do not necessarily agree with the entire study and its conclusions, and of course they hold no responsibility for any errors or omissions, which remain the authors' own.

The team from the World Bank Group includes: Jean-Luc Bernasconi (Lead Economist), Erik Churchill (Advisor), Doerte Doemeland (Senior Economist), Caroline Duclos (Consultant), Diego Angel-Urdinola (Senior Economist), David Robalino (Lead Economist and Head of Labor Markets Team), Gael Raballand (Senior Economist), Martha Martinez Licetti (Senior Economist and Head of Competition Policy Team), Georgiana Pop (Economist), Laurent Gonnet (Senior Financial Sector Specialist), Olivier Cattaneo (Consultant), Natsuko Obayashi (Consultant), Ann Hilger (Consultant), Arvo Kuddo (Senior Labor Economist), Jan Rukowsky (Lead Economist), Gustavo De Marco (Lead Economist), Carlo Maria Rossotto (Lead ICT Specialist), Magdi Amin (Manager, Investment Climate MENA), Amina Khaled El Zayat (Investment Officer), Mohamed El Shiaty (Investment Officer), Sebastian James (Senior Tax Specialist), Arbind Modi (Senior Tax Specialist), Marc Schiffbauer (Economist), Hania Sahnoun (Economist), Cedric Mousset (Lead Financial Sector Specialist), Djibrilla Adamou Issa (Senior Private Sector Development Specialist), Mehdi Benyagoub (Economist), Daniela Marotta (Senior Economist, World Bank), Giuliana Cane (Private Sector Development Specialist, International Finance Corporation, IFC), Jaafar Sadok Friaa (Lead Urban Specialist), Somik V. Lall (Lead Urban Economist), Nancy Lozano-Gracia (Senior Urban Economist), Alexandra Le Courtois (Urban Specialist), Lana Salman (Economist), Tara Vishwanath (Lead Poverty Economist), Heba Elgazzar (Senior Economist), Bill Sutton (Lead Agricultural Economist), Markus Kitzmuller (Economist), Claude Menard (Professor of Economics, University of Paris Pantheon-Sorbonne), Cyrille Bellier (Head of Economic and Social Research Department, Agence Française de Développement), Will Stebbins (Senior Communications Officer), Besma Saadi Refai (Team Assistant), Narjes Jerbi (Team Assistant), Donia Jemail (Communications Associate), Sadok Ayari (Communications Associate), Ashraf Al-Saeed (Online Communications Officer), Sophie Brown (Consultant), Matej Bajgar (Consultant), and Tanja Goodwin (Consultant).

From the Tunisian side, the team includes Abdel-Rahmen El Lahga (Associate Professor of Economics, University of Tunis), Sofiane Ghali (Professor of Economics and Director of ESSEC, University of Tunis), Mohamed Ali Marouani (Associate Professor of Economics, University of Paris Pantheon-Sorbonne), Ghazi Boulila (Professor of Economics, University of Tunis), Moez El Elj (Associate Professor of Economics, University of Tunis), Rim Mouelhi (Professor of Economics, ISCAE Campus Universitaire la Manouba, University of Tunis), Mongi Boughzala (Professor of Economics, University of Tunis El Manar), Samir Ghazouani (Professor of Economics, University of Tunis Carthage), Fathi Lachab (Consultant, World Bank), Hamouda Chekir (Consultant, World Bank), Majdi Hassen (Executive Director, Institut Arab Chefs d'Enterprises), Jamel Boumediene (Institut Arab Chefs d'Enterprises), Ramzi Labidi (Consultant, World Bank), Hassen Arrouri (Senior Statistician, Institut National de la Statistique, INS), Ali Bouzeyani (Director of Enterprise Statistics, INS), Adel Souiden (Director of National Accounts, INS), Yamen Hellel (Director of Labor Force Surveys, INS), Fadia Boughacha (Statistician, INS), Mohamed Amara (Consultant, World Bank), and Leila Baghdadi (Assistant Professor, University of Carthage).

Invaluable comments and guidance were provided by Abdelhamid Triki (former Minister of Planning and International Cooperation) and by the four peer reviewers: Ann Harrison (Professor of Management at the Wharton School, University of Pennsylvania), Phil Keefer (Lead Economist, World Bank), Celestin Monga (Economic Advisor, World Bank), and Vincent Palmade (Lead Private Sector Specialist, World Bank).

Excellent comments were also provided by Shanta Devarajan (MENA Chief Economist, World Bank), Caroline Freund (former MENA Chief Economist, World Bank), Manuela Ferro (former MENA PREM Sector Director, World Bank), Simon Gray (Country Director for the Maghreb, World Bank), Eileen Murray (Country Manager for Tunisia, World Bank), Najy Benhassine (Manager, Investment Climate, IFC), Melise Jaud (Economist, World Bank), James Trevino (Consultant, DECOS), Chunlin Zhang (Lead Private Sector Specialist, World Bank), Jean-Pierre Chauffour (Lead Economist, World Bank), Mustapha Kamel Nabli (former Central Bank Governor), Radhi Meddeb (President IPMED and Chair of Action et Développement Solidaire), Nejmeddine Hamrouni (former Deputy Minister and Advisor to the Head of Government), Elyès Jouini (Vice President, University of Paris-Dauphine), Aziz Mbarek (Co-Founder and Director General Tuninvest/Africinvest Group), Kamel Laazar (Founder and Chairman, Swicorp), Jamel BelHaj (Director General, Caisse des dépôts et des consignations, Tunisia), Sami Zaoui (Partner, Ernst & Young), Fares Mabrouk (Director, Yunus Social Business Tunisia), Mondher Khanfir (President of Tunisian American Young Professionals Tunisia Chapter), Maher Kallel (President, Nou-R Forum), Anis Dakhli (Advisor, Office of the Head of Government), Nizar Alaya (Advisor, Office of the Head of Government), Zakarias Belkhoja (former Advisor to the Minister of Investment and International Cooperation), Ahmed Bouzguenda (President of the Institut Arabe des Chefs d'Entreprises, IACE), Majdi Hassen (Executive Director, IACE), Anouar Ben Kaddour (Deputy Secretary General, Union Générale Tunisienne du Travail, UGTT), Mongi Smaili (UGTT), Hichem Elloumi (First Vice-President, Union Tunisienne de l'Industrie, du Commerce et de l'Artisanat, UTICA), Kais Sellami (UTICA), Nafaa Ennaifer (UTICA), Abdelaziz Halleb (UTICA), Lofti Bouzaiane (Professor of Economics, IHEC Carthage, University of Tunis 7 November), Taoukif Rajhi (Economic Advisor, African Development Bank), Zouhour Karray (Associate Professor, University of Economics and Management of Nabeul), Moez Labidi (Professor of Economics, University of Monastir), Mohamed-Safouane Ben Aissa (Professor of Economics, University of Tunis El Manar), Ali Chebbi (Professor of Economics, Institut Supérieur de Gestion de Tunis, University of Tunis), Mohamed Haddar (President, Tunisian Association of Economists, ASECTU), Mohamed Kriaa (Associate Professor, Institut Supérieur de Gestion de Tunis, University of Tunis), Mohamed Goaid (Professor of Applied Econometrics, Statistics and Microeconomics, IHEC Carthage, University of Tunis 7 November), Asma Bouraoui Khouja (Maghreb Economic Forum, and Tunisian Association of Economists, ASECTU), Lamia Zribi (Director General of Planning, Ministry of Economy), Hmida Kelifi (Director General of IEQ, Ministry of Economy), Moussa Maaref (Director and Chief Economist of IEQ, Ministry of Economy), Jalleledine Ben Rejeb (former Director General, INS), Mustapha Bouzayane (Director of Economic Analysis, INS), Taha Khsib (Director of Demography, INS), Abdelmalek Saadaoui (Director General of Budget Balance, Ministry of Economy), Fatma Moussa (Director General Observatoire National d'Emploi et des Qualifications, Ministry of Employment and Vocational Training), Imed Turki (Chef de Cabinet, Ministry of Employment and Vocational Training), Ridha Klai (Director General of Industry, Ministry of Industry), Ridha Karoui (Director General of Taxation, Ministry of Finance), and Fattouma Zakhama (Director of Research, APII).

In addition, the report was greatly strengthened through the excellent comments and feedback received in formal and informal consultations during the preparation phase of the report. Notably we are grateful to the many representatives from government, civil society, and academia who participated in the two seminars to discuss the concept note in June and July 2012, and the four workshops to discuss the preliminary analysis on structural transformation, on firms' dynamics, on labor markets, and on competition in February and March 2013. In addition we also thank the many participants from government, academia, private sector, civil society, and bilateral and multilateral partners, during the presentation and discussion of the draft report in November 2013. We also gratefully acknowledge the many comments and feedback received during our presentation and discussion of the initial draft of the report between November 2013 and March 2014 to the Finance and Planning Committee of the National Constituent Assembly, the Research and Studies Departments of the Union Générale Tunisienne du Travail (UGTT), the Economic Affairs Committee of the Union Tunisienne de l'Industrie, du Commerce et de l'Artisanat (UTICA), the Institut Arabe des Chefs d'Entreprise (IACE) and the Institut Tunisien de la Compétitivité et des Etudes Quantitatives (ITCEQ).

Finally, our special gratitude goes to the many colleagues from the Institut National de la Statistique (INS) who have collaborated in much of the analysis and have been extremely supportive and patient in facilitating access for us to their databases, without which this study would not have been possible. As mentioned above, we gratefully acknowledge all the contributions and support received, without in any way implying that these experts and/or institutions agree with the analysis and conclusions of the study, and for which we retain sole responsibility.

We also want to thank Eileen Byrne (freelance journalist) for preparing a series of short stories which are included in the various chapters and highlight how the analysis of the DPR relates to everyday challenges facing Tunisians.

This Development Policy Review (DPR) draws on a series of World Bank reports prepared in parallel to the DPR, and a series of background reports prepared specifically to inform this DPR:

Chapter One draws on two background reports prepared for the DPR, respectively by Bob Rijkers on Private Sector Paralysis: Firm Dynamics in Tunisia (World Bank 2014b) and Doerte Doemeland and Caroline Duclos on Tunisia's Structural Transformation: Evolution of Productivity, Employment and Exports (World Bank 2014d).

Chapter Two draws on the DPR background report Opening Markets to New Investment and Employment Opportunities in Tunisia (World Bank 2014a) prepared by a team of the Investment Climate Department of the International Finance Corporation, under the leadership of Martha Martinez Licetti and Georgiana Pop.

Chapter Three draws on several qualitative and quantitative studies prepared by Bob Rijkers, Gael Raballand, Claude Menard, and Hamouda Chekir on cronyism and corruption in Tunisia.

Chapter Four builds on various analytical reports prepared by the IFC Investment Climate team under the leadership of Magdi Amin and including Mohamed El Shiaty, Amina Khaled El Zayat, Sebastian James, and Arbind Modi. It also draws on the recent Tunisia Investment Climate Assessment led by Djibrilla Issa and Mehdi Benyagoub (World Bank 2014e).

Chapter Five draws on the DPR background report Creating Good Jobs in Tunisia: Revisiting Labor Market Outcomes, Constraints, and Institutions in Tunisia (World Bank 2014c) prepared by Diego Angel Urdinola, and including David Robalino, Ann Hilger, Arvo Kuddo, Jan Rukowsky, and Gustavo De Marco.

Chapter Six relies on a background paper prepared by Laurent Gonnet and Samir Ghazouani, and also draws on the Financial Sector Assessment Program report (IMF and World Bank 2013), which for the World Bank was led by Cedric Mousset.

Chapter Seven builds on analysis and background papers on exports of Tunisia's industrial products by Doerte Domeland, Caroline Duclos, Marc Schiffbauer, and Hania Sahnoun.

Chapter Eight draws on the chapter on services liberalization in the Tunisia Advancing Global Integration report (World Bank 2014h) prepared by Olivier Cattaneo and Daniela Marotta.

Chapter Nine builds on an earlier World Bank report focusing on the Agriculture Sector (World Bank 2009d) prepared by Bill Sutton and updated and expanded by Fathi Lachab.

Chapter Ten draws on the upcoming Tunisia Urbanization Review: Reclaiming the Glory of Carthage (World Bank 2014g) prepared by the Urban Team led by Jaafar Sadok Friaa and including Somik Lall, Nancy Lozano-Gracia, Alexandra Le Courtois, Lana Salman, and Tara Vishwanath.

Executive Summary

Tunisia holds enormous potential, but poor economic performance, including high unemployment and low quality jobs, continues to weigh on the country's prospects. Until 2010 the World Economic Forum repeatedly ranked Tunisia as the most competitive economy in Africa, and the International Monetary Fund (IMF) as well as the World Bank heralded Tunisia as a role model for other developing countries. The Tunisian model, however, had serious flaws. Inadequate creation of jobs, notably for university graduates, and deep regional disparities were a source of increasing frustration across the country in the run up to the January 2011 revolution. This book shows that, beyond the shiny façade often presented by the former regime, Tunisia's economic environment was and remains deeply deficient. Our analysis highlights an economy that has remained frozen in low-value added activities and where firms are stagnating in terms of productivity and jobs creation.

This book argues that Tunisian prosperity has been held back by policies that have reduced the country's overall economic performance. This poor performance results from multiple barriers to the operation of markets and deep distortions introduced by oftentimes well-intended, but misguided, economic policies. Specifically, a protected regulatory environment resulting in lack of competition and large bureaucratic burden, a financial sector hampered by governance failures, labor rules that paradoxically promote job insecurity, regulatory policies that limit competition, and an industrial policy and agricultural policy that introduce distortions and deepen regional disparities are at the core of Tunisia's economic impasse. These policies accompanied what had been a tightly controlled social and political space, in which public support for the ruling party was highly beneficial, if not an outright requirement for social inclusion, whether it be hiring into jobs in the public sector, access to finance, or engagement in social action, such as the limited space allowed for civil society.

Restrictions to economic participation not only caused social exclusion but also dampened economic performance. Pervasive restrictions to the number of firms allowed to operate in the domestic market (the so called "onshore sector"), coupled with many legal (public) monopolies and undue regulatory constraints, severely limit competition, such that investment faces restrictions in over 50 percent of the economy. These barriers to market entry and contestability (introduced by the Competition Law, the Investment Incentives Code (IIC), the Commerce Code, and other sectoral legislation regulating services sectors, notably telecommunications, health, education, and professional services) stifle economic growth by hampering private initiative and discouraging innovation and productivity. The lack of competitive pressure results in lower productivity and jobs creation, as well as in higher prices charged to consumers and firms. Take for instance the price of international telephone calls—10 to 20 times more expensive than in most OECD countries—or the price of air tickets—estimated at 30 to 50 percent more expensive than what could be expected.

The heavily regulated market access has also created opportunities for rents extraction by cronies who receive privileged access to certain lucrative activities. The heavy state regulation has become a smokescreen for crony practices, severely hampering the performance of private sector and the entire economy, to the exclusion of those who do not have good connections to politicians or the administration. More perniciously, we also found evidence that the regulations themselves were in fact being adjusted in response to personal interests and corruption. This reflects an environment, still largely in place three years after the revolution, where cronyism and rents extraction (rather than competition and performance) drive economic success.

This regulatory burden stifles both opportunity and initiative and allows inefficient firms to gain unfair advantages via privileges and corruption. The cost of compliance with the many regulations

is equivalent to a “tax” on Tunisian firms of 13 percent of revenues. Further, more than a quarter of all firms report having provided some informal payment to the administration “to speed things up,” which is higher than in nearly all other countries. This reflects significant discretion and arbitrary application of the rules, giving a strong unfair advantage to the better-connected firms. We also find evidence of discretionary implementation of customs regulations and tariff evasion resulting in an annual revenue loss of at least US\$100 million (or 0.22 percent of GDP). Further, there is strong evidence that these problems may even have worsened since the revolution. These practices have a cost that goes beyond the corruption itself—they prevent the success of the best performing firms, and thereby lower the performance of the entire economy.

The banking sector provides an example of the effects of limited competition—but the same problem affects many other sectors of the economy. The governance failures affecting the large state-owned banks (SOBs) effectively undermine competition in the banking system and result in weak performance and inefficiency in the channeling of funds from lenders to businesses. Tunisian banks funded businesses linked to the family of former president Ben Ali to the tune of 2.5 percent of GDP (that is, the equivalent of five percent of all financing by the Tunisian banking sector). Further, nearly 30 percent of the cash was provided with no guarantees of repayment. Such governance failures are at the root of the large percentage of non-performing loans (NPLs) on banks’ balance sheets and contrasts with the fact that Tunisian firms report substantial difficulties in accessing credit from banks—it is regarded as a major constraint by 34 percent of firms. In fact while cronies have had unrestricted access to credit (at convenient rates and low collateral or guarantees), ordinary businesses struggle to gain access to finance. The outcome is a significant cost to the country both directly in terms of accumulated losses in public banks (estimated at between three to five percent of GDP as of the end of 2012) and indirectly by reinforcing the anticompetitive environment for private sector.

The investment policy, which is centered on the separate treatment of companies producing for the domestic market (onshore) and companies producing for exports (offshore), is at the root of the development challenges facing Tunisia today. This segmentation, which limits links between firms in the two regimes, has resulted in greater imports of intermediate products and fewer products made in Tunisia (that is, less value added in Tunisia). The onshore-offshore dichotomy was initially helpful in the 1970s but is now contributing to keep both sides of the economy trapped in low productivity. On the one hand the highly protected onshore sector is characterized by low-productivity firms that survive largely thanks to privileges and rents extraction (arising from the barriers to entry facing competitors). On the other hand, the firms that operate in the 50 percent of the economy that is open to competition (the so called offshore sector) are harmed by the fact that the services and intermediate goods produced in the onshore sector have low quality and/or are not competitively priced. In order to be competitive and be able to sell their products in the global market, these firms cannot use these low-quality and expensive parts in their manufacturing processes and instead import most of the inputs they need.

As a result, firms in the offshore sector also tend to be stuck in low-productivity and low-value added activities, and mostly focus on the assembly of imported intermediate goods produced from or for France and Italy. It is not by chance, therefore, that these two countries account for more than 55 percent of total exports—companies in these countries have outsourced the assembly tasks and other low-value added tasks to Tunisia attracted by the very favorable offshore tax regime, the availability of cheap low-skilled human resources, and the subsidized energy. Hence, while more than half of Tunisia’s exports are finished products, including many high-technology goods like sewing machines, television sets, and precision medical instruments, in practice Tunisia does not produce much of

these products—mostly it assembles parts produced abroad. As a result, not only are there fewer jobs but there is also no demand to hire the many skilled graduates. And, because the value added by Tunisians workers to the exported products is small, the salary these jobs can pay is also low.

Further, the generous incentives offered by Tunisia to attract investment in exporting companies (offshore) are expensive and largely ineffective, and paradoxically have accentuated regional disparities. The direct cost of the investment incentives is high (estimated at 2.2 percent of GDP, or approximately US\$1 billion each year). Further, 79 percent of this amount is wasted in that it benefits firms that would have invested even in the absence of incentives. As a result, each additional job created thanks to the investment incentives costs as much as US\$20,000 per year. Further, over 85 percent of the projects and jobs benefiting from the incentives were created in the coastal regions, where exporting firms are naturally located.

Labor market rules and institutions have exacerbated the bias toward low-value added activities, while failing to protect either workers or jobs. The dichotomy between the rigid firing rules for open-ended contracts and the “savage flexibility” of fixed-term contracts indirectly promotes informality and job insecurity because firms avoid giving workers open-ended contracts to maintain flexibility—which has been abused giving rise to exploitative labor practices, which in Tunisia are referred to as the phenomenon of *sous-traitance*, or subcontracting of jobs to outside firms, which generally offer low wages, few opportunities for advancement, and no job security.

Services sectors underperform as a result of economic policies that have favored barriers to entry and privileges at the expense of consumers and of the economy as a whole. Services sectors in Tunisia remain among the most highly protected and inefficient in the world (both retail and distribution and backbone services to firms like trade logistics, telecoms, and air transport), which undermines the competitiveness of the entire Tunisian economy. Previous studies have identified that Tunisia holds high potential in information and telecommunication technology (ICT) and offshoring, professional services, air and maritime transports and logistics, tourism, and health and education.

Agricultural policy is also inefficient and inequitable, as it contributes to shift production away from labor-intensive crops produced in interior regions, thus paradoxically increasing unemployment and regional disparities. Tunisia does not really have an agricultural policy; rather it has a food security policy that in fact hinders the development of its agricultural sector. The current system of state intervention has repressed the agricultural sector, distorting production away from Mediterranean products in which Tunisia has a natural comparative advantage toward continental products in which Tunisia is not very competitive but which are key to food security. The overall cost of agricultural support in Tunisia is estimated at approximately four percent of GDP and entails a net welfare loss for the country and redistribution away from interior regions toward coastal areas. Further, existing agricultural subsidies are inequitable because they mostly benefit a few large landowners (producing wheat, milk, and sugar), and mainly those in coastal areas, and do not significantly benefit smallholders.

Tunisia is Now at a Crossroads

The January 2011 revolution reflects the failure of this economic model. Tunisia does not, however, have to follow this model. In the three years since the revolution, Tunisia has achieved significant progress on the political front, with the consensual adoption of a new constitution and the emergence of a vibrant civil society. However, the economic system that existed under Ben Ali has not been changed significantly—and the demands of Tunisians for access to economic opportunity have not yet been realized. The post-revolution transition still represents a unique opportunity for Tunisians to revisit their economic system and agree on bold changes to open up economic opportunity to

all Tunisians, accelerate shared growth, create quality jobs, and promote regional development. This requires a national social dialogue to discuss the radical changes needed to create a healthier economic environment that can promote investment and enable firms to increase their productivity and be competitive, and thereby accelerate creation of good quality jobs. At the same time, Tunisians need to decide what level of redistribution may be appropriate to share fairly the benefits of economic growth and to ensure that no one is left behind.

This report is intended as a contribution to this dialogue. It provides an assessment of Tunisia's development policies and articulates a vision for a different development model—to move Tunisia from a system based on privileges to one based on competition, bringing good quality jobs and prosperity to all Tunisians. It argues that, in order to fulfill its economic potential, Tunisia needs to create a level playing field by opening up the economy and removing Tunisia's three dualisms, namely the onshore-offshore division, the dichotomy between the coast and the interior, and the segmentation of the labor market. A strong social policy is also necessary, of course, and should be designed to accompany private sector-led growth.

A series of deep economic policy reforms is required to transform the Tunisian economy and enable it to take off. In addition to preserving macroeconomic stability (which requires resources for public investment and reforms control of public expenditures, not discussed in this study), changing the dynamics of the economy will require a package of ambitious economic reforms. Here we briefly outline the main axes of the reforms agenda capable of delivering long-run economic growth:

- Remove barriers to market competition and improve the regulatory environment for investment to increase firms' competitiveness and their ability to create good quality jobs: The removal of barriers to market competition should be gradual, starting with backbone sectors and sectors with high potential for jobs creation. Our empirical analysis in Tunisia found that a five-percentage point decrease in firms' profit margins (driven by greater competition) would translate into additional GDP growth of around 4.5 percent per year and approximately 50,000 new jobs per year. There is also a need to reform the competition law and the public procurement system, which are pivotal to increase the competitiveness of the domestic (onshore) sector. The government should also revise the Investment Incentives Code to progressively eliminate the onshore-offshore dichotomy and level the playing field to boost investment and jobs creation—this also requires the reform of the corporate tax policy, since the duality is largely caused by the dichotomy in fiscal regimes between onshore and offshore firms. Finally, there is a need for a drastic simplification and reduction in the number of regulations, which cost the private sector approximately the equivalent of 13 percent of sales, with a view to reducing the room for discretion in their implementation. Notably, it is urgent to improve the operation of the customs and the tax administration, and also the administration of the land offices and the land registry.
- Reform the financial sector to enable resources to be channeled to the most productive projects and increase the quantity of financing available to the private sector for investments: Better performance in the banking sector could increase the level of credit to the private sector by at least 10 percent of GDP, which could generate in excess of US\$10 billion in additional investments to be injected in the economy over the next 10 years, corresponding roughly to an additional 38,000 additional jobs per year. To improve the efficiency of the banking system, priority should be given to strictly enforcing banking regulations, revising the procedures to deal with banks in financial difficulty, and restructuring the state-owned banks. Reexamining the role of the state in the banking sector, which long served as a tool for rents extraction and crony capitalism, is paramount. In addition, a reform of the bankruptcy framework (to more effectively save viable enterprises and enable non-viable businesses to

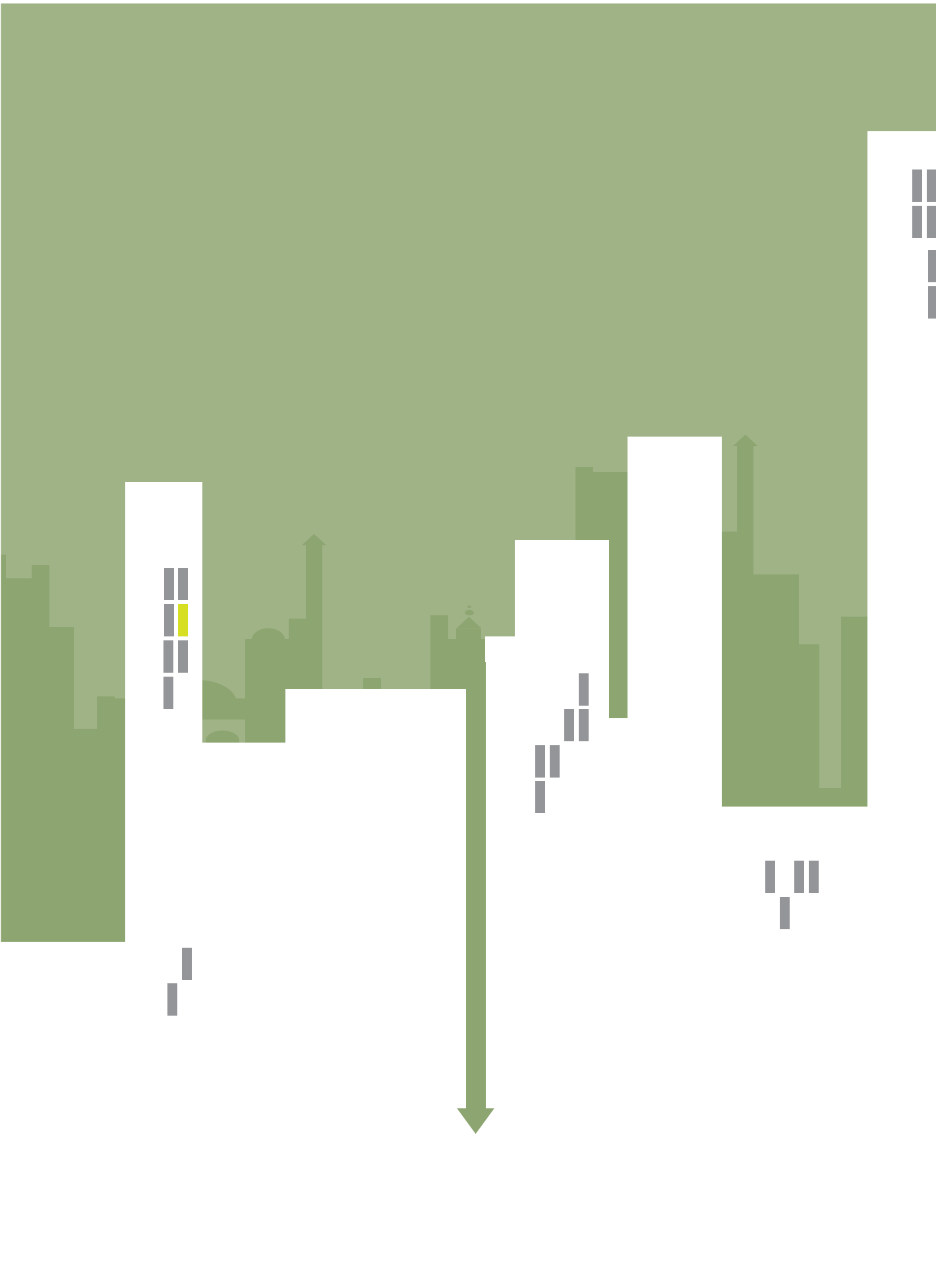
exit the market) could lead to significant benefits for Tunisia. Our estimates suggest that the reform of Tunisia's bankruptcy regime would result in an additional US\$2.1 billion (or 4.5 percent of GDP) in funds from current NPLs which if reinvested could generate approximately 80,000 new jobs. In parallel, resolving the problem of the excessive debt of the tourism sector can be tackled via the establishment of a dedicated Asset Management Company (AMC) with complete independence from the government.

- Strengthen the social protection system, reform the tax system, and adopt a package of policies attacking regional disparities in order to share fairly the benefits of economic growth and ensure that no one is left behind: The current social protection model relies mostly on untargeted fuel subsidies, which are expensive and inequitable—because they largely benefit the rich. The reform of the social protection system (including fuel subsidies) is not discussed in this report, as it is the subject of a recent dedicated study, *Toward Better Equity in Tunisia* (World Bank 2014f). The system of taxation (personal income tax, corporate taxes, consumption taxes, payroll taxes, and trade taxes) also affects the process of redistribution of wealth across people and should therefore be seen as complementary to the social protection system. Further, continuing large-scale tax and tariff evasion result in massive losses in public resources for the government and hamper competition in the private sector, giving an unfair advantage to (larger and) better connected firms. While regional disparities cannot be eliminated, minimizing them requires a rethinking of Tunisia's regional development policies. International experience shows, and indeed the Tunisian experience confirms, that the solution is not the provision of fiscal and financial incentives, but rather it is essential to improve the quality of life, access to basic services, and connectivity of interior regions. This also requires improving the design, execution, and monitoring of public investment projects. There is also a need to ensure that existing economic policies are “spatially blind” (instead of favoring coastal regions, as is currently the case).
- A second phase of reforms should include improving labor market rules and institutions, revamping the industrial policy, including policies to foster innovation, changing the strategy for services sectors, and reorienting the agricultural policy: First, building on the national tripartite social dialogue and the signing of the new Social Pact in January 2013, it should be possible to agree on a comprehensive and balanced labor market reform that would facilitate firms' competitiveness, and therefore increase investment and jobs creation, while better protecting all workers. Second, Tunisia should adopt an “offensive” trade strategy in services sectors in which it has a comparative advantage. Tunisia's high potential in the services sector could bolster the process of structural transformation and become a source of dynamic growth and jobs creation, notably for graduates. Third, our analysis suggests that there is no shortage of industrial products or services in which Tunisia has the potential to become a global player. Tunisia's successes in the offshore sector show how such opportunities can be seized—that experience now needs to be expanded to the entire economy. In this setting, the industrial policy will need to place less emphasis on blunt subsidies and tax breaks, and more on addressing infrastructure and regulatory bottlenecks, coordination failures, and other “soft” aspects of the industrial environment. Fourth, a reform of agricultural policies could unleash the potential of agriculture in interior regions by refocusing agricultural support toward labor-intensive Mediterranean products (durum wheat, olive oil, fruit, vegetables, and fisheries), in which Tunisia holds great potential. In addition the type of support needs to be refocused toward improving the infrastructure and the hard and soft services to agriculture, notably research and extensions, irrigation, the land registry and access to land, access to financing and insurance, and the transport infrastructure, which are essential to agriculture. Streamlining institutional and bureaucratic processes is particularly urgent to enable investment in the agricultural sector.

International and regional trade integration could support the transition to a more open and competitive economy, including by locking in reforms that are necessary. Tunisia has a unique opportunity: it is situated next to the massive market offered by the EU-28, and it has so far only started to scratch the surface of the potential for exports into the EU (since, as discussed, Tunisia's trade integration has been largely limited to assembling and re-exporting products for France and Italy). Most of the reforms to remove existing bottlenecks to greater global integration are domestic ones and should be undertaken from a unilateral basis since they would increase investment and jobs in Tunisia. However, the multilateral or regional trade integration process could help focus the action of the government, as experienced during the Central and Eastern European countries' integration with the EU. In terms of strategic orientation, the potential for Tunisia to expand its exports to the EU remains far larger than the potential to MENA or Africa.

Changing the development model will not be easy. The privileges and rents associated with the current system are deeply entrenched and those lobbies will argue strongly against any changes that remove their privileges. Likewise, the gradualism of economic reforms, so much cherished by Tunisia's policy makers and administration prior to the revolution, poses a risk to Tunisia's future. Marginal changes to the economic policies will not be sufficient to address the deep dysfunctions of the economic model discussed above.

It is critical, therefore, for reforms to be undertaken quickly. Not only will they take time to take effect and accelerate job creation and inclusive growth, but time increases the risks that vested interests will capture existing opportunities for rent seeking and be in a stronger position to prevent change. In January 2011 Tunisians surprised the world with the audacity of the revolution which removed Ben Ali from power. Similar audacity is now required in the economic reforms.



Introduction



Where is Tunisia Today, and Where Does It Need to Go?

An active role by the state has accompanied Tunisia's economic development since the 1960s. The Tunisian economic model is characterized by prudent macroeconomic management, the segmentation of the economy between the export-oriented (offshore) and domestic-oriented (onshore) sectors, heavy protection and entry restrictions to large parts of the onshore economy, and an active role of the state in key sectors ¹.

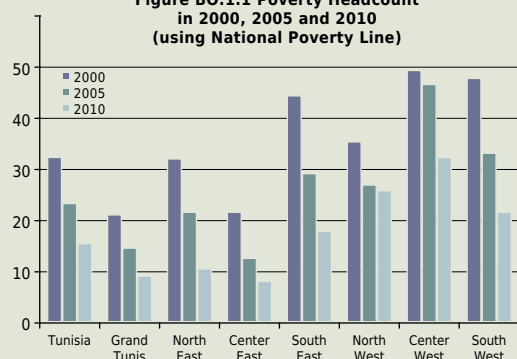
During the 1970s and 1980s this state-led dual-economy model was successful at accompanying a structural transformation of the economy. The onshore-offshore duality played a positive role as the offshore sector was relatively open to foreign investors and earned much-needed foreign exchange, while the heavily protected onshore sector facilitated the development of a local industrial base. As a result, Tunisia experienced rapid increase in exports and sophistication of the economy. In parallel, public investments and state-owned enterprises (SOEs) built up the infrastructure and the basic utilities and services (water, electricity, telecommunications, transport and logistics services) needed to accompany the economic transformation of the country.

This public sector-led development model served Tunisia well in many ways after independence and enabled the country to experience increased prosperity and rapid poverty reduction (box O.1). Tunisia enjoyed a nearly five percent average annual growth in GDP since the 1970s, placing the country among the leading performers in the MENA region. Growth was fairly inclusive because the bottom 40 percent of the population saw its level of income improve rapidly over the period ². Poverty reduction continued in recent years, such that Tunisia was able to slash poverty by half from 32 percent in 2000 to 16 percent in 2010. Further, the reduction in poverty was greatest in the poorest regions, such that, while regional disparities persisted, they decreased over the period. Tunisia also performed well on most development indicators: public investments contributed to impressive improvements since 1990 to reduce infant and maternal mortality and child malnutrition, and education levels increased dramatically.

Box O.1: Tunisia's Track Record in Poverty Reduction

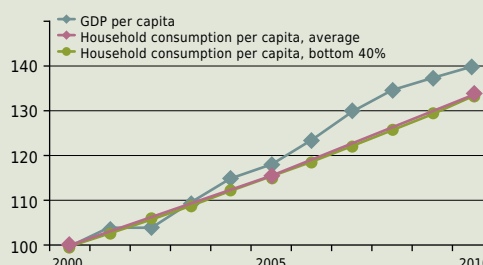
Tunisia enjoyed a 4.4 percent average annual growth in GDP over 2000-2010, placing the country among the leading performers in the MENA region. This level of growth was accompanied by rapid poverty reduction, from 32 percent in 2000 to 16 percent in 2010 using the national poverty line. Similarly, the percentage of the population below the international US\$2 per day (PPP) poverty line dropped from 12.8 percent in 2000 to 4.3 percent in 2010. Indeed growth was fairly inclusive, as shown by the fact that the bottom 40 percent of the population saw its level of income improve rapidly over the period.

Figure BO.1.1 Poverty Headcount in 2000, 2005 and 2010 (using National Poverty Line)



Source: INS, AfDB, and World Bank (2012)

Figure BO.1.2 Shared prosperity in Tunisia, 2000 to 2010



Source: World Bank staff calculations

Tunisia also performed well on most development indicators. Economic growth and public investments in human development contributed to impressive improvements since 1990 to reduce infant and maternal mortality and child malnutrition at the national level, while access to basic water and sanitation services increased.

Indicators	1990	2000	2010
Primary school enrollment rate (%)	92.4	95.6	98.7
Progression to secondary school (% of primary)	-	75.3	74.5
Ratio of girls-to-boys in primary & secondary education (%)	83.5	97.6	101
Prevalence of malnutrition (Stunting %)	-	16.8	10
Infant mortality rate (per 1,000 live births)	40.3	24.7	14.8
Maternal mortality ratio (per 100,000 live births)	130	84	56
Access to improved water source (%)	81	90	96
Access to improved sanitation facilities (%)	74	81	94
Life expectancy at birth (all/women)	70/72	73/75	75/77

In addition, although aggregate poverty and social indicators improved, regional disparities remained large. Glaring regional disparities persisted, with poverty estimates in 2010 ranging from a low rate of eight to nine percent in the Center East region and Greater Tunis to a high of 26 and 32 percent in the North West and Center West regions respectively. Similarly, while aggregate human development indicators improved, progress was limited in remote regions. In rural areas children are more than twice as likely to be stunted (10 percent in rural areas versus four percent in urban); fewer women get prenatal services or treatment for high-risk pregnancies, and maternal mortality rates are three times higher (70 versus 20 deaths per 100,000 live births); and only 50 to 60 percent of the population has access to safe drinking water and 40 percent to modern sanitation (compared to near universal access in urban areas).

Sources: Poverty estimates: INS, AfDB, and World Bank (2012); World Bank (2011); Ministry of Public Health and UNICEF (2012); UNICEF (2009); World Development Indicators (WDI).

Nevertheless, there were fundamental problems with the Tunisian economic development model, which set the stage for the January 2011 revolution. Although Tunisia's real GDP per capita growth since the 1990s was the second strongest in the MENA region, it has remained far below the growth rates observed in other upper-middle-income countries over the same period—and unlike many of its peers Tunisia did not experience an economic take off during the past two decades. Further, Tunisia has been plagued by persistently high unemployment, as the rate of jobs creation was insufficient and the quality of the jobs created remained low. Most of the jobs created by the economy were in low-value added activities and mostly in the informal sector, offering low wages and no job security, which did not meet the aspirations of the increasingly large number of university graduates. As a result, in recent years the inflow into unemployment has mostly fallen on young and educated individuals, reflecting a structural mismatch between the demand for labor, tilted toward the unskilled, and a growing supply of skilled labor³. These high rates of unemployment, as well the low quality of available jobs, underpin the great discontent which has been expressed by Tunisia's youth in mass social movements.

To make things worse, lack of adequate participation, transparency, and accountability in the management of public affairs facilitated corruption, such that opportunity was not the same for all, further frustrating the Tunisian population. The extensive web of regulations associated with pervasive state intervention facilitated the growth of corruption and cronyism (box O.2)⁴. Cronyism and corruption increasingly became rampant, and those in power bent the rules to serve their interests. Ultimately rents extraction by the few who were closer to political power undermined the economy's ability to take-off and bring prosperity and good jobs to all. Cronyism was not limited to the presence and sphere of influence of the Ben Ali clan, however. Rather it permeated Tunisian society and continues to form the basis of the current economic policy architecture⁵. The resulting unequal access to opportunity gave rise to resentment among the population. One of the words most frequently heard from young people demonstrating in Tunisia in early 2011 was "dignity." This highlighted that social and economic problems went beyond the narrow dimension of material poverty. It was first and foremost about exclusion and lack of access to opportunities and participation in the economy.

Box O.2: What the World Bank Has Learned from Tunisia

Until 2010 Tunisia appeared to be doing well and was heralded as a role model for other developing countries by the World Bank and the IMF, and the World Economic Forum repeatedly ranked Tunisia as the most competitive economy in Africa. As the revolution made absolutely clear, however, the Tunisian model had serious flaws. Inadequate creation of jobs, notably for university graduates, and deep regional disparities were a source of increasing frustration across the country in the run up to the January 2011 revolution. In fact, as is discussed in this report, beyond the shiny façade often presented by the former regime, Tunisia's economic environment was (and remains) deeply deficient. Even more important, not only has the policy infrastructure put in place during the Ben Ali period resulted in inadequate economic outcomes but it also supports a system based on privileges, which invites corruption and results in social exclusion of those lacking significant political connections.

This harsh assessment is not new. The shortcomings of Tunisia's economic model were in fact largely visible already during the presidency of Ben Ali. The move toward a knowledge economy highly heralded in the last few years of Ben Ali's government was seen as the solution to increasing the sophistication of Tunisia's production and to employing the growing number of graduates. The corruption was also not a mystery (see, for instance, Hibou 2006; 2007) to the point that the release of the Wikileaks diplomatic cables in 2010 only added detail to anecdotes that were widely circulating informally. In fact, arguably, the revolution was one

of the outpourings of popular discontent against the system that the Ben Ali clan created because, even if Tunisians weren't allowed to talk about it, everyone knew what was going on behind the scenes.

While previous World Bank reports regularly detailed the regulatory failures, the barriers to entry, and the privileges of the old system, these were often masked in bureaucratic language that did not get to the heart of what was clearly a system asphyxiated by its own corruption. In retrospect, the Bank has learned that, in its effort to remain engaged and help the poor, it can far too easily overlook the fact that its engagement might perpetuate the kinds of economic systems that keep poor people poor. Learning from this lesson will require the World Bank to unreservedly emphasize, for itself and its partners, the critical importance of the right to access to information, transparency, and accountability as part of a pro-poor development agenda, in Tunisia and everywhere else.

The main contribution of this report is to help advance public understanding of Tunisia's economic model by going beyond an explanation of the inadequacies to look at the root causes of the problem. It retrospectively consolidates into a coherent and systematic storyline the mechanics of Tunisia's economic model and explains the causes of its inadequate performance, namely the inadequate creation of high-skill jobs and the severe regional disparities, showing how these outcomes are the direct result of the current set of (misguided) economic policies. It also lays bare and quantifies the impact of the system put in place under Ben Ali, which is based on privileges and cronyism at the expense of competition and performance.

The dearth of economic opportunities in the interior parts of the country fueled even more frustration. While economic conditions improved for all, significant disparity persisted between the coast and the interior regions of the country. Average poverty rates remained four times as high in the interior of the country, compared to the richer coastal areas. Economic policies contributed to maintain these disparities, as most investment was attracted in the export-oriented sector and therefore largely located along the coastline, close to the export infrastructure.

Ultimately, Tunisia's economic model proved inadequate to tackle Tunisia's changing development challenges. The high and rising youth unemployment and unequal access to opportunity, coupled with lack of transparency and rampant abuse by cronies, fueled frustration among the population and set the stage for the January 2011 revolution (box O.3).

Box O.3: Why Did Tunisians Participate in the Revolution?

The Arab Barometer surveys in the spring and summer of 2011 explored the causes of the revolution. The Arab Barometer is a nationally representative survey of 1,196 in Tunisia using area probability sampling techniques. The results point to a balance of grievances about feeble economic opportunities and governance failures, with a slight prevalence of the former in Tunisia. Among participants in the Tunisian Revolution: as many as 58 percent identified the reasons for participation as mainly the economy (but all of these identified governance failures as their second motivation, with 32 percent indicating corruption and 26 lack of civil and political freedoms, as their secondary motivations). A further 36 percent identified the reasons for participation as mainly governance failures, of which 21 percent indicating lack of civil and political freedoms (secondarily corruption) and 15 percent concerned mainly about corruption (secondarily economics). Finally, six percent identified establishing an Islamic regime as the main motivation for participation.

Toward a New Development Model: Opening Up Economic Opportunity to All Tunisians

The Tunisian economy needs to grow much faster than in the past in order to reduce unemployment substantially. Accelerating economic growth and jobs creation will require a significant increase in investment (compared to historical levels). Although Tunisia still has room to increase the level and improve the efficiency of public investment projects, ultimately there are inherent limits to a growth-enhancing expansion in public investment. The limits of debt financing on private sector investment arise from both the fiscal sustainability constraints, because public investments weigh on the national budget and therefore there is a limit to how much can be spent, and the crowding out effects, since the government's needs to borrow large amounts in domestic capital markets to finance the public investments may result in higher interest rates which would have a negative impact on private sector investment (World Bank 2012e). Similarly, over the long term there are limits to foreign-financed private investment, as the resulting increase in current account deficit and in external debt would leave the economy vulnerable and dependent on foreign capital inflows.

Hence, while both public investment and foreign-financed investment have a large role to play, ultimately the key ingredient required to boost economic growth and jobs creation in the long run will be domestic private investment. Unleashing private sector investment is thus the overarching challenge to accelerate sustainable growth and jobs creation in Tunisia.

Tunisia today is at a crossroads and needs a new development model. Tunisia needs to review its economic policies to enable an economic take off. It can choose to continue with the same state-led, rent-prone economic model or it can choose to take the path of other upper-middle-income countries (U-MICs), which have performed much better than Tunisia over the past two decades, in favor of real integration into the global economy. In contrast with the past, the new model should eliminate privileges, open up economic opportunity to all Tunisians, and increase prosperity across the country. This requires moving from a paternalistic state, which has given rise to cronyism and privileges for the elites, to a system where the state is focused on leveling the playing field, enabling private initiative (across the country, not just along the coast), and effectively supporting the poor and vulnerable.

It is clear that the choice facing Tunisia is not merely an issue of economic policies. It is first and foremost a societal one. Tunisia is at a crossroads of values, norms, and beliefs—it needs to debate and choose a vision for society, which will then largely determine the economic policies in the next decades. This report offers a fresh diagnosis of the performance and shortcomings of the Tunisian economic model, with a view to providing evidence and ideas to fuel this debate. Several other books and studies have been published in the past few years that also provide a rich contribution to this debate (see, among others, Achy 2011; Meddeb 2011; AfDB/MCC/MDCI 2013; and Jouini 2014).

This report starts by providing a diagnostic of the state of the economy, which sets the stage for tackling the challenges facing Tunisia.

- Chapter One provides a detailed analysis of the structural evolution of the economy at the macroeconomic level and in terms of firms' dynamics—highlighting an economy with stunted structural evolution where firms are stagnating in terms of growth, jobs creation, and productivity.

The following chapters seek to identify the barriers to a more dynamic economic environment.

- Chapter Two argues that Tunisian markets are characterized by lack of competition that,

in addition to fostering rents and cronyism, is also hampering the performance of the economy, lowering productivity growth and jobs creation.

- Chapter Three explains how the complex array of state interventions in the economy has resulted in extensive (and expensive) opportunities for corruption and cronyism, which have exacerbated inequality of opportunity.
- Chapter Four highlights how the investment policy (through the Investment Incentives Code) has segmented the economy into onshore and offshore sectors to the detriment of performance in both sectors, and has contributed to keeping the economy stuck in low-value added production.
- Chapter Five shows how the policies regulating the labor market, while well intended, have reinforced the incentives for firms to pursue low-value added activities, thereby exacerbating graduate unemployment and job insecurity.
- Chapter Six discusses the inability of the financial sector to direct resources to the most productive projects.

Subsequent chapters investigate policies to steer the economy toward faster and more inclusive growth.

- Chapter Seven advocates for an industrial policy that can create a level playing field and enable Tunisia to increase the value added content of key products.
- Chapter Eight argues that opening up services sectors to competition could yield significant gains for Tunisia. Most of the required reforms, however, are domestic ones; and it is in Tunisia's self-interest to proceed with them without waiting for trade negotiations with the EU.
- Chapter Nine highlights that agricultural policy is not currently geared to take advantage of Tunisia's comparative advantage and export opportunities to the EU. While intended to support farmers, it has in fact undermined the agricultural sector by supporting products in which Tunisia is not competitive—and paradoxically this is penalizing interior regions.
- Chapter Ten examines the options to foster the development of interior regions and reduce regional disparities.

The final chapter provides a synthesis of the report and its policy recommendations.

- The concluding chapter brings together the various parts of the analysis into a coherent overview of Tunisia's structural economic challenges, and provides a prioritized set of policy reforms to accelerate creation of good quality jobs and bring greater wealth to all Tunisians.

This report does not pretend to be exhaustive; there are several important aspects of Tunisia's development model which are not discussed in this study. First, pursuing sound macroeconomic policies and maintaining fiscal sustainability is also necessary for investment and jobs creation. In the case of Tunisia there are two key aspects of macroeconomic policies that deserve discussion in a "structural" sense: fiscal sustainability and the management of the capital account. Macroeconomic management was good during the Ben Ali period, but growing fiscal pressure was accumulating in the public sector (from state-owned enterprises, civil service wages, food and fuel subsidies, and pensions), such that these aspects of state intervention now

require reform in order to maintain the sustainability of public finances. Although ensuring fiscal sustainability requires difficult structural reforms, it has not been discussed in detail in this study because we have chosen to focus mainly on the impediments to private sector growth and jobs creation. Nevertheless, the sustainability of public finances has become increasingly uncertain since the revolution, and therefore a short note on fiscal sustainability is included as annex I.1. In addition, Tunisia's capital account remains closed and constitutes a barrier to deeper economic integration. The (prudent) opening of the capital account can help increase the availability of capital to finance investment and innovation while expanding opportunities for risk sharing and consumption smoothing (Agénor 2003; Edison, et al. 2004). Opening the capital account also calls for a more flexible exchange rate, because a float allows greater freedom in responding to exogenous shocks, particularly destabilizing movements in short-term private capital flows—despite the fact that large nominal exchange rate fluctuations themselves may entail some risks. The opening of the capital account is not discussed here as it has been discussed in detail in the previous Development Policy Review (DPR; World Bank, 2010a).

Second, strengthening Tunisia's social protection system is a necessary complement to pro-growth reforms in order to effectively protect the poor and vulnerable, and to ensure that no one is left behind. The equity and effectiveness of Tunisia's social protection system is not discussed here. However, it clearly constitutes a core aspect of Tunisia's development model and is therefore an essential complement to the discussion in this report—it is discussed in a dedicated report, *Towards Better Equity in Tunisia* (World Bank 2014f), prepared in parallel with this Development Policy Review. As is discussed in that report, the social security system in Tunisia currently fails to protect the poorest and paradoxically largely benefits the better off, thus exacerbating inequality and social tension. The current model relies mostly on untargeted food and fuel subsidies, which are expensive and inequitable—because they largely benefit the rich⁶. Also, in tandem with international food and fuel prices, the fiscal costs have increased rapidly in recent years, reaching seven percent of GDP in 2012⁷. Combined with the fiscal losses of the social security funds (pensions and health insurance), as discussed above, this has highlighted the need for an urgent comprehensive reform of the social security system in Tunisia. The experience of social protection programs in Brazil and Mexico, and several other countries all over the world, has shown that well-designed social protection programs can foster inclusive economic development.

Third, as Tunisia addresses the policy failures highlighted in this report and begins to move from a low-value added and low-cost economy to a higher-value added, it will need to ensure that it puts in place the mechanisms to become a knowledge-intensive economy. Creating an environment which fosters innovation and technology adoption is not discussed in this report, however, because it was the focus of the 2010 DPR report: *Towards Innovation-Driven Growth* (World Bank 2010a). That study provides a detailed discussion of the key issues and challenges that are involved in achieving this goal. To this end, it discusses innovation policies that could facilitate the structural transformation of the economy.

Finally, there are also other aspects which are not treated or are insufficiently discussed in this report. This study focuses on the role of the public sector to enable the private sector to create wealth and jobs; increasingly, however, modern societies have recognized the growing importance of the so called third sector, the social or “not-for-profit” sector, which is the sphere of social activity undertaken by organizations that are not for profit and non-governmental, and is a growing provider of services. Although the third sector cannot by itself provide the solution to Tunisia's development aspirations, it can add a significant contribution to economic activity and wellbeing—nevertheless it is not discussed in this report because there are already other

studies that have elaborated on its potential role in Tunisia (Meddeb 2011). The reform of the public administration is also not discussed as it is a complex and separate topic. That said, it will be difficult to improve the environment for the private sector without a strong modernization program of the public administration: the goal should not be to have less administration, but a better administration (Jouini 2014). Trade policy is discussed only briefly in Chapter One and Chapter Seven, but it is the topic of a dedicated World Bank report prepared in parallel with this DPR: *Tunisia Advancing Global Integration* (World Bank 2014h). Finally, the reform of the education system (at all levels) is only briefly discussed in Chapter Five but deserves a more in-depth study as it is critical for Tunisia's future.

Notes

1. Throughout this report we use the terms “development model” or “economic model” interchangeably to refer to the set of socio-economic policies which regulate the creation and distribution of wealth in a given country.

2. These poverty headcount numbers are based on the updated national poverty line calculated by the Institut National de la Statistique in 2012, with technical assistance by the World Bank and the African Development Bank. Similarly, the percentage of the population below the international US\$2 per day (PPP) poverty line dropped from 12.8 percent in 2000 to 4.3 percent in 2010.

3. World Bank (2010a). *Development Policy Review: Towards Innovation Driven Growth*. Report No. 50847-TN. The World Bank, Washington D.C.

4. More generally, Tunisia performed poorly across most dimensions of governance and anti-corruption. Global Integrity and Freedom House rankings rate Tunisia as ‘very weak’ or ‘not free’ in most dimensions of governance. Most notably, Tunisia had important shortcomings and failures related to lack of voice and accountability, a highly centralized decision-making process which undermined the system of checks and

balances (which largely existed on paper only), and more generally substantial discretion in the application of the laws.

5. Indeed it affects most of the MENA and Mediterranean region (World Bank 2009a).

6. Fuel subsidies are particularly inequitable, with 70 percent of the benefits accruing to the wealthiest 20 percent of the population (World Bank 2014f)—in fact only 7 percent of the benefits from gasoline and diesel subsidies reach the bottom 50 percent of the population. While food subsidies in Tunisia are significantly less inequitable, yet they also benefit the rich the most.

7. Expenditures on food and fuel subsidies increased from approximately 1 percent of GDP in 2000-2004 to reach approximately 5 percent of GDP in 2012. Further, in chapter two, a system of hidden cross-subsidies to SOEs (STIR and STEG) masks the full extent of the expenditure on energy subsidies. The cost of these hidden subsidies in 2012 was estimated at approximately 2.2 percent GDP. Hence, the total cost of subsidies to Tunisia is some 30 percent higher than appears in the budget, reaching over 7 percent of GDP (World Bank 2013e).

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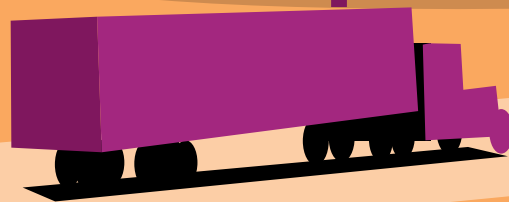
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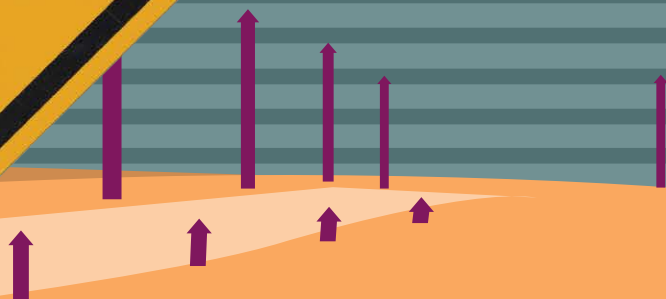
An economy with deep-running dysfunctions,
which are at the root of the feeble
performance in creating good quality jobs





An Economy Performing
Below its Capacity

01



This chapter assesses the health of the Tunisian economy. It highlights an economy with deep-running dysfunctions, which are at the root of the feeble performance in creating good quality jobs. Section One focuses on the analysis of Tunisia's structural transformation. It discusses the rate of productivity growth and the extent of reallocation of resources toward the most productive sectors. The analysis highlights an economy characterized by limited structural change and indicates that economic performance has been driven mainly by the expanding role of the public sector. It also suggests the existence of severe distortions, which have contributed to a suboptimal allocation of resources, keeping economic performance below potential. The analysis of firm-level dynamics presented in Section Two highlights the corresponding paralysis of private sector firms and also points to the existence of significant distortions, which are at the root of the under-performance of private firms. It highlights an economy where firms' dynamics are stunted and characterized by stagnant productivity, weak jobs creation, and feeble export performance—all attesting to the limitations of Tunisia's current economic environment.

1.1 / Stunted Macro Dynamics: Persistent Unemployment, Low Productivity, Misallocation of Resources, Weak Structural Change, and Feeble Export Performance

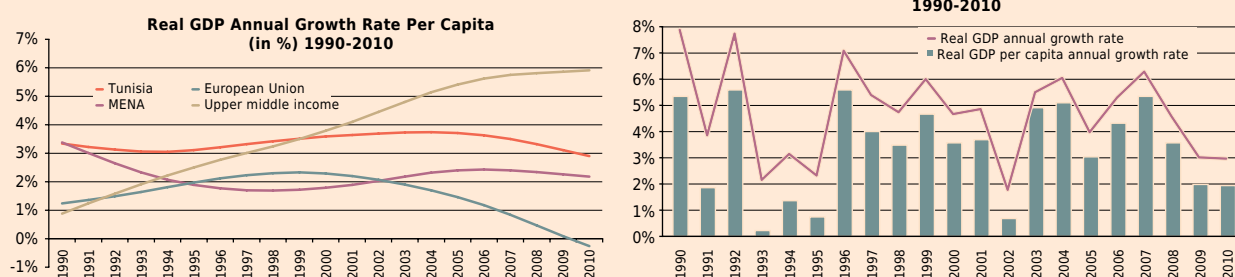
Tunisia's growth performance from 1990 to 2010 was good compared to its regional peers but substantially weaker than other upper middle-income countries, notably from 2000 to 2010. Tunisia grew at about 3.4 percent per year in real per capita terms during 1990 and 2010 and was the second fastest growing country in the MENA region since 1990. Nevertheless, other upper middle-income countries (U-MICs) on average grew at 1.5 times that speed over the last decade (table 1.1 and figure 1.1). Well-performing U-MICs such as Bosnia and Herzegovina and China enjoyed double-digit growth over the same period.

Table 1.1: Average Annual Growth Rate in Real GDP Per Capita (in %)

	Tunisia	Upper MICs
1990-2010	3.4	3.8
2000-2010	3.5	5.2

Source : World Development Indicators (WDI)

Figure 1.1: Real Per Capita Growth Rate, 1990-2010



Source: World Development Indicators (WDI); authors' calculations.

Note: MENA refers to non-oil-rich MENA countries. Growth rates in graph have been smoothed with HP filter.

Underpinning this meek performance, Tunisia suffers from a structurally low level of investment, and domestic private investment is especially low. Investment hovered around 24 percent during 2000-2010, which is low compared to other U-MICs and take-off countries. The level of private domestic investment is especially low, at around 15 percent in Tunisia over the period. Further, domestic private investment remained focused on real estate (considered safer from predation by Ben Ali—see Chapter Three). In terms of sectors, most of the domestic private investment (54 percent) is concentrated in the services sector, which is highly shielded from international competition (see Chapter Eight).

Foreign Direct Investment (FDI) inflows were significant but mainly focused in the energy sector; however, investments in manufacturing remained mainly in low value added and assembly activities. FDI inflows to Tunisia reached 3.7 percent of GDP on average during 2000-2010 compared to 3.1 percent average for MICs and 3.3 for U-MICs. In reality the apparent success of Tunisia in attracting FDI hides a paradox. Although Tunisia is geographically well positioned and is well endowed in skilled human resources, it has attracted mainly FDI targeting natural resources, 60 percent on average during 2006-2012 (table 1.2). In fact, FDI in manufacturing dropped by half between 2000 and 2006 and stabilized around an average of 26 percent of FDI during 2006-2012. Further, FDI in industrial sectors has remained focused on low value added industries, notably electric cabling, construction materials, and textiles (table 1.3)¹. In addition, unlike the recent trends in Morocco, FDI in the services sector continues to remain below 10 percent, even though these sectors are critical to improving employment of university graduates (figure 1.2).

From 1990 to 2010, Tunisia rapidly expanded access to education, particularly to higher levels of education². As a result, impressive progress has been made in enrollment and completion rates in both secondary and tertiary education. In particular, gross secondary enrollment rates increased from 52 percent in the early 1990s to 89 percent in 2009, and gross tertiary enrollment rates increased from 8 percent in the early 1990s to 34 percent in 2009. These increases have made it possible for some education outcomes for girls—such as access to tertiary education—to surpass those for boys (figure 1.3). As discussed in Chapter Five, however, challenges remain in ensuring the quality of higher education degrees in Tunisia.

Table 1.2: Share of FDI by Sector in Tunisia, 2006-2012 average

Average 2006-2012	
Manufacturing industry	25.7
Energy	60.4
Tourism and housing	3.5
Agriculture	0.5
Services	9.9
Total FDI	100.0

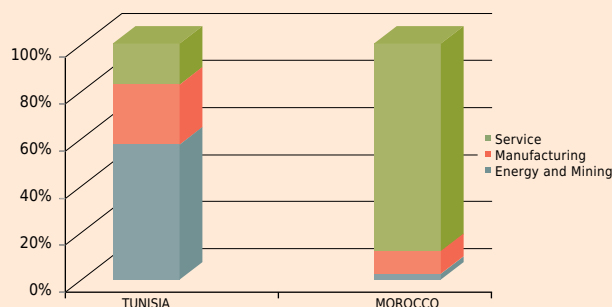
Sources: Data from Tunisian authorities
(Foreign Investment Promotion Agency-FIPA)

Table 1.3: Share of FDI by Industrial Sector in Tunisia, 2006-2012 average

Average 2006-2012	
Various industries	6.0
Agro-food	5.5
Construction materials	16.0
Mechanical, electrical and electronic	28.6
Chemical and rubber	21.7
Textiles and garments	11.7
Leather and shoes	4.9
Plastics	6.7
Total industry	100.0

Sources: Data from Tunisian authorities
(FIPA)

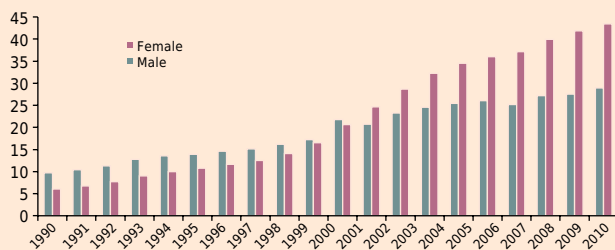
Figure 1.2: FDI Inflows Across Sectors, Tunisia and Morocco, 2008-2010 average



Sources: Data from Tunisian (FIPA) and Moroccan authorities

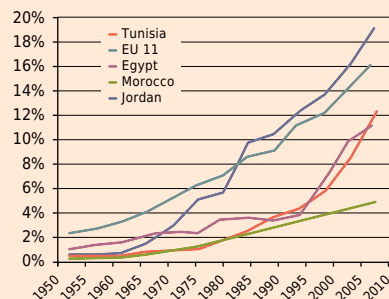
Figure 1.3: Expansion of Tertiary education in Tunisia, 1950–2010

a) Tertiary Gross Enrollment Rates in Tunisia, 1990–2009



Source: World Bank EdStats.
<http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTEDUCATION/EXTDA-TASTATISTICS/EXTEDSTATS/0,,contentMDK:21528247~menuPK:3409442~pagePK:64168445~piPK:64168309~theSitePK:3232764,00.html>

b) Share of Population with Tertiary Education, 1950–2010

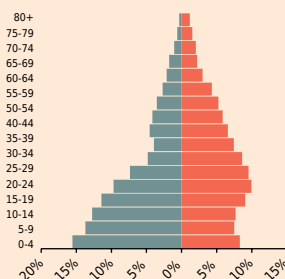


Source: Barro-Lee (2011)
 Notes: EU11 refers to the new EU member states, excluding Cyprus and Malta, and including Croatia.

In parallel, the unemployment rate remained persistently high and increasingly focused on young graduates. Unemployment hovered above 13 percent over the past two decades. Between 1990 and 2010, the share of population aged 15 or more with a tertiary education nearly quadrupled from 3.7 percent to 12.3 percent. Yet as the economy remained stuck in low productivity activities, it was unable to absorb this rapid increase in university graduates. Many of these graduates were hired by the public sector at large, which by 2010 employed over 60 percent of all university graduates. Still, the unemployment rate of skilled workers increased steadily. Until the 1990s unemployment among university graduates was negligible, but by the end of 2012 over 30 percent of university graduates had no job (Figure 1.4).

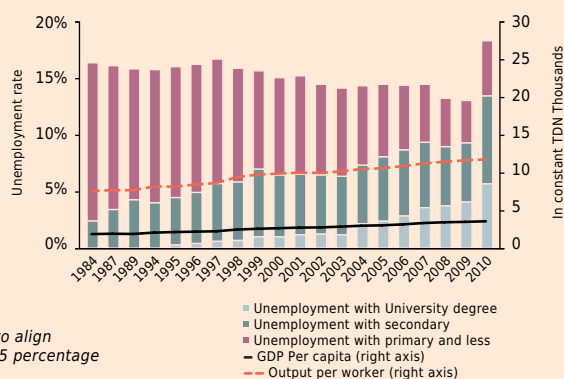
Figure 1.4: Tunisia's Youth Bulge and Unemployment of University Graduates

a) Demographic Changes in Tunisia



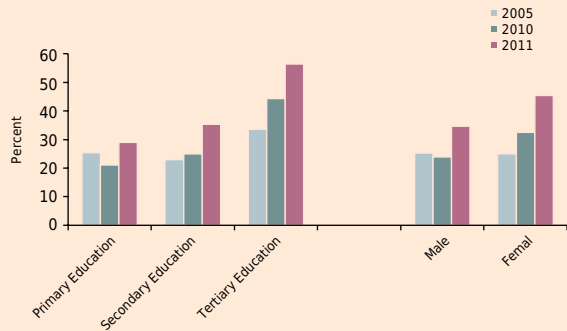
Source: INS; authors' calculations
 Note: A change in the definition of unemployment was introduced in 2008 to align Tunisia to the ILO definition and resulted in a reduction of approximately 1.5 percentage points in the level of unemployment.

b) Evolution of Unemployment by Level of Education



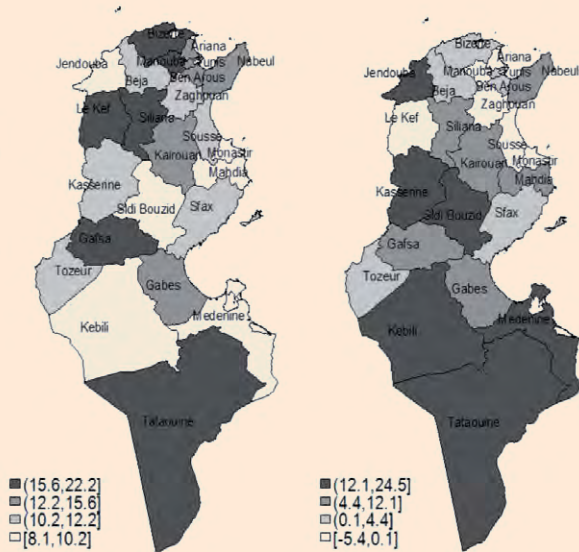
Tunisia suffers from high and increasing rates of youth and graduate unemployment, especially among females and in the interior rural regions. Although the stock of unemployed is still mostly made of low-skilled male individuals, perhaps the most concerning feature of the Tunisian labor market is the high rate of unemployment among educated youth, and especially women, many of whom have become long-term unemployed. The national unemployment rate, which peaked at 18.9 percent in 2011 in the aftermath of the revolution, has decreased to 15.3 percent as of December 2013 (see details in Chapter Five). It is much higher among women, at 21.9 percent (up from 15.4 percent in 2005) compared to 12.9 percent for men. Unemployment is increasingly concentrated on youth and graduates (from 13.3 percent in 2005 to 31.9 percent in December 2013), which tend to be the most productive group in the population. It is at crisis level for women graduates—41.9 percent of women graduates were unemployed as of December 2013. Further, abnormally large numbers of human resources, particularly women, remain out of the active work force and are not counted in unemployment statistics because they are not actively seeking employment (box 1.1). Unemployment is concentrated geographically in the north west (at 20.3 percent) and the interior south of the country (at 23.5 percent). Levels of unemployment are lower along the north eastern coastal areas (at 12.5 percent as of mid-2013).

Figure 1.5: Unemployment Rates Among Youth 15 to 29 Years Old, in 2005, 2010, and 2011



Source: Authors’ calculations using the Tunisia Labor Force Surveys 2005, 2010, and 2011

Figure 1.6: Unemployment Rates by Region in 2005 and Change to 2011

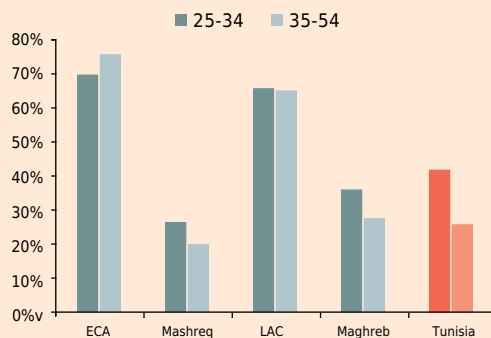


Source: Authors’ calculations using the Tunisia Labor Force Surveys 2005 and 2011
 Note: Numbers in brackets at the bottom of figure 1.6 represent rates of unemployment (as percentage).

Box 1.1 Women's Participation in the Labor Force is Very Low

Despite recent improvements, labor force participation rates remain low for women. Data from the labor force survey (LFS) indicate that labor force participation rates have increased between the years 2005 and 2011, particularly in rural areas and among younger and more educated segments of the population. At 27 percent, however, levels of female participation remain low by international standards although in line with MENA regional standards. According to ILO KILMnet data for 2008, labor force participation among women was at 51.6 percent worldwide, at 28.1 percent in North Africa, and at 25.4 percent in the Middle East. Female labor participation rates among younger and among more-educated women are much higher than among older or less-educated women (at 54 percent among women with tertiary education).

Figure B1.1.1: Female Labor Force Participation Rates in 2010



Source: World Bank 2013b and Labor Force Survey 2010.

Note: ECA = Europe and Central Asia; LAC = Latin America and the Caribbean

In Tunisia, and in the MENA context, low female participation rates can be attributed to both social and economic factors (World Bank 2014c). Beyond social norms that tend to privilege male employment, a number of important economic factors undermine women's decisions to join the labor force. High reservation wages—that is, the lowest wage rate at which they would be willing to accept a particular job—arise from low access to and/or the high cost of outsourcing child care and domestic work as well as the existence of transportation constraints and/or employment quality or safety of available jobs.

Specifically, the most important factors that affect Tunisian women's decision to participate in the labor force include:

- **Educational Attainment:** A closer look at the labor force participation profile reveals that low participation rates in Tunisia are mainly driven by very low participation in the labor force of less educated women (at 20 to 26 percent). In fact, labor force participation among women with university degrees (at 53 percent) is only slightly below that in more developed countries. Examining the determinants of female labor force participation using a simple probit regression model, results indicate that (controlling for other factors), a woman with a university degree is 64 percent more likely to be participating in the labor force than a woman who completed only primary education. Interestingly, obtaining secondary instead of primary education increases a woman's likelihood of being in the labor force by only 16 percent (World Bank 2014c).

- **Age and Marital Status:** Moreover, results indicate that participation of women tends to be higher in urban areas, among younger cohorts (25–34 years old), and among women who are not married. Indeed, regression analysis indicates that marriage is a main factor reducing women’s labor force participation. Being married decreases a woman’s likelihood of participating in the labor force by 31 percent compared to single women (other things being equal). As noted, both social norms and economic factors are likely to contribute to this result. Corroborating this statement, data from the 2010 labor force survey reveal that family reasons are most often cited for women’s nonparticipation in the labor force. In comparison, illness and education are the main reasons for men’s nonparticipation in the labor force.

- **Number of Dependents in the Household:** The number of babies in the household (generally a very important determinant of female labor force participation) plays a less important role in Tunisia (World Bank 2014c). Indeed, regression analysis indicates having one infant in the household (that is, a child less than 6 years of age) decreases female participation by only 4 percent (compared to 10 to 15 percent in countries like Turkey; see World Bank 2009b). The number of seniors (aged 65 and over), on the contrary, has a small but positive effect on labor force participation. The elderly, hence, seem to play a supportive role (for example, helping with household chores and children), instead of needing attention themselves. That said, the effect of household composition on female participation remains limited.

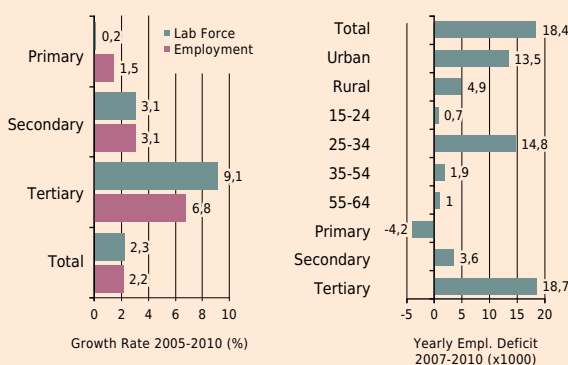
- **Education of the Household Head:** Characteristics of the household head (usually the male) also influence a woman’s decision to work. Surprisingly, results indicate that higher education of the household head is negatively associated with female participation. This could be due to two factors. On the one hand, a highly educated household head is more likely to be employed and to earn sufficient income. On the other hand, a less educated household head is more likely to work in a family business or in agriculture, in which case the woman would often help in the family business or on the farm. If the head of the household is female, the likelihood of another woman living in the household participating in the labor market increases by 8 percent.

- **Education of the Household Head’s Spouse:** Female role models can influence a woman’s decision to look for work, especially in societies driven by different cultural preferences and values. Women look at the behavior of other women in the household as role models, thus influencing their preferences. For instance, the education of the spouse of the household head is positively associated with female labor force participation. Women living in households where the head’s spouse has a university degree are 12 percent more likely to participate in the labor force than are women who live in a household with a spouse who attained primary education at most.

- **Local Labor Market Conditions:** Local labor market conditions (such as the prevalence of unemployment) could also influence female labor force participation. Women may be less motivated to enter the labor force if they feel there are limited employment opportunities (that is, discouragement). For instance, women living in localities where female unemployment rates are higher are less likely to participate in the labor force (an increase of the regional female unemployment rate of 1 percent decreases the probability of a woman participating by almost 1 percent). On the contrary, in regions where unemployment rates among men are higher, women tend to display higher rates of participation. This is explained because women’s reservation wages decrease if men in the household are idle, thus making it necessary for the household to get additional sources of income (an increase in the regional male unemployment rate of 1 percent increases the probability of a woman participating by almost 1 percent).

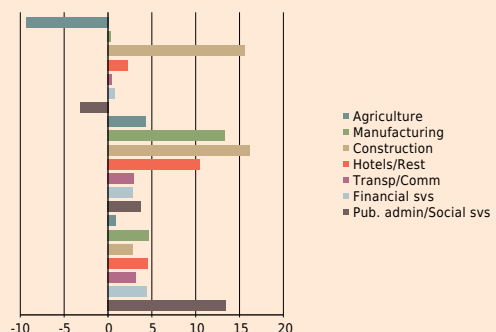
Although the Tunisian economy has been able to create jobs for the growing labor force, employment growth has not been enough to absorb all new entrants (nor to reduce the large stock of unemployed) and jobs have mostly been of low quality. Despite positive employment growth, there is an average annual net employment deficit of approximately 18 thousand jobs affecting disproportionately young highly skilled workers in urban areas (figure 1.7)⁵. In fact, employment creation has been concentrated in low-productivity activities and many of the jobs created for high-skill workers are of rather precarious quality (as discussed in Chapter Five). With few exceptions (that is, telecommunications and financial services), employment creation has been concentrated in low value added sectors, such as construction, trade, and non-financial services (figure 1.8). Construction, manufacturing, and services (economic activities that display high informality rates—as documented below) have been the main sectors for employment for low- and semi-skilled workers.

Figure 1.7: Employment Growth, 2005-2010, and Yearly Employment Deficit, 2007-2010



Source: Authors' calculations using the Tunisia Labor Force Surveys 2005, 2007 and 2010

Figure 1.8: Net Yearly Employment Creation by Industry, 2007 and 2010

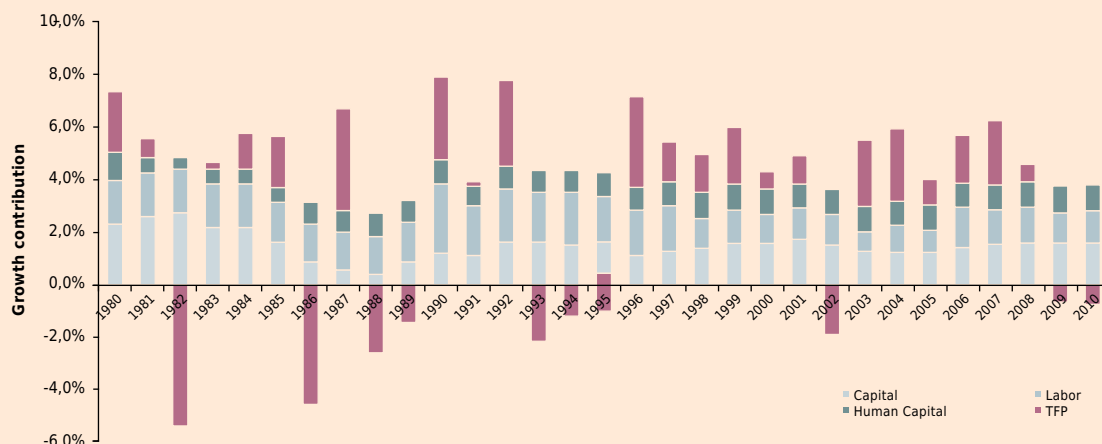


An Economy Affected by Low Productivity, Distortions, and Misallocation of Resources

While most U-MICs experienced an economic take-off during this period, Tunisia was crippled by the failure to adapt its development model. An analysis of the decomposition of GDP growth highlights that Tunisia's growth over the past two decades was largely driven by factor accumulation, with only a small contribution from improvements in Total Factor Productivity (TFP)⁶. Hence, although as discussed above the levels of investment and employment remain insufficient, their increase accounts for most of the growth over the past two decades, suggesting the existence of shortcomings in the economy. Between 1990 and 2010, accumulation of capital and labor contributed on average 36 percent and 35 percent to growth, respectively⁷. Only the remaining 28 percent of growth can be attributed on average to improvements in Total Factor Productivity (TFP). This corresponds to an average annual TFP growth rate of approximately 1.3 percent, which is low when compared to fast growing countries⁸. This is important because TFP growth ultimately increases the demand for labor. Further, controlling for human capital, the growth contribution of capital, labor, and human capital in Tunisia becomes 36 percent, 35 percent, and 22 percent respectively, such that contribution of improvement in TFP shrinks to an

average 5 percent over the last two decades (figure 1.9)⁹. In other words, once we account for the improvement in the quality of the labor force, we find that productivity improvements have been very limited over the past two decades.¹⁰

Figure 1.9: Growth in Total Factor Productivity (with Human Capital-Adjusted Labor), 1980-2010



Source: INS; authors' calculations

Higher productivity growth is important because it implies greater wealth creation per capita, which results in more jobs creation and creation of better quality jobs (box 1.2). An economic growth strategy entailing large factor accumulation is appropriate when a country has a large stock of untapped human resources, such as is the case for Tunisia. Productivity growth, however, is required to generate more wealth per capita and ultimately faster jobs creation. The rate of TFP growth is a good indicator of the overall efficiency of the economy—it measures the improvement in the use of these factor inputs. Low TFP growth suggests the existence of barriers that prevent a reallocation of resources towards more productive activities and hamper the economy's capacity to generate wealth and jobs. Increase in TFP (that is, efficiency improvements in the use of factor inputs) can take place within a given production activity or sector, or can be the result of a reallocation of resources across sectors.

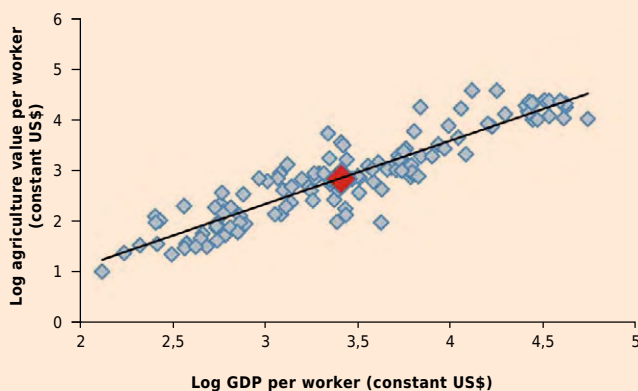
Box 1.2: What is Productivity and Why Does It Matter?

Productivity is a key driver of wealth and jobs creation. We can think of economic growth as the result of the accumulation of human and physical capital—that is, more (high-skill) jobs, and more investment—and increased “productivity.” Productivity shows how well people combine resources to produce goods and services. For countries, it is about creating more from available resources—such as raw materials, labor, skills, capital equipment, land, intellectual property, managerial capability, and financial capital. Higher productivity is therefore synonymous with higher production, higher value creation, and higher incomes. As a result, the higher the productivity of a country, the higher the living standards it can afford and the more it can improve the wellbeing of its citizens (for example, through healthcare, education, roads and telecommunications, security, and a stronger social support for people who need it). At the aggregate (economy-wide) level, productivity also brings more jobs and better quality jobs, as it stimulates additional growth in income and output to generate overall employment growth and for firms to pay better salaries.

Contrary to more advanced economies, developing countries tend to be characterized by large differences in productivity across sectors. Productivity gaps persist in developing countries across sectors and even across firms (Hsieh and Klenow 2009). As mentioned, these productivity gaps may be indicative of misallocation of resources. Large productivity gaps across sectors suggest that reallocation of workers from low-productivity to high-productivity sectors can be an important driver of growth¹¹. In fact, in many high-growth countries, in particular in Asia, re-allocation of workers across sectors has contributed positively to growth during the last twenty years (McMillan and Rodrik 2011).

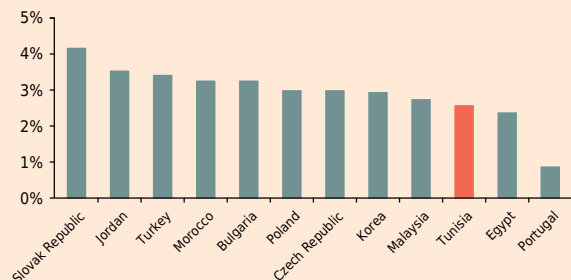
While Tunisia displays fairly large differences in productivity across sectors, it has surprisingly only a small productivity gap between manufacturing and agriculture, which underscores the low productivity of Tunisian manufacturing. This agriculture-manufacturing gap is very low in Tunisia compared to other countries¹². In 2005, labor productivity in manufacturing in Tunisia was only 1.7 times higher than in agriculture—this is even lower than the 2.3 gap in Sub-Saharan Africa and much below the 2.8 in Latin America and 3.9 in Asia (McMillan and Rodrik 2011)¹³. Although the productivity of the agricultural sector in Tunisia is in line with that of other countries (figure 1.9), what is noteworthy is the low productivity of the manufacturing sector. In most developing countries, agriculture is the sector with the lowest productivity; however, in Tunisia manufacturing is not much more productive than agriculture, and in fact the textiles sector is less productive than agriculture¹⁴. As discussed below, this reflects the fact that with some notable exceptions manufacturing in Tunisia tends to focus on simple assembly and other low value added activities, which in turn explains the low quality of jobs. In a sense these findings capture the essence of the problem with the Tunisian economy.

Figure 1.10: Tunisia's Agricultural Productivity in International Comparison, 2009



Source: World Development Indicators (WDI); author's calculations.
 Note: The red dot represents Tunisia.
 Note: The measure of output per worker includes the impact of improvements in capital stock and in human capital

Figure 1.11: Output per Worker Average Annual Growth Rate, 2000-2010



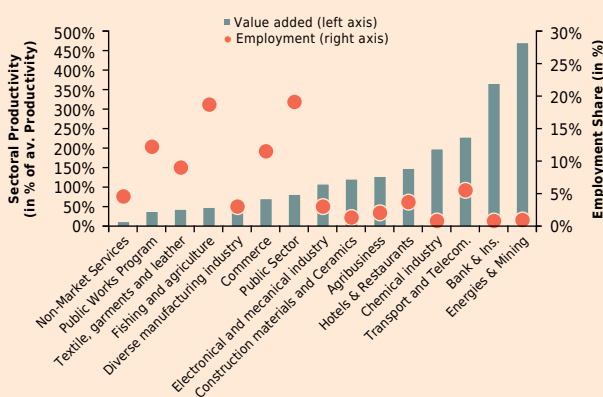
Source: World Development Indicators (WDI); author's calculations.
 Note: The red dot represents Tunisia.
 Note: The measure of output per worker includes the impact of improvements in capital stock and in human capital

Tunisia's labor productivity remains low, and Tunisia has been losing ground with respect to benchmark countries over the past decade. The growth in output per worker (which we use as a proxy of labor productivity throughout this report) was around 2.5 percent on average in Tunisia over the past decade, below most benchmark countries in MENA (such as Jordan and Morocco) and take-off countries in the EU and Asia (figure 1.11). The low labor productivity reflects the production structure of the Tunisian economy, which is centered on low value added activities and low quality jobs¹⁵. It is worth noting, however, that wages increased by 2.1 percent on average during 2000-2009 (ILO 2011), below the increase in labor productivity over the period¹⁶. The wage restraint increased the competitiveness of Tunisian firms in labor-intensive products, notably assembly activities¹⁷.

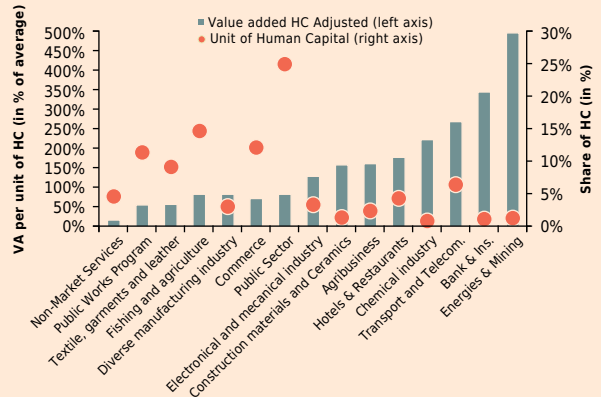
As much as 77 percent of Tunisia's workforce is employed in low-productivity sectors. Low-productivity sectors here refer to sectors with below average productivity, which in 2009 included agriculture, textiles, most manufacturing sectors, commerce, the public sector, construction, and public infrastructure (figure 1.12). High-productivity service sectors—such as banking, transport, and telecommunications—absorbed only 7.7 percent of total employment. The share of workers in low-productivity sectors is high when compared to other developing countries¹⁸. Controlling for human capital reveals an even more profound misallocation of human capital (figure 1.12). In 2009, as much as 75 percent of Tunisia's human capital-augmented labor was employed in sectors with below-average productivity, with 24 percent in public administration. Further, this pattern has persisted, with only minimal reallocation across sectors over time—and what reallocation has taken place has been largely from low-productivity agriculture into low-productivity manufacturing.

Figure 1.12: Sectoral Labor Productivity and Employment in 2009

a) Output per Worker



b) Output per Units of Human Capital



Source: Authors' calculations based on INS National Accounts and Enquête Nationale des Entreprises-ENE.

Note: Public works programs refers to construction and public infrastructure

Note: In the graph of the right hand side, the units of human capital are calculated as the weighted average of the number of employees, where the weights are determined by their years of education and the annual return to education. We use information from the ENE to determine the share of workers with primary, secondary and university degree to make these calculations. The left axis compares the sector value added as a share of human capital (HC) to the average value added as a share of HC. The right axis shows the sectoral share of HC (such that all the red dot values sum up to 100%).

Limited Structural Change, 1990-2010: An Economy Stuck in Low-Productivity Activities

To assess how much structural transformation has contributed to Tunisia's growth in the past, we carried out a different decomposition of GDP per capita growth. In order to explore the dynamics of the Tunisian economy we decompose GDP growth in the contribution of changes in the demographics, the level of employment and the level of productivity growth (box 1.3)¹⁹. The latter can then be further divided into two additional components: changes in sector level productivity ("within" component) and changes arising from a reallocation of labor between sectors ("across" component), which measures the speed of structural change in the economy²⁰.

Box 1.3: GDP Decomposition and the Measurement of Structural Change in the Economy

One of the key insights of development economics is that growth is driven by a structural shift from agriculture to the industrial sector. This process of structural change tends to be mirrored in the pattern of employment so that over time the labor force in the nonagricultural sector increases while employment in the agricultural sector declines (Kuznets 1967). As labor moves to the industrial sector, overall productivity rises and incomes expand. Reallocation of workers from one sector to another is hence an important aspect of economic development. Recent research highlights that as much as 85 percent of the international variation in aggregate Total Factor Productivity (TFP) can be attributed to differences in the relative efficiency across sectors, underlining the importance of enabling a dynamic economic environment (Chanda and Dalgaard 2008).

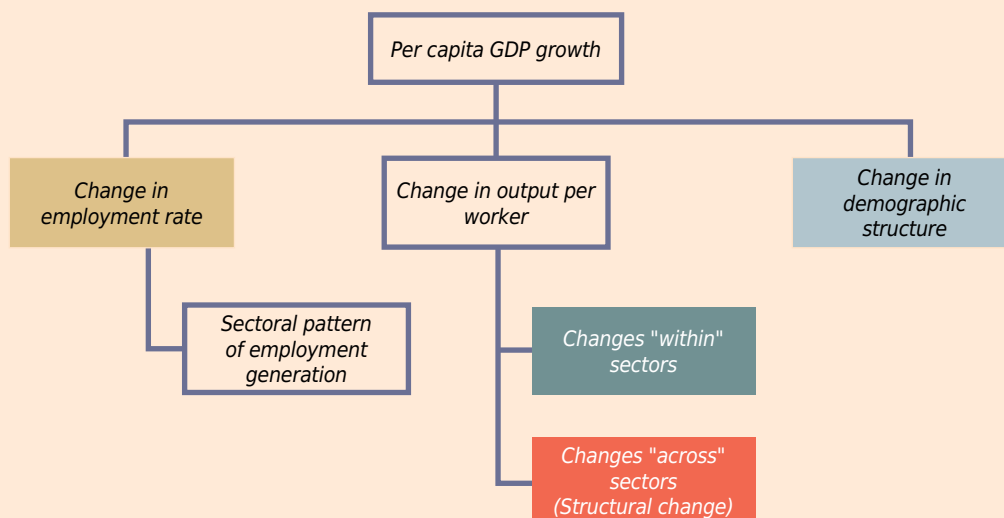
Reflecting the observation above, GDP per capita growth can be decomposed into the following components: (a) change in employment rate, (b) change in labor productivity (which we proxy by looking at change in output per worker), and (c) change in demographic structure. Each of these components is important in its own right: the employment rate and the demographic structure components reflect the change in the number of jobs, while the productivity component captures the change in the value creation of those jobs, which normally reflects the wages and quality of jobs. Labor productivity can be decomposed further into two additional components: changes in sector level productivity ("within" component) and changes arising from a reallocation of labor between sectors ("across" component). Using the Shapley decomposition (Shorrocks 1999), this can be written as:

$$\Delta y_t = \sum_N \frac{s_{i,t} + s_{i,t-k}}{2} \Delta y_{it} + \sum_N \frac{y_{i,t} + y_{i,t-k}}{2} \Delta s_{it}$$

where Δy_t is the change in aggregate labor productivity between t and $t-k$, θ_{it} is the employment in sector i at time t , and y_{it} is the productivity level in sector i at time t . The first term is the "within sector" component, and the second term the "across sectors" component. The latter is a measure of how reallocation of labor has contributed to Tunisia's growth in the past, that is, the contribution of structural change to growth. Similar decompositions have been used in World Bank (2009b). An alternative methodology for decomposing labor productivity has been proposed by Pages (2010) and McMillan and Rodrik (2011) and is discussed in the DPR background report on "Tunisia's Structural Transformation: Evolution of Productivity, Employment and Exports" (World Bank 2014d).

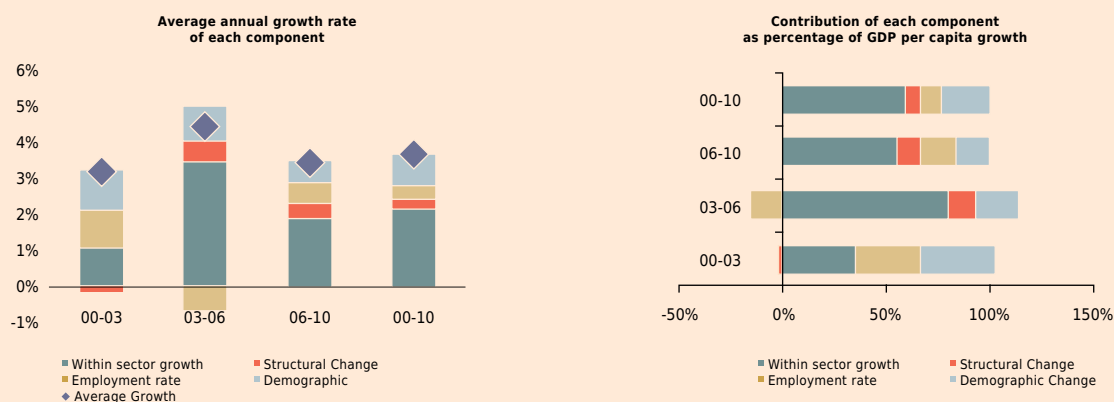
It should be highlighted that at the sectoral level the "within" component should also be considered as a measure of the profitability of the sector in that it measures the return to resources invested in that sector per unit of labor. While we use this as a measure of higher productivity, however, it can also reflect the ability of firms to extract rents from consumers. Similarly, it is important to underline that not all structural change is good. For example, productivity may be higher in sectors with monopoly power, and a reallocation to these sectors would contribute positively to structural change but would not necessarily promote growth or enhance welfare (for a more detailed discussion, see Lederman and Maloney 2012).

Figure B1.3.1: GDP Growth Decomposition



Demographic change and increased employment account for one-third of growth over the past decade. As mentioned above, Tunisia witnessed a rapid increase in working-age population over the past two decades (figure 1.4). This demographic change, measured as the growth in working-age population as a percent of total population, contributed about 23 percent to real per capita growth over the period 2000-2010 (or 0.8 percent to annual GDP growth per capita; figure 1.13). Similarly, although the rate of unemployment decreased only marginally, the economy has done quite well in terms of absorbing its youth bulge. Between 2000 and 2010, active population as a share of working-age population increased from 49.6 percent to 51.1 percent as the unemployment rate decreased marginally from 15.7 percent to 13.3 percent²¹. The change in the "employment rate" component contributed 10 percent to growth per capita over the period 2000-2010 (or 0.4 per year; figure 1.13).

Figure 1.13: Contribution of Demographics, Employment, and Productivity to GDP Growth Per Capita in Tunisia, 2000-2010

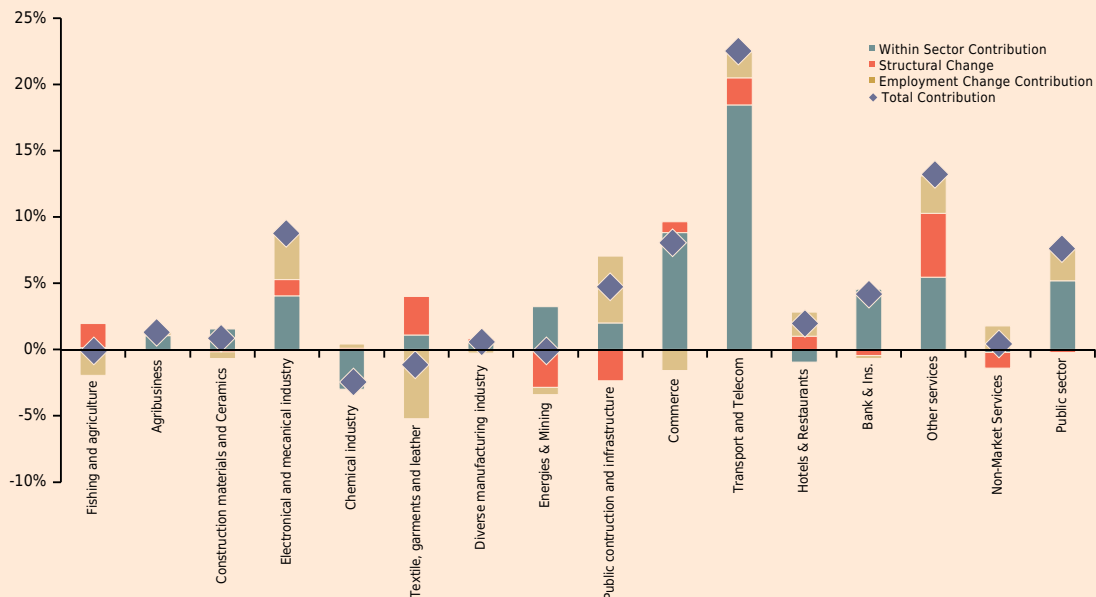


Source: Authors' calculations based on INS National Accounts and ENE.

The results confirm that the Tunisian economy has been characterized by low productivity and limited structural change over the past decade. Decomposing output per worker in its “within” and “across” components highlights that between 2000 and 2010 the contribution of structural change to economic growth has been positive but weak. As mentioned above, labor productivity increased at a rate of 2.5 percent per year, contributing roughly 68 percent to GDP growth between 2000 and 2010²². Most of this productivity growth took place “within” sectors, accounting for 60 percent of real GDP growth per capita over the period (or 2.2 percent per year; figure 1.12). Structural change, the reallocation of labor from low-productivity to high-productivity sectors, contributed only 8 percent to the change in real GDP per capita between 2000 and 2010 (or 0.4 percent per year; figure 1.13). For comparison, Macmillan and Rodrik (2011) calculated that during 1990 to 2005 the “within” component in China; Hong Kong SAR; India; Malaysia; Mauritius; Taiwan, China; and Turkey ranged from 7.8 percent per year to 1.7 percent per year, while the structural change component accounted for between 1.4 percent per year to 0.4 percent per year (figure 1.13). They also found, however, that in many Latin American and Sub-Saharan African countries “structural change” between 1990 and 2005 has been negative, depressing economic growth (McMillan and Rodrik 2011).

These results indicate that the Tunisian economy has been unable to efficiently reallocate resources from low-return to high-return activities but also highlight that, despite some reallocation of resources having taken place, the entire economy appears to have remained in a low-productivity conundrum. This means that the economy operates below potential, which is reflected in the relatively low rate of GDP growth and insufficient and low quality jobs creation. Performance was even weaker when we consider that our measure of productivity is inflated by the expansion of the public sector. A large share of our measure of productivity therefore simply reflects the increase in the size of the public administration: there is not a real increase in productivity but just an increase in public expenditures²³.

Figure 1.14: Sectoral Contribution to GDP Growth in Tunisia, 2000-2010

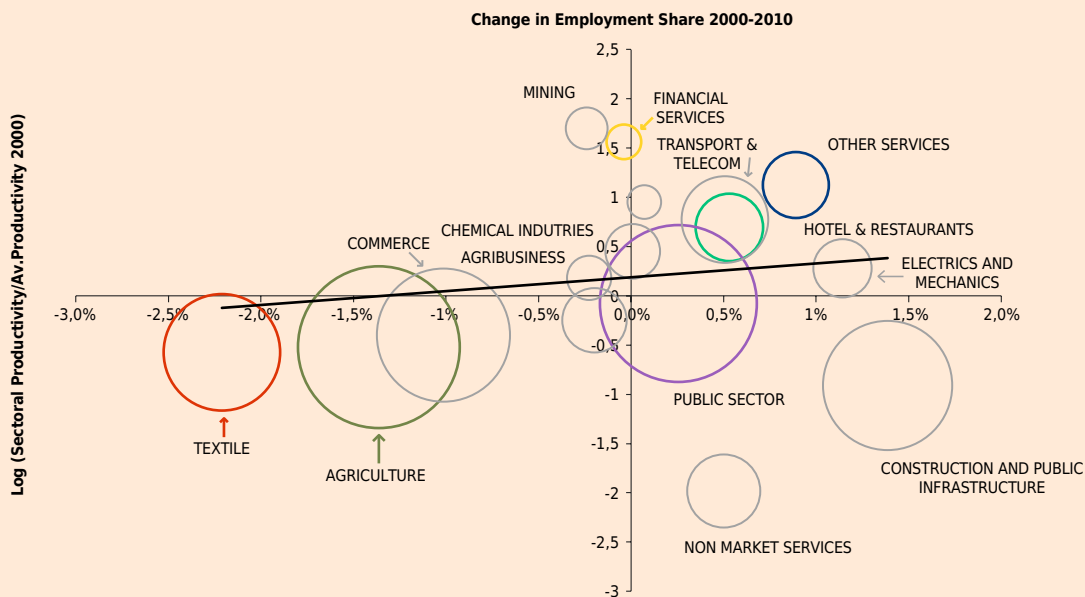


Source: INS; authors' calculations

Further, an analysis of GDP decomposition at the sectoral level highlights that our measure of productivity is inflated by the monopolistic profits in the transport, telecommunications, and commerce sectors. Performance was also lower when we consider that at the sector level productivity appears to have increased the most in transport, telecommunications, and commerce (figure 1.14), largely reflecting the rents which exist in these sectors as a result of the barriers to entry—only a few companies have been licensed to operate in these sectors, which in fact were primary targets of Ben Ali’s clan (see Chapter Three)²⁴. As will be discussed in Chapter Two and in Chapter Three, the limited competition in these sectors allows incumbents to charge exorbitant prices to Tunisian consumers (and firms), in a sense syphoning off wealth creation from the rest of the economy.

The overall contribution of manufacturing to growth has been weak, lacking productivity and employment growth. In line with our previous discussion, the sectoral GDP growth decomposition also confirms that the contribution of manufacturing to growth has been weak overall, lacking both in productivity and employment growth. In fact, the average productivity of the manufacturing sector remains very low and not much greater than the agricultural sector. Overall labor productivity growth in the manufacturing sector contributed only 0.9 percent per year to real GDP growth per capita between 2000 and 2010. About half of this productivity growth can be attributed to the “within” component which contributed 5 percent in total to Tunisia’s GDP per capita growth over the period 2000-2010; the structural contribution accounts for 4.3 percent. Its employment contribution was negative, largely driven by shedding of jobs in the textile sector, which struggled to remain competitive after the phasing out of the multi-fiber agreement in 2005 (figure 1.15). The manufacturing sector with the highest productivity growth was the electronics and mechanical industry where productivity increased by 30 percent over this period. Productivity of the chemical sector shrank by 33 percent over this period²⁶.

Figure 1.15: Sectors and Structural Change in Tunisia, 2000-2010



Source: INS; authors' calculation

Note: The circles represent the sectoral employment shares in the year 2000.

Box 1.4: Tunisia's Offshore-Onshore Dichotomy

Tunisia's economic environment is characterized by a stark differential treatment of exporting and non-exporting firms. Already in the early 1970s Tunisia embraced an export-led growth strategy and instituted a special tax regime favoring exporting companies. This dual regime was consecrated in the 1993 Investment Incentives Code. While the Code has undoubtedly been successful in attracting foreign investors and boosting exports and served Tunisia well in the initial stages of industrialization after independence, the dual economic system is at the core of the shortcomings of Tunisia's economic model (see Chapter Four).

The Investment Incentives Code distinguishes between "fully exporting" or "not fully exporting" firms, commonly referred to as "offshore" and "onshore" enterprises. Fully exporting firms benefit from tax exemptions on profit and income taxes during the first ten years of their activity, a 50-percent reduction for another ten years, and full tax deduction for reinvested profits. The state also grants duty-free access to all inputs and equipment. It also often provides the necessary infrastructure and assumes employers' social security contributions during 5 years. These firms also benefit from streamlined customs procedures, corresponding to significant costs savings since the local administration is complex, unpredictable, and burdensome. A fully exporting enterprise may sell up to 30 percent of its turnover in the domestic market. Anecdotal evidence indicates that few enterprises choose this option, since the fraction of the production sold on the domestic market is exempt from the offshore benefits. This implies that the fraction sold on the domestic market is not only taxed under the general tax regime but also subject to standard local administrative procedures. Not fully exporting enterprises can export their production; however, enterprises are often split into two distinct entities: one dedicated to the onshore market and the other fully exporting. Imported intermediate goods required for these exports are exempt from import taxes if the corresponding exports take place within a three-month period. This results in costly administrative procedures, such as obtaining specific certificates of corresponding imported and exported goods from the customs officers confirming that they have actually seen the goods. As a result, domestic companies that start to export tend to divide themselves into two distinct entities: one dedicated to the onshore market and the other under the fully exporting offshore regime.

Offshore firms account for just over half of all exporters (52 percent) but almost three-quarters (72 percent) of all exports. Twenty-three percent of exporters are foreign-owned, and these are largely offshore firms. Roughly 6 out of every 10 offshore firms are in fact domestically owned. Although not all offshore firms are foreign and not all foreign firms are offshore, approximately 45 percent of all offshore firms (8,261 out of 18,211 offshore firms) are foreign, while only 1.8 percent of all firms are foreign owned, indicating that the offshore sector is an FDI magnet. Foreign offshore exporters account for 37 percent of all exports, thereby accounting for just over half of all offshore exports (recall that total offshore exports account for 72 percent of all exports; $0.37/0.72=0.51$). Offshore firms accounted for roughly 33 percent of all wage employment in 2010, even though only 6 percent of all firms that offer wage jobs are registered as offshore firms. (Freund, et al. 2013).

As discussed in detail in Chapter Four, the offshore-onshore dichotomy imposes high costs on the economy. First, the manufacturing sector is considered important for economic growth since it tends to have strong backward and forward links with other sectors of the economy. The offshore-onshore dichotomy has weakened those links. Second, it weakens the dynamic links between the domestic market and the export sector. The export industry could play an important role in supporting the development of a network of domestic suppliers and incentivizing local innovation, but this does not happen in Tunisia due to the segmentation between the two regimes. Also, a vibrant domestic market is often considered a driving force for the export industry (Porter 1990), but instead segmentation keeps the onshore sector stuck in low productivity and low growth. Further, the complex administrative burden associated with the regime opens the door for corruption (see Chapter Three).

Only a few sectors contributed positively to structural change. Labor moved from textile, commerce, and agriculture toward transport and telecommunications, hotels and restaurants, electronics and mechanical industry, and other services (which includes business services). This structural change contributed positively to productivity as it entailed a contraction in below-average productivity sectors, which in turn enabled employment gains in sectors with above-average levels of productivity and better quality jobs (figure 1.15). That said, as mentioned above, the overall rate of structural change was limited. Comparing Tunisia's structural change with that of selected countries also confirms the low contribution of its manufacturing sector as well as its financial and business services (annex 1.4).

Overall sectors dominated by offshore firms had on average weak "within" productivity growth, while sectors dominated by onshore firms have been characterized by rents extraction. In order to explore the differences in performance between onshore and offshore sectors (box 1.4; see also Chapter Four for a detailed analysis of the onshore-offshore dichotomy), we carried out a growth decomposition distinguishing between sectors where more than 60 percent of firms are totally exporting (which we consider as prevalently "offshore sectors" and which to a large extent are confined to the manufacturing sectors) and other sectors (which we consider as prevalently "onshore sectors"). As expected, prevalently offshore sectors had on average weak "within" productivity growth over the past decade, reflecting the fact that offshore firms have largely remained focused on low value added manufacturing and assembly activities. Overall the offshore economy reduced employment without increasing productivity. The positive structural change in this sector is therefore unlikely to be the result of labor shedding toward more productive sectors, but rather reflects a possible loss of competitiveness. On the other hand, the prevalently onshore sectors show a large "within" contribution to growth. As discussed above, this reflects the rents extracted in key onshore sectors as a result of market access restrictions which allow only a few privileged firms to operate in these markets (see Chapter Two and Chapter Three). Structural change was negative in the onshore economy as high-productivity service sectors, such as financial intermediation services, shed labor and low-productivity sectors, such as enterprises services, absorbed them.

In sum, the Tunisian economy appears stuck in a low-productivity conundrum which is reflected in the limited and low quality jobs creation. The analysis of structural change highlights an economy that is performing weakly, as reflected in relatively low productivity growth and employment generation, because of the characteristics of the economy. On the offshore side (i.e. for the exporting firms) the low productivity is the result of a sector mainly focused on low value added and assembly activities for the EU. On the onshore side (i.e. the firms producing for the domestic market), rents extraction by the privileged cronies has undermined the growth of the rest of the economy. To make matters worse, the lack of structural change highlights an economy that lacks dynamics toward a more productive model.

Tunisia's Feeble Export Performance, 1990-2010

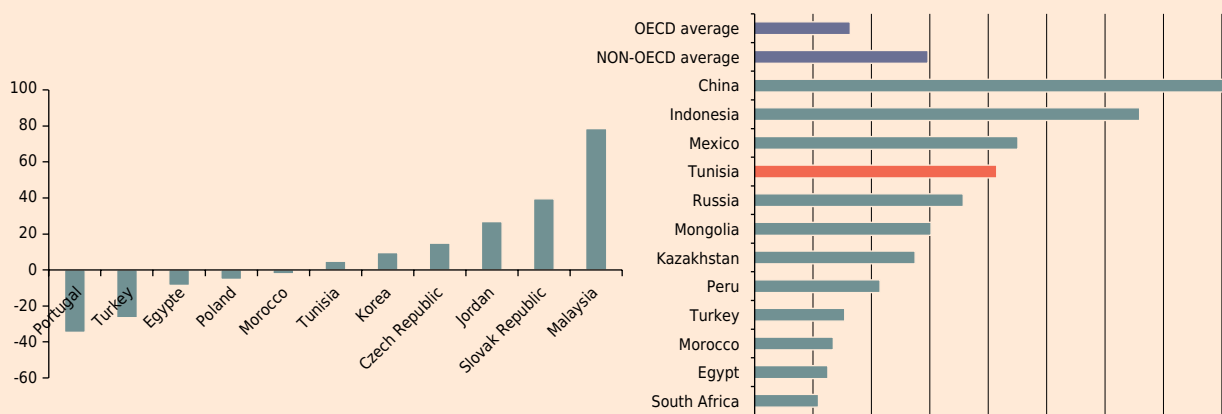
As a small economy with limited natural resources, Tunisia's trade integration and export performance are critical to its prosperity. Tunisian companies need to sell to foreign markets in order to expand, enjoy scale economies, and create more jobs. In fact, exporting is a way to expand the demand for locally made products and therefore also the demand for local labor. More generally, exports are another indicator of productivity, since by definition exporters successfully compete against international firms.

Tunisia remains a fairly closed economy, and its export performance has been relatively weak. Although the perception in Tunisia is that the economy is open and relatively well integrated, in

fact compared to benchmark countries Tunisia remains less open (as measured by the share of exports and imports in GDP) and quite protected. Based on GDP per capita, size of population, and whether or not a country is landlocked, Tunisia is less open than fast-growing countries such as the Czech Republic, Malaysia, the Republic of Korea, or the Slovak Republic—but more open than Egypt, Morocco, or Turkey (figure 1.16)²⁷. This reflects the discussion in the previous section that most of the onshore economy remains protected and subject to severe market access restrictions (see also Chapter Two). Non-tariff measures remain common and used to protect the domestic market (box 1.5; Augier, et al. 2012). Similarly Tunisia continues to rank very low on the OECD FDI Restrictiveness index, ranking 42nd out of the 51 countries for which the index is available, below the non-OECD average and also well below Egypt and Morocco (figure 1.17 and figure 1.18)²⁸.

Tunisia's governments in the past pursued an export-led growth strategy (through the offshore sector); however, contrary to public perception in Tunisia, export performance has been weak. Tunisian exports growth (in volume) over the past 20 years was the second lowest in the region—just above Jordan—and the worst performer compared to other benchmark countries (figure 1.18). Tunisian exports growth was positive but slower than export growth in many other countries and also slower than Tunisian GDP growth. As a result, Tunisia's exports as a share of GDP declined from 38 percent to 35 percent over two last decades, which masks an increase during the 1990s and a drop over the past decade. This contrasts with the increase in the share of exports in GDP over the period in all other benchmark countries, except Jordan³¹.

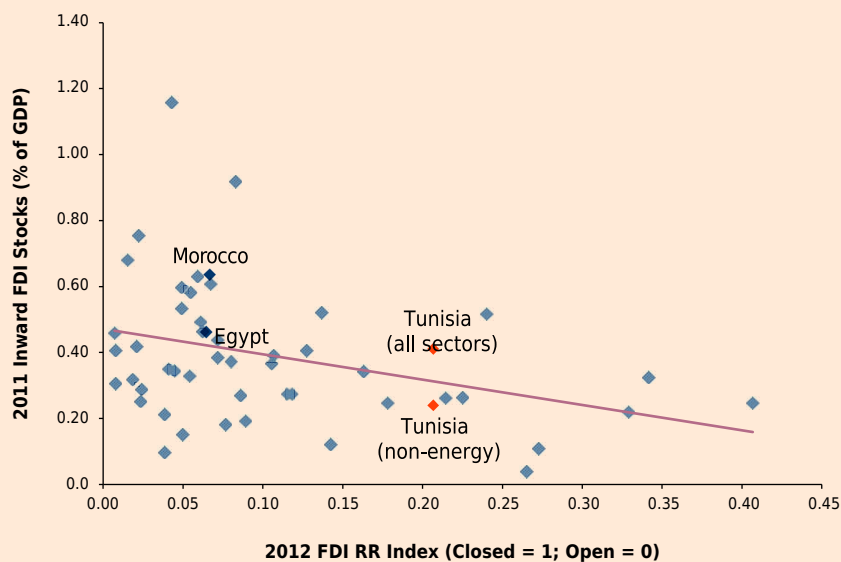
Figure 1.16: Degree of “Openness” of Tunisia and FDI Regulatory Restrictiveness Index, 2012



Source: Authors' calculations based on WDI and data from OECD on the FDI Regulatory Restrictiveness Index.

Note: In the left hand side graph 'openness' is calculated as the residual of an OLS regression of the share exports and imports in GDP on log GDP, log population and a dummy for landlocked countries.

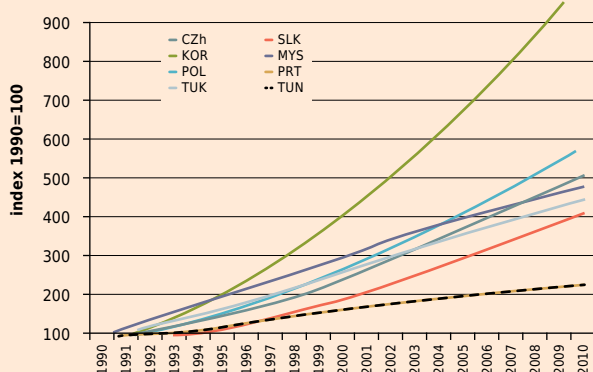
Figure 1.17: FDI Inflows and Regulatory Restrictiveness Index, 2012



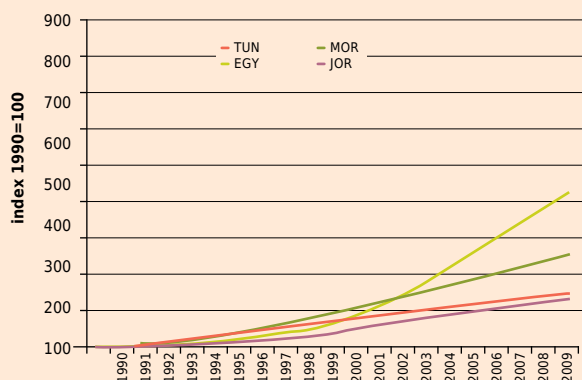
Source: Data from OECD on the FDI Regulatory Restrictiveness Index

Figure 1.18: Evolution of Value of Exports of Goods and Services (1990 = 100), 1990-2010

a) Among the benchmark countries (1990=100)



b) Among the regional comparators (1990=100)



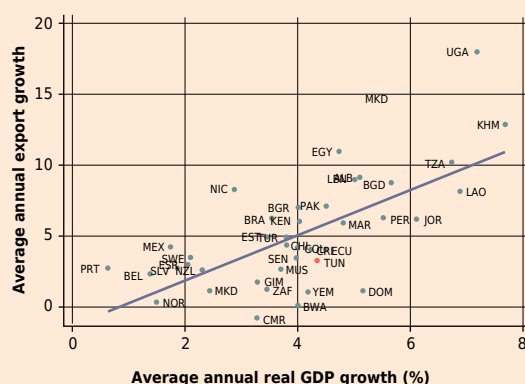
Source: WDI; authors' calculations

Note: Evolutions in graph have been smoothed with HP filter.

Tunisia's share of goods exports in world trade has been declining in recent years. Between 2002 and 2010, Tunisia's trade share fell slightly while most benchmark countries and all regional comparators increased their export share in the world. Similarly, a regression of GDP growth and export growth in a number of countries shows that Tunisia falls below the regression line (figure 1.19), suggesting that its exports underperformed relative to the rest of its economy and that exports played a smaller role as a driver of growth in Tunisia than in other economies. As discussed below, a plausible explanation for this finding is that exports growth was to a large extent fuelled by imports, with little value addition in Tunisia, reflecting the fact that the onshore-offshore dichotomy attenuates backward links from FDI (see discussion in Chapter Four).

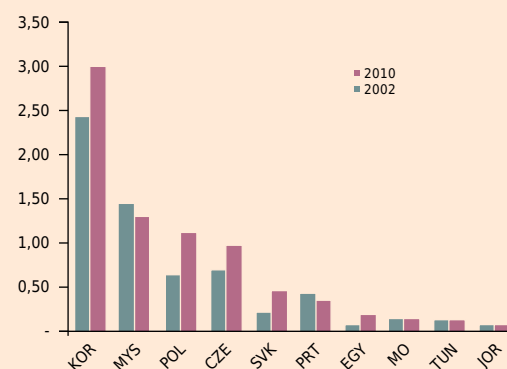
Figure 1.19: Tunisia's Exports growth in a Global Context

a) Export Growth and GDP Growth, 2000/2010



Source: Exporter Dynamics Database; Authors' calculations

b) Evolution of Goods Exports as Percentage of World Exports between 2002 and 2010



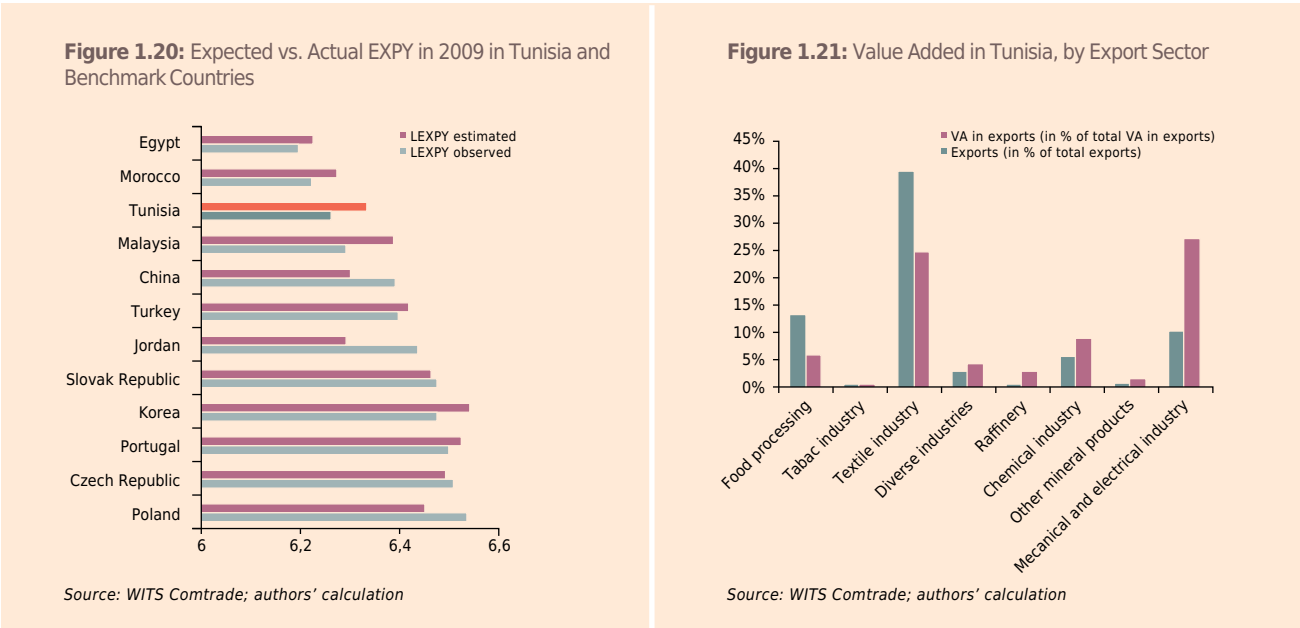
Source: WITS Comtrade; authors' calculation

Low Sophistication and Value Added of Tunisia's Exports

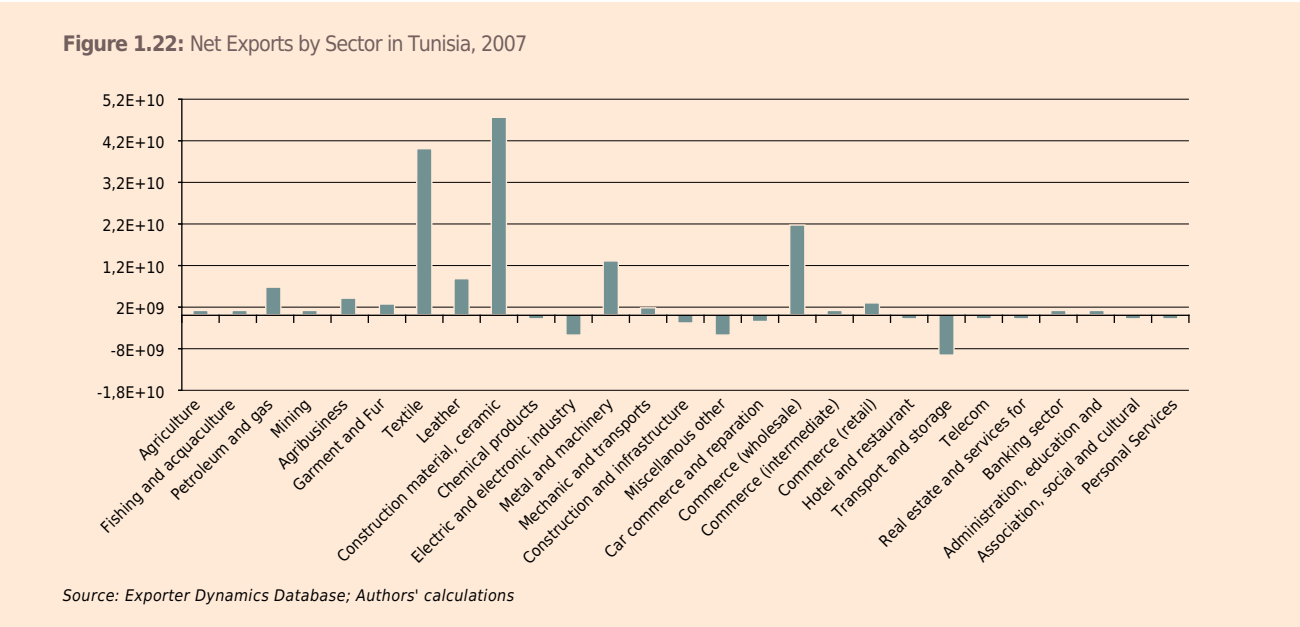
Tunisia's export sophistication is low compared to benchmark countries and has increased only slightly over the past decade. Even when controlling for GDP per capita, Tunisian sophistication of exports is significantly below what would have been predicted by its level of income, as measured by an observed EXPY of 6.26 against an expected EXPY of 6.33 (figure 1.20)³². Additional measures of export sophistication also confirm that technology intensity and the skill intensity of Tunisia's exports have increased only slightly over the past decade³³. The slight improvement reflects the fact that Tunisia has increased its exports of goods in high-tech sectors—notably the recent increase in export of electronic appliances and the decline in textile related exports largely explains Tunisia's increase in EXPY³⁴. In fact, as discussed below, these exports are largely only assembled in Tunisia, with little value addition and improvement in productive capacity.

The above measures of export sophistication are likely misleading, since they focus on the final exports and ignore the fact that the value added of Tunisian manufacturing exports has remained extremely low. The above measures of export sophistication say little about the domestic value added of an export good. Domestic value added does not so much depend on the good in itself but how (and how much of) the good is produced in a given country³⁵. In other words, looking at exports of goods says little about the domestic net value added created at home. Using input-output tables for individual G7 countries, the value added of exports has been estimated to be approximately 70-80 percent and decreasing over time (Hummels, Ishii, and Yi 2001; NRC 2006). Conversely, estimates of value added of exports from countries heavily engaged in processing trade (for example, China) are on the order of 50 percent (Koopman, Wang, and Wei 2008). Using the same methodology, we calculate that the

value added to exports ratio of Tunisian exports was only 33 percent in 2009³⁶. This compares to a ratio of 43 percent for the Czech Republic and 38 percent for Hungary (Johnson and Noguera 2012).



More than half of Tunisia’s exports are final goods, many of which are only assembled in Tunisia. There has been only a slight increase in exports of intermediate goods to some extent reflecting the increase in mechanical and electrical components. Although transport, real estate services, and telecommunication sectors create an important part of value added, their net exports are low (figure 1.21). It is chemical products, textiles, garments and leather, and the mechanical and electrical industry that contribute the most value added in export—as shown above, however, the contributions of these sectors to overall value added is very low (figure 1.22).

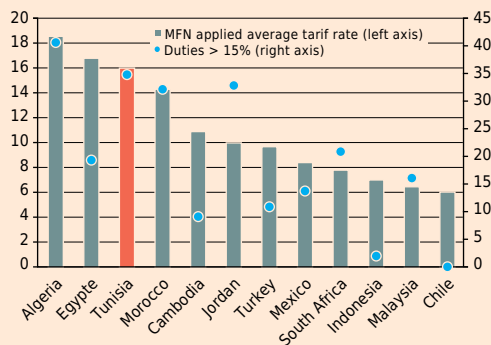


Box 1.5: Lukewarm Trade Integration Brings Lukewarm Results: Contrasting the Experience of Reforms in Tunisia with That of the Central European Countries

Eastern European countries cut tariffs and reduced non-tariff barriers at an early stage of their transition process in the 1990s and underwent drastic liberalization reform of their economies. Trade reforms were only one part of the comprehensive reforms package implemented by these countries. They implemented broad institutional and structural reforms that included domestic deregulation, some privatization, and other macroeconomic adjustments. Further, many of these economies were able to integrate in the EU. These countries now enjoy a liberal trade environment that supports their industries and has resulted in rapid increases in exports and incomes per capita.

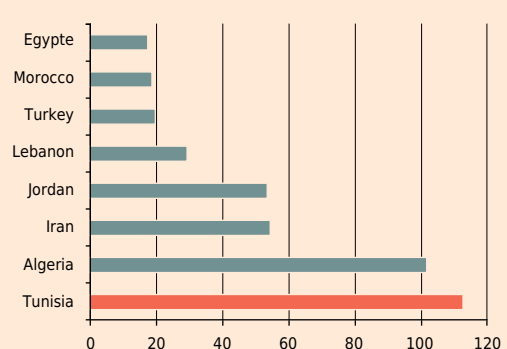
In contrast, despite the trade reforms since the mid-1990s, Tunisia's tariff structure and degree of openness remains very restrictive. Tariff reforms gradually reduced the average "most favoured nation" (MFN) tariff (calculated as the simple mean of MFN duties level at the HS 6-digits level) from 30 percent in 2002 to 16 percent in 2011; however, Tunisia's average tariff remains one of the highest among comparable countries. Tunisia also has one of the largest binding overhangs (calculated as the difference between the bound and applied MFN rates) in the MENA region and among WTO member countries and a high share of MFN applied tariff lines greater than 15 percent (at the HS 6-digits level). In fact, while tariffs have been gradually reduced, non-tariff barriers have become more prominent. Tunisia has relatively low non-tariff measures (NTMs) frequency and coverage ratios, but it has highly complex NTMs formalities (Augier, et al. 2012)ⁱ. It still has a high level of pre-shipment inspection and para-tariff measuresⁱⁱ. Its NTMs composition is closer to that of Uganda than of other emerging countries (which tend to have a higher portion of technical measures that replaced other types of NTMs). Importers in Tunisia spend nine days on average for customs clearance at port, and the share of export subject to inspection reaches 10 percent, placing Tunisia among the lowest performers of the region (see Chapter Four; Hoekman and Zarrouk 2009). Moreover, Tunisia continues to apply several implicit restrictions—such as an import quota on cars—that were to be abolished after the 2008 free trade with the EU and an import survey on products under surveillance, which serves as a de facto authorization for imports. These restrictions are part of the country's complex regulations, which create market distortions, increase costs to Tunisian consumers and firms, and create opportunities for non-transparent

Figure B1.5.1 Levels of Applied Average MFN Tariff Rate and Share of Tariff Lines Above 15 Percent in 2011



Source: WTO, World tariffs profiles 2012
 Note: MFN applied average tariff rate is calculated as the simple average of the ad valorem duty for all products at HS 6-digit. Share of HS 6-digit subheadings subject to ad valorem duties greater than 15 percent. All data are for 2011, except for Jordan which shows 2010 data.

Figure B1.5.2 Liner Shipping Connectivity Index Rank (out of 159 countries)

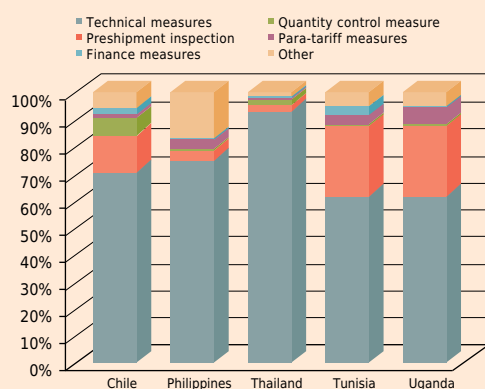


Sources: UNCTAD LSCI 2012
 Note: The Liner Shipping Connectivity Index (LSCI) of the UNCTAD assesses how well a country is served by container shipping (countries with high activity or hosting shipping hubs have a better rank).

rents and abuse of the regulations (see Chapter Two and Chapter Three). In addition, Tunisia's actual trade costs are estimated to be very high because Tunisia has one of the lowest levels of shipping connectivity in the region. On the contrary, Morocco and Egypt have made large investments in transshipment activities and are among the countries with the best shipping connectivity in the world.

The result of the different speed and depth of trade reforms in the Central European countries as compared to Tunisia is reflected in stark performance differences in exports and income levels. The eight countries that accessed the EU in 2004 (EU8) increased merchandise exports from 26 percent of GDP in 1995 to 57 percent in 2011. Instead, while Tunisia had a higher level of merchandise exports in 1995 at 30 percent of GDP, it experienced much smaller progress—with exports accounting for only 39 percent of GDP by 2011. The process of trade liberalization and economic integration brought rapid growth in the Central European economies, resulting in increase in per capita GDP. For instance, Poland was among the poorest countries (in terms of per capita income) in the region in 1995. It implemented the most drastic and rapid reforms and has now become one of the richest countries in the region. These examples exist also in other parts of the world. Mexico implemented broad structural and regulatory reforms and removed many barriers to investment to accompany the opening up of trade with the United States under the NAFTA agreement. These reforms helped attract FDI during the 1990s and contributed to building Mexico's exports sector. Hence, although Mexico's per capita export level was similar to Tunisia's in the early 1990s, it is now more than double that of Tunisia.

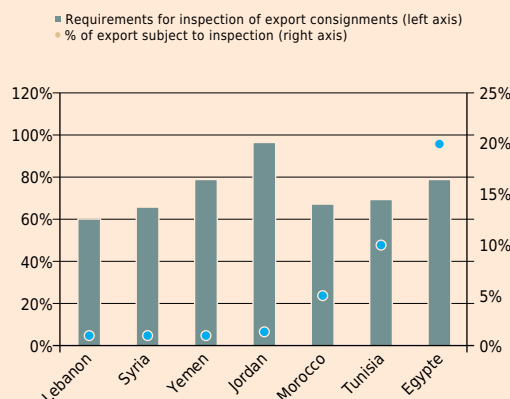
Figure B1.5.3 NTMs Experienced by Exporting Companies as NTBs (based on ITC/UNCTAD firm survey), (as % of NTBs)



Source: Data from Mimouni, Averbeck and Skorobogatova, 2009

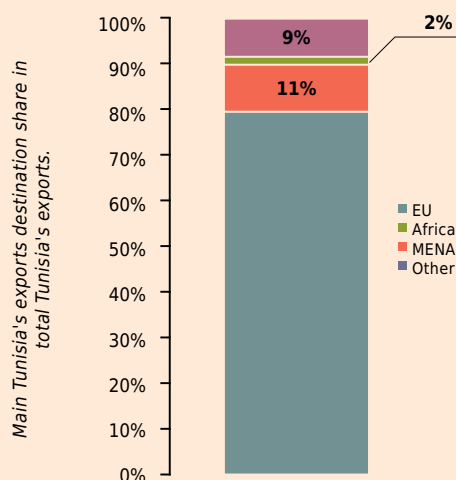
Notes : (i) Tunisia has a lower frequency index than Morocco, but imposes more than five types of measures on the majority of products under NTMs, against Morocco which imposes only more than two types of measures (Augier, et al. 2012).
(ii) A firm-level survey conducted by UNCTAD among exporters showed that 63 percent of NTMs in Tunisia are technical measures, while 23 percent are pre-shipment inspection, and 5 percent are para-tariff measures.

Figure B1.5.4 Requirement for Inspection of Export Consignments (as a percentage) and Share of Export Subject to Inspection



Source: Data from firms survey, Hoekman and Zarrouk 2009.

Figure 1.23: Tunisia's Exports Concentration by Country, 2007



Source: WITS Comtrade; authors' calculations

Table 1.4: Tunisia's Exports and Imports Shares by Destination, 2007

	EU	MENA	Africa
Share of Tunisia's exports in region's imports	0.23%	0.25%	0.09%
Share of region's import in Tunisia's exports	79%	11%	2%

Source: WITS Comtrade; authors' calculations

Note: The year 2007 has been chosen as it is prior to the global financial crisis.

The value added of export sectors with a high share of high technology goods tends to be low in Tunisia, confirming that the sophistication of exports remains limited. Food processing, followed by the textile sector, has the largest domestic value added but does not produce any high technological products nor employ high skilled workers (figure 1.22). On the contrary, the mechanical and electrical industry is the manufacturing sector contributing the smallest share to value added, despite the fact that this sector seems to produce a relatively large part of high technological products³⁷. This observation is consistent with the anecdotal evidence that Tunisia has mainly attracted assembly tasks in the value chain of sophisticated goods. The chemical sector exports the largest share of high technological products but domestic value added accounts for only 22 percent of production. In sum, while Tunisia's exports appear to have started to diversify into more sophisticated products, in fact largely only the assembly of these products is carried out in Tunisia and hence there is no real improvement in the sophistication of the production structure.

Tunisia's exports are concentrated on very few countries, reflecting the fact that a large share of Tunisian exports consists of goods assembled for France and Italy. Geographic diversification of exports has been very limited, with the EU absorbing nearly 80 percent of Tunisia's exports and within the EU France and Italy accounting for nearly 50 percent (figure 1.23 and table 1.4)³⁸. This structure of exports is consistent with the reality of the Tunisian economy. In a sense Tunisia does not "produce" its manufacturing exports—it assembles them for or to France and Italy. Companies in these countries have outsourced the assembly tasks and other low value added tasks to Tunisia, taking advantage of

the very favorable offshore tax regime and the availability of cheap low-skilled human resources. This is not a problem in itself; however, the challenge is that the Tunisian economy has been unable to move beyond the assembly and low value added processes. As discussed in Chapter Four, this is largely the result of the duality between onshore and offshore sectors. The difference in tax regimes, combined with the heavy bureaucratic burden and limited competition in the onshore sector, discourages offshore companies from interacting with (and purchasing or selling intermediate inputs from or to) onshore ones, resulting in the segmentation of the economy and the lack of links and spillovers between these two parts of the economy. This means that the exporting offshore sector uses fewer intermediate inputs "made in Tunisia," contributing to keeping the Tunisian economy limited to low value added and assembly tasks, and offering mainly low quality jobs.³⁹

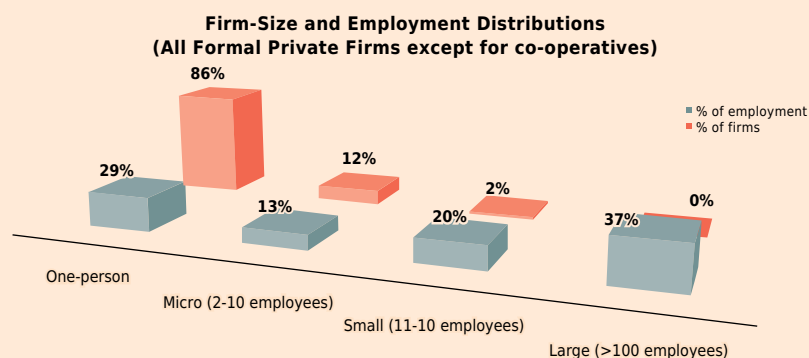
1.2 / Private Sector Paralysis: Firm Dynamics in Tunisia⁴⁰

The limited dynamics of the economy at the macro level suggest that the performance of Tunisian private sector firms in terms of job creation, productivity, and exports growth is weak. In this section we examine the performance of Tunisian private firms in terms of job creation, productivity, and exports growth, which will pave the way to identify policy levers to promote employment creation and growth. We first focus on arguably the most salient policy issue, notably job creation, by examining which firms create the most jobs. Subsequently, we examine the drivers of productivity growth, arguably the most important determinant of income and jobs creation in the long run. Finally, we analyze Tunisian firms' trade performance and focus on which sectors and which firms have driven exports growth. The analysis of firm dynamics can shed light on Tunisia's jobs crisis, as jobs growth ultimately comes from firms' creation and growth. The analysis allows us to assess whether the process of "creative destruction" is working and driving productivity growth and jobs creation among private firms in Tunisia⁴¹ and can also help us pinpoint problems in the business environment in which firms operate.

Low Entry of New Firms and Lack of Growth Result in Limited Job Creation

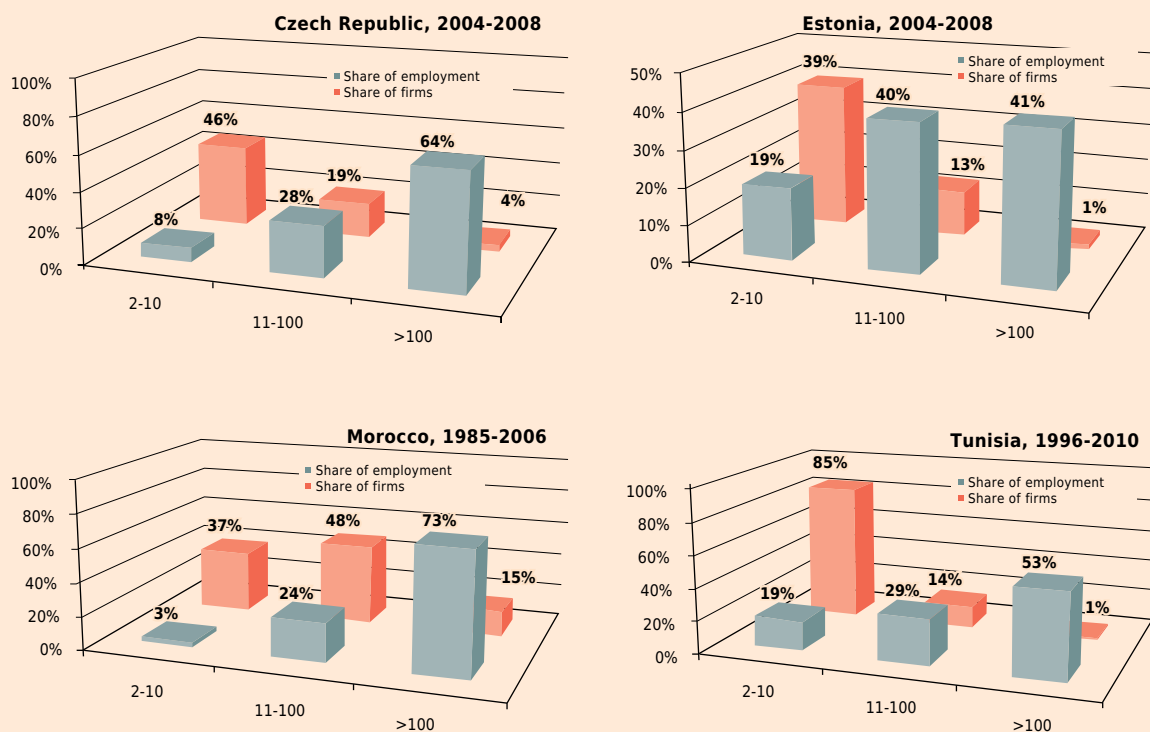
Tunisia's private sector is skewed toward small-scale activities. The distribution of private sector firms by employment size highlights that one-person firms account for the vast majority of enterprises; 86 percent of all Tunisian firms are one-person enterprises (meaning self-employment), and only 0.4 percent of all firms employ more than 100 workers (figure 1.24). These large firms, however, account for more than a third of all jobs in Tunisia, more than all one-person firms combined. Comparing the distribution of firm sizes in Tunisia with that in more developed countries, we find that it is skewed toward smaller firms—in fact, by international standards employment in Tunisia is concentrated in comparatively small firms (figure 1.25)⁴². In other words, the scarcity of medium and large firms appears to be a key explanation for the low level of jobs creation. This observation is confirmed by the analysis of the dynamics of firms' jobs creation (box 1.6).

Figure 1.24: Employment and Firm-Size Distribution, 1996-2010



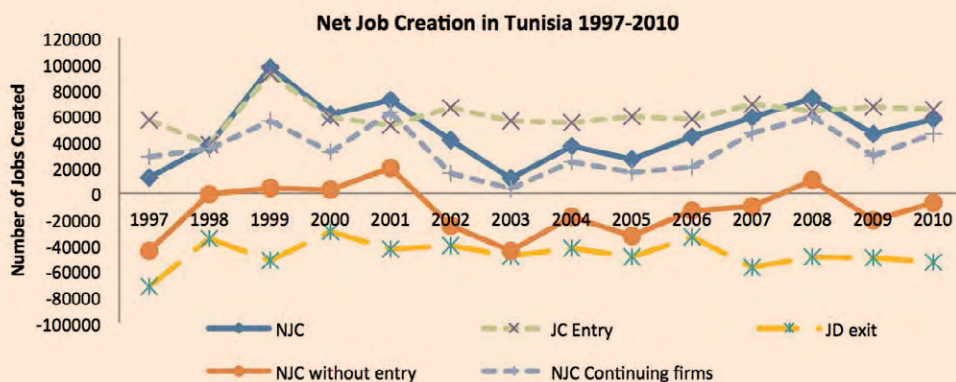
Source: Authors calculations using Répertoire National des Entreprises-RNE.
Note: One person firms are synonymous with self-employment.

Figure 1.25: Employment and Firm-Size Distribution (Excluding Self-Employment) in the Czech Republic, Estonia, Morocco, and Tunisia



Source: Figures for Czech Republic, Estonia and Morocco are from: Hallward-Driemeier, Mary and Reyes Aterido (2014). "Firm Dynamics and Job Creation: Are Gazelles Born or Made?" World Bank, mimeo.
 Note: Data for Tunisia are the same as presented in Figure 1.23, but we exclude self-employment to allow comparison with the other countries (for which data on self-employment is not available).

Figure 1.26: Aggregate Job Creation Patterns

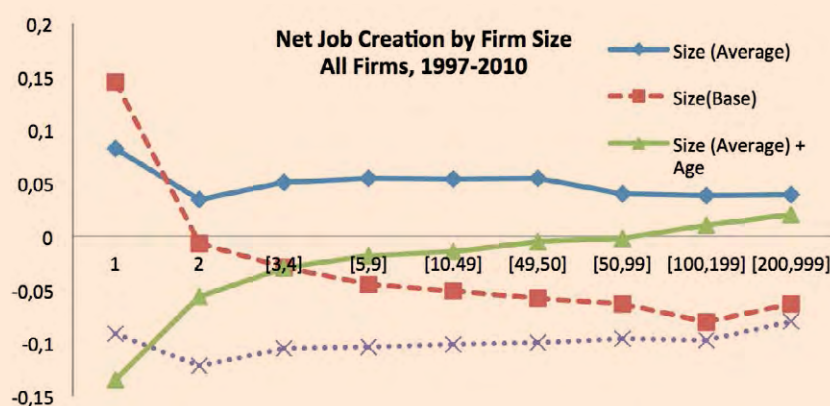


Source: Authors' calculations using RNE

Box 1.6: Which Firms Create the Most Jobs in Tunisia?

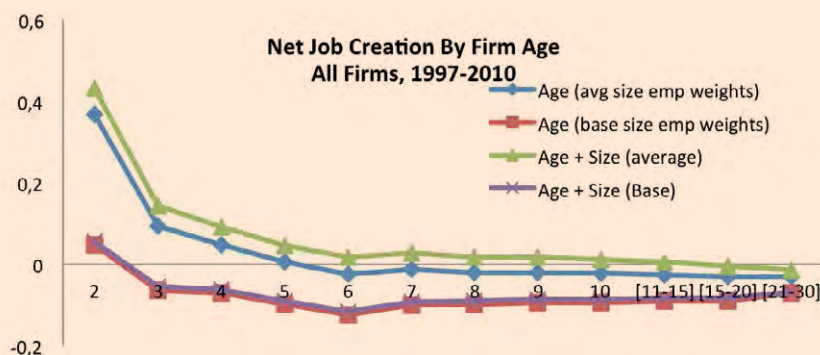
Small firms contribute the least to employment creation in Tunisia (once we account for firm age). Many SME promotion programs are predicated on the notion that small firms create more jobs than larger firms. The results of non-parametric regressions in which we regress firm growth, measured as the change in employment between period t and $t+1$, on firm size and age dummies are presented in the figures below. As shown below, when we control for firm age (the green and purple lines), the relationship between firm size and growth shows that small firms contribute the least to employment creation. In other words, small firms grow because they are young, not because they are small. In fact, young firms consistently record the highest rates of net jobs creation. Further the results indicate that, all else being equal, large firms create more jobs than do small firms. Promoting more entry would thus not only result in more job opportunities in the short run but would also likely generate more jobs in the medium run, since young firms grow faster than older firms. Promoting entry of large firms would pay a double dividend since large firms create more jobs from the get-go, and also have superior dynamic performance and jobs creation over time.

Figure B1.6.1: Net Job Creation by Firm Size



Notes: The dependent variable is the Davis-Haltiwanger-Schuh growth rate, which allows for an integrated treatment of the contributions of entering, continuing and exiting firms. The regressions are weighted and control for industry and year effects; the resulting coefficients are thus interpretable as conditional average net job flows. To minimize the impact of measurement error, we base our size dummies on average size categories. Since we have more than 7 million observations, all size category variables are significant at the 0.01 percent significance level.

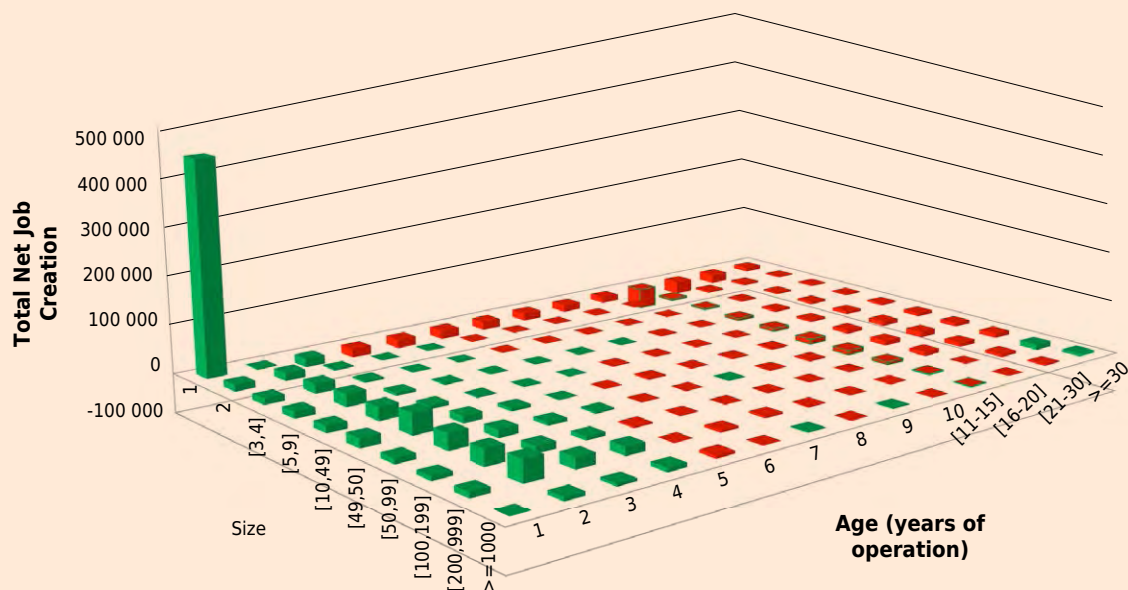
Figure B1.6.2: Net Job Creation by Firm Age



Notes: The dependent variable is the Davis-Haltiwanger-Schuh growth rate, which allows for an integrated treatment of the contributions of entering, continuing and exiting firms. The regressions are weighted and control for industry and year effects; the resulting coefficients are thus interpretable as conditional average net job flows. To minimize the impact of measurement error, we base our size dummies on average size categories. Since we have more than 7 million observations, all size category variables are significant at the 0.01 percent significance level.

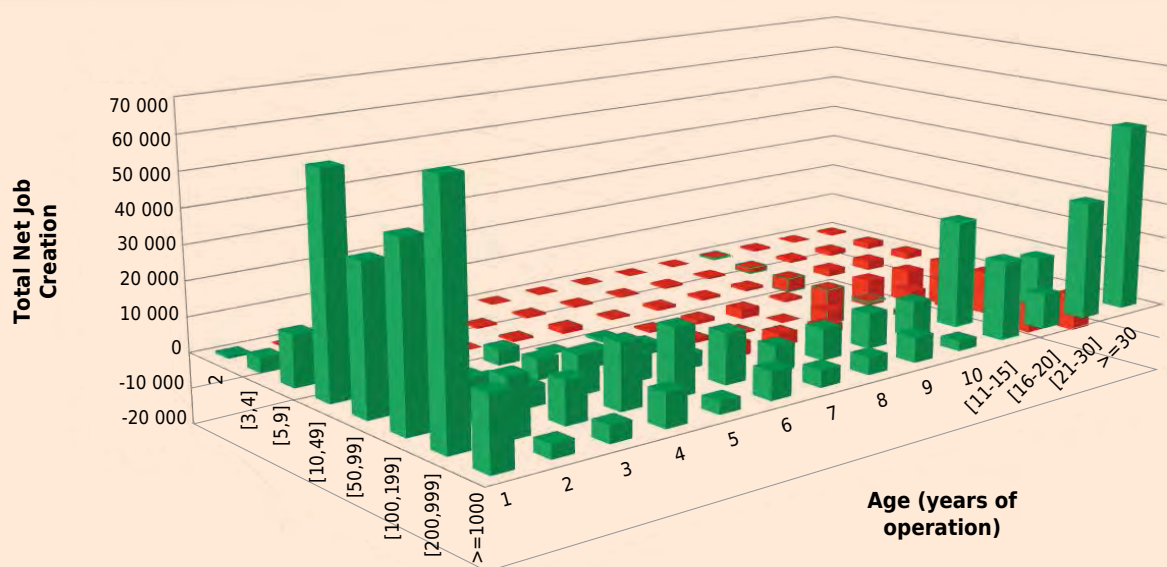
Source: Rijkers, et al. (2013).

Figure 1.27: Net Job Creation in Tunisia by Firm Size and Age, 1997-2010 (Green=positive, Red=negative)



Source: Authors' calculations using RNE.

Figure 1.28: Net Job Creation in Morocco by Firm Size (but Excluding Self-Employment) and Age, 1985-2006, (Green=positive, Red=negative)



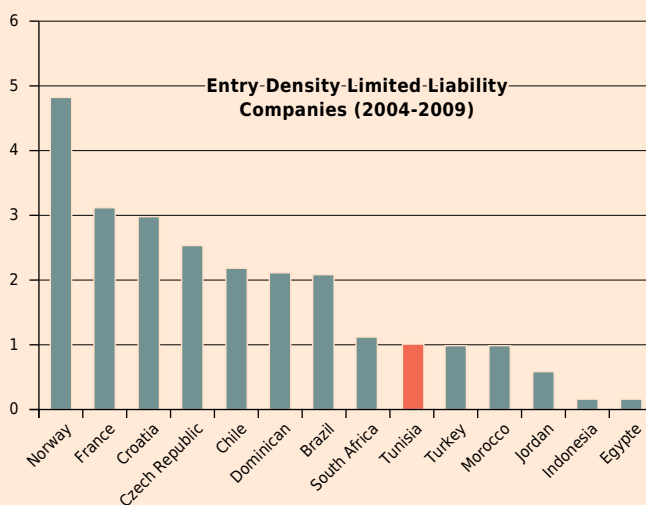
Source: Hallward-Driemeier and Aterido (2014).
Note: Excludes self-employment

Aggregate job creation has been highly disappointing and driven mostly by entry of one-person firms (self-employment). An analysis of net job creation over the period 1997-2010 decomposed into the contributions of entering firms, exiting firms, and continuing firms shows that most of the net new jobs (with the exception of 2001) were created in entering firms (figure 1.26). In fact, without these entrants, net new job creation over the period would have been negative. However, the bulk of net job creation is driven by entry of one-person firms, which accounts for 74 percent of all net new job creation. Annual average job creation patterns by firm size and age over the period 1997-2010 show that the contribution of start-up self-employment clearly dominates the contribution of all other groups of firms and is in fact larger than the sum of all other groups combined (figure 1.27). Furthermore, subsequent to entry, one-person firms on average exhibit far less growth, such that the net contribution to job creation of one-person firms is much more modest. Nonetheless, half of all net new jobs created between 1997 and 2010 were in self-employment. It is also interesting to note that across size classes net job creation is typically concentrated among the youngest firms: after approximately four years, firms on average start to shed labor. In fact, once we account for firms' age, we find that young firms create the most jobs. Other countries in the region show similar patterns of jobs creation. When we look at more dynamic and rapidly growing economies, however, much more of the net jobs growth takes place at the larger end of the firms' size distribution (figure 1.28; also annex 1.5 shows net jobs creation dynamics in Chile, the Czech Republic, Estonia, and Germany). It therefore appears that the lack of entry (and growth) of new medium and large firms is at the root of Tunisia's weak jobs creation (box 1.6).

Job creation is hampered not only by limited entry but also by a lack of (upward) mobility; very few firms grow both in the short and the long run. Aggregate net job creation rates show that post-entry job creation is low on average (figure 1.27). In principle this need not be inconsistent with high dynamism; low average job creation could mask a combination of both rapid expansion of a group of successful firms and high exit rates of less successful firms. Alternatively, low job creation could reflect stagnation across the board. To unveil which mechanism accounts for the disappointing net job creation numbers, we examine the transitions of firms between broad size-classes (table 1.5). The top panel in table 1.5 presents evidence on annual size transitions, whereas the bottom panel presents transitions between 1996 and 2010, the longest period available in our database. The matrices show the proportion of firms in a particular size class moving into another size class one year and, respectively, fourteen years later. The table reveals that most firms do not grow, even in the long run. Staggeringly few firms change size class, even during a fourteen-year period; one-person firms (the registered self-employed) are least likely to expand into a larger size class, and very few micro and small firms ever grow large. For example, only 2 percent of all firms employing between 10 and 50 people in 1996 employed more than 100 workers by 2010.

Entry rates other than self-employment are very low—in other words, the creation of new firms in Tunisia is very low compared to rates observed in other countries. The entry density of limited liability companies suggests that Tunisia enjoys lower entry rates than in advanced countries and many other developing countries (figure 1.29)⁴³.

Figure 1.29: Firm Entry Rates in Various Countries, 2004-2009



Source: Klapper and Love 2010. Note: Entry density measures the number of newly registered limited liability firms per 1,000 working-age people (between ages 15-64).

Table 1.5: Employment Transitions

EMPLOYMENT TRANSITIONS								
Short-Run: Annual Transitions (1996-2010)								
Size in year t	Size in year $t+1$							
	Exit	1	[2-5]	[5,9]	[10,49]	[49,99]	[100,999]	≥ 1000
1	6.51	91.98	1.34	0.10	0.06	0.01	0.01	0.00
[2-5]	8.16	7.82	79.61	3.93	0.44	0.02	0.01	0.00
[5,9]	6.91	1.30	14.18	68.75	8.71	0.10	0.04	0.00
[10,49]	3.79	0.90	1.80	8.76	80.51	3.73	0.49	0.00
[49,99]	2.72	0.61	0.43	0.50	16.04	67.84	11.84	0.01
[100,999]	1.83	0.37	0.21	0.26	1.91	8.31	86.56	0.56
≥ 1000	1.59	0.00	0.14	0.14	0.14	0.14	11.56	86.27
Long-Run: 1996-2010								
Size in 1996	Size in 2010							
	Exit	1	[2-5]	[5,9]	[10,49]	[49,99]	[100,999]	≥ 1000
1	59.25	37.81	2.45	0.31	0.15	0.01	0.02	0.00
[2-5]	53.36	15.59	25.44	4.29	1.21	0.05	0.07	0.00
[5,9]	53.69	2.59	14.64	18.07	10.21	0.53	0.27	0.01
[10,49]	46.54	2.18	5.71	9.69	28.93	4.92	2.02	0.02
[49,99]	43.42	1.77	2.65	1.87	18.96	19.16	12.18	0.00
[100,999]	38.11	1.17	1.93	1.17	7.37	10.30	38.44	1.51
≥ 1000	18.75	0.00	0.00	0.00	3.13	0.00	37.50	40.63

Source: Authors' calculations using RNE

This is a clear symptom of the country's difficult business environment that prevents firm entry (or exit) and hence distorts the process of creative destruction, which would lead to faster productivity growth, investment, and jobs creation. It should be noted, however, that these entry rates (of limited liability companies) may not be good proxies for overall entry rates in the economy⁴⁴.

The transition matrices also show that overall exit rates seem quite low, perhaps in part due to the limited competition (see Chapter Two) and complex bankruptcy procedures (see Chapter Six). While low exit rates help preserve job opportunities, they are also indicative of limited competitive pressure and a lack of dynamism. In other words, unproductive firms are somehow able to remain active in the market and feel no pressure to improve their performance. Keeping low performance firms indefinitely in operation, however, should not be interpreted as a positive feature—although jobs in incumbent firms are not lost, new and better performing firms are unable to enter and grow and thereby create even more and better quality jobs.

In sum, the lack of net job creation that underpins Tunisia's disappointing aggregate unemployment numbers does not appear due to excessive job destruction but rather reflects limited entry, especially of large firms, and a lack of upward mobility (limited firms' growth). These patterns of firm mobility, entry, and exit are at odds with the existence of an up-or-out dynamic observed often in developed countries in which entrants tend either to survive and grow or to exit.

Overall these findings are indicative of the existence of severe restrictions to market access and barriers to competition, which hinder the growth of new and existing productive firms (see Chapter Two)⁴⁵. Removing market barriers and promoting more entry would thus not only result in more job opportunities in the short run but also likely help generate more jobs in the medium run, since young firms grow faster than older firms.

Weak Relationship Between Firms' Productivity, Profitability, and Employment Creation

Firm growth is only very weakly correlated with profitability and productivity—pointing toward severe barriers to competition and weaknesses in the reallocative process. Given the limited upward mobility, it is important to examine which firms are able to expand employment and what might be the impediments to firms' growth. The results of regressions indicate that productive firms and more profitable firms expand employment faster, but the relationship between productivity, profitability, and employment creation is weak. Although our proxies for productivity and profitability may suffer from substantial measurement error, taken at face value our estimate suggests that doubling output per worker is associated with only 1 percent to 5 percent higher employment growth. Similarly, moving up a decile in the profitability distribution (by sector and year) is associated with an acceleration of employment growth of approximately only 1-2 percent⁴⁶.

Offshore firms grow faster—because they are larger, younger, and foreign owned and they export and import. For a limited number of years, notably 2006-2009, we observe whether or not firms are foreign owned and whether or not they are in the offshore sector. Despite the 2008-2009 trade collapse due to the global crisis, offshore firms consistently outperform onshore firms in terms of net job creation (table 1.6). The superior job creation performance of offshore firms is not in itself due to being in the offshore sector, but is instead due to offshore firms being larger, younger, and more likely to be foreign owned and to export (table 1.6).

Firms that both import and export grow the fastest. When we interact importing and exporting dummies, we find that firms that both import and export grow the fastest. This finding underscores the importance of linking into global value chains and resonates with a large literature on exporting firms that finds that such firms tend to be more productive and more likely to grow. That said, importing firms appear to be performing extremely well. This could be the result of benefiting from exclusive licenses for importing and distribution-retail of goods in the domestic markets, which enabled rents-extraction by cronies of former president Ben Ali (see Chapter Three). Put differently, the superior job creation by importing-only firms may be a symptom of a privileged access to import licenses. Alarming, this systematic preferential treatment has survived the 2011 revolution, and import activities remain highly vulnerable to corruption.

In sum, our results on firm dynamics are consistent with the findings of structural stagnation at the macro level: firm entry and exit are very low, and mobility is extremely limited and only weakly correlated with productivity. The fact that firm growth is only very weakly correlated with profitability and productivity points to the existence of barriers to competition and severe weaknesses in the reallocative process. We also find that offshore firms are the best performers, largely because they are larger, younger, foreign owned, and actively trading⁴⁷. That said,

importing-only firms appear to be performing extremely well, possibly reflecting the rents associated with licenses for the import and distribution-retail of goods in the domestic markets (which was largely a privilege granted to cronies of the former president Ben Ali).

Table 1.6: Net Job Creation and International Orientation

Net Job Creation and International Orientation OLS Regressions Dependent Variable: DHS growth measure						
Average Size	1	2	3	4	5	6
Offshore	0.074	0.021	-0.054	-0.050	-0.095	-0.055
Foreign		0.115	0.046	0.052	0.046	0.046
Exporting				0.046	0.006	-0.042
Importing					0.091	0.080
Exporting*Importing						0.053
Firm Size Dummies	No	No	Yes	Yes	Yes	Yes
Firm Age Dummies	No	No	Yes	Yes	Yes	Yes
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Activity Dummies	Yes	Yes	Yes	Yes	Yes	Yes

Source: Authors' calculations using RNE

Notes: The dependent variable is the Davis-Haltiwanger-Schuh growth rate, which allows for an integrated treatment of the contributions of entering, continuing and exiting firms. The regressions are weighted and control for industry and year effects; the resulting coefficients are thus interpretable as conditional average net job flows. Note that since we have more than 400,000 observations, the estimates of the coefficients are typically statistically significant at conventional significance levels and we therefore do not report standard errors.

Slow Productivity Growth and Persistent Allocative Inefficiency: Evidence from the Manufacturing Sector ⁴⁸

Productivity of Tunisia's manufacturing firms increases with firm size and foreign ownership and is higher in the offshore sector. As discussed in Section One, the productivity of the manufacturing sector is very low, which is reflected in low quality jobs. Average total factor productivity increases with firm size, with the very largest firms being the most productive and the smallest firms being the least productive (figure 1.30). On average, firms that employ more than 200 workers are roughly twice as productive as firms employing between 6 and 9 people. In spite of the fact that larger firms are more productive, however, the data also suggests that allocative efficiency is rather low; high productivity dispersion within size categories is indicative of frictions and distortions. Productivity is also higher in offshore and foreign firms (see also Ghali and Rezgui 2008)⁴⁹. The findings that offshore firms are both larger and more productive even when we control for their size attests to the existence of duality, the segmentation of the economy between the onshore and offshore sectors.

Productivity growth has been stagnant⁵⁰. The evolution of productivity is arguably the most important determinant of income in the long run. In Tunisia, manufacturing sector (agro-food, chemical products, textiles, footwear, electronics, ceramics) growth in total factor productivity (TFP) and output per worker (as a proxy for labor productivity) have stagnated during 1995-2010, with the highest sectoral TFP growth rate being 1.5 percent for firms in the chemical industry and average annual growth rate of less than 1 percent for most sectors (figure 1.31). This compares to around 10 percent growth of output per worker hour in manufacturing in the Czech Republic or around 3 percent

in France during 2000-2007 (Bureau of Labor Statistics 2012). The high correlation between labor productivity and TFP growth reflects the fact that firms did not on average increase the amount of capital per worker; in fact if they had done so, one would see increases in labor productivity over time⁵¹. Thus, investment into physical capital has been limited. Investments in innovation have been lagging too; according to the *Institut Tunisien de la Compétitivité et des Etudes Quantitatives* (ITCEQ), R&D expenditure accounted for 1.2 percent of GDP in 2009, whereas OECD countries on average spend 2.3 percent of their GDP on R&D (ITCEQ 2010; OECD 2012). The lack of investment is consistent with the lack of firm growth documented above.

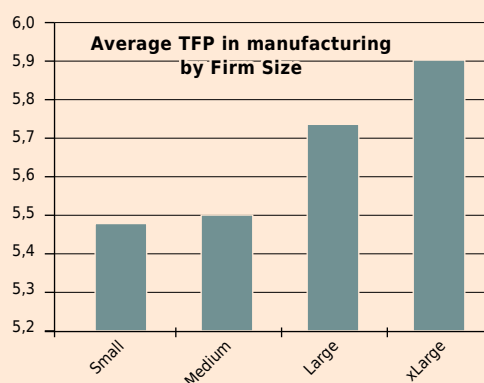
Allocative inefficiency persists, as there has been no significant reallocation of resources towards more productive firms. Sectoral productivity is essentially a weighted average of the productivity of all firms in a sector, with weights corresponding to the market share of each firm. If the most productive firms have the largest market shares, the weighted average productivity will be much higher than a simple unweighted average. The difference between weighted average productivity and (unweighted) average productivity is thus a proxy for allocative efficiency; the larger the difference, the better the market is at allocating resources to firms that use them most productively (see Olley and Pakes 1996). Tracing the evolution of the difference between unweighted and weighted productivity thus enables us to assess to what extent productivity growth has been driven by increase in average firm productivity—the “within” effect—and the reallocation of resources from less to more productive firms—the “between” effect. The evolution of these measures over the period 1997-2007 for various manufacturing sub-sectors shows that the gap between weighted and unweighted productivity is low and has not increased substantially over time (figure 1.32). This suggests that “within” firm productivity growth has been the dominant driver of the limited productivity growth observed in Tunisia over the past decade; by contrast, reallocation of resources from the least productive to the most productive firms has been limited, accounting for roughly only 9 percent of overall growth. This is yet another piece of evidence pointing toward lack of creative destruction and structural stagnation, which are at the root of Tunisia’s feeble economy and low quality jobs creation.

In sum, these results reinforce the evidence of persistent allocative inefficiency in the economy, which resonates with the absence of a strong correlation at firms’ level between employment growth and productivity presented above and also with macro-level evidence showing a lack of structural change (see previous section). It is also consistent with the presence of relatively few large firms. On the positive side, it suggests there is scope for significant growth if distortions that obstruct efficiency can be removed (to enable the reallocation of resources across sectors and the growth of productive firms).

Firms’ Export Performance

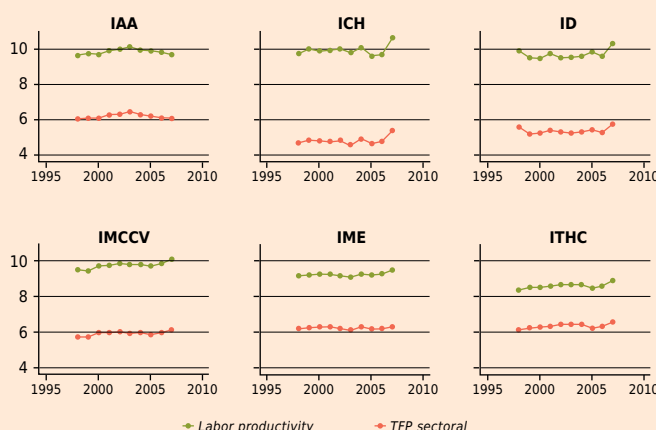
Tunisian exporters tend to operate in sectors with a low average exporter size and are in fact larger on average than their peers in similar sectors in other countries⁵². Econometric analysis shows

Figure 1.30: Productivity by Firm Size in Tunisian Manufacturing, 1997-2010



Source: Marouani and Mouelhi (2013). Productivity in Tunisian Manufacturing
 Note: Small: 6-9 employees, Medium: 10-49 employees, Large: 50-199 employees, Xlarge: ≥ 200 employees.

Figure 1.31: Labor Productivity and TFP Evolution by Manufacturing Activity, 1997-2007



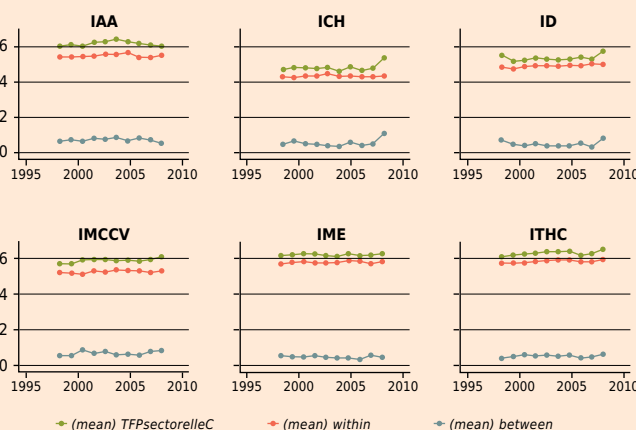
Source: Marouani and Mouelhi (2013).

Note: Sectors abbreviation: Agribusiness (IAA); Chemical industries (ICH); Diverse industries (ID); Construction material, ceramics and glass (IMCCV); Mechanics and electrics (IME); Textile, Garment and Shoes (ITHC).

that Tunisian exporters are in fact on average larger when we compare them with exporters in the same sector in other countries (results are presented in the DPR background report on “Private Sector Paralysis: Firm Dynamics in Tunisia,” World Bank 2014b). They are on average seven times larger across all sectors and 14 times if we put greater weight on the sectors in which Tunisia has strong exports. These findings are in line with the observation that the size of private sector firms tends to be smaller on average in Tunisia and suggest that in fact Tunisian firms sort into sectors where firms tend to be small. In Tunisia exports are less concentrated in a relatively small number of “export superstars” than we observe in other countries (table 1.7)⁵³. These findings are consistent with evidence that firms were trying to stay below the radar in order to avoid predation by the family of former president Ben Ali (see Chapter Three).

Small exporters are more likely to die and hardly ever grow large; the largest exporters start large. Underpinning these aggregate export dynamics we observe a lot of churning. Table 1.8 shows how firms that exported in 2000 fared ten years later, classifying firms depending on the value of their exports in 2000. It shows that only approximately a third of exporters survived and that the likelihood of export survival increases with the initial volume of exports; the exit rate of firms in the bottom export quartile in 2000 is roughly twice as high as that of exporters in the top 5 percent of the export value distribution. Moreover, it shows that virtually all large exporters (together accounting for the bulk of

Figure 1.32: Decomposition Overtime of Manufacturing Firms' Production Growth, 1997 - 2007



Source: Marouani and Mouelhi (2013).

Note: Sectors abbreviation: Agribusiness (IAA); Chemical industries (ICH); Diverse industries (ID); Construction material, ceramics and glass (IMCCV); Mechanics and electrics (IME); Textile, Garment and Shoes (ITHC).

all exports) either had been exporting large quantities for a long period of time or had started out exporting large export volumes from the beginning (approximately 26 percent of firms in the top 1 percent in 2010). Qualitatively, these results resonate with those observed for job creation, where we also observed that few small firms ever grow large, that small firms are more likely to die, and that most large firms had already been large for a while.

Foreign, larger, more experienced, and more diversified exporters are more likely to continue exporting. In fact, regressions of export survival (the chance that an exporter exporting in year t will also export in year $t+1$) show that the probability of export survival increases both with the volume of initial exports and with export experience⁵⁴. Survival chances also increase with the number of products being exported as well as the number of destinations; more diversified firms do better. Interestingly, foreign-owned firms are much more likely to continue exporting

Table 1.7: Skew Toward Large Exporters

Export Concentration			
	Share of top exporters in total exports		
	top 25%	top 5%	top 1%
Median of 44 countries	0.98	0.83	0.56
Tunisia	0.95	0.72	0.48

Source: Authors' calculations using RNE

Table 1.8: Exports Growth at the Firm Level

Percentile in 2000	Percentile in 2010						
	Exited	0≤Q<25	25≤Q<50	50≤Q<75	75≤Q<95	95≤Q<99	top 1%
0≤Q<25	78.9%	7.8%	7.3%	4.2%	1.4%	0.3%	0.0%
25≤Q<50	72.8%	5.6%	9.2%	8.0%	3.4%	0.9%	0.0%
50≤Q<75	61.4%	2.9%	8.2%	15.0%	11.4%	1.1%	0.1%
75≤Q<95	58.0%	1.4%	2.4%	8.7%	23.4%	5.8%	0.5%
95≤Q<99	36.2%	1.4%	0.4%	2.2%	20.4%	14.4%	5.0%
top 1%	38.0%	0.0%	0.0%	2.0%	7.0%	16.0%	38.0%
Share of New Firms per 2010							
quartile that did not exist in 2000		82.3%	73.3%	65.3%	50.9%	35.0%	26.0%

Source: Authors' calculations using RNE

even if we condition on their size. By contrast, being an offshore firm is not in itself correlated with export survival. For surviving firms, exports growth is higher among firms that just started exporting, firms that are able to charge higher unit prices, and foreign firms. The results of these growth regressions therefore also resonate with those observed for net job creation, with the youngest exporters driving growth (albeit that this result is conditional upon survival) and foreign firms outperforming domestic firms, underscoring the importance of attracting FDI.

1.3 / Conclusions

The Tunisian economy registered some notable achievements since the 1970s, but has increasingly been stuck in low performance. Since the 1970s Tunisia experienced reasonably good levels of economic growth, one of the fastest in the MENA region, accompanied by rapid poverty reduction. Further, significant public investments in infrastructure and in education have endowed the country with a significant stock of capital and human resources⁵⁵. Nevertheless, as shown by the January 2011 revolution, substantial shortcomings underpinned Tunisia's economic performance. Notably, the economy has been unable to accelerate growth and jobs creation and has in fact remained stuck in low productivity activities. As a result a high level of unemployment persisted, over time becoming increasingly concentrated in the growing number of university graduates, and the quality of jobs created was low.

This chapter has shown that indeed the Tunisian economy is not in good health. While growth performance was good by regional standards, Tunisia's GDP per capita since the 1990s was far below the growth rates observed in other upper middle income countries. Further, a large share of the growth has been driven by an expansion in the size of the public sector and some expansion in the offshore sector. Exports have decreased as a share of GDP and Tunisia's share in world exports has reduced over the past decade.

At the macro level the Tunisian economy is characterized by structural stagnation and a severe misallocation of resources. Although productivity gaps between the fastest growing sectors and the least dynamic ones are large, there has been little reallocation of resources from low-productivity to high-productivity sectors—that is, the contribution of “structural change” to growth has been weak, reflecting the economic stagnation which affects the country. Similarly, “within sectors” productivity growth and job creation in sectors dominated by private firms have been weak. Tunisia is suffering from weak productivity growth in key sectors, especially in manufacturing, which is then reflected in limited jobs creation and low quality jobs. Overall, our results suggest that Tunisia is suffering from a large misallocation of labor and human capital. Today 77 percent of Tunisian workers and 75 of its human capital-adjusted labor work in sectors with below-average levels of productivity. These symptoms are indicative of barriers to competition and abundant distortions that impair Tunisia's structural transformation and prevent a more efficient allocation of resources—ultimately resulting in stunted growth and lower quality jobs creation.

This stagnation is reflected in stunted firms' dynamics: Tunisia is experiencing a private sector paralysis. Firm-level productivity growth has been very low. Firms remain active in low-productivity sectors—mobility is extremely limited and only weakly correlated with productivity, reflecting the allocative inefficiency seen at the macro level. Structural stagnation prevails. In terms of job creation, the greatest net employment creation is in young firms one to two years of age. However, very few firms enter the market, and in particular very few new large firms are created. Most firms stagnate, and very few firms grow. As such, aggregate net job creation has been disappointing. This is in spite of low firm exit rates, which themselves are a manifestation of limited competitive pressure.

The analysis has shown that Tunisia's private sector is suboptimally skewed toward relatively unproductive small firms. Tunisian firms are small on average compared to their counterparts in other countries; and very large firms are scarce, both in absolute and in relative terms. This is important because the results also indicate that, all else being equal, large firms in Tunisia perform better and create more jobs than do small firms. Since larger firms have superior performance (in terms of productivity, export, and jobs creation), their scarcity is a symptom of Tunisia's weak private sector performance. Exporting firms specialize in products for which firms tend to be smaller than in other sectors, but within these sectors they are larger than their peers in other countries. This suggests that sectoral specialization is not due to imperfections in financial markets (which limit the access to credit in certain sectors) and instead reflects deeper distortions under which private sector operates, hampering firms' (and the economy's) performance. Part of the explanation for these paradoxical findings could be that (onshore) firms try to stay below the radar to minimize the risk of predation during the time of Ben Ali. Overall, the evidence indicates that the process of “creative destruction,” an important driver of productivity growth and economic performance, is attenuated in Tunisia, resulting in private sector paralysis.

Firms' performance is also impaired by the onshore-offshore duality. The analysis also provides evidence for significant duality between the onshore and offshore sectors, manifested in among other things differences in the firm-size distribution, average productivity, and export performance. The offshore sector has performed better than the onshore sector as an engine of job creation and

exports growth, stemming to a large extent from its ability to attract FDI. However, offshore firms rely heavily on imported inputs, as they mainly focus on low value added assembly activities, with limited links to the domestic economy. The results also highlight that importing firms are among the best performing in terms of profitability, likely reflecting the rents extracted as a result of exclusive import licenses. It was common under Ben Ali for exclusive import licenses (for import and distribution of specific products) to be awarded to cronies and family members. More generally, as discussed in Chapter Two and Chapter Three, there is strong evidence that the dual economy system, entailing restrictions to market access and regulatory control especially in the onshore sector, has been systematically abused by cronies to receive special privileges and extract rents, thereby stifling competition and investment.

The chapter has also shown that, although the perception in Tunisia is that the economy is open and integrated with the EU, in fact international indicators suggest it remains very protected and closed to international trade. The export performance has been weak, especially in terms of value added. In fact, more than half of Tunisia's exports are final goods, most of which are only assembled in Tunisia. Export sophistication is low compared to benchmark countries and has increased only slightly over the past decade. The value added of export sectors with a high share of high technology goods tends to be low in Tunisia, confirming that the sophistication of exports remains limited. Although Tunisia may appear to be integrated with the EU, in truth Tunisian exports are concentrated almost only on France and Italy. In a sense Tunisia does not produce its exports but rather assembles components from or to the EU (and largely for France and Italy). This superficial trade integration reflects the fact that Tunisian firms have been unable to move beyond the assembly and low value added processes.

By documenting the symptoms of stagnation, this chapter underscores the importance of reforming the policy environment to promote competition and remove barriers to market access. The stunted pace of structural change suggests the presence of widespread barriers to the efficient operation of markets, preventing the reallocation of resources to the most productive sectors. At the firms' level, the evidence suggests the existence of severe distortions that attenuate the process of creative destruction. To facilitate a more dynamic economic environment and unleash private sector growth, the focus needs to be on how to remove the restrictions to market access and barriers to competition that undermine productivity growth and ultimately job creation, as well as to promote entry of new firms, especially of large firms, and to remove constraints to firms' growth, enabling small firms to grow large.

The evidence presented in this chapter also highlights some more focused policy actions that would be beneficial to Tunisia. The analysis has highlighted that the level of FDI is low and limited to few sectors of the economy—Tunisia could triple its level of FDI to achieve the same levels as Morocco if it reduced the regulatory and entry barriers to foreign investors. Promoting entry of large firms would pay a double dividend since large firms create more jobs from the get-go, and also have superior dynamic performance and jobs creation over time. The finding that, all else being equal, large firms create more jobs than do small firms is also relevant for industrial upgrading strategies because it questions the usefulness of targeting small firms, as is often done by programs such as the *Programme de Mise a Niveau* and the FAMEX program. Moreover, the success of the offshore sector (relative to the onshore) in generating jobs and attracting foreign investment suggests that, when considering policy reforms to minimize the duality between the onshore and offshore sectors, it is important to minimize distortions and to release constraints that impede the growth of domestic firms.

There is a spectrum of reasons that lead an economy to exhibit such low productivity and the absence of creative destruction. As discussed in the next chapters, the economic environment in Tunisia is characterized by pervasive barriers to entry and competition, giving rise to rents and privileges for

the few at the expense of the majority of Tunisians. As discussed in Chapter Two, the restrictions to market access and the prevalence of statutory monopolies have closed the domestic economy to competition and have created an onshore environment stagnating in terms of productivity such that, as was shown in this chapter, good firms are unable to grow. Further, as will be shown in Chapter Three, these rents have been captured by cronies of the former president, creating a system that is not only inefficient but also highly unfair. Following chapters will also discuss how current investment policies, the bureaucratic regulatory environment, labor market policies, and the inability of the financial sector to channel resources to productive projects all contribute to distort and hinder the performance of Tunisia's private sector and thereby keep the economy below potential.

Notes

1. It is important to emphasize that these foreign investments are desirable and create jobs; the challenge for Tunisia is how to also attract investments in higher value added activities that create more wealth and can employ skilled workers. As discussed in the next chapters, the current set of economic policies hampers Tunisia's ability to attract higher value added activities.

2. The tertiary education system in Tunisia offers various tracks: two-year programs on technical education (Technicien Supérieur, BAC+2), three-year bachelor programs (Licence beaux arts, BAC+3), four-year programs on humanities (Maîtrise; BAC+4), and 5-year university programs (e.g. doctors, engineers, and architects; BAC +5).

3. While the statistical series suggests a decrease in unemployment from 16 percent in 1989 to approximately 13 percent in 2010, in fact the reduction in unemployment has been smaller, since approximately 1.5 percentage points of the reduction in the unemployment rate can be attributed to the change in the definition of unemployment introduced in 2008 to align Tunisia to the ILO definition. More recently unemployment rose to 18.9 percent in 2011 following the revolution and declined to 15.3 percent as of December 2013.

4. Despite the recent increase, the share of active population remains much lower than in comparable middle-income countries in Latin American and the Caribbean and in Eastern Europe and Central Asia (at 36 percent and 44 percent, respectively).

5. The Tunisian economy is creating jobs for low-skilled individuals at rates that are faster than their entry into the labor force, contributing to a general decrease in unemployment among low-skilled individuals.

6. Our growth accounting methodology is described in Annex 1.1 and the underlying data in Annex 1.2. Total Factor Productivity (TFP) is a commonly used measure of productivity. In a nutshell TFP is calculated as the residual growth that cannot be attributed to increased use of labor and capital. In other words, everything not captured by changes in labor or capital is picked up by TFP growth. This includes measurement errors and changes in utilization rates of factor inputs. It should be noted that estimating the capital stock is beset with problems. We use the Perpetual Inventory Method to estimate the capital stock using investment data since 1960. Available data did not allow us to separate private and public investments. It is worth noting that Total Factor Productivity can be shown to be a component of labor productivity (which we will discuss below), but that the two do not coincide as the latter is also influenced by the amount of capital per worker.

7. It is worth noting that the large contribution of capital accumulation to GDP growth was largely driven by FDI in the offshore sector, which, as mentioned above, largely consisted of investments in energy and in low productivity activities with limited spillovers (such as the textile sector).

8. Many developed countries experienced TFP growth of more than 50 percent between 1950 and 1970 (Christensen 1980), with TFP growth rates higher than 2 percent per year. The Republic of Korea's 8. Many developed countries experienced TFP growth of more than 50 percent between 1950 and 1970 (Christenson, Caves, and Swanson 1980), with TFP growth rates higher than 2 percent per year. The Republic of Korea's annual TFP growth rate was a record average 4 percent during

the 1980s. Productivity in Republic of Korea later 'slowed down' to 2.6 percent during the 1990s and 1.9 percent during 2001 to 2006. Over the same periods, Malaysia's TFP growth rate was 1.5 and 1.7 percent respectively (World Bank, 2010a).

9. Unfortunately no country comparisons can be made in the level of TFP with human-capital adjusted labor, as estimates are not yet available for most countries.

10. It should be noted that the role of human capital may be overestimated in our analysis since, as discussed in more detail in Chapter Five, many graduates are underemployed (that is they have jobs below their qualification) and/or mismatched (that is, their jobs are in a specialties other than those in which they are qualified).

11. Labor productivity in mining, Tunisia's most productive sector, was 12.9 times higher than productivity in the sectors with the lowest productivity in 2005. In comparison, this ratio is 12.7 in Turkey and 11.2 in Chile (McMillan and Rodrik 2011).

12. This analysis is based on average productivity. Under perfect competition, marginal labor productivity should be equalized. Assuming a constant returns production function, since labor share is not necessarily negatively correlated with average productivity, large gaps in average productivity may reflect large gaps in marginal labor productivity. There are some caveats. For example, high average labor productivity in capital-intensive sectors, such as mining, may simply reflect the fact that the labor share is low.

13. One possibility is that we overestimate productivity in the agricultural sector because employment in the agricultural sector may not be well captured in the *Enquête Nationale des Entreprises* (ENE) or *Répertoire National des Entreprises* (RNE). However, both ENE and RNE include information on micro-enterprises and self-employed.

14. It is worth noting that this result is not a result of good weather in any one year. Productivity in agriculture (output per worker) has been higher than in the textile sector over the entire decade 2000-2010 with a bigger discrepancy since the middle of the decade. This result suggests that textiles in Tunisia have extremely low productivity. A different explanation could be that international textile firms that operate part of their production in Tunisia practice "transfer pricing," such that part of the value created in Tunisia is in fact accounted for abroad.

15. Further, over the past two decades Tunisia has gradually been moving towards the bottom of the group reflecting the structural stagnation of the economy in low productivity sectors (See the DPR background report on "Tunisia's Structural Transformation: Evolution of Productivity, Employment and Exports," World Bank 2014d).

16. The wage restraint was made easier by the state policy to heavily subsidize the price of basic food and fuel products and to keep affordable the price of basic utilities (notably public transport, water, electricity, and gas). In addition, access to education and to health care was reasonably priced. Even beyond the basic commodities, Tunisia has one of the lowest costs of living in the whole of Africa.

17. The results of the Investors Motivation Survey carried out in Tunisia by the World Bank Group in 2012 indicate that availability of cheap labor is one of the top motivations for entrepreneurs to invest in Tunisia (see Chapter Four). In fact,

Tunisia's competitiveness over the past two decades has been centered on the availability of cheap labor and the provision of generous incentives to attract investment in the low-tax export-oriented "offshore sector" (see box 1.3).

18. The average share of workers in low-productivity sectors of seven Latin American countries (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, and República Bolivariana de Venezuela) was 66 percent in 2005, ranging from 53 percent in Mexico to 81 percent in República Bolivariana de Venezuela. In Asia, the share of workers in low-productivity sector was high in India, amounting to 84 percent, but significantly lower in countries with a strong manufacturing base such as Malaysia (64 percent), Republic of Korea (66 percent), Taiwan, China (56 percent), and Thailand (70 percent).

19. For a discussion of data sources used in this analysis, see the DPR background report on "Tunisia's Structural Transformation: Evolution of Productivity, Employment and Exports" (World Bank 2014d).

20. It should be noted that this methodology does not prove any causal relations but rather reflects associations between the variables of interest, such as demographic change and growth.

21. For the purpose of this analysis, the "employment rate" component captures the combined effect of changes in labor force participation rate (that is, active population as a share of working-age population) and the actual employment rate (that is, employed as a share of active population). We likely overestimate the impact of the employment rate component since, as mentioned above, approximately 1.5 percentage points of the reduction in the unemployment rate is due to a change in the definition introduced in 2008 to adopt the ILO definition of unemployment.

22. In fact this contribution includes both the impact of increased capital stock and human capital.

23. Measuring productivity of the public sector is notoriously difficult since it produces non-market outputs whose value cannot be directly observed. As a result, public sector output is generally calculated by equating it to its inputs (that is, the amount spent on producing this output, which to a large extent consists of wages). The economic rationale behind equating output and input is that "rational" governments would spend up to the point where the marginal benefit from spending was equal to its marginal cost. This implies that increases in public spending translate automatically into one-to-one increases in output, rendering an analysis of public sector productivity based on national accounts data meaningless. In other words, in our analysis the increase in value added of the public sector reflects simply an increase in the budget expenditures on wages.

24. The expansion in the telecommunications sectors was also the result of growth in the mobile market over the period. In 2002, Tunisia allowed the private provider Ooredoo Tunisie (which until April 2014 was called Tunisiiana), a joint venture of Egypt's Orascom and Kuwait's Wataniyya, to enter the mobile phone sector, leading to a steep decline in prices and increase in coverage rates. A 35 percent stake of Tunisie Telecom was privatized in 2006. And a new mobile and 3G license was issued in 2008 to a consortium led by France's Orange. The family of President Ben Ali held stakes in both the Ooredoo (formerly called Tunisiiana) and Orange operators. Nevertheless, prices of telecommunications in Tunisia remain some of the highest in the world (see Chapter Two), reflecting the monopolistic power of these operators who are able to extract enormous rents from consumers—see also the DPR background report on "Opening Markets to New Investment and Employment Opportunities in Tunisia" (World Bank 2014a).

25. As mentioned not every structural change is good. In the case of Tunisia, the decline of employment in the low-productivity textile sector significantly contributed to Tunisia's positive structural change. To pass judgment on whether this change was welfare improving and growth promoting, however, would require a more in-depth analysis—looking at marginal productivity of the sector and whether the labor resources were reemployed in other economic activities.

26. A detailed analysis of "structural change" with a 90-sector breakdown is presented in annex 1.3 and in the DPR background report on "Tunisia's Structural Transformation: Evolution of Productivity, Employment and Exports" (World Bank 2014d).

27. To enrich the analysis in this section we compare Tunisia to a set of regional and international benchmark countries. Benchmark countries include those that are 100-300 percent richer than Tunisia, have grown dynamically over the last twenty years, and have similar factor endowments. These criteria are in line with the key selection criteria for benchmark countries proposed under the Growth Identification and Facilitation Framework (see Chapter Seven; Lin and Monga 2010). These criteria apply to the Czech Republic, Malaysia, Poland, the Slovak Republic, and Turkey. Average growth rates of these countries were 4.3 percent, similar to Tunisia's growth rate but higher than the median growth of other countries with a similar income level. Countries with higher growth rates in this income category include, for example, Chile, Lebanon, and Panama, which have very different economic structures than Tunisia. Moreover, while Tunisia's real exports have grown by 3.7 percent on average, exports of these countries have grown nearly twice as fast. Benchmark countries also include Korea as a high-performing country and Portugal. Portugal's economic structure twenty years ago was very similar to Tunisia's current economic structure. Regional comparators are Egypt, Jordan, and Morocco (see Chapter Seven).

28. Within the MENA region, FDI in Morocco and Egypt for instance face much less restrictions, including in the agricultural and service sectors. Morocco allows far greater flexibility to FDI in the service sector (see also figure 1.2). Moreover, the FTA between the United States and Morocco served to clarify Morocco's investment regime, as it inventoried its FDI restrictions on the basis of a negative list. Morocco gradually moved toward international best practices regarding transparency and dialogue with investors. Their application is being extended to broader fields related to FDI including from other countries. As such, FDI in Morocco is much more diversified than in Tunisia.

29. For a detailed discussion on the evolution of Tunisian exports also see El Ej (2012).

30. Exports growth was driven mostly by an expansion of electrical machinery and mineral fuels exports that offset a rapid (30 percent) contraction of not-knitted apparel exports. Exports of other important sectors such as knitted apparel and footwear saw only a minor increase. The poor performance of these sectors probably was due in large part to the gradual dismantling of the multi-fiber agreement completed in 2005, which meant that Tunisian apparel exporters had to face competition from China and other countries.

31. In general, export performance of MENA countries is weak. Standard gravity models conclude that MENA countries export significantly below their potential, that is, what would be expected given their economic, cultural, and geographical characteristics (Bhattacharia and Wolde 2010; Behar and Freund 2011). Exports in East European benchmark countries such as the Czech Republic, Poland, and the Slovak Republic accelerated over the 1990s as they transitioned from

communist regimes into market economies. Their export growth gained further speed as they integrated into the European Union. Korea's performance was outstanding as the value of its exports almost quadrupled over the period.

32. The EXPY index was developed by Hausmann, Hwang, and Rodrik (2004). The EXPY is linked to the productivity level of countries exporting these goods, building on the assumption that the export products predominantly produced by higher income countries are more likely to be associated with a higher productivity level. The EXPY is based on PRODY. The PRODY of an exported good is calculated as the GDP per capita of each country exporting the good weighted by the export of each given country as a share of the sum of all export shares. Goods primarily exported by richer countries are presumed to be more sophisticated and receive higher PRODY. A country's EXPY is thus calculated as the PRODY of each good that country exports weighted by the share of these goods in the country's exports basket. Jordan is the only MENA country to have an EXPY superior to what has been expected given its GDP per capita level (as the two largest exporting industries in Jordan are the pharmaceutical industry and minerals).

33. Sophistication of exports can be measured along several dimensions. For a detailed discussion of the sophistication of Tunisia's exports, see Ghali (2012).

34. Products that have the largest contribution to Tunisia's EXPY are petroleum, electronic appliances, and olive oil. Petroleum and olive oil tend to be exported by higher income countries and therefore have a higher PRODY. These three products alone contributed about 28 percent to Tunisia's EXPY in 2010. On the contrary, the PRODY of textile products tend to be weak.

35. One of the most famous examples, in this context, is the Chinese exportation of iPad. China's export value of one iPad is 499 USD, but the domestic value added per iPad is only 10 USD (2 percent) because China's role in the iPad is relegated to assembly of the final product. Increased trade links among countries have come hand in hand with a fragmentation of production (Jones and Kierjowski 2001). Goods and services once produced in a single country have become part of a production chain spanning different countries around the globe. Today, trade in intermediate inputs accounts for roughly two-thirds of international trade.

36. In fact this estimate is likely to significantly overestimate the share of domestic value added in the case of Tunisia's exports. A key assumption of the approach developed by Hummels, Ishii, and Yi (2001) is that the intensity in the use of imported inputs is the same between production for exports and production for domestic sales. This is unlikely to be the case in countries with a lot of processing exports—that is, import for exports—which is the case of Tunisia's offshore sector. Countries like Tunisia may exhibit significant differences in the intensity of imported intermediate inputs in the production for processing exports as compared to the production of domestic final sales and non-processing exports. Koopman, Wang, and Wei (2008) show that for these countries the above formula is likely to lead to a significant over-estimation of the domestic value added in exports. While more than half of Tunisia's exports are final goods, in fact many of them are only assembled in Tunisia. Given this significant share of processing exports, actual value added of exports may even be lower.

37. A large part in the domestic value added of exports tends to be created in the services sectors, in particular transport, real estate services, and telecommunications. Disentangling the domestic value chain into its sectoral components would therefore be important in understanding the direct and indirect employment impacts of trade.

38. Nevertheless, as discussed in Chapter Seven, the EU remains the market with the greatest potential for absorption of Tunisian exports.

39. That said, it should also be noted that the EU policy is also only to decentralize low value added jobs, and those countries resist fiercely any moves by companies to outsource any higher quality jobs. Tunisia's policy, however, plays right into the hands of the EU strategy.

40. The analysis in this section uses data from the Repertoire National des Entreprises (RNE), an administrative database containing information on all registered private sector enterprises, including one-person firms, maintained by the Institute National de la Statistique. Note that one-person firms are synonymous with self-employment; these are firms that do not hire any paid laborers and for which the owner provides all labor input.

41. The term "creative destruction" was developed by the Austrian economist Joseph Schumpeter (1883-1950). It refers to the idea that economic growth is the result of a dynamic, evolving system—it results from technological change and the innovations of new goods and services that emerge from the ashes of obsolete industries. The paradigm has been subsequently elaborated in Aghion and Howitt (1992). It relies fundamentally on three underlying ideas. First, long-run growth relies on process innovations, namely to increase the productivity of production factors and/or organizational innovations to make the combination of production factors more efficient. Second, innovations result from investments, firms' investments in skills, and the search for new markets that are motivated by the prospect of monopoly rents for successful innovators. Third, new innovations tend to make old innovations, old technologies, and old skills obsolete, such that growth involves a conflict between the old and the new: the innovators of yesterday resist new innovations that render their activities obsolete. The Schumpeterian growth paradigm thus places firms and entrepreneurs at the heart of the economic performance and growth process and stipulates that economic progress is the result of continuous changes in the structure of the economy.

42. For example, in the United States as much as 48 percent of all employment is accounted for by firms employing more than 10,000 workers (Haltiwanger, et al. 2013), whereas no such firm is observed in our data: the maximum employment size ever observed between 1996 and 2010 was 9,222 workers.

43. In our sample of emerging economies, only India and Indonesia had a lower entry density than MENA countries mainly due to India's and Indonesia's high shares of rural population and non-registered (informal) firms.

44. Reliable cross-country data on entry rates are difficult to come by. In interpreting the figure it is important to bear in mind that limited liability companies comprise only a subset of all firms, and the numbers may thus not be representative of the private sector at large.

45. The lack of mobility may also in part be driven by restrictive labor regulations that make firing of workers with open-ended contracts both costly and difficult (see Chapter Five) and by financial markets that have been unable to channel resources toward productive projects (see Chapter Six).

46. To conserve space, the results are not presented here but are discussed in detail in Rijkers et al. (2013).

47. The relatively better performance of the offshore sector shows the virtues of an open and competitive economic environment. While the performance of the offshore sector has remained stunted, compared to the rest of the economy the

offshore sector has been an engine of job creation and exports growth, stemming to a large extent from its ability to attract FDI. For instance, according to the specification in column 6 of Table 1.5, firms that have foreign ownership have job creation rates that are 4.6 percent higher than other firms. Hence, it is important not to lose sight of the fact that offshore firms on average have a much better performance in terms of jobs creation, productivity, and exports, compared to the firms in the protected onshore sector.

48. This section draws on Marouani and Mouelhi (2013). The analysis uses data from the Enquête National des Entreprises (ENE), which contains information on manufacturing firms with more than 5 employees.

49. Marouani and Mouelhi (2013) estimate that offshore firms are roughly 18 percent more productive on average than onshore firms, even after we account for the fact that offshore firms tend to be larger. It should be noted, however, that official tax data records do not yield the same monotonic relationship between productivity—proxied by output per worker—and firm size, most likely reflecting the impact of measurement error and differences in sectoral composition (see Rijkers, et al. 2013).

50. Analyzing the drivers of Total Factor Productivity (TFP) growth and allocative efficiency requires firm-level data on capital, labor, and value added, available only for manufacturing firms, which account for roughly one-fifth of aggregate employment and output. This section uses data from

the Enquête National des Entreprises (ENE), an annual firm survey that covers approximately a third of all manufacturing firms; the main findings are briefly presented here (and are elaborated upon in Marouani and Mouelhi 2013).

51. This matches the results of the growth decomposition presented in Section One, where we saw that the contributions of the increase in capital and labor to GDP growth were roughly similar.

52. With exports accounting for just over half of GDP, firms partaking in international trade are an important source of income and jobs. Only 8 percent of firms that offer wage jobs are involved in exporting and 5 percent in importing. Firms that export (import) account for a third (half) of all employment. In fact, it is noticeable that the offshore firms, which are predominantly focused on exporting, accounted for roughly 33 percent of all wage employment in 2010, even though only 6 percent of all firms that offer wage jobs are registered as offshore firms.

53. In a typical country the top 1 percent of firms account for 56 percent of all exports, and the top 25 percent account for almost all export value (Freund and Pierola 2012).

54. See details in DPR background report on “Private Sector Paralysis: Firm Dynamics in Tunisia,” World Bank (2014b).

55. As discussed in Chapter Ten; however, significant differences in infrastructure and human capital persist across regions.

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Opening Markets: Creating an Environment for Investment and Jobs Creation | 02



More than 50 percent of
Tunisia's economy is in
sectors subject to entry
restrictions



Opening Markets: Creating an Environment for Investment and Jobs Creation

This chapter reviews the status of competition policies and their effectiveness in promoting functioning markets and more efficient resource allocation in Tunisia¹. The previous chapter has highlighted an economy with stunted structural evolution where productive capacity is centered mainly on low value added activities and most of the jobs created offer low wages and limited job security. Firms are stagnating in terms of growth, jobs creation, and productivity; and the persistent lack of firm growth, combined with low exit rates, is indicative of limited competition in Tunisian markets. This lack of structural change and “creative destruction” is at the root of the weak economic performance of Tunisia and the insufficient rate of jobs creation. This chapter discusses the barriers to the efficient operation of Tunisian markets. It also presents an analysis of the expected benefits of increased market rivalry on productivity of Tunisian firms and highlights that Tunisia would reap large gains (in terms of faster growth and greater jobs creation) by allowing greater competition in the markets².

The economic benefits from competition on growth, productivity and job creation are well documented by the international empirical evidence (box 2.1). Firms operating in a competitive environment are more likely to innovate and to increase their productivity and create jobs. Competition boosts investment, generates employment, and ultimately speeds up economic growth and improves overall welfare. Competitive pressure in input (upstream) markets, such as transportation, financial services, energy, telecommunications, and construction services, is a key driver of efficiency and productivity growth in downstream sectors—the users of these inputs. Increased international competitiveness is another important and positive effect associated with increased competition in domestic markets. Finally, consumers benefit from lower prices, direct savings, and improvements in the variety and quality of goods and services. Consumers also find enhanced job opportunities and additional income as investors.

As discussed in this chapter, Tunisia’s economic environment is not based on competition. It is not an environment in which the most productive firms can succeed, grow, and create jobs. A key reason for the status quo is the absence of a competitive environment in which successful firms thrive and grow and in which less productive firms eventually are pushed out of the market with the resources they employ easily reallocated toward new, more productive activities. This is largely the result of a regulatory environment that does not support competition—based instead on restrictions to entry that, as will be discussed in Chapter Three, breed rents-extraction and cronyism—and on the preponderant role state-owned enterprises (SOEs) play in the economy which also distorts competition as SOEs receive unfair advantages from the state.

Box 2.1: International Experience on the Impact of Competition on Growth, Productivity, and Job Creation

The economic benefits from competition are well documented. Firms operating in a competitive environment are more likely to innovate (Bassanini and Ernst, 2002; Bloom, Draca, and Van Reenen 2011) and to increase their productivity (Acemoglu et al. 2007; Aghion and Griffith 2005). Competition boosts investment (Alesina, et al. 2005), generates employment, and ultimately speeds up economic growth and improves overall welfare. Competition in input (upstream) markets, such as transportation, financial services, energy, telecommunications, and construction services, is a key driver of efficiency and productivity growth in downstream sectors—the users of these inputs. Empirical evidence strongly supports the positive effects of competition policy enforcement on productivity growth (Voigt, 2009; Buccirossi, et al. 2009). Tough enforcement against the practices of cartels, based on well-designed anti-cartel laws, for example, constitutes an effective tool to reduce negative impact of anticompetitive behavior (Symeonidis 2008; Alexander 1994). Increased international competitiveness—and therefore more favorable terms of trade—is another important and positive effect associated with increased competition in domestic markets. Finally, consumers benefit from lower prices, direct savings, and improvements in the variety and quality of goods and services. Consumers also find enhanced job opportunities and additional income as investors.

Anti-competitive practices also result in welfare losses for the economy as a whole. Price-fixing agreements among competitors impose significant costs on society. Connor (2010) examines studies and judicial decisions on 381 cartelized markets worldwide and estimates a long-run median overcharge of 23.3 percent of prices above competitive levels. Estimations from the European Commission (2008) suggest that average productivity would fall by 13 percent in the presence of market-sharing cartel agreements among member states. A recent study of the international market for coffee beans finds that the cartel's breakdown explains 49 percentage points of the 75 percent drop in the real coffee price between 1988 and 2001 (Igami 2011). Apart from increasing the cost of goods and services to conduct business, cartels are also associated with low labor productivity and reduced incentives to innovate (Broadberry and Crafts 2001; Evenett, Levenstein, and Suslow 2001; Symeonidis 2003). In a study of 42 countries, Kee and Hoekman (2007) found that, in industries where competition rules were actively enforced, antitrust enforcement increased the number of domestic firms by 7.2 percent. Similarly, a 20 percent increase on an index scale—roughly equivalent to moving from the level of competition rules enforcement in the Czech Republic to that in the United Kingdom—resulted in faster total factor productivity growth of 1 percent.

International experience shows that the introduction of a comprehensive national competition policy framework can bring substantial economic gains. Australia is one of the countries that serve as an example of successful implementation of a national competition policy framework. Estimates suggest that competition policy reforms boosted Australia's GDP by at least 2.5 percent or US\$20 billion due to their effect on increased productivity and lower prices during the 1990s. Likewise, conservative estimates for the United Kingdom suggest that direct consumer savings resulting from the enforcement of competition law are worth US\$112 million a year. In the case of the Netherlands, the positive impact of the competition agency's actions on Netherlands society is estimated at US\$426 million (a 3-year rolling average). Finally, recent studies also provide evidence that budgetary commitments to competition agencies and institutions yield economic benefits in terms of improved economic growth since they are associated with higher levels of per-capita GDP growth.

It is also important to highlight that there is a close connection between the discussion in this chapter on opening markets and the discussion in the previous chapter on jobs and productivity. In fact, the existence of monopolies and oligopolies (which may result from unnecessary barriers to competition) raises the costs for the rest of the economy, reducing the payoff to (job-creating) investment and productivity improvements. Further, the results shown in Chapter One have highlighted that removing restrictions to entry directly increases employment growth—because in Tunisia employment growth largely comes through creation (that is, entry) of new firms, such that restrictions on entry undermine jobs creation.

2.1 / How Open Are the Tunisian Markets?

Since the 1970s Tunisia adopted a public sector-led development model that saw the state play an active role in strategic sectors and in imposing barriers to entry into large segments of the economy. Tunisia developed well during the 1970s as limited steps were taken to open up the economy, notably with the inception of the “offshore” regime (see Chapter One), coupled with proactive government industrialization policies. By the 1980s, however, the limits of the state-led economic model started to emerge as Tunisia was impacted by a severe economic crisis. Parts of the economy were liberalized in the late 1980s and 1990s with the consolidation of the “offshore” sector and as part of a process of greater integration with the European Union (EU). However, the core thrust of the economic model remained fundamentally unchanged because the state retained close control of most of the domestic economy. As a result, by the late 1990s the economy increasingly struggled to advance and economic performance remained insufficient³.

In fact, as discussed below, today over 50 percent of the Tunisian economy is still either closed or subject to entry restrictions, and numerous government regulations and interventions are distortive of market development and generate unintended barriers. Specifically we find that markets in Tunisia are not well functioning due to: (a) the existence of restrictions to the number of firms allowed to operate in the market, restrictions towards private sector activities, including restrictions to foreign investors, and prevalence of statutory monopolies; (b) the lack of a level playing field and of non-discriminatory treatment across firms; and (c) controls on prices and other market variables which increase business risk and reduce ability of firms to compete⁴. We discuss each of these three areas in turn below.

Widespread Restrictions on the Number of Firms, Restrictions on Private Sector Activities, Especially for Foreign Investors, and Prevalence of Statutory Monopolies Hinder Competition in Tunisia

In Tunisia, widespread restrictions on the number of firms allowed to operate in the market are coupled with many legal (public) monopolies and undue regulatory constraints in network sectors. Regulatory barriers discourage investors, both Tunisian and foreign, from creating new companies and expanding existing companies, and therefore hinder them from hiring more people (see box 2.2 and box 2.4). In fact, sectors in which investment faces restrictions account for over 50 percent of the Tunisian economy, whether through the Investment Incentives Code, the Commerce Code, the Competition Law, or specific sectoral legislation regulating services sectors—notably telecommunications, health, education, and professional services. The number of competitors is explicitly restricted by law or regulation in some markets (for example, water, electricity, telecoms, road transport, air transport, railways, tobacco, fisheries, tourism, advertising, health, education, vocational and professional training, real estate, agricultural

extension services, retail and distribution, and so on), such that several of these sectors at present remain de facto closed to competition. The operation of markets in Tunisia is also constrained by regulatory limitations on the number of competitors in network industries and other business activities and services, which restrict free entry. Network sectors such as gas and electricity; water

Box 2.2: Banking on the Future: Mobile Technology Meets Complex Regulations in Tunisia's Financial Sector

TUNIS-It has been an uphill struggle for returning Tunisian expatriate Ramzi El Fekih to get his mobile-phone banking system, Viamobile, off the ground. First, he had to find a local bank to team up with. Under current Tunisian legislation, mobile banking can still only be provided via a bank.

Unlike in Europe, or even in the Arab Republic of Egypt, Jordan, or Morocco, the legal framework in this respect lags behind technological developments, El Fekih argues.

Viamobile allows clients to open accounts that they can access from their mobile phones. As well as busy urban folk, it hopes to attract people living in rural areas who are opening a bank account for the first time. Where it has been implemented, mobile banking has been beneficial for consumers and retailers especially in rural and remote areas, among the least served by traditional banking models.

Its distribution network would not ideally be through a standard brick-and-mortar bank, El Fekih says. "A mobile payments system has to be present everywhere—which is not the banking model. Our prices are cheap, and the only way we're going to be profitable is if we have volume."

However, having secured Banque Internationale Arabe de Tunisie (BIAT), one of the country's leading private-sector banks, as a partner, El Fekih's company Creova prepared to launch the service in 2009. The planned launch may have attracted the attention of Sakhr El Materi, son-in-law of then-president Zine el Abidine Ben Ali.

Word in Tunisian financial circles was that El Materi planned a mobile banking service for his own Banque Zitouna.

Three weeks before Viamobile was due to launch, BIAT was notified by the central bank that it should not proceed until further notice. No reason was given, El Fekih says. "We'd done everything by the book, so there was no reason to stop it. We knew something was going on."

The central bank repeatedly promised a clarification, which was never given. It was only after the 2011 revolution abruptly ended the influence of business circles close to the Ben Ali family, including the confiscation and sale of Banque Zitouna, that the central bank finally gave Viamobile the green light.

However "The distribution channel is a big hurdle still. It's our biggest complaint from users," says El Fekih. In 2012, officials from the technology ministry and the central bank got together to find a way forward for mobile payments. One idea was to put distribution and sales in the hands of approved individuals who would be certified as agents, said El Fekih. But, once again, there has been no update on official thinking, and he is not sure how things stand.

Société Monétique de Tunisie, which is owned by the country's leading banks and has a monopoly on processing credit card payments, should not see its revenue undermined by Viamobile, El Fekih says. "I see Viamobile as a complementary service, because users have access to a credit card issued by BIAT."

He estimates that Creova's sales, at less than one million dinars (about \$625,000) in 2013, could have been double that had the distribution issue been resolved. Indeed, financial-sector experts estimate that the potential of mobile banking in Tunisia is large and in three to five years could reach one million unbanked people and account for over \$1 billion in transactions.

"The regulations haven't changed since the revolution. The will to change is lacking. Things are still stuck."

Source: Interview with Mr Ramzi El Fekih, Tunis, May 2014.

collection, purification, and distribution; and rail transport (infrastructure operation, passenger and freight transport)—as well as other sectors such as the tobacco supply chain—are legal/state monopolies. In addition, regulatory barriers to international telecommunications and air transport entail de facto monopolies or oligopolies also in those sectors. It is not unusual across the world to see (public) monopolies in basic network utilities, notably water, gas, and electricity (although in some countries even some market segments of these utilities have been opened to more operators). In Tunisia, however, even the segments of transport and telecommunications services where private sector participation is common remain closed compared to comparator countries.

The telecommunications sector is characterized by low levels of competition due to restricted entry and regulations that do not promote competition among incumbents and that result in very high prices for Tunisian firms and consumers. The state-controlled operator, Tunisie Telecom (TT), holds a monopoly on fixed-line telephone communications, one of the three cellphone and 3G licenses in the country. In the national market, all operators use Tunisie Telecom's national connection infrastructure (backbone), including the administration and private companies. Tunisie Telecom also owns all the landing stations of international submarine cables and enjoys de facto a quasi-monopoly position in the sale of national and international leased lines. There are two more cellphone and 3G operators, namely Ooredoo Tunisie (which until April 2014 was called Tunisiana) and Orange. As of 2012 Ooredoo held approximately 53 percent of the mobile market, while Tunisie Telecom held approximately 36 percent and Orange held the balance of 11 percent. In practice, the telecommunications market can be characterized as a duopoly. In fact, given the restrictive regulatory environment that limits competition, it will be several years before the third cellphone operator, Orange, can compete on an even footing with Tunisie Telecom and Ooredoo⁵.

In the international telecommunications market, only the same three operators (Tunisie Telecom, Ooredoo, and Orange) are allowed to offer international voice communications in Tunisia. By contrast, Eastern Europe has, on average, 10 facilities-based international communications operators. Further, when it comes to international voice communication, the three operators offer international communications services only to their own access clients (that is, Ooredoo is not allowed to offer international communications services to subscribers of Orange or Tunisie Telecom, and so on)⁶. Good practice calls for liberalization of this segment (since a large number of operators typically operate in this segment) and allowing operators to address the whole access subscriber base in a given country⁷.

As a result of the limited competition in most segments of the telecommunications market, Tunisian consumers pay very high prices, which also damages Tunisian firms' competitiveness (box 2.3)⁸. It should be clarified that, while some segments of the telecoms market suffer from restrictions to entry notably in international telecommunications, other segments—for instance cellphone telecommunications—are naturally limited by the small size of the Tunisian market. However, even when the number of providers cannot be increased, it is important to regulate these markets so as to foster competition (for instance among the three providers in the cellphone market) and to remove the scope for oligopolistic profits (which are extracted at the expense of Tunisian consumers, firms, and the economy at large).

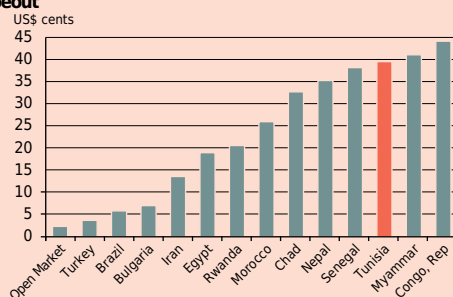
Box 2.3 Comparative Snapshot of the Telecom Sector Performance in Tunisia

Whereas Tunisia aims to become an internationally competitive player in the global market, Tunisian consumers and private sector face some of the highest costs for communications in the world. A benchmark on “Skypeout” calls (which generally reflects the most competitive prices for international telecommunications) shows that an incoming international call to Tunisia costs \$0.40/minute—nearly twenty times the international market price and approximately twice the price paid in neighboring MENA countries (Morocco is at \$0.25; Algeria, Egypt, and Libya are between \$0.15 cents and \$0.20; Turkey is at \$0.04; France is at \$0.02; see figure B2.3.1). For instance a phone call from Paris to Tunis is 11 times more expensive than a call from Paris to Istanbul (Turkey being a model of successful reform). Prices of outgoing international calls are slightly cheaper but remain more than ten times the international prices. As a consequence, Tunisians avoid communication via international calls: Tunisia’s per capita international calling minutes amount to merely half the Arab Maghreb Union (AMU) average, they are 7 times fewer than the MENA average and 3 times fewer than Eastern European average international calling minutes (see table B2.3.1). Moreover, Tunisia’s international communications are stagnating, while other countries are increasing and using them as natural tools for a better integration of their economies into the global market. Again, the main reason is the high cost of international calls due to the monopoly in Tunisia, whereas MENA and AMU started liberalizing the sector in 2006. Similarly, despite the high prices charged to consumers for ADSL (Asymmetric Digital Subscriber Line, ADSL) services, the coverage remains limited and of weak quality, which has constrained the development of ADSL (World Bank 2012a; Gelvanovska et al. 2014). Even with much lower per capita income than Tunisia, Egypt and Morocco are better positioned to become regional hubs in the sector, with three and seven operators respectively. These numbers are still much lower when compared to more integrated countries such as in Eastern Europe (10 providers per country on average) (see figure B2.3.4). High communications prices discourage foreign direct investment (FDI), trade, and regional integration and are particularly damaging for the competitiveness in information and communications technology (ICT) and offshoring services—they also bear social costs for Tunisians at home and overseas.

Table B2.3.1: Comparative Statistics on International Communications

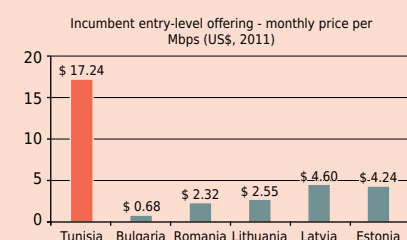
	Year of Liberalization	Per capita communication in 2010 (minutes)	Cumulative growth 2004-2010
MENA average	2006	181	10%
AMU average	2006	48	11%
Eastern Europe average	2002	73	8%
Tunisia	Not yet	25	1%

Figure B2.3.1: Cost of Calls from the U.S. to Countries Using Skypeout



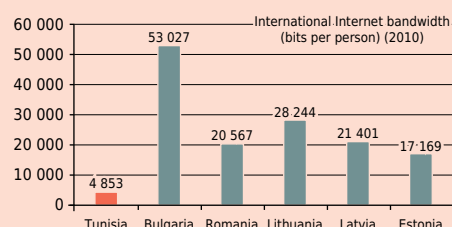
Source: Gelvanovska, Rogy, and Rossotto (2014).

Figure B2.3.3: Entry Ticket for International Connectivity (\$/Mbps/month), 2011



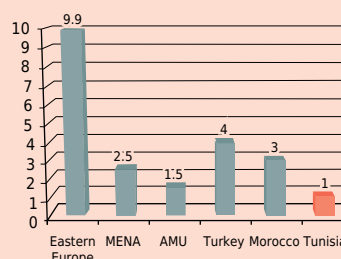
Source: Telegeography Globalcomms Database, Sep. 2011 and WDI

Figure B2.3.2: International Internet Bandwidth Usage



Source: Telegeography Globalcomms Database, Sep. 2011 and WDI

Figure B2.3.4: Number of Providers of International Bandwidth, 2011



Source: Gelvanovska, Rogy, and Rossotto (2014)

Box 2.4: Enabling Technology to Save Taxpayers Money

TUNIS-It was with a sense of another opportunity lost that managers at NGI Maghreb read in early May that thousands of official cars provided to ministerial staff and senior civil servants would be replaced by allowances. As part of the cost-cutting, gasoline vouchers issued to officials would likewise be replaced by more modest cash allowances to cover purchases at the pump, the cabinet had decided.

"Instead of simply cutting all the cars, they could have used our fleet management services to monitor mileage, location, and gasoline consumption," said Mohamed Chouchane, the company's associate manager. This was a clear example of how technological solutions developed by the private sector could promote efficient allocation of public resources, he argued.

NGI Maghreb, which employs 70 people at its Tunis offices, is the local operation of Groupe NGI, of France. It offers a range of location-based services (LBS), and is keen to start bidding for the public-sector contracts that are key to its growth strategy in Tunisia.

The company estimates that, on average, the use of its fleet management services results in an 18 to 20 percent reduction in fuel usage (which is the easiest saving to track). They see the possibility of making enormous savings, at Tunisia's Ministry of Agriculture, for instance, which has a fleet of over 8,000 vehicles of various kinds.

Tunisian legislation has failed, however, to keep pace with technical developments in this fast-evolving field, Chouchane says. With a new legal framework still under discussion, any ministry thinking of launching a tender for a private-sector operator to provide it with location-based services has to put that idea on hold for now.

As discussions proceed, Chouchane is concerned that a framework that might include official input on the pricing of LBS services could "prevent companies from coming up with solutions at costs that are in line with those elsewhere in the world."

NGI Maghreb is not new to administrative hurdles. Before the 2011 revolution, it had to overcome the intensely security-minded mentality of the era when in partnership with mobile phone operator *Tunisiana* it launched *Weenee* (meaning "Where am I?" in Tunisian Arabic). *Weenee* was to be the first GPS service marketed to the Tunisian public.

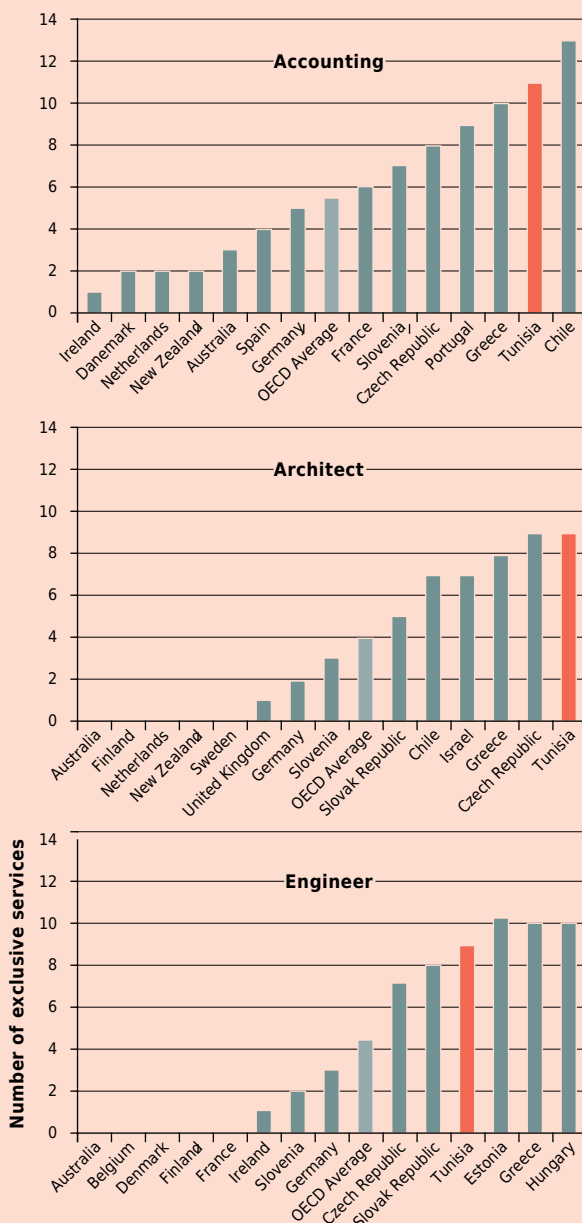
Its launch was delayed for some months in 2008, after the infrastructure ministry secured an injunction blocking it on grounds of national security. Chouchane recalls explaining to the ministry that imaging of the presidential palace, for example, was already available on Google Earth. It was only after NGI Maghreb successfully challenged the injunction in the courts that the launch was able to go ahead as planned.

Source: Interview with Mohamed Chouchane, Tunis, May 2014.

In the retail sector, several regulatory restrictions distort market conditions. The retail sector seems to be polarized and includes numerous micro shops and three large outlets⁹ (the latter have around 16 percent of the market share and are distributing mostly food products, reaching around 62 percent of their sales); food prices distributed by large outlets seem to be on average lower by 10-15 percent than those in other shops, given economies of scale (Boughala 2013a)¹⁰. In an attempt to maintain a balance between large commercial outlets and small retailers, the regulatory framework introduces an additional authorization by the *Commission Nationale de l'Urbanisme* (CNUC) (as specified in the *Code d'Urbanisme*) for the opening of large outlets (above 1500 square meters) and commercial centers (above 3000 square meters) and additional administrative requirements for foreign investors (*carte de commerçant*)¹¹. While the CNUC's role is to ensure observance of legal provisions on urban planning and environmental issues, the procedure to obtain such an authorization is burdensome and creates unnecessary hurdles to entry¹². A further restriction in the same regulation obliges suppliers to sell their products through wholesalers or large outlets that act as wholesalers and retailers, limiting incentives for suppliers to expand their activities and obtain higher margins. In some instances, producers can distribute their products, but only upon approval by the Ministry of Commerce. Moreover, as discussed further below, some agricultural products (for example, cereals and imported meat) may be distributed only by state entities (*Offices*) at controlled prices¹³.

When compared to international best practice, Tunisia also imposes severe restrictions to competition in the professional service markets. Both self-regulation and state regulation of professions have the potential for creating anti-competitive effects that do not benefit or protect consumers. There is a general consensus that professional regulations that create anticompetitive structures or permit anticompetitive behavior should be eliminated¹⁴. Specific structural and behavioral restraints on professional practices should be eliminated

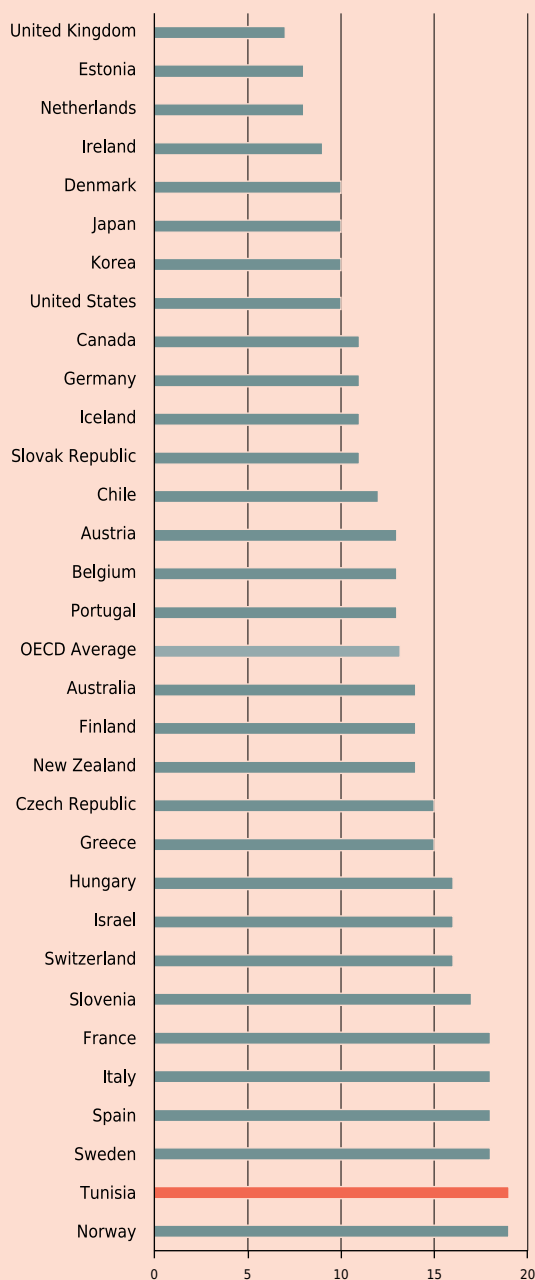
Figure 2.1: Number of Exclusive Services by Profession in Tunisia: Comparison with OECD Countries



Source: Data for Tunisia are from a 2012 survey carried out by the World Bank following the OECD PMR template; data for other countries is from the OECD PMR database for from 2013, except for Poland for which the latest available PMR data is from 2008.

Note: (i) Top five performing countries are those OECD countries (out of 34 OECD countries) with no or minimal regulatory limitations in this area. Typically, regulatory limitations for liberal professions are designed to ensure a certain standard of service quality and not to impose restrictions on market variables (such as prices or number of service providers). (ii) The exclusivity of legal services is more or less similar to the other OECD countries. Therefore, we have not included it in the figures, focusing instead on the three professional categories (services) where exclusivity is more problematic.

Figure 2.2: Number of Sectors with at Least One SOE in Tunisia Compared to OECD, non-OECD, and Central and Eastern Europe (CEE) Countries



Source: World Bank 2012 PMR survey for Tunisia; OECD 2008 PMR database for Brazil, Italy, Japan, Luxembourg, Mexico, Poland, Republic of Korea, Turkey, and United States; OECD 2013 PMR database for all other countries.

because they have no demonstrable consumer welfare benefits, or the benefits do not outweigh the costs. In many countries, professional self-regulations have the direct or indirect effect of restricting competition in these markets, raising the price and limiting variety and innovation in professional services. Elimination of regulations that facilitate coordinated behavior will reduce the costs of professional services. First, all professions enjoy extensive exclusive rights on service provision and only Tunisian firms can provide these exclusive services (except investment advice which can be provided by foreign operators). Further, there is a complete prohibition of advertising for all four professions (architects, engineers, legal services, and accountants). For some professions, prices are also regulated. It should be noted that, although it is not unusual that EU/OECD governments endow selected professions with the exclusive or shared exclusive rights to provide specific services, Tunisia appears to be much more restrictive and protective of professional privileges (figure 2.1). The majority (more than 60 percent) of OECD and EU countries do not have any regulations of prices in these professions.

Openness to FDI is particularly constrained in Tunisia, and regulation does not guarantee a level playing field across domestic and foreign firms. Statutory or other legal limits to the number or proportion of shares that can be acquired by foreign investors are frequent in Tunisia (see also Chapter Four). For 49 sectors (which account for 38 percent of the economy), investment projects are subject to the authorization of the High Commission of Investment when foreign ownership exceeds 50 percent. As mentioned above, foreign ownership restrictions also exist for all liberal professions (legal, accounting, architecture, engineering), which makes it difficult for foreign investors to enter this market. Also, wholesale trade is only permitted to Tunisian firms. In the road transport sector, foreign companies are subject to the authorization of the High Commission for Investment when foreign ownership exceeds 50 percent. More generally, foreign firms cannot have redress through private rights of action in Tunisia¹⁵.

Beyond entry restrictions and public monopolies, state-owned enterprises (SOEs) still play a dominant role in Tunisia, with the government controlling firms in markets that are typically open to private sector participation. SOEs account for approximately 13 percent of GDP (UNCTAD 2006) and almost four percent of total employment in the country (box 2.5). According to the information available, the government controls at least one firm in 19 sectors compared to an OECD average of 13 sectors and an average of 8 sectors in the top five performers among OECD countries (figure 2.2)¹⁶. In the infrastructure sector there are an

estimated 32 SOEs¹⁷. In comparison in EU countries there are on average nine SOEs in infrastructure/network industries (OECD PMR database). The state is active especially in the field of public services (electricity, water, sanitation, passenger transport) as well as in the import of some basic products considered sensitive, such as cereals, tea, coffee, vegetable oils, iron, and pharmaceuticals (ACRLI 2008). In Tunisia, SOEs hold between 50 percent and 100 percent of the markets of gas, electricity, railroad transport, air transport, and fixed-line telecommunication services; and many SOEs act as monopolists in the production, import, and distribution of various goods (for example, cereals, olive oil, meat, and sugar) (figure 2.3)¹⁸. It is important to clarify upfront that there is no problem with state ownership of these companies in itself. In terms of the efficient operation of markets, however, what is important is that these firms are forced to operate efficiently by introducing adequate corporate governance rules (which include independence from the government and the public administration), and also that these public companies do not benefit from unfair privileges from the state (see below)¹⁹.

What is unusual is that in Tunisia the presence of SOEs is relatively large in sectors such as manufacturing, transport, tourism and recreation, and other services that are key for private firms. Although the presence of SOEs is not unusual in certain segments of network industries, the Tunisian government is also present in various sectors in which it is difficult to justify (as there is no clear rationale for the state to be involved). The government controls firms in many manufacturing and service subsectors, such as hotels, restaurants, and other business activities. Further, there are three SOEs providing golf facilities and 12 SOEs in the real estate sector. SOEs' presence in these sectors is contrary to international practice and lacks any economic rationale.

Box 2.5: State-Owned Enterprises (SOEs) and Public Banks in Tunisia

The role of SOEs in Tunisia has historically been and remains very significant in terms of their contribution to economic activity, employment, and the provision of vital services. As of the end of 2011, there were 104 public enterprises in the government's portfolio, in 14 sectors, for total employment estimated at almost 120,000 (or almost four percent of total employment). Beyond public utilities, the main sectors in which SOEs' presence is strong are currently transport and infrastructure, industry, and banking.

Public enterprises tend to be ripe with governance problems and cronyism. SOEs' performance in Tunisia highlights that in general Tunisian SOEs suffer from problems related to their internal and external governance.ⁱ As a result, in Tunisia the privileged access to state-owned assets was an important target for rent-seekers, as also described at length in the report of the Commission nationale d'investigation sur la corruption et la malversation (CNICM) published in November 2011.ⁱⁱ

On the whole, SOEs usually underperform, and many also incur financial losses despite protection from competition and significant government support. In recent years budgeted annual transfers to loss-making SOEs amounted to 0.8 percent of GDP on average. Additional losses were financed by access to loans by SOEs (or were carried forward), but no accurate estimates of such liabilities exist. Further these financial costs should be augmented by the many implicit transfers benefiting SOEs, for instance in terms of monopolistic position in the market, which allows them to extract rents from the economy and populations (for example, the exorbitant cost of international calls to and from Tunisia, and the high cost of air travel to and from Tunisia), or in terms of below-cost access to natural resources (see below). As discussed in the main text, in Tunisia these generous subsidies imply that SOEs enjoy anti-competitive advantages, such that the management of SOEs in Tunisia results in an uneven playing field that reduces competition and penalizes the most efficient firms, hindering their growth (and therefore jobs creation). In addition, as also discussed in Section 2.3, SOEs impose severe economic costs to the economy, both directly and indirectly. Inefficient provision of critical inputs and services increases costs for local business, limits expansion, and hampers competitiveness and growth.ⁱⁱⁱ

Beyond official transfers to SOEs, hidden cross-subsidies mask the ineffectiveness of some of the SOEs, at an enormous cost to the country. For instance, in the energy sector, the national oil company, ETAP, imports oil and gas on behalf of the refinery of the country, the STIR, and the company responsible for the production of electricity, STEG. ETAP imports crude oil and sells it at less than a third of the international market price. Hence, ETAP profits (and revenues for the budget) are lower because of this hidden transfer to STIR. The amount of hidden transfer is even higher for natural gas, which is sold to STG at 10 percent of the international price. Overall the full amount of hidden subsidies to STIR and STEG was estimated at approximately 2.2 percent GDP in 2009 (or TND 1.5 billion). In addition, because production is insufficient to satisfy internal demand, a large share of domestic consumption of LPG, petrol, and diesel is imported (as much as 72 percent by volume in 2008). The costs are covered by the state, but no one has full knowledge of the effectiveness of procurement procedures for imports and effectiveness of the company. This model seems expensive and not transparent, as the financial losses do not appear explicitly.

Similarly, in Tunisia State-Owned Banks (SOBs) have been accumulating large liabilities and now require a massive transfer from the state budget. Ben Ali's circles used public banks to obtain privileged access to credit at advantageous conditions. In addition, public banks gave loans to SOEs to finance their activities, thus masking their operational losses, and the SOEs were unable (or unwilling) to repay the loans. These governance failures have prevented the financial sector from channeling resources to the most economically rentable projects and have undermined the stability of the financial sector, such that it is now in need of a large recapitalization (see Chapter Six). The 2012 Bank/IMF FSAP report estimates that the SOBs require a recapitalization of the public banks on the order of three to five percent of GDP, under the baseline scenario.

Source: World Bank (2013e). *La nécessité d'une meilleure gouvernance des entreprises publiques en Tunisie*. Report N.78675-TN, Washington DC.

Notes: i Notably, limited transparency and weak accounting, reporting, and budgeting functions; weak ownership function of the state; weak internal corporate governance, characterized by weak boards; proliferation of controls but with limited efficiency.

ii Several practices were recurrent regarding SOEs: (i) access to public land at non-market conditions, which was very lucrative in a context of booming real estate sector; (ii) use of insiders' information on assets to be privatized and restructured to acquire stakes at non-market terms; (iii) abuse of public services and assets for private purposes, like Karthago Airlines, which used Tunisair maintenance and catering services without paying; (iv) share takeovers in strategic sectors such as privatized banks and use of utilities to give ruling family companies a comparative advantage in some sectors. Moreover, the former president's circles used public banks to obtain privileged access to credit at advantageous conditions. Overall, during that time, it was well known that appointments of CEOs were "politicized" and large amounts of public resources were transferred to cronies.

iii Sekkat (2009) demonstrated for Egypt that the importance of an SOE in a given industry was negatively correlated with total factor productivity explaining mainly this by the fact that SOEs enjoy a rent irrespective of their productivity performance.

Figure 2.3: Extent of Public Ownership in Gas Sector and Air Transport in Tunisia



Source: Data for Tunisia are from a 2012 survey carried out by the World Bank following the OECD PMR template; data for other countries is from the OECD PMR database for from 2013, except for Poland for which the latest available PMR data is from 2008.

Note: In the gas sector, for Tunisia the figure shows only the gas importer that is an SOE.

Market segments of transport services that may be supplied by private operators are still serviced by dominant SOEs with market shares larger than 50 percent. Two dominant SOEs provide maritime transport services and also operations in ports, respectively. The *Compagnie Tunisienne de Navigation* (CTN) ensures passenger transport through the Goulette port (merchandise transport in this port is limited to break bulk cargo), while STAM is a de facto monopoly that ensures freight forwarding, operations, and maintenance in the port of Rades. The latter is the most important port for merchandise transport—95 percent of containers go through the port of Rades—but its infrastructure is not adequate for container transportation, and maintenance of port infrastructure requires improvements. It also has substantial pricing power because tariffs are reportedly 30 to 50 percent higher than those of its competitors. Similarly, in air transport, the national incumbent, Tunisair, combines several functions: air transport services as well as cargo and handling services in the airport. Most passenger transport is provided by Tunisair on international regular and chartered routes—it accounts for about 63 percent of all offered seats in the market. Tunisair also dominates cargo and handling services. Besides Air France, which is a shareholder of Tunisair, the market remained relatively closed to other airlines²⁰. The regulatory framework protecting Tunisair prevents other airlines from offering viable transport alternatives, resulting in higher prices and lower quality services for Tunisian consumers; creating negative repercussions on many key sectors, notably on tourism; and hampering competitiveness and job creation across the entire economy. Contrary to many OECD countries, Tunisia has no regional agreement in air transport with other countries from the region, nor did Tunisia sign an EU–Tunisia open skies agreement (see box 2.6).²¹

Box 2.6: Open Skies—Greater Economic Outcomes than Challenges for Incumbent Firm

Historical experiences on Open Skies agreements demonstrated their significant economic contribution at multiple levels: on the number of air passengers, on jobs creation and competitiveness in the air transport industry and related activities, and on tourism and on related activities. While pre-negotiation talks on Open Skies with the EU were initiated before the revolution, discussion was put on hold, partially for political reasons, but also due to the concerns about the competitiveness of Tunisair compared to its potential competitors, European low-cost operators. Liberalization of air services could be socially challenging because it would require Tunisair to implement further restructuring.

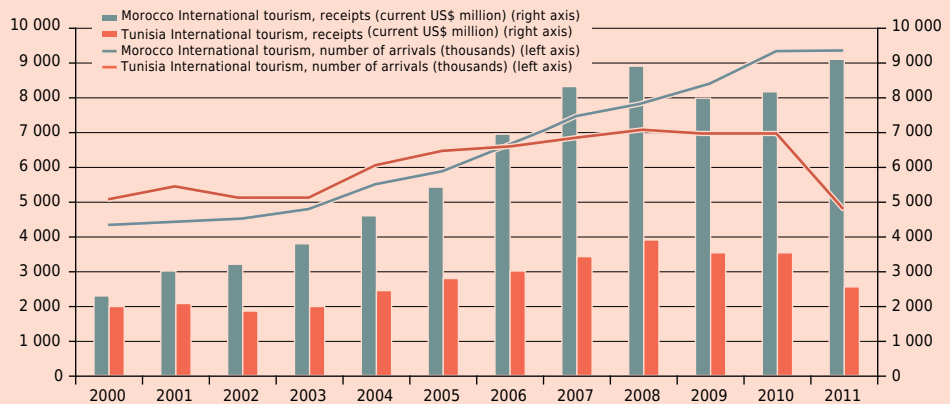
An Open Skies with the EU could, however, lead to significant jobs creation across the economy, notably in tourism. For instance, Morocco has successfully boosted its tourism sector and its airline since reaching an Open Skies agreement with the U.S. in 2000 and with the EU in 2006. The Open Skies agreements boosted international traffic: the number of passengers almost doubled between 2006 and 2011, the number of tourist arrivals increased by more than 42 percent, and tourism receipts increased by 32 percent. In addition, the annual growth of frequencies attained 12 percent during 2003 and 2010, such that Moroccan companies gained 402 additional frequencies in seven years while foreign companies gained 241 additional frequencies. And of course consumers (and the tourism sector) benefited enormously as increased competition pushed the fares down significantly. In contrast, Tunisia increased the number of passengers by only 33 percent, the number of tourist arrivals by 5 percent, and tourism receipts by 16 percent between 2006 and 2010 (see figure B2.6.1).

Further, the Open Skies agreement with the EU has considerably increased competitiveness of Royal Air Maroc (RAM), which is almost entirely government owned. RAM still dominates the market with over 50 percent market share, despite entry into competition of 22 foreign companies (of which 19 are European) in the market since 2004. (In addition to the five local companies, three new Moroccan low-cost airlines were set up and four new licenses were issued for handling services in the airports.). European low-cost carriers increased their share in the EU-to-Morocco market, from 12 percent in 2006 to 40 percent in 2011. Interestingly,

however, the decrease in the market share of RAM from 60 percent in 2004 to 53 percent in 2010 was accompanied by a dramatic increase in the volume of passengers transported—from 820,240 during 1998 and 2003, to 8.6 million during 2004 and 2010. In fact RAM has continued to remain competitive and has kept the highest share of the number of passengers between Morocco and Western Europe.

Encouraged by the successful outcomes of the EU-Morocco Open skies agreement, Jordan signed an Open skies agreement with the EU in 2010. Similarly, an Open Skies agreement between Turkey and the U.S. in 2000 has contributed to boost air traffic and tourism in Turkey, with 4.4 times the number of passengers in 2011 than a decade ago, 3.2 times the number of tourist arrivals, and 2.8 times the number of tourism receipts.

Figure B2.6.1 Tourism Receipts and Arrivals in Morocco and Tunisia, 2000-2011



Source: World Development Indicators

Perhaps most important, it is not unusual in Tunisia for SOEs to receive special treatment in various forms, and as such a level playing field is not guaranteed among all market players, resulting in distortions and economic losses. SOEs regularly benefit from state aid (that is, any aid granted by a government entity which distorts competition by favoring certain markets or firms)²²—such as capital injections and guarantees for SOEs in financial difficulty or preferential loans from state-controlled banks or the state itself. As discussed in box 2.5, the Tunisian government often bails out loss-making SOEs at the expense of the state budget. These various forms of government support are granted through an ad-hoc process instead of clearly defined criteria. Best practice requires instead that, where the Tunisian government directly participates in markets, it is important to guarantee that competitive neutrality principles are in place. Competitive neutrality requires that no entity operating in an economic market is subject to undue competitive advantages or disadvantages²³. Controlling state aid and ensuring competitive neutrality will help avoid favoritism and ensure a level playing field among public and private companies. In Brazil, for example, the constitution expressly prohibits granting of fiscal privileges to SOEs if such advantages are not available to the private sector as well. In Australia, the dimensions of competitive neutrality include taxation, debt, and regulatory neutrality as well as the application of commercial rates of return as justification for asset retention in the case

of public enterprise and no cross-subsidization or hidden subsidies to SOEs from public funds. In Hungary, statutory regulations have been adopted to observe competitive neutrality principles in the field of finance neutrality, relating to “the transparency of the financial relationships between general government organs and public enterprises and the financial transparency within enterprises.” (Capobianco and Christiansen 2011).

In addition, extensive price controls and other market variables increase business risk and reduce the ability of firms to compete in Tunisia. Price controls exist in Tunisia at all levels of production and distribution for a wide range of food and non-food products and services. Similarly, distribution margins for many products are subject to state control (see table 2.1). An UNCTAD peer review indicates that in the production sector, the prices of 13 percent of products are still regulated, as compared with 20 percent in the distribution sector—the report concluded that a non-negligible part of the Tunisian economy is not open to free competition and there are no signs of improvement in this respect (UNCTAD 2006). The sectors where prices are controlled at all levels of distribution are also associated with significant SOE presence accounting for at least 55 SOEs²⁴, compared to at least four SOEs in the sectors where prices are controlled at the production level and at least 12 SOEs in sectors where distribution margins are controlled²⁵.

Marketing boards for agricultural products also continue to interfere with the operation of markets, undermining local production and investment. There are several agricultural-sector SOEs that hold monopolistic positions along many agriculture value chains in the domestic market as well as in the import-export segment. The state intervenes in the agriculture sector in various ways beyond the subsidy programs (which target bread, grains, couscous, pasta, oils, UHT milk, and tomato concentrate), namely through the operation and control of production, distribution, and marketing of various agriculture products. For example, the *Office des Céréales* intervenes in the collection and transport of cereals as well as imports; the *Office du Commerce* has a monopoly over imports of sugar, coffee, and potatoes; and the *Office National des Huiles* imports oils and exports olive oil (bulk, unrefined)—it has no exclusive rights on the exports of olive oil but controls access to EU quotas (especially for the unrefined oil). In some cases, such as for the *Office des Huiles*, the market share the state controls is fairly small, but the Offices have other levers through which they can influence the markets, for instance through market regulations or the issuance of quality certifications to private exporters. Also, for products whose prices are typically determined by demand and supply (vegetables, poultry meat, beef, lamb, and eggs), price interventions can occur indirectly—for example, through imports, price stabilization funds, and other market operations. It is a matter of the extent and type of intervention beyond subsidies. A unilateral decision by the government to scale down market operations or interventions of marketing boards would provide a positive signal to private investors in this sector.

Table 2.1: List of Products Subject to Price/Margin Controls

Products and services whose prices are controlled at all levels of distribution	Products and services whose prices are controlled at the production level	Products subject to control of the distribution margins
<ul style="list-style-type: none"> • Subsidized bread • Subsidized flour and semolina • Subsidized couscous and pasta • Subsidized edible oils • Subsidized sugar • Papers, textbooks and notebooks, subsidized school exercise books • Tea • Drugs and medical procedures • Fuel • Electricity, water and gas • Passenger transport • Subsidized regenerated milk • Postal and communications services (rates for communication services that fall under universal • telecommunications services framework cannot exceed maximum ceilings) • Tobacco, matches and alcohol • Harbor services • Hot drinks (coffee and tea) served in coffee shops and bars 	<ul style="list-style-type: none"> • Bakers' yeast • Beer • Barrels and metallic packaging • Motor vehicles • Lime, cement and reinforcing bars • Compressed gas 	<ul style="list-style-type: none"> • Rice • Fruits • Vegetables, plants and condiments • Poultry • Eggs • Bran and derivatives of milling • Roasted coffee • Butter • Tomato paste • Sugar cubes • Yeast • Beer • Tobacco • Salt • Artificial cement • White cement • Reinforcing bars • Metal cans • Auto vehicles • School ink • Compressed gas • School paper • School text books • Lacteal powder for children

Source: Government of Tunisia, Decree No. 31-1996 of 23 December 1991 (modified by Decree 95-1142)

In sum, Tunisian markets are characterized by multiple restrictions to competition that result in an environment in which firms are unable to compete and cannot grow based on their productive capacity and/or the quality of their services. Our findings highlight that competition is severely restricted in Tunisia due to a combination of regulatory barriers and statutory monopolies, privileged support to SOEs, and extensive price controls. As will be discussed in Chapter Three, firms survive by twisting the regulatory environment to their advantage at the expense of consumers and overall economic performance. In fact these barriers result in higher prices for consumers and firms: for example, the price of bananas and the price of roasted coffee beans in Tunisia are both roughly twice as much as in the international market, the price of car tires is 30 to 50 percent higher than the international price, the price of international telephone calls is 10 to 20 times the international market price, the price of air tickets is estimated at 30 to 50 percent higher than elsewhere, and so on. It is worth noting that most of the barriers to entry and competition concern the onshore sector; however, the offshore sector—while more successful than the onshore sector—also suffers from the impact of these regulations (albeit indirectly). The low efficiency of these onshore sectors, especially the backbone services, negatively affects the competitiveness of the offshore economy, condemning it to low value added activities, which largely rely on cheap labor (for assembly of intermediates purchased abroad). Hence the impact of these barriers to competition is at the core of the shortcomings of Tunisia’s economic model.

It is worth highlighting that these barriers to competition are at the heart of the crony system of rents-extraction and social exclusion which afflicts Tunisia. As will be shown in Chapter Three, the existing regulatory architecture is itself a product of cronyism—which resulted in the proliferation of regulations and restrictions. In this context, the removal of barriers to competitive pressure and the simplification of procedures are not only necessary to achieve a more efficient allocation of resources but also required to ensure a more equitable access to opportunity for all Tunisians. In fact, as will be discussed in Chapter Three, a byproduct of the system of pervasive regulations and restrictions to market access is the insider-outsider culture. This system allows a great deal of scope for administrative discretion, which has been palpably abused in Tunisia to award privileged access and advantages to those within the inner circle of the political and administrative powers.

2.2 / Is Tunisia’s Competition Policy Framework Effective in Combating Market Distortions Associated with Anticompetitive Behavior of Firms and in Removing Anticompetitive Regulation?

Despite successive improvements, Tunisia’s Competition Law still faces fundamental shortcomings. The Competition Law in Tunisia is ineffective because it excludes key markets from its application and provides for administrative price control of a wide range of food and non-food products and services (well beyond products of first necessity). Against best practice (including in other OECD, MENA, and Central and Eastern European (CEE) countries), the Competition Law in Tunisia is not applicable to key markets, restricting its ability to deter anticompetitive behavior. Major exceptions to the scope of application of the Law include products that: (a) are considered of first necessity; (b) face long lasting difficulties of supply due to legal/regulatory barriers (such as dates and other vegetables used during religious holidays); or (c) are provided by a monopolized sector²⁶. In fact the list of products excluded from the Competition Law in Tunisia is very broad compared to in other countries²⁷. Further, Tunisia’s Competition Law also does not apply to legal monopolies, limiting the effectiveness of competition in key sectors such as agribusiness inputs, mining, and construction materials²⁸.

Tunisia's regulatory framework hampers the Competition Council's ability to address anticompetitive practices and regulations. Effective enforcement of competition policy and rules can gradually transform the competitive environment by triggering positive changes in market structure and reducing concentration. Addressing and tackling cartel behavior is key to deterring most harmful anticompetitive behavior. Effective control of mergers can prevent concentrations that stifle competition, and meaningful enforcement of antitrust law toward dominant firms will discourage behavior that hampers competition. Against best practice, however, the current competition framework and its implementation do not tackle cartel agreements. In fact, the Competition Law provisions may even encourage the creation of further cartels instead of encouraging their disappearance. The Tunisian merger control regime also requires several improvements²⁹. In addition, the advocacy competences of the Competition Council appear to be weak. Besides effective antitrust enforcement, advocacy mechanisms are key to minimizing anticompetitive regulations, including minimum and maximum prices and unnecessary price controls³⁰.

As part of the obligations under the Association Agreement with the EU, Tunisia is required to implement a state aid framework. Currently, in Tunisia the scrutiny of state aid, grants, and subsidies is not consolidated under a specific law or authority³¹. In Tunisia, each ministry can approve, ad hoc and without planning, their own state aid (that may be granted through various instruments or objectives). The Ministry of Finance participates in each sectoral commission where state aids are decided³². State aids can take various forms in Tunisia, including: (a) fiscal advantages; (b) capital transfers; and (c) guarantees for SOEs in financial difficulties. Fiscal advantages take the form of direct tax exemptions and indirect imports with reduced VAT and tariffs or customs duties. Capital transfers can take the form of injections dependent on strategic outlook and sectoral focus granted by the *Comité Général du Budget*. At the same time, government-controlled firms may receive financing (for example, loans guaranteed by the state, preferential loans from state-controlled banks or the state itself, and so on) which is not available to private companies. Finally, the General Directorate for Debt grants guarantees to SOEs in financial distress as permitted under the Association Agreement with the EU of 1998. The introduction of a comprehensive state aid legal framework could ensure a level playing field for companies and avoid the use of public funds toward objectives that will discourage expansion and entry of new investors.

2.3 / Would Tunisia Benefit from Increased Competitive Pressures in the Markets?

The lack of competitive pressure entails significant costs for the Tunisian economy. The previous sections highlighted that barriers to competition are pervasive in Tunisia, partially as a result of a weak regulatory and legal framework. There is overwhelming empirical evidence that the lack of competition results in severe economic losses in an economy because markets are unable to function and allocate resources efficiently. As summarized in box 2.1, firms operating in a competitive environment are more likely to increase their productivity. Stronger incentives to innovate due to high competitive pressure affect industry-wide growth of productivity. Competition boosts investment, generates employment, and ultimately speeds up economic growth and improves overall welfare. Competitive pressure in input (upstream) markets, such as transportation, financial services, energy, telecommunication and construction services, is a key driver of efficiency and productivity growth in downstream sectors—the users of these inputs. On the contrary, anti-competitive practices result in welfare losses for the economy as a whole. Price-fixing agreements among competitors impose significant costs on society. Apart from increasing the cost of goods and services to conduct business, cartels are also associated with low labor productivity and reduced incentives to innovate.

In this section we quantify the implications of lack of competitive pressure on labor productivity growth in Tunisia and find that greater competition would result in substantial gains for Tunisians. It has been empirically shown that the level of competition intensity affects firms' decision to innovate and therefore boosts productivity growth (Aghion, Harris, and Vickers 1997; Aghion and Griffith 2005; and Aghion, Braun, and Fedderke 2008). In this section we apply the empirical framework proposed by these studies, which is based on Price Cost Margins (PCMs) as a measure of competitive pressure in markets³³ (Annex 2.2; for details see DPR background report on "Opening Markets to New Investment and Employment Opportunities in Tunisia," World Bank 2014a). Higher margins signal a lack of competition as they reflect the market power of the firm to charge higher prices. Our analysis then estimates the effect of competition intensity on labor productivity growth³⁴.

The results show that, on average, a five-percentage-point decrease in the price cost margins of a sector (that is, an increase in competitive pressure) is expected to increase labor productivity by five percent. The econometric analysis using annual data from 2000 to 2010 for more than 90 different sectors of the Tunisian economy highlights that higher PCMs (implying lower levels of competition intensity) are significantly associated with lower growth of labor productivity in the following year (table 2.2). Overall, the results show that a five-percentage-point reduction in price cost margins of a sector is expected to generate additional growth in labor productivity of five percent, on average. Productivity growth may accelerate to a much larger extent in individual sectors. This result is robust to various specifications of the analysis (for details see DPR background report on "Opening Markets to New Investment and Employment Opportunities in Tunisia," World Bank 2014a).

These results suggest that greater competition in Tunisians markets would result in significant benefits in terms of higher growth and faster jobs creation. In terms of economy-wide benefits, our results imply that a reduction of the price-cost margin of five percentage points in all sectors of the economy (would boost labor productivity growth by five percent on average and) would translate into additional GDP growth of around 4.5 percent per year and approximately 50,000 new jobs per year³⁵. For manufacturing sectors and sectors without SOEs, the results suggest a six- and a 6.5-percentage-point increase in growth of labor productivity, respectively. As discussed in Chapter One, the average annual growth in productivity across sectors over the last ten years was approximately 2.5 percent. This highlights that the magnitude of the expected changes in growth of labor productivity is large relative to Tunisia's usual growth rates, indicating how much Tunisian markets are being affected by lack of competition³⁶.

Further, the effect of very fierce competition dampening productivity growth (denoted in Chapter One as the "Schumpeterian effect") cannot be identified in Tunisia³⁷. Less market power seems always to provide firms more incentives to innovate and stimulate productivity growth, with no evidence of a nonlinear relationship between PCM and labor productivity growth (table 2.2). One potential explanation of this result is that the initial level of competition in Tunisian markets is so low that any increase in the intensity of competitive pressure leads to significant productivity gains.

These results suggest that the distance of Tunisian firms with respect to the technology frontier is still large and that there is ample space to escape from competition through innovation. These results are consistent with the findings presented in Chapter One, which highlight that the correlation of labor productivity growth and Total Factor Productivity (TFP) at the firm level is high in the manufacturing sector in Tunisia (calculations based on firm-level data collected for 1997-2007)-which is an indication that firms' investment in physical capital has been limited and market pressure on firms' performance is weak. This finding also mirrors limited investment in innovation—according to ITCEQ (2010), the R&D expenditure in Tunisia accounted for around 1.2 percent of GDP in 2009, whereas OECD countries spent on average 2.3 percent of their GDP on R&D.

The presence of SOEs appears to undermine competitive pressure and dampens the beneficial impacts of competition on productivity growth. It is worth noting that the muted relationship between productivity growth and PCMs in sectors with high SOE presence likely reflects the drag these public firms have on the economy. This hints at the paralyzing effects of state presence, which as discussed is usually associated with high regulation and uncompetitive practices (notably in the use of state aids)³⁸. In fact, as discussed above it is not the public ownership in itself but is rather the competitive structure of the sector that matters and dampens the beneficial impacts of competition on productivity growth.

Table 2.2: Relationship Between Competition (PCMs) and Labor Productivity

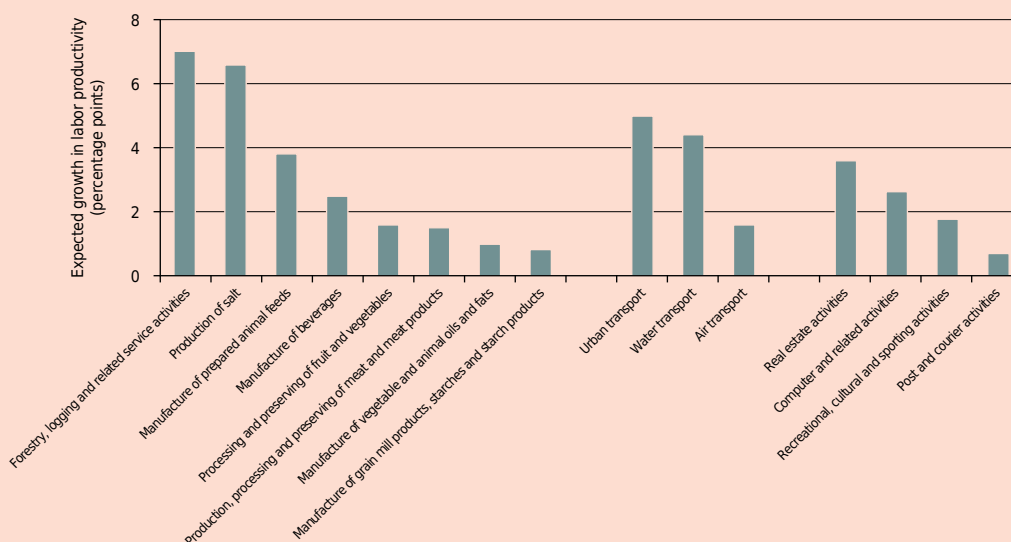
	Baseline- all sectors		Manufacturing sectors		Sectors without SOEs	
	linear (1)	non-linear (2)		(3)		(4)
PCM[t-1]	-0.98	*** -1.24	*	-1.15	***	-1.25 **
†	0.00	0.05		0.01		0.02
PCM[t-1] ²		0.53				
†		0.53				
constant	0.63	*** 0.59	***	0.19	***	0.35 ***
†	0.00	0.00		0.00		0.00
Number of Observations	888	888		455		528
R-squared adj	0.08	0.09		0.12		0.09

Source: Authors' calculations

Note: Regression Results with Dependent Variable: Growth in Real Labor Productivity (percentage changes).

Note: † p-values in second line below coefficients, standard errors clustered by sectors; all regressions with year and sector-fixed effects.

Figure 2.4: Expected Gains in Labor Productivity Following a Five-Percent Decrease in PCMs (Relative to the Median 2003-2010 by Subsector)



Source: Authors' calculations

Note: The figure shows conservative estimates of the expected growth in labor productivity (in percentage points), following a decrease in PCMs of 5 percent relative to the median 2003-2010. Given that some of these results present large confidence intervals, the values presented here refer to the conservative estimate of the average expected increases in the growth of productivity in each sector compared to the growth rates in the reference sector (e.g. pipeline transport). All reported interaction effects are significantly different from zero (at the 1% significance level).

Productivity dividends that result from an increase in market rivalry in Tunisia are particularly high in some sectors. The expected impact of a change in market power has been evaluated for particular sectors (at the 3-digit level) in Tunisia (figure 2.4). Unsurprisingly, even minor relative changes in the mark up of sectors that notoriously suffer from competition constraints in Tunisia (such as the agriculture and the agribusiness sector) are expected to add significantly to sector-wide growth. Many of the sectors that would benefit most are backbone services (such as transport services or professional services) that are particularly important for the overall competitiveness of the economy. Increased competition also constitutes a significant opportunity for productivity growth in key upstream sectors, namely urban, water, and air transport as well as real estate, postal, and other business services³⁹. It should be noted that these results represent a very conservative estimate of the potential additional growth in productivity.

2.4 / A Reforms Agenda to Increase Competition in Tunisia: Opening Markets to New Investment and Employment Opportunities

Three key axes of reform are required to bring competition to Tunisian markets and firms, namely to remove barriers to entry, improve the governance of SOEs, and strengthen the legal framework for competition. First, the removal of most sector-level barriers to entry and competition is a prerequisite for faster economic performance (see Chapter Four). As mentioned above, over 50 percent of the Tunisian economy is subject to entry restrictions, including in backbone services sectors (such as telecoms, air and maritime transport, professional services, commerce and distribution, and so on)⁴⁰, which determine the competitiveness of the entire economy, and also in high potential growth sectors (such as health services, education services, and so on). At present these barriers exist through several pieces of legislation, notably the Investment Incentives Code, the Commerce Code, many of the sectoral legislation regulating services sectors, and are also permitted by the Competition Law. It is worth highlighting that, first and foremost, these barriers limit investment and economic initiative by Tunisians. Most of the barriers pertain to the entry into (or operations in) onshore sectors. However, as will be discussed in Chapter Four, it is worth reiterating that the low efficiency in the onshore sectors (and particularly in the backbone services) also negatively affects the competitiveness of the offshore economy, condemning it to low value added activities which largely rely on cheap labor (for assembly of intermediates purchased abroad). In other words, the limited competition across the economy, and notably in the onshore sector, is at the root of the scarcity and low quality of jobs available to Tunisians.

Beyond removing the barriers facing domestic investors, Tunisians would benefit from opening up the economy to foreign investors, allowing for more investment; faster jobs creation; and increased know-how, efficiency, and quality standards. As discussed in Chapter Four, the barriers to entry largely limit foreign investors only to the offshore sectors—in fact this investment policy has failed to attract investors other than (energy and) low value added and assembly type activities. Further, as also elaborated in Chapter Four, the segmentation between onshore and offshore has limited the opportunity for backward-forward links in production and sale of intermediate inputs.

Second, reforming the governance of SOEs and the use of state aids is also critical. It is important to clarify that improving the operation of markets does not require privatization of public companies. There is no need for the state give up the ownership of the companies; however, it is important to ensure that the governance of the SOEs enables them to operate on a par with

private companies and that they are exposed to competition from other private firms. This also entails the need for a comprehensive state aid framework to ensure a level playing field for firms and avoid the use of public funds to distort competition, which would discourage the entry of new investors. Reducing the direct involvement of the state (through SOEs and other operations) should also be considered especially in typically competitive markets where there is no clear rationale for the state to be present, notably in manufacturing, transport, tourism and recreation (hotels and restaurants, golf facilities), and the real estate sector.

Third, improvements in the legal framework for competition are also warranted. A more effective competition policy framework could be achieved by (a) increasing the efficiency of antitrust enforcement; (b) pursuing advocacy activities to minimize anticompetitive regulation; (c) adopting best practices for state aid control; and (d) guaranteeing competitive neutrality between private and public companies and among private firms. Such reforms would also foster a more predictable and transparent business environment. As highlighted below, key aspects of these legal and institutional reforms would accompany and reinforce the removal of barriers to entry and improvements in the performance of SOEs:

- Remove regulatory barriers to boost competition: Reducing restrictiveness of product market regulation requires sustained reforms aiming principally at: (a) reducing the involvement of the state through SOEs and other operations particularly in typically competitive markets—this will also promote a more effective use of public funds to alternative policy goals; (b) minimizing the scope of administered prices at all levels of the product value chains and eliminating caps on distribution margins both for food and non-food products; and (c) eliminating discriminatory treatment of foreign investors vis-à-vis the domestic ones as well as among domestic investors in sectors where such regulatory restrictions create an uneven playing field. There is an opportunity to boost competition, and thereby productivity, by reducing restrictive product market regulation and introducing adequate regulatory oversight in key sectors. It is critical that the government eliminates distortive government interventions and promotes a more competitive environment particularly in sectors with spillover effects on the overall Tunisian economy. This report has highlighted that competition is especially restricted in transport services (airlines, railroads, maritime, road); network services (notably electricity and gas); the telecommunications sector; professional services; and in the tourism and the agriculture sectors. Detailed assessments of these sectors and policy recommendations to address the specific barriers to competition for each of these sectors are discussed in the DPR background report on “Opening Markets to New Investment and Employment Opportunities in Tunisia” (World Bank 2014e).
- Mainstream competition and competitive neutrality principles within government policies: In the medium term, the Tunisian government could evaluate the design and adoption of a comprehensive regulatory framework to achieve competitive neutrality among all market players.
- Increase the effectiveness of the competition framework and its implementation by amending the Competition Law: Specific amendments to the Competition Law should be primarily aimed at (a) limiting exceptions of anticompetitive practices; and (b) applying competition rules to all market participants, be they private or public. These should be complemented by the elimination of undue price controls and distribution margin caps. There is also a need to strengthen merger review and to strengthen the advocacy mandate of the Competition Council. Annex 2.3 presents a detailed list of required amendments to the Competition Law and the institutional set-up for competition enforcement (and see also the DPR background report on “Opening Markets to New Investment and Employment Opportunities in Tunisia,” World Bank 2014e).

- Pursue advocacy activities to minimize anticompetitive regulation: By strengthening its advocacy mandate, the Competition Council will be able to prevent and to address any potential competition distortions in key sectors of the economy (such as infrastructure or professional services) and open markets to competition. The Competition Council could also help to deter the enactment of anticompetitive regulation by increasing the awareness of other government agencies and regulators on the distortive effects of specific regulatory provisions. Working closely with other sectoral regulators will also avoid overlap of competencies in the competition space and more effectively tackle anticompetitive regulation.
- Create an inventory of state aid and develop state aid provisions to minimize potential distortive effects on competition: The introduction of a comprehensive state aid framework could ensure a level playing field for firms and avoid the use of public funds to support distortive state aid schemes discouraging the entry of new investors. Implementation of such a framework would promote a shift of state aids toward horizontal objectives that could benefit entire industries instead of specific firms. This approach would redirect aid to economy-wide objectives, such as R&D and innovation, start-up and risk capital, training, renewable energy and climate change, and other measures for the protection of the environment. Setting up a state aid inventory will help ensure transparency and accountability in the use of public funds, while applying best practice criteria to grant state aid would minimize distortive incentives granted to specific firms.
- Revise the rules on government procurement to increase competition and efficiency, notably in the engineering and construction sectors: These reforms should aim at increasing the efficiency, transparency, and accountability of public procurement (see World Bank 2012e, for a detailed discussion of public procurement reforms in Tunisia).

It is important to emphasize that to transition to a more open and competitive regime will be very challenging. It will be important to develop a concrete sequenced strategy as to exactly which entry barriers to dismantle and which FDI restrictions to eliminate. With such high unemployment and recent unrest, exposing on-shore firms to more competition and encouraging entry into previously protected sectors must be carefully executed. If not properly sequenced, reforms could result in job loss and policy reversals. Issues that could be considered as part of this strategy include:

- Entry promotion without privatization: As indicated above the key objective is not to privatize but rather to improve the performance of SOEs and to level the playing field. As an example, encouraging partnerships between foreign firms and SOEs has been actively pursued in China for more viable firms with excellent effects on performance. This approach minimized the job losses that could have accompanied a large-scale privatization episode.
- Phased-in competition: Lowering entry barriers and eliminating regulatory barriers could be gradually phased in with a pre-announced sequencing; in fact the priority should be to increase competition in sectors that provide services to firms (and to Tunisian citizens)—such as telecoms, air and maritime transport, commerce and distribution, and so on—since these services affect the competitiveness of the entire economy. It is also equally important to remove barriers and allow greater investment in sectors which have high potential growth and job creation prospects in Tunisia—such as health services, education services, and indeed the telecommunications and ICT services (see Chapter Eight).
- Starting with opening to regional competition: Eliminating regional barriers to competition would allow on-shore firms to adjust to competition by focusing on regional rivalry first, before moving to the global market.

- Avoiding a convergence of regulations that increase barriers instead of removing them: Particularly in the areas associated with labor market reform, there is the risk that the convergence could lead to an increase in regulation.

2.5 / Conclusions

Pervasive lack of competitive pressure characterizes the economic environment in Tunisia—and is at the root of the failures of the current development model, notably the lack of good jobs. The pervasive barriers to market entry and contestability impede the structural transformation of the economy and stifle economic growth by hampering private initiative and discouraging innovation and productivity. The restrictions to market access (introduced by the Investment Incentives Code; the Commerce Code; and other sectoral legislation regulating services sectors, notably telecommunications, health, education, and professional services, and encouraged in some cases by the Competition Law) and the prevalence of statutory monopolies have closed the domestic economy to competition and have created an onshore environment which stagnates in terms of productivity, as good firms are unable to grow (see Chapter One). This results in higher prices for consumers and firms: international telephone calls are 10 to 20 times more expensive, and airline tickets are 30 to 50 percent more expensive. The business environment rewards rent seeking and cronyism to the point that, as will be discussed in Chapter Three, the heavy state regulation has become a smokescreen for crony practices, severely hampering the performance of the private sector and the entire economy, excluding those without good connections to politicians or the administration. In turn, the inefficiency and rents-extraction by cronies in the onshore economy also undermines the competitiveness of the offshore sector, which as a result has remained largely limited to low value added and assembly-type tasks. The economic costs of this economic model, which dampens competition and promotes rent seeking, are therefore enormous.

There is significant scope to achieve efficiency gains from pro-competitive sector policies and more effective economy-wide competition policy enforcement in Tunisia. The empirical evidence from across the world documenting the benefits arising from greater competition is overwhelming—as firms are stimulated to invest more, innovate, and improve their efficiency. Ultimately, competition generates employment, speeds up economic growth, and increases overall welfare. Consistent with this, the empirical analysis presented in this chapter has shown that the gains from higher competitive pressure in Tunisian markets would be considerable—this result is not surprising since economic regulations have systematically stifled competition in Tunisia. Focusing narrowly on labor productivity the results of our econometric analysis suggest that Tunisia’s economy could grow significantly faster if firms were given incentives to eliminate inefficiencies in the production process and to invest more in innovations that reduce the costs of production. Driven by competition, a five-percentage-point decrease in the profit margins of a sector (also referred to as the “price cost margins”) can increase labor productivity by five percent, on average. This implies that a reduction of the price-cost margin of five percentage points in all sectors of the economy (would boost labor productivity growth by five percent on average and) would translate into additional GDP growth of around 4.5 percent per year and approximately 50,000 new jobs per year. Hence, increasing competitive pressure to reduce firms’ market power (and the price mark-ups they can extract as a result) would give a significant boost to reduce Tunisia’s unemployment. Further, the sectors that would benefit most are the backbone services (such as telecoms, transport services, or professional services), and these are particularly important for the competitiveness of the entire economy (as they are intensely used as inputs in value chains).

In order to realize this potential there is a need to open up the economic field to more actors, both Tunisians and foreigners, in order to expand economic activity and wealth creation. It is worth emphasizing that removing barriers to competition is not intended mainly to allow foreigners to invest in Tunisia. Rather the analysis in this chapter has highlighted that it is Tunisians themselves, first and foremost, who are currently facing severe restrictions to entering large parts of their economy. In addition, Tunisians should also consider removing (most) barriers to entry of foreign investors, and indeed should seek to attract foreign investors, as the additional investments would bring additional jobs and wealth creation. Further, as shown in Chapter One, firms with ownership have job creation rates that are substantially higher than do other firms.

The removal of barriers to market contestability should be gradual, starting with backbone sectors and sectors that hold high potential for jobs creation. The greatest economic gains would arise from increasing competition in sectors that provide services to firms (and to Tunisian citizens) such as telecoms, air and maritime transport, commerce and distribution, professional services, etc., since these services affect the competitiveness of the entire economy. In parallel there is a strong rationale to remove barriers and allow greater investment in sectors with high potential growth prospects in Tunisia, such as the health services, education services, and indeed the telecommunications and ICT services (see Chapter Eight).

The current state-controlled development model, which served Tunisia well in the initial stages of its economic development, has now increasingly become a brake to Tunisia's development. In order to enable Tunisia to move to the next stages of economic development, there is a need to open up the economy and level the playing field to encourage the entry of new investors and enable the most productive and innovative to succeed and expand their businesses, thereby expanding economic activity and jobs creation. In order for this to become possible, the state needs to relax the current strict limitations to market entry and to scale down its direct interventions in the markets, in order to minimize distortions and unfair competition.

It is important to clarify, however, that opening up the economy to greater competition does not require the state to relinquish ownership of public enterprises. There are some manufacturing and service subsectors in which the state at present has public enterprises—such as hotels, restaurants, golf facilities, and the real estate sector—but where there is no clear rationale for the presence of the state. Beyond these obvious cases, however, the recommendation is not that public companies should be privatized. What is critical instead is to ensure that public companies operate efficiently—and this objective can be achieved by adopting a strong corporate governance framework in line with best international practice. It is also critical that public companies do not receive special treatment or privileges from the state. This is required to ensure a level playing field among all market players, so that the most efficient firms (whether public or private) can grow and create jobs.

In concluding, it is worth emphasizing again that the discussion in this chapter is not about deregulation or about reducing the role of the State. A new economic model will continue to require an active and crucial role for the State. This role, however, needs to be different in order to support, rather than impede, the private sector. The ample literature on market failures shows that the state has a critical role to play to enable the operation of markets and foster a competitive private sector. The challenge therefore is to move from a paternalistic state—which seeks to control everything, breeds inefficiency, and has given rise to cronyism and privileges for the elites—to a system where the state is focused on leveling the playing field, enabling private initiative (across the country, not just along the coast), and opening up economic opportunity to all Tunisians.

Notes

1. This chapter draws on the DPR backgrounds report on “Opening Markets to New Investment Opportunities in Tunisia” (World Bank 2014a) which discusses in detail the operation of Tunisian markets and reviews the restrictiveness of the government regulations and policies that affect product markets, including the effectiveness of the competition and antitrust framework. The background report also includes an analysis of the impact of increased market rivalry on productivity and a snapshot of market restrictions in selected sectors (tourism, agriculture, transport and telecom) that require particular attention from policy makers.
2. Competition policies are defined as the set of policies and laws ensuring that competition in the marketplace is not restricted in a way that reduces economic welfare. In practical terms, competition policy usually involves the enforcement of antitrust legislation (typically rules against anticompetitive business conduct and mergers) and the promotion of measures to enable firm entry and rivalry, through the elimination of restrictive product market regulation and the opening of markets to competition—typically referred to as competition advocacy (Motta 2004).
3. In fact, as discussed in Chapter One, while Tunisia’s real GDP per capita growth since the 1990s was the second strongest in the MENA region, it has remained far below the growth rates observed in other upper middle income countries over the same period—and unlike many of its peers Tunisia did not experience a take off during the past two decades.
4. In order to identify markets where competition is restricted and anticompetitive regulation, the analysis used the Regulatory Indicators questionnaire developed for the OECD Product Market Regulation (PMR) Indicator. The PMR measures the degree to which policies promote or inhibit competition in several areas of the product market. Each of the areas addressed within the PMR questionnaire sheds light on specific restrictions of the Tunisian regulatory framework both economy-wide and in key sectors of the economy. Details are provided in Annex 2.1.
5. Ooredoo (formerly Tunisiiana) was awarded the cellphone licence in 2002. It has since enshrined its dominant position in the cellphone market via creation of so called club offers (e.g. “amigos” or “familia” offers in 2013) substantially ensuring very low incentives for members to switch to competing networks, while Orange and Tunisie Telecom compete for the residual demand via sometimes predatory, mostly time-restricted offers (such as “Allo Lekoll” in 2013) designed to attract a profitable minimum amount of customers in the first place.
6. Orange recently proposed to allow all operators to terminate international communications services to all access customers. Orange has a small access base and would benefit from the access base of their competitors for terminating calls. Second, they can benefit from the wholesale market power of France Telecom for calls to Tunisia and drive prices down. The regulator is concerned about the potential dominance of France Telecom despite the fact that Tunisie Telecom has submarine cables with strong competitors of Orange in the wholesale market (such as Telecom Italia), and fears that an amendment to the existing licenses can be met with opposition and even legal challenges from the other operators. On the other hand, this would effectively increase competition in the market. (World Bank, 2012e; Gelvanovska et al. 2014).
7. The introduction of Mobile Virtual Network Operator (MVNO) and Virtual Network Operator (VNO) licenses could increase competitive pressures in the sector, especially if these services are not be limited only to voice communication, but are expanded also to 3G data and allow operators to provide VoIP solutions.
8. Similarly, removing existing restrictions in key input markets, notably in gas and electricity, would be beneficial for a wide variety of sectors in the economy, as well as consumers. Also, entry in most segments of transport services and access to key transport infrastructure remains limited, resulting in high costs to consumers and firms.
9. UHD (Carrefour), Monoprix (Géant) and Magasin Général. In addition, there were around 232,000 micro enterprises in 2010.
10. Boughzala, M. (2013a), Background note for the DPR: “Le commerce en détail en Tunisie”, Mimeo, April, 2013.
11. Law No. 69/2009, August 12, 2009.
12. An application has to be submitted to the Ministry of Commerce that further transmits the file to the Ministry of Interior, Ministry of Equipment, Habitat and Planning, Ministry of Environment, Ministry of Social Affairs and Ministry of Agriculture. The authorization is issued only if all these Ministries clear the application. The government recently adopted Decree 664/2013 (on the criteria and procedure for granting authorizations for opening large outlets) to clarify the technical and urban criteria for obtaining such an authorization; this decree does not provide a significant improvement from the old practices, however.
13. Rules concerning access and operation of retail outlets (especially large ones) were found to increase the costs of activities in the retail industry in many EU countries (including Eastern Europe). Competition authorities in some countries have considered that retail regulation makes market access of new firms and expansion of existing firms difficult, and induces negative effects and distortions. See European Competition Network (ECN) Subgroup Food (2012), ECN Activities in the Food Sector—Report on competition law enforcement and market monitoring activities by European competition authorities in the food sector, May 2012, page 11. See also Irish Competition Authority (2009), Retail related import and distribution study, pages ix and 35.
14. Typically, self-regulations of professional services have included measures that affect entry into the respective profession, the conduct of members of the profession, including price-controls, and the granting of exclusive rights to carry out certain activities. The EU Commission analyzed the markets in which lawyers, notaries, accountants, architects, engineers and pharmacists operate in the European Union and identified five main categories of national legislation or self-regulation that restrict competition: fixed prices; recommended prices; advertising restrictions; entry restrictions and reserved rights/exclusivity on the provision of services; and regulations governing business structure and multidisciplinary practices. Source: European Commission (2004).
15. As mentioned in Chapter One, FDI in Morocco and Egypt for instance face much fewer restrictions, including in the

agricultural and service sectors. In Morocco, commerce is open to foreigners, and leases of 99 years are allowed which contributes to attracting FDI into agriculture. Morocco allows far greater flexibility to FDI in the service sector, such as through bilateral agreements based on the reciprocity principle for many professional services.

16. Top performing countries are those OECD countries (out of 34 members) with SOE presence limited to essential public utilities, mostly encountered in infrastructure sectors (electricity, gas, water).

17. These SOEs operate transport services and infrastructure; extract, refine, and distribute oil and gas; and generate as well as distribute electricity.

18. The SOE STEG (*Société Tunisienne de l'Electricité et du Gaz*) has the monopoly over gas and electricity supply and distribution. Two companies (STEG, which holds 80 percent market shares and CPC, a private company, which holds 20 percent market shares) are the electricity generators, but STEG has the monopoly over the distribution and supply of electricity. In the gas sector, production is ensured by five companies (British Gas; ENI; PETROFAC; PERENCO; and Winstar), while imports are performed by one SOE (ETAP). The SOEs *Société du Réseau Ferrovière Rapide de Tunis* (SRFRT), *Société des Travaux Ferrovières* (STF) et *Société Nationale des Chemins de Fer Tunisiens* (SNCFT) are the most important enterprises in the railways sector.

19. China adopted a dual track and gradual approach to SOE reform focused on lowering barriers to private firm entry and encouraging viable SOEs to join with foreign partners.

20. Tunisair, an SOE created based on an agreement between the Tunisian government and Air France in 1948, controls 63 percent of this closed market. Tunisair is owned at 75 percent by the Government of Tunisia, 20 percent are listed in the public stock market, and 5 percent are owned by Air France.

21. Beyond an Open Skies agreement with the EU, there is potential to encourage more competitive conditions with bilateral air service agreements (BASA) with countries from Eastern Europe, Russia, Sub-Saharan Africa, or North America, where demand for transport services is growing, especially regarding increased frequencies and multiples designations of air carriers. Tunisia has signed multiple bilateral air service agreements with European, Arab and African countries, but its small size and restrictive nature of agreements limited its connectivity.

22. Common types of aid include: deferral of tax payments, subsidies, guarantees, land transfers or leases, free or below the market price, privileged access to infrastructure, free or at a subsidized fee, direct transfers or grants, tax exemptions, capital injections, equity participation and soft loans.

23. The rationale for pursuing competitive neutrality is both political and economic. The main economic rationale is that it enhances allocative efficiency throughout the economy—where economic agents (whether state-owned or private) are put at an undue disadvantage, goods and services are no longer produced by those who can do it most efficiently. The political rationale is linked to governments' role as universal regulators in ensuring that economic actors are "playing fair" (where state-owned corporate assets are concerned and vis-à-vis other market participants), while also ensuring that public service obligations are being met. See OECD (2012).

24. Based on data received from Tunisia's Prime Minister's Office (2012).

25. Price controls are not uncommon in sectors that are typically providers of public interest services, such as health, education, public transportation, but in Tunisia price controls extends well beyond these sectors.

26. An effective competition policy and law framework includes four key elements: (i) applies to all firms, be they private or public; (ii) focuses on combating the most harmful anticompetitive practices (such as cartels); (iii) focuses on deterring anticompetitive behavior and not on price control and regulation; and (v) is transparent and predictable. A well-designed competition law is part of the competition policy framework. Nevertheless, the mere presence of a competition law is not always sufficient to create a level playing field for investors. What matters most is its effective enforcement and ensuring that markets enable firms to compete and enhance productivity growth.

27. For example, recent international benchmarking based on the OECD Database on product market regulation (2008), evidences that only 7 countries (China, Russia, Israel, Korea, Iceland, Canada and Greece) out of the 32 countries analyzed applied some type of price control on certain staples such as milk and bread.

28. In the case of natural monopolies, the application of the competition law should ensure open and fair access for service providers. Typically, natural monopolies, such as those governing the gas or electricity distribution, give rise to a potential conflict between cost efficiency and competition, with an increased number of competitors leading to some loss of scale efficiencies. In these segments, the entry of new provider requires a great deal of investment and introducing competition is not always the most efficient solution to ensure universal and high quality service. For example, the EU developed the concept of legally separating the provision of the network from the commercial services using the network, in so introducing competition in the sector.

29. See details in the DPR background report on "Opening Markets to New Investment and Employment Opportunities in Tunisia", World Bank (2014a).

30. Interest groups (or interested parties) in every country will lobby with the relevant authorities for the imposition of regulatory measures to their own benefit, but to the detriment of the society as a whole, particularly the consumers.

31. As discussed above, governments provide a variety of subsidies and direct aid to firms in the economy which may result in significant distortions on the dynamics of market competition. Beneficiaries that receive state aid enjoy a comparative advantage over their competitors that is not necessarily associated with their efficiency. This situation may distort competition by creating barriers to entry for competitors, increasing the asymmetry among competitors, facilitating anticompetitive exclusionary practices, and affecting trade flows. The potential harmful effects on competition include: (i) support to inefficient production in specific firms or sectors, which reduces the efficiency of market structures and of the economy as a whole by, for example, rescuing firms in financial distress, supporting companies using outdated technologies, or aiding industries that already have excess capacity; (ii) distortion of dynamic incentives by potentially influencing the investment decisions of beneficiaries' competitors and crowding out investment or by reducing beneficiaries' incentives to become more efficient; and (iii) an increase in

the market power of the dominant firm through the creation of barriers to the entry of competitors. Note however that not all types of State aid are counterproductive. State aid and subsidies can also be provided to address market failures, for instance, aid to support education and foster innovation and the environment-horizontal aid which does not undermine competition could include R&D and innovation, risk capital measures, training, renewable energy/climate change and other measures for protection of the environment that are available for all firms in the markets. Source: Friederiszick, Röller, and Verouden (2007).

32. The website of the Ministry of Finance lists all the legal/regulatory instruments that grant a fiscal or financial advantage. See http://www.portail.finances.gov.tn/accueil_fr.php.

33. The PCM is defined as difference between price and marginal cost as proportion of the price. It is a proxy for the Lerner index and a measure of market power. We use industry-wide statistics (at 2 or 3 digit levels) and calculate the difference between value added and labor costs as proportion of output, thus approximating marginal costs with average costs. This follows the methodology used by Aghion et al. (2008), for example. In an alternative specification and for the purpose of robustness check, we use the difference between value added and wages as proportion of turnover (sales). Output is defined as the total production of all firms in a sector. It includes sales and changes in inventories. Value added is output less intermediate consumption. Both value added and output are valued at basic prices (as opposed to producer prices).

34. It is important to clarify the relationship between the concepts of price-cost margins (PCMs) at the firms levels compared to the measure of total factor productivity (TFP) at the aggregate-economy level. At the economy-wide level the 'margins' above the cost of input used reflect the productivity (or efficiency) of the economy, which indeed corresponds to the TFP measure presented in Chapter One. At the firm level, however, higher margins could reflect improvements in productivity growth (via higher efficiency and innovation) or they could instead be the result of market power (and hence rents-extraction, at the expense of the rest of the economy). In the analysis of competition at the firm level presented in this Chapter we seek to focus on the rents-extraction. In order to do so, we assume that the cost-advantage gained by innovation and efficiency gains can generate higher margins when looking at contemporaneous values, but these margins would be eroded over time in a competitive market. Hence, in our analysis we relate PCMs from the preceding year (denoted as "[t-1]") with changes in contemporaneous productivity growth.

35. It should be noted that this is a back of the envelope calculation and does not take into account potential secondary effects from labor market rigidities.

36. It should be emphasized that a 5 percent improvement in PCMs can be achieved easily in Tunisia. In the past ten years, annual changes in the PCM of around 5 percentage points were recorded for example in the manufacture of domestic appliances (in 2009), manufacture of machine-tools (2008), casting of metals (2008, 2009) and several textile industries (2007, 2008). The average absolute change in PCM per year lays around 3 percentage point.

37. The relationship between competition and productivity is not necessarily the same for all levels of competition intensity. Recent studies (Aghion et al., 2005, 2008) have shown that when competition is extremely intense (firm's margins on their sales is almost zero), additional competition does not provide incentives for firms with backward technology to innovate more and at times even less. This dampening effect is known as 'Schumpeterian effect'. By allowing for a non-linear relationship between market power and productivity growth, we assess whether any markets in Tunisia present such absence of market power and whether additional competitive pressure could harm productivity growth in such sectors.

38. In a sense, it was the absence of competitive pressure which resulted in the SOEs' managers to prefer to extract rents rather than improve productivity.

39. The positive impact of higher firms' rivalry on productivity holds also in Tunisian sectors in which there are no SOEs. Since changes in the market share of SOEs may distort the productivity growth measure, specific estimations were conducted in sectors less subject to SOE presence. Results are consistent with the importance of the effect of competition on productivity growth. The positive impact of competitive pressure on productivity is clearly visible also among a subset of Tunisian sectors, in which only private sector firms operate and no SOE activity could be identified.

40. In addition, as will be discussed in Chapter Four, there is a need to pursue a very ambitious regulatory and administrative simplification to reduce the room for discretion in the application of the regulations. As will be discussed in Chapter Six, the banking sector is a further area which is characterized by limited competition, notably as a result of the weak governance in the management of State owned banks.

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Cronyism, Economic Performance, and Unequal Opportunity | 03



Barriers to market entry and bureaucratic administrative procedures create rents which are captured by those closer to power



Cronyism, Economic Performance, and Unequal Opportunity

This chapter shows that Tunisia's policy environment offers a fertile ground for cronyism and other anticompetitive practices, which hamper private sector growth and jobs creation in Tunisia. Chapter One discussed how Tunisia's economic performance has been characterized by low structural change and private sector paralysis. Chapter Two has shown the existence of widespread barriers to competition and a web of regulations and restrictions introduced with the interventionist economic policies since independence. This chapter adds that the pervasive barriers to competition in the Tunisian economy allow underperforming firms to survive in low productivity and make room for cronies and rent seeking—Tunisia's economy is burdened by a system of rents and privileges that thrives as a result. The inefficiencies and distortions resulting from this perverse system of rents extraction continue to obstruct the development of a dynamic economic environment—which is at the root of the economic stagnation of Tunisia as discussed in Chapter One. The chapter explores the main channels used for rent extraction and predation, with a view to explaining as much as possible the impact on private sector development. The analysis explores the instruments used for rents extraction and how these tools benefited firms owned by cronies. The findings also highlight that corruption has resulted in the proliferation of unproductive regulation and has consequently distorted state intervention, hampering the development of Tunisian firms.

The prevalence of cronyism predates President Ben Ali and continues to hinder the development of the Tunisian economy after his departure. Over the past decade, extensive corruption and abuses were associated with the activities of the cronies and family of former president Ben Ali (Hibou 2006 and 2007). It is important to underline, however, that the Ben Ali clan arrived relatively recently on the Tunisian economic scene while the system of privileges has characterized the economic environment since the early post-independence period¹. Similarly, it would be a mistake to assume that following the departure of President Ben Ali and his family the cronyism and rent seeking have disappeared in Tunisia. While predation likely has disappeared with the exit of President Ben Ali and his family, however, most of the system of rents and privileges remains untouched. Pervasive market restrictions and discretion in the (excessive) regulatory burden persist in Tunisia, maintaining the opportunities for firms to earn rents, via cronyism and corruption. Indeed as shown in this chapter, there is some evidence that these problems may even have gotten worse since the revolution. In sum, while Ben Ali has been toppled, corruption and regulatory abuse remain critical development challenges.

This chapter also highlights that Tunisia's rents-prone economic system is not only inefficient but also highly inequitable. Inequality of opportunity characterizes Tunisia today, as the current institutional infrastructure creates an "insider-outsider" culture. Even if the interventionist policies were originally introduced to foster the development of the country, in practice they have become captured for rents extraction and privileges by those close to those in political power, thereby resulting in inequities and exclusions of those lacking significant political connections.

3.1 / Cronyism, Corruption, and Predation in Tunisia

It has been estimated that corruption costs Tunisia approximately two percent of GDP per year. Global Financial Integrity estimated that the amount of illegal money Tunisia loses from corruption, bribery, kickbacks, trade mispricing, and criminal activity between 2000 and 2008 was, on average,

approximately two percent of GDP per year (approximately US\$1.2 billion per annum). With a population of approximately 10.6 million that means almost \$110 are lost per person per year in the unrecorded transfers of illegal capital (Global Financial Integrity 2011). Further, in the aftermath of the Tunisian revolution, assets of the Ben Ali clan were confiscated. The confiscation process involved the 114 individuals, including Ben Ali himself, his relatives, and his in-laws, and concerned the period from 1987 until the outbreak of the revolution. The confiscation commission estimates that the total value of these assets combined is approximately US\$13 billion, or more than one quarter of Tunisian GDP in 2011 (which would correspond to a one-off transfer per person of approximately US\$1,230 per person in Tunisia, about one quarter of average income).²

The cost of cronyism and corruption to Tunisia is much higher because it also hinders job creation and investment and contributes to social exclusion. Prior to the Arab Spring, the World Bank 2009 Flagship Report “From Privilege to Competition: Unlocking Private-Led Growth in the Middle-East and North Africa” argued already that one of the main reasons private sector growth has remained stunted is policy uncertainty and discretion in implementing the rules, to the benefit of insiders close to those in political power. The findings of a qualitative survey (carried out by the World Bank in 2012 as part of this report; Chekir and Menard 2012), suggest that predation, cronyism, and distortions have played a considerable role in firms’ behavior in Tunisia (see box 3.1). As discussed in this chapter, firms developed a set of techniques of avoidance ranging from remaining below the radar or working exclusively with foreign partners, and consenting to pay taxes in the form of grants and sponsorship to some of the social activities of the cronies. Hence the distortions shaped the Tunisian private sector by biasing the choice of sectors (and a preference to export) away from sectors in which Tunisia has a comparative advantage, hindering the growth of productive firms, and hampering the process of creative destruction that drives productivity growth.

Box 3.1: The Definitions of “Cronyism,” “Corruption,” and “Predation”

In this chapter we make extensive use of these three terms, such that it is useful to define them up front.

Cronyism is partiality to long-standing friends, especially by appointing them to positions of authority, regardless of their qualifications, or granting privileged access to economic opportunities and/or preferential treatment in dealing with administrative procedures. In the economic sphere, “crony capitalism” is a term describing an economy in which success in business depends on close relationships between business people and government officials. It may be exhibited by favoritism in the distribution of legal permits, government grants, special tax breaks, or other forms of state interventionism.

Corruption is described as the illegitimate use of public power to benefit a private interest. Corruption may include many activities including bribery and embezzlement. Government, or political, corruption occurs when an office-holder or other governmental employee acts in an official capacity for personal gain.

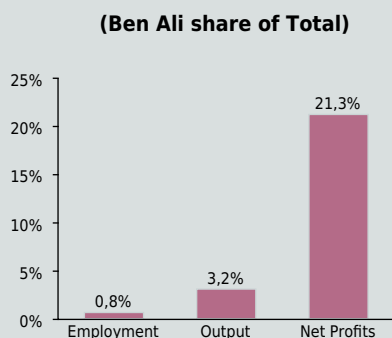
Predation takes many forms beyond simple theft. In many economies Mafia-like activities are rampant. Criminals collect extortion money and are also paid to provide protection, to collect debt, and to solve problems. One strategy is “straddling,” whereby political insiders own firms that private sector companies have to consult and remunerate in order to have certain contracts signed and enforced. Another strategy is to force entrepreneurs to enter into partnership with the criminals or to sell their enterprises to the criminals in order to avoid repercussions. Extortion and other forms of predation lower profitability in private businesses and distort investment incentives.

It is difficult to demonstrate clearly the impact of cronyism and predation on firms' growth and characteristics because access to relevant data is usually difficult. In this chapter we focus our analysis on the firms confiscated from President Ben Ali and his family to explore the extent and impact of rents extraction on the economy, and we subsequently seek to infer how these practices extended to and affected the entire private sector ³. It is important to underline, therefore, that our analysis is limited to the tip of the iceberg—in fact cronyism is a widespread phenomenon in Tunisia (and indeed in large parts of the Middle East and North Africa region and many other countries; World Bank 2009a; Malik and Awadallah 2012; see also "The Economist" magazine article: "The New Age of Crony Capitalism", March 15, 2014) ⁴ and a significant share of the private sector has benefited from it to different degrees. The extent of the problem and its poisonous impact on the economic environment, therefore, is much larger and could be extended to more sectors than identified in our quantitative analysis.

How Important Were Ben Ali's Family Interests, and Were They Spread Equally Across the Economy?

Cronyism and corruption thrive in sectors with heavy state involvement and considerable room for administrative discretion. The report of the anticorruption commission highlighted that the areas which had been the most at risk during the Ben Ali regime were real estate, agricultural land, SOEs, public procurement and concessions awards, large public investments projects, privatization, IT, financial and banking sectors, customs and taxation, and justice (*Commission nationale d'enquête sur la corruption et les malversations*). The Organization for Economic Cooperation and Development (OECD) carried out an assessment of corruption risks in Tunisia and found similar problems (OECD 2012). The results of our qualitative and quantitative analysis presented in this chapter broadly confirm this diagnosis.

Figure 3.1: Economic Significance of Connected Firms



Source: Authors' calculations

Confiscated firms are very important from an aggregate economic point of view and appear to account for an enormous share of net profits in the country ⁵. Detailed data on the economic characteristics of firms confiscated from President Ben Ali's extended family are presented in annex 3.2. Although they account for less than one percent of all jobs, firms confiscated to Ben Ali's extended family account for 3.2 percent of all private sector output, and a striking 21.3 percent of all net private sector profits in Tunisia (equivalent to US\$233 million in 2010, corresponding to over 0.5 percent of GDP; figure 3.1) ⁶. That such a small group of 114 entrepreneurs could appropriate such a large share of Tunisia's wealth creation illustrates how corruption has been synonymous with social exclusion. Further, considering that we identify only firms with direct links to the Ben Ali family, as opposed to all firms with cultivated connections, this number is probably best interpreted as a lower bound on the importance of political connections.

The results of econometric regressions confirm the spectacularly superior performance of confiscated firms on average. Confiscated firms are dramatically larger than their peers, both in terms of the number of people they employ and especially in terms of output and profits, and that they have higher market share (which on average is 6.2 percent higher than that of their peers—annex 3.2).

The superior output, profits, and market share of confiscated firms are to a large extent associated with confiscated firms being larger. However, even after we condition on size and age, confiscated firms still on average produce 346 times as much output as their peers. While these results are very crude and potentially reflect measurement error, as well as the fact that we are using the full universe of firms, they underscore the dramatically superior performance of confiscated firms on average.

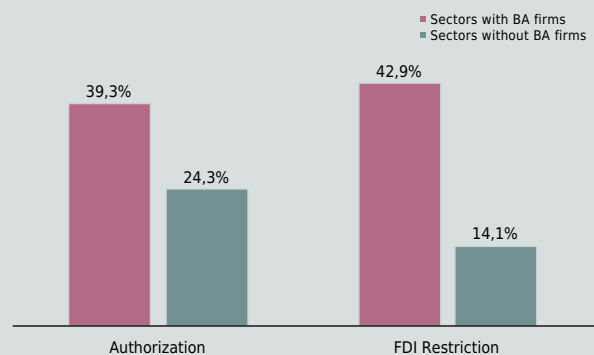
Cronyism and corruption go hand in hand in Tunisia with restrictions to market access and heavy regulatory burden. The findings of our qualitative survey indicate that cronyism and predation is most prevalent in: (a) highly regulated sectors in which cronies could abuse their influence and privileged access to the decision-making spheres; (b) business relying on imports (for example,, clothing trade, car imports, electronic equipment); and (c) purchase of state-owned assets at non-market conditions or subsidies (for example, land for real estate projects). The quantitative evidence presented in this chapter also strongly supports these findings. In fact the firms confiscated from President Ben Ali's family were concentrated in sectors where profit margins are quite high and close relations with government counterparts is an important determinant of profitability, notably in the real estate and enterprise services sectors (59 firms), personnel services (20), transport (16), wholesale trade (15), automobile trade (11), construction (9), financial services (8), the food industry (7), hotels and restaurants (7), and 5 firms engaged in media activities (see annex 3.2 for details) ⁷.

Confiscated firms are much more likely to operate in sectors which are highly regulated. Connected firms are more likely to operate in sectors subject to entry regulation. Approximately 40 percent of Ben Ali firms were in sectors subject to authorizations and restrictions to foreign direct investment (FDI). When considering firms not connected to Ben Ali, we find that authorization requirements apply to only 24 percent of all sectors in which Ben Ali firms are not present while FDI restrictions apply to approximately 14 percent of such sectors (figure 3.2) ⁸. In fact there is a strong and statistically significant correlation between the presence of regulatory restrictions and the presence of Ben Ali firms. Highly regulated sectors included air transport and maritime transport (the licenses for the ferry services between Sfax and Tripoli and the charter airline company Nouvelair-Karthago), telecommunications (the licenses for mobile telecommunication, including 3G authorizations, and the licenses for internet providers), fishing, banking, commerce and distribution, real estate, hotels and restaurants, and so on.

Similarly, confiscated firms are much more likely to import than other firms, and they are disproportionately oriented toward the domestic market. Although 35 percent of all connected firms are active importers and account for roughly 2.7 percent of all private sector non-oil imports in 2009, confiscated firms are not dramatically more likely to export: only 14 connected firms export (less than seven percent of confiscated firms) and only eight of them (four percent of confiscated firms) operate in the offshore sector. This is somewhat surprising when we consider that confiscated firms are much larger than non-connected firms, and that larger firms are usually much more likely to export (see

Figure 3.2: Cronyism and Regulation in 2010

Prevalence of Regulatory Restrictions across Sectors



Source: Authors' calculations

Chapter One). Confiscated firms are thus disproportionately oriented toward the domestic-onshore market, which is consistent with their ability of evading tariffs and extract rents from market access authorizations (see below).

Indeed the superior performance of Ben Ali firms is especially marked in highly regulated sectors. The results of the quantitative analysis confirm that when we control for regulation (at the 5-digit sector level) we observe that the superior performance of Ben Ali firms is especially marked in densely regulated sectors. Entry restrictions to these sectors translated in greater market share, higher prices, and more money for the firms of Ben Ali's extended family, who had privileged access. While all firms in sectors that require authorization tend to produce more output (as is evidenced by the positive and statistically significant coefficient on operating in sectors requiring an authorization), this is particularly true for confiscated firms, which on average produce 205 percent more than non-connected firms in such regulated sectors, while their market share exceeds that of non-connected firms in such sectors by four percentage points on average (annex 3.3); this is a very sizeable difference when one considers that the average market share of non-connected firms in sectors subject to authorization requirements is 0.27 percent. The market share differential between connected and non-connected firms associated with FDI restrictions is even larger, notably 6.4 percentage points, and statistically significant. Interestingly, these market share and productivity premia associated with being connected are only significant in sectors subject to authorization requirements and FDI restrictions; in sectors covered by the Investment Incentives Code but not subject to these regulatory requirements, differences in market share are statistically negligible once the larger size of connected firms is accounted for. It thus seems that their greater market share can be attributed to entry restrictions.

Arguably even more dramatic performance differences between confiscated firms and their competitors are observed when we examine profit differentials. Ben Ali firms are especially more profitable than their peers in sectors subject to authorization and FDI restrictions; these regulations thus appear disproportionately to assist the profitability of Ben Ali firms. In sectors not subject to these restrictions, however, Ben Ali firms make significantly less profit than their competitors, which countermands the idea that Ben Ali family members were innately better entrepreneurs across the board. One explanation for the finding that Ben Ali firms are less profitable than other firms when regulations are absent but more profitable when they are present is that inferior management on the part of Ben Ali firms can be offset with regulations that target their competitors. Alternatively, it could be the case that these profit numbers reflect the fact that enterprises were not truly economically active, but instead served as a smokescreen for money laundering and other socially unproductive activities. In summary, performance differentials between Ben Ali firms and their peers are significantly larger in sectors subject to authorization requirements and FDI restrictions. The results show that these entry regulations are associated with greatly enhanced size, output, market share, and profitability of Ben Ali firms. These results are indicative of regulatory capture.

In terms of firms' dynamics, the econometric analysis also confirms that confiscated firms exhibit significantly higher unconditional market share, output, and profits growth (annex 3.3), albeit that differences in output growth between Ben Ali firms and their competitors are only significant at the 10 percent level. However, once we control for initial employment, profits, and output, confiscated firms expand output, employment, and profits significantly faster at conventional significance levels. It also appears as though Ben Ali firms in sectors that are more densely regulated exhibit especially fast growth as compared to their peers (annex 3.3).

3.2 / How are Rents Extracted in Tunisia? Using Regulations for Rents Extraction

Our analysis has established that crony firms in Tunisia receive huge rents and make astounding profits, in part because they operate in more profitable sectors, which tend to be highly regulated by the government. Next we explore the source of these rents in more detail. As discussed, confiscated firms seem to strategically sort into sectors where close relations with government counterparts is an important determinant of profitability (for example, in real estate profitability in part hinges on the ability to secure land), rents are high, and there are economies of scale such that markets are quite thin with only a few pivotal players (such as the transport industry).

Indeed we find evidence that abuse of the regulatory interventions of the state is the main avenue for rents extraction by cronies in Tunisia. The results of the qualitative survey suggest that the most common practices used to extract rents include the abuse of “authorizations” requirements (that is, restrictions in access to markets), import protection and import licenses, discretionary enforcement of regulations, abuse of access to public assets and SOEs (including public land and loans by public banks), use of the tax administration and customs to prevent competition and extract rents, the capture of public procurement, and the capture of the privatization of public enterprises (see also Hibou 2007). In this section we explore three different explanations for rents, notably regulatory capture through restrictions on foreign investments and licensing requirements, taxation and tariff evasion, and abuse of access to public assets ⁹.

The (Ab)use of Sector-Related Policies and Regulation as a Smokescreen for Rents Extraction

The policy of extensive state intervention in the economy pursued since independence has given rise to opportunities for rents and cronyism. State interventionism after independence was motivated by a policy of industrialization, initially through the development of state-owned enterprises (SOEs). State intervention rapidly extended to other sectors, notably tourism. The policies adopted (such as tax and customs exemptions or privileged access to financing) introduced important distortions in the Tunisian economy (box 3.2). The government development strategy also entailed the protection of the domestic market. Starting in the early 1970s the government pursued a strategy to develop Tunisian private sector capacity to serve local consumption. This implied strong support and

Box 3.2: Two Examples of Interventionist Policies That Resulted in Cronyism and Distortions: The Tourism Sector and the Automobile Industry

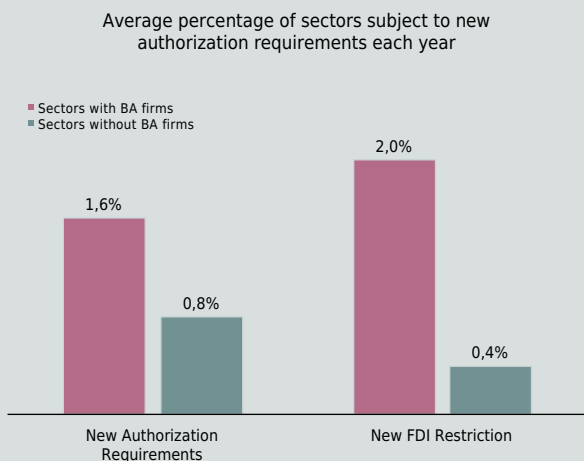
The government gave strong advantages to those who entered the tourism sector. It opened credit facilities up to 90 percent of the capital requirements on favorable terms, tax exemptions on the investment, and privileged access to state lands. This led to several distortions. First, it attracted a high rate of non-competent ‘entrepreneurs’, which resulted in high debt default rates (see also Chapter Six). Second, it fed speculative behaviors, particularly for land ownership. Third, it induced corruption since access to land was crucial to enter the sector. Fourth, it maintained a large pool of unskilled labor in precarious jobs on a seasonal basis.

The automobile industry presents another interesting illustration. During Prime Minister Nouria’s era, the Tunisian authorities imposed on constructors that all imported cars enter the Tunisian territory without batteries and tires and gave exclusive rights (on the domestic market) to two Tunisian batteries constructors and one major pneumatic tires producer. This provided these firms with extremely valuable rents.

protection to entrepreneurs who set up businesses that enabled import substitution. Such protection rapidly evolved into opportunities for rents.

An analysis of changes in the Investment Code over time suggests that amendments to the investment code were plausibly due to manipulation by the Ben Ali clan. To start with, the correlation between crony presence and regulation was already present in 1993 when the current Investment Code was introduced; the prevalence of FDI restrictions and requests for authorization requirements was significantly higher in sectors in which Ben Ali firms were present.

Figure 3.3: Prevalence of Legal Changes (New Regulations) Across Sectors by Presence of Ben Ali Firms, 1994-2010



Source: Authors' calculations

Moreover, the proliferation of regulation over time was strongly correlated with the presence of Ben Ali-owned enterprises. The list of activities subject to authorization evolved over time as it has been supplemented and amended by subsequent decrees, resulting in more than 73 amendments at the NAT96 level. Given the intimate association between the success of confiscated firms and regulatory density, an important question is whether or not the Ben Ali family might have manipulated the Investment Code to serve its business interests¹⁰. While the number of observations we have is very small, it appears as though novel restrictions were especially likely to be introduced in sectors in which confiscated firms were already active¹¹. The probability of new FDI restrictions and authorization requirements being introduced is much higher in sectors in which confiscated firms are active than in sectors in which they are not. Sectors in which Ben Ali firms are active are two times more likely to be subjected to new authorization requirements than sectors in which they are not, and five times more likely to be subjected to new FDI restrictions (figure 3.3; see also annex 3.4 and Rijkers, Freund, and Nucifora 2014)¹². In sum, if regulations did not protect a lucrative sector, Ben Ali would use executive powers to change the legislation in his favor.

Discretionary Application of Tax and Customs Regulations

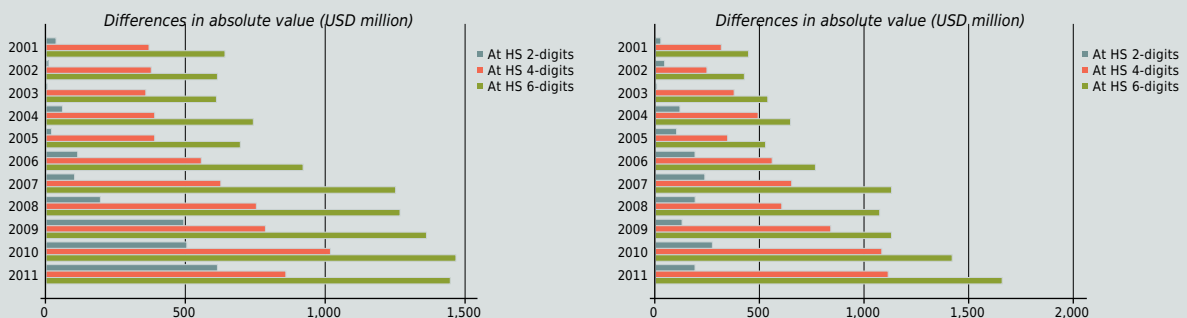
Another common method used by crony firms to gain an unfair advantage, extract rents, and hamper competition is the abuse of fiscal regulations (tax and customs). The qualitative survey provides ample evidence of these practices. The interviewees suggest that this is especially salient for onshore companies (as offshore have a very light tax regime). These practices went beyond simple tax and tariffs evasion, abusing the system of regulations and authorizations to their advantage. For instance, firms wishing to compete for public procurement could be prevented from doing so by the fiscal authorities—who could delay providing the needed certification confirming that the firm was en règle (that is, it had all its accounts in order) with the fiscal authorities. Several interviewees noted that the fiscal administration could be very slow to deliver the certificates, particularly when a firm had challenged some of its decisions. Further, in some cases the delays were amplified by pressure from cronies wishing to eliminate their most dangerous competitors. Such practices prevented competition in public procurement. Similarly, import operations requiring authorization or licensing (such as franchises and dealerships of foreign brands) often resulted in rent-extraction opportunities for cronies. Notorious examples are the quotas on the number of imported luxury products (which entailed huge rents to those who were granted the import

licenses), such as cars, trucks, and several other manufacturing products. Such restrictions have been a major hurdle to competition and impeded the development of several activities.

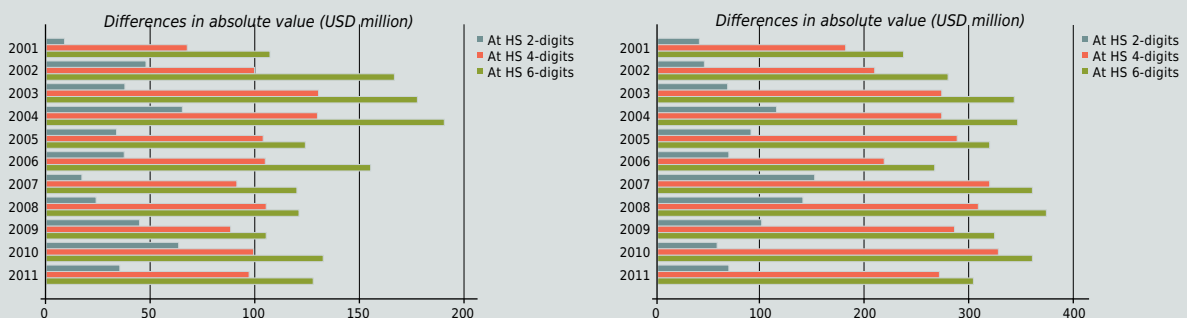
Tariffs and tax evasion hampers competition and gives a strong unfair advantage to the (larger and) better-connected firms. Using “mirror statistics” analysis techniques, we find strong evidence of discretionary implementation of customs regulations and tariff evasion (annex 3.1). Corruption in customs has received considerable media attention and has been argued to be one of the key mechanisms by which Ben Ali clan members were able to reap rents. We find that underreporting of values and misclassification (which are the main tools to evade customs duties) are done subtly, and are limited to a relatively limited number of tariff lines only. Figure 3.4 shows the differences calculated between total mirror and reported imports (in red) and calculated at the HS 6-digit level and then aggregated in absolute values (in blue) in millions and in percentage of total imports. It is worth noting that in absolute terms, trade gaps (defined as the difference between exports to Tunisia reported by source countries and imports reported into Tunisia) was above US\$10 billion in 2011 or over 60 percent of total imports (at 6-digit level). It could be argued that trade gaps (defined by the difference in reported data from exporters and Tunisia) derive from statistical capacity or reporting problems. However, this argument does not necessarily hold since median trade gaps are close to zero for over 4,800 lines over a decade. Indeed, the largest discrepancies (up to over US\$200 million) are limited to few chapters and lines ¹³.

Figure 3.4: Evidence of Tariffs Evasion in Tunisia, 2001-2011

Trade gaps at 2, 4 and 6 digits in imports of ‘Machinery and mechanical appliances’ (HS84, left hand side graph) and ‘Electrical machinery and equipment and parts’ (HS85, right hand side graph).



Trade gaps at 2, 4 and 6 digits in imports of ‘Apparel and Clothing, Knitted or Crocheted’ (HS61, left hand side graph) and ‘Apparel and Clothing, not Knitted or Crocheted’ (HS62, right hand side graph).

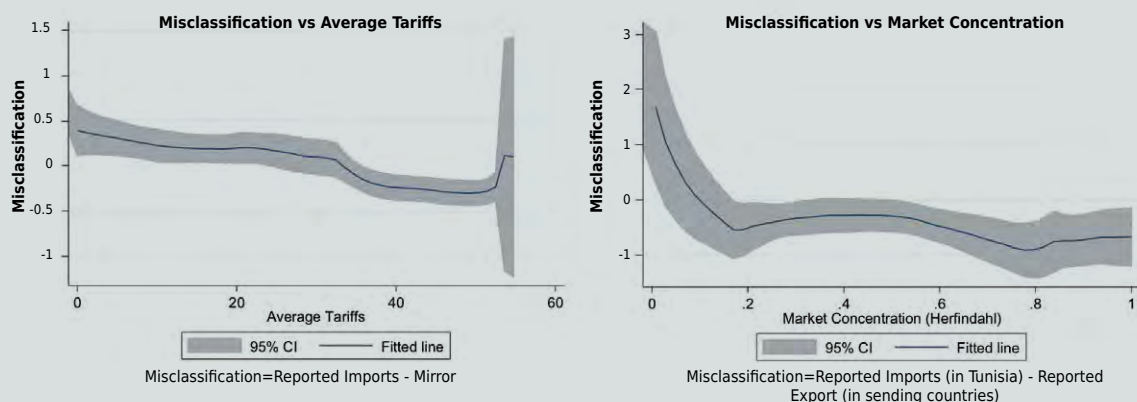


Source: Authors' calculations

These findings are confirmed from an exam on the sectors where trade gaps or data discrepancies are the highest. The most important discrepancies seem to be for chapters 84-85 (machinery, electrical appliances, and so on), chapters 50-63 (textile and clothing), and chapters 25-27 (minerals). Aggregation at the HS 2-digit and HS 4-digit levels underestimate a significant proportion of the differences (figure 3.4). Indeed, the highest differences are in green, which are the ones computed at the 6-digit level, whereas at the 2-digit level (in blue) differences are much lower (because a plus is offset by a minus in another tariff line in the same chapter). The analysis of trade gaps shows the largest discrepancies in the most disaggregated data, which means that tariff misclassification is probably the most common problem (figure 3.4). Further, the phenomenon seems to have doubled or even tripled over the past decade. Indeed 2011 was the worst year in terms of data discrepancies for chapter 85 and close to be the worst for chapter 84 (figure 3.4) ¹⁴.

Preliminary evidence also suggests that levels of underreporting increase with the tariff levels faced by imported products and are highest in industries dominated by a few firms only, which again reinforces the evidence that privileged market access authorization and abuse of regulations by cronies are closely linked. The relationship between misclassification and average tariffs is negative since as expected the higher the tariff the more the underreporting of imports. The difference between imports reported by Tunisian customs and exports reported by their counterparts becomes more negative as the tariffs increase (figure 3.5). This evidence is fully in line with the studies on governance and tariff evasion. According to our estimates, such tariff evasion results in an annual revenue loss of at least US\$100 million (approximately 0.15 percent of GDP) ¹⁵. Using the firm-level data on imports, we also examine the relationship between market concentration and reporting sign (over or under) in sectors where the suspicion is the highest, notably the textiles and clothing and the machinery and electrical equipment chapters, and find that the highest levels of underreporting are in highly concentrated industries (figure 3.5). Moreover, we estimate that import-monopolists (firms that are the only firms that import particular products) on average under report on the magnitude of 131 percent relative to firms that do not.

Figure 3.5: Relationship Between Misclassification and (i) Average Tariffs and (ii) Market Concentration



Source: Authors' calculations

In sum, it appears that tariff misclassification (with potential tariff evasion) has been increasingly pervasive in Tunisia and highest in a few sectors, such as trading and imports of consumer goods and textile products, where crony firms are most prevalent. While there may be other explanations

Box 3.3: Protecting Tunisia's Banana Growers?

BIR AL KASSAA, Tunis—The banana wholesalers' stores are found at the far end of the market in Bir al Kassaa, a place bustling with early-morning energy. Porters come and go, coffee is drunk, and market information exchanged. Outside one store incense burns in an earthenware pot. It helps bring in business, the wholesaler explains. A couple of inspectors from the trade ministry arrive for a chat, as they do each morning.

Today the banana boxes bear the brand names Simba and Happy—from Costa Rica—or Joe, Dole, and Ecuasabor—from Ecuador. Some days there are Mexican or Colombian bananas, and you may also find a few boxes of pineapples, mangos, or kiwi fruit in the corner of the store. But for most Tunisian households bananas are the one tropical fruit their stretched budgets allow.

Importers (or “businessmen” as the wholesalers refer to them) sell their bananas each afternoon out of their “frigos,” or refrigerated warehouses, near the capital's port at Rades or down in Sfax.

Since 2007, import licenses have no longer been required for fruit imports. It is common knowledge at Bir al Kassaa, however, that contacts with members of Ben Ali's circle allowed a select group of importers to buy their way past the steep 36-percent import tariff on bananas, a tariff that remains in place even though Tunisia no longer has any significant banana production.

Since the 2011 revolution, the circle of importers has widened to just six or seven businessmen, and not all the faces at the frigos in Tunis and Sfax have changed. With the container-loads of bananas now arriving at the docks through more regular channels, however, wholesalers find that daily prices fluctuate more, reflecting price changes in Central and South America.

But, as long as the tariff on imported bananas remains far higher than in neighboring Libya or Algeria, there will still be contraband, said one young wholesaler at Bir al Kassaa. At Libyan ports, bananas officially pay just 5.25 percent import duty. Since 2011, shipments seem to have had little difficulty entering Tunisia by road via the busy border crossing near Ben Guerdane in southern Tunisia. (See Ayadi, L., Benjamin, N., Bensassi, S., and G., Raballand (2013). Estimating Informal Trade across Tunisia's Land Borders, World Bank Policy Research Working Paper 6731).

Some of these contraband bananas, as well as apples, reached the Bir al Kassaa market. But since March 2014 armed units from the Tunisian customs service have been stationed at the market, wholesalers report. Sure enough, four customs officers wearing black leather jackets were sitting in an all-terrain vehicle at the market's entrance. They were ready, they confirmed, to intercept any truck attempting to bring apples or bananas into the market without the correct documentation.

Source: Interviews with market traders, April 2014.

for our results, the evidence from the data is most plausibly explained by tariff evasion and this explanation is also fully consistent with common knowledge about the crony practices of the Ben Ali family. Further evidence that this misclassification is likely to be correlated with corruption is provided by the analysis of confiscated firms which as discussed above are prevalently focused on import-related businesses—in fact approximately half of all the products imported by confiscated firms fall into chapters 84 and 85.

Results of regressions of trade gaps with tariffs levels and the prevalence of confiscated firms support the thesis of significant tariff evasion by crony firms. An alternative approach to detect firm-level differences in tariff evasion is to examine whether the price and quantity elasticity of reported imports with respect to tariffs are higher for confiscated firms than for other firms.

A correlation between tariffs and trade gaps at the HS 6-digit product country-year level is suggestive of tariff evasion—and, if confiscated firms are especially likely to evade tariffs, one would expect the evasion gap to be especially higher when confiscated firms are present. The results reveal that in product-source lines in which confiscated firms are present there is a positive and strongly statistically significant relationship between the evasion gap and the share of importers that were owned by the Ben Ali family, and the share of import value they account for (annex 3.6). The regressions also show that this result is robust to controlling for tariffs, which

Box 3.4: The Explosion of Informal Trade across Tunisia's Land Borders

Informal trade between Tunisia, Libya, and Algeria developed significantly in the last few years of the previous political regime (Meddeb 2012). In fact there is abundant anecdotal evidence that the Ben Ali clan used to extract rents by having the state set very high import tariffs and other non-tariff barriers to import various consumer products into Tunisia, only to then circumvent these barriers by obtaining privileged passage through customs. This enabled the cronies of the president to control a large share of the Tunisian market for various consumer products.

Following the departure of Ben Ali and his close entourage, the level of informal trade appears to have grown strongly. A recent World Bank study¹ found that informal trade in 2013 accounts for only a small share of Tunisian trade as a whole (approximately 5 percent of total imports) but that it is nonetheless at least worth TND 1.8 billion (approximately US\$1.2 billion, or 2.2 percent of GDP). Moreover, this type of trade represents an important part of the bilateral trade with Libya and Algeria, accounting for more than half of the official trade with Libya and for more than total official trade with Algeria. It is possible to estimate that roughly 20 percent of the fuel consumed in Tunisia is in the form of informal imports from Algeria.

The Causes of Illegal Trade: The main reasons behind this large-scale informal trade are differences in the levels of subsidies and/or the taxation (import taxes and consumption taxes) on either side of the border. For example, the price of fuel in Algeria is around one-tenth of that in Tunisia. While this makes petroleum more affordable for Tunisian households, total informal trade also leads to a shortfall in revenue for the Tunisian authorities estimated at around TND 1.2 billion (or the equivalent of a quarter of total customs revenues).

Table B3.4.1 Price of Various Goods in Tunisia, Libya, and Algeria

Product	Unit	Tunisian price (in TND)	Libyan price (in TND equivalent)	Algerian price (in TND equivalent)
Cheese (gruyère)	kg	30	15	10
Corn oil	1 liter	3	1.2	-
Bananas	kg	3	1.5	-
Apples	kg	4.5	2	
Gasoline	1 liter	1.57	0.19	0.23
Fuel oil	1 liter	1.17	0.19	0.20
Roasted coffee	kg	9	-	4
Tea	kg	5	-	2.5
Juice	1 liter	2	-	1
Sparkling drinks	1.5 liter	1.6	0.9	-
Round steel bars	per ton	1,600	-	900
Air conditioners	12,000 BTU	900	560	450
32" LCD TVs	per unit	770	450	-
Vodka	bottle	150	-	25
Foreign cigarettes	per packet	4.95	-	1

Source: Ayadi, et al. (2013).

Estimates of Informal Trade with Libya: The information gathered at the Ras Jedir crossing point enabled us to estimate the number of vehicles, trucks, vans, and cars that cross the border each day as well as what they are transporting. The traffic is significant: between 200 and 300 of these commercial vehicles cross the border into Tunisia every day. To this figure must be added the 500 to 600 or so cars that transport fuel and smaller goods (for the most part small electronic goods and clothing) across the border. Finally, around 150 to 200 Libyan 38-ton trucks also cross the border into Tunisia. Based on the data collected, it is possible to estimate that the level of informal trade flowing through the Ras Jedir border crossing point is significant, with goods worth around TND 600 million per year entering Tunisia informally from Libya via Ras Jedir. This gives the traders involved in this cross-border business a profit of around TND 120 million, although the size of profits varies greatly according to the type of good being transported. Trade in fuel is the predominant activity, accounting for 10 percent of illegal sale values and 30 percent of the profits. That said, other products are also important, notably bananas which account for 15 percent of sale values and 10 percent of profits. The major categories of goods passing through the Ras Ajdi border post are as follows: fuel, apples, bananas, textiles, shoes, household electrical goods (LCD TVs, satellite receivers), white goods (refrigerators, air conditioners), and tires. These goods are either heavily subsidized in Libya but not in Tunisia (this is the case for fuel, for which subsidies in Libya cover 80 percent of the cost) or are much more heavily taxed in Tunisia than in Libya (all the other products listed above), leading to significant differences in price (see table B3.4.1). Other goods, in particular tobacco, alcohol, and medicines are not transported via the Ras Jedir border crossing when entering (for tobacco and medicines) or leaving (alcohol and medicines) Tunisia. These goods are carried over the border in both directions via contraband routes through the Tunisian-Libyan Saharan route using convoys of all-terrain vehicles.

Estimates of Informal Trade with Algeria: In the case of Algeria, the most common form of transport used in this type of informal trade is the van, with 3,000 of these vehicles being used to transport goods illegally across the Algerian-Tunisian border, according to those we interviewed. On average, these vans make one crossing per day. Clearly, trade in fuel and fuel oil is the most important, involving 60 percent of the vehicles taking part in this activity. Traffic in cigarettes (which was not seen on the Tunisia-Libya border) accounts for the activity of around seven percent of the vehicles. Again the existence of considerable differences in prices of certain products appears to be the main reason for informal cross-border trade in the region (table B3.4.1).

Implications and the Way Forward: This type of trade has an important economic and social impact in border regions. In many of these regions, informal trade is one of the most important economic activities—if not the most important—as is the case, for example, in Ben Gardane. Numerous individuals and organizations are involved in informal trade. While some are highly visible, such as transporters carrying the goods across the border, street vendors, and ad hoc traders (known informally as “ants”), others are less so, such as wholesalers, currency changers; and officials in the relevant administrations are willing to turn a blind eye on the practice. This kind of trade also keeps many goods within budget for Tunisian consumers. This situation clearly leads to strained relations between the authorities and local populations. As local populations depend on cross-border trade for income generation, they worry about local authorities taking action against cross-border trade, as is the case in western Tunisia. At the same time, customs officials are concerned about the risk of local protests if they strictly enforce tariff regimes in place, as is the case on the Libyan border.

Tackling informal trade is no longer simply a question of stepping up the number of controls and sanctions because, as is clearly shown in a number of countries, sharp differences in prices between two countries will inevitably lead to informal trade (and to an increase in corruption levels among border officials) even in cases where the sanctions are severe. Without greater harmonization of prices at the regional level, there is every chance that the level of informal trade will continue to grow. Therefore, the first priority is to pursue closer regional coordination between Tunisia and its neighbors in terms of tariffs, tax levels, and subsidies.

The economic and social importance of informal trade in the regions means that any attempt to strengthen controls at the borders would probably cost more in terms of equipment and infrastructure and probably lead to higher levels of corruption among customs officials based on the border, further undermining government control. However, it is also important to gather more information about trade flows and the behavior of officials in order to limit illegal flows as much as possible since there are links between informal trade and illegal imports such as weapons.

Global experiences in this field have shown that the strengthening of controls (with more technology) cannot alone cope with smuggling. A comprehensive policy should be undertaken which should limit the incentives for smuggling, such as changing the tariff policy for certain products, strengthening internal controls within Customs to limit the emergence of local deviant practices. In addition, it is very important to monitor data on seizures, number of declarations, average value, and so on. With this end in view, it is important to analyze product by product the main drivers for informal exchange (for example, tariff peaks for bananas and cheese or import prohibition for carpets and apples flooding the parallel markets in any case). For many products, such as those mentioned above, a revision of the tariff policy or import procedures is necessary and requires political decision. It is also important to strengthen cooperation with neighboring countries and consider informal cross-border trade and smuggling as a major concern during the various bilateral and multilateral meetings. In this regard, tax policies and subsidies harmonization should be a common goal to fight smuggling and fraud.

Source: Ayadi, et al. (2013).

Note: This study focuses solely on informal trade and land borders and not on informal sector in general. Although some of the informal trade into Tunisia passes through the port of Tunis, this study does not take account of goods entering the country in this manner. For the purposes of this study, informal trade is defined as the flow of goods that are unreported or incorrectly reported by the country's customs authorities. This definition therefore covers a number of different aspects, including trade in goods passing through border posts with falsified customs declarations (in terms of the type or quantity of goods concerned) as well as smuggling (that is, when goods cross the border without the knowledge of customs authorities) either through border posts or elsewhere along the border. However, this paper does not cover products that cannot be licitly traded in the country (such as weapons or drugs).

as discussed earlier are themselves positively and significantly correlated with evasion gaps. We also find that import quantities reported by confiscated firms decline significantly faster with tariffs than average import quantities by non-connected firms, whereas no statistically significant effect is observed for import prices.

All in all, as expected the evidence thus suggests that crony firms are more likely to evade tariffs. However, the implications of such tariff evasion were arguably quite modest from an aggregate perspective since confiscated firms accounted for only a small share of aggregate imports into Tunisia. The effects are much larger, however, when we consider the broader impact on hindering competition and the rent extraction which accompanied the regulatory abuses—both of which are at the root of the private sector paralysis and structural stagnation of Tunisia discussed in Chapter One.

Abuse of Public Assets, State-Owned Enterprises, and State-Owned Banks

Privileged access by cronies to state assets was also an important target for rents extraction and unfair competition. The information collected in the qualitative survey highlights that abuse of public assets would take place in several ways: access to public land at non-market conditions (which was very lucrative in a context of booming real estate sector); use of insiders' information on assets to be privatized and restructured to acquire stakes at non-market terms; abuse of public services and assets for private purposes (like Karthago Airlines, which used Tunisair maintenance and catering services without paying); and share takeovers in strategic sectors such as privatized banks and use of utilities to give ruling family companies a comparative advantage in some sectors. Use of public assets and SOEs was used to predate resources and prevent competition, with negative impact on productivity (box 3.5) ¹⁶.

Box 3.5: Examples of Privileged Access to the State's Assets

Based on investigations, interviews as well as studies of archives and internal documents, the report of the National Anti-Corruption Commission presents how SOEs could have been used to create rents for the Ben Ali clan. Large SOEs, such as STIR, Tunisie Telecom or STEG had to sign procurement contracts to cronies' firms. Businessmen close to the ousted President were able to obtain exclusive rights and benefited from large contracts on a single source basis. Often the board of directors was not even informed of such decisions, and everything was settled between the CEOs, the relevant sectoral Minister and the Advisors to the President.

Similarly, public banks were used to grant privileged access to credit at advantageous conditions to cronies. Tunisian banks funded businesses linked to the family of president Ben Ali to the tune of TND 1.75 billion (or approximately 2.5 percent of GDP), the equivalent of five percent of all financing by the Tunisian banking sector, and nearly 30 percent of the cash was provided with no guarantees of repayment (Source: Press statement by the Governor of Central Bank of Tunisia in February 2011). According to the GFI, the STB (*Société Tunisienne de Banque*) was the most exposed explaining also why the STB now owns shares in hundreds of companies after having been changed from non-performing loans to shares. The BNA (*Banque Nationale Agricole*) seems to be equally exposed for having granted cronies loans at very preferential prices.

Access to land was also subject to significant abuses. A large share of land (77 hectares) belonging to the SPLT (*Société pour la Promotion du Lac de Tunis*) was sold at extremely low prices to the son of the President and then resold with large profits. Another example was that the *Agence Foncière d'Habitation* (AFH) had to sell land to cronies at very low prices in La Marsa, which is beachfront residential area near Tunis.

The anticorruption commission also documented several cases of mis-procurement where contracts were awarded to cronies using a variety of methods to eliminate other competitors. In 2012 the government mandated the *Comité National de Coordination et de Suivi* (CNCS)—a task force including representatives of public large purchasers, control bodies, private sector, civil society, and university scholars—to carry out a self-assessment of the national procurement systems (using the OECD-DAC methodology). The results suggest that the lowest scores for Tunisia were in the area of integrity and transparency. The conclusions of the report highlight the need to reorganize the various control bodies and highlighted the need to revamp appeals mechanisms (in cases of complaints) or disputes, as well as to increase transparency.

3.3 / Impact on Private Sector Development: Coping with Predation and Cronyism

The qualitative survey highlights that close connections with the administration and political power are an important way to get protection and advantages in Tunisia. The evidence presented above highlights the extensive advantages accruing to cronies in Tunisia. Although interviewees were not eager to talk about these issues, several of them were quite frank in emphasizing that having a relative as a minister of Ben Ali, or cultivating close relationships with members of Ben Ali's extended family, helped them. However, they indicated that this approach had the major drawback of making them dependent on the alliance and support of the Ben Ali's clan, which ultimately entailed a risk of capture and was subject to the risk of changes in political favor. Those who did not want to cooperate with the cronies but who were willing to maintain warm relations with them frequently had to pay a "tax" ¹⁷.

The most widely adopted technique was to minimize exposure and try to remain hidden below the radar of the family; this distorted and hindered private sector performance in multiple ways. First, firms purposely kept a lack of transparency about structure of activities and subsidiaries. Doing so enabled family groups to increase their investments while keeping most of their activities at a relatively small size so as not to get on the radar screen of predators¹⁸. In that perspective, very few companies published the totality of their annual reports or had a full presentation of their activities. Second, staying below the radar screen entailed developing sub-optimal business strategies, typically through diversifying activities, selecting sectors outside the sphere of interest of the Ben Ali family, and limiting firms' size. This strategy prevented the exploitation of economies of scale in the Tunisian industrial landscape. It also required limiting risks by strictly limiting cooperation with peers, which is consistent with the widespread presence of family-run firms in Tunisia. Interviews also confirmed that firms avoid profitable lines of activities in sectors entrenched with interests or connections to the administration or the political power. Third, several interviewees mentioned that, notwithstanding opportunities this could have opened, they avoided asking for financial support by banks. If they needed financial support, they would go to the private banks reputed to have the lowest level of connections and avoid public banks because of the risk of exposure to predation. Fourth, even though there may be several explanations, the environment was biased against pursuing mergers and acquisitions because they would signal to predators the success of a firm¹⁹. Another consequence of this inhibition is the low rate of some necessary restructuring and the lack of efficient reallocation of factors among Tunisian firms, hampering the development of large groups and of "national champions"²⁰.

The only cooperation sought was with foreign partners, which indeed could also provide an opportunity to hedge against the risks of predation²¹. In line with this, the offshore sector was preferred as it was more transparent and allowed a more level playing field, there was less role or discretion by the administration, and the presence of foreign firms forced the Ben Ali family to moderate its abusive practices. Hibou (2011) explains, "Once [foreign firms] have passed the entrance gate into Tunisia, they are protected from the predatory activities of greedy intermediates." Note, however, that in many sectors the viability of this strategy was limited by presence of severe FDI restrictions. Worse still, it is precisely in protected sectors that Ben Ali firms were most important.

In sum, beyond the losses directly associated with corruption and rents extraction, the widespread cronyism, unfair competition, and the possibility of predation all negatively impacted private sector performance in Tunisia, hampering growth and jobs creation. Overall the consequence of unfair competition fed by the combination of administrative distortions and predation is that firms remain below potential, never reach their production possibility frontier, and rarely grow vertically on the value chain. Hence, there is a significant hidden economic cost inherent in having private sector pursue a strategy to avoid or limit the risk of predation and exposure to cronies. While there is no way to easily quantify these economic costs, the perception of lost opportunities by top entrepreneurs is very high²². What is clear is that this system was both extremely inefficient and supremely inequitable; only a small minority of entrepreneurs could credibly aspire to succeed.

3.4 / The Impact of Cronyism and Predation on the Tunisian Economy

The presence of pervasive cronyisms and the risk of predation help explain the private sector paralysis in Tunisia. The stunted private sector dynamics in Tunisia described in Chapter One

result from several problems. As discussed below, the diagnosis presented in Chapter One is consistent with the narrative offered by the entrepreneurs that took part in our qualitative study and by the available quantitative evidence on the impact of cronyism presented in this chapter.

- The evidence presented in Chapter One highlighted that the private sector in Tunisia is skewed toward small-scale activities and that large firms are scarce, both in absolute and in relative terms. The absence of relatively large firms is also apparent when we examine the exporter size distribution. In fact Tunisian exports are significantly less concentrated than in other countries. The observation that Tunisia's private sector is specialized in small-scale activities and characterized by limited dynamism is consistent with firms trying to stay below the radar screen.
- We also found evidence that firm growth in Tunisia is only weakly correlated with productivity; and in fact the relationship between employment creation, productivity, and profitability is very weak. We observed that few small firms ever grow large, that small firms are more likely to die, and that most large firms had already been large for a while. Indeed job creation is not only hampered by limited entry, but also by a lack of (upward) mobility; very few firms grow both in the short and the long run, which is at odds with the existence of an up-or-out dynamic often observed in developed countries in which entrants tend to either survive and grow or exit. From a dynamic perspective we found that private sector performance has been weak and that the process of creative destruction that drives productivity growth is severely attenuated in Tunisia. All of the above are consistent with the impacts of cronyism on firms' dynamics highlighted in this chapter.
- We also found that the Tunisian economy does not rapidly reallocate resources to its most productive and profitable uses—which again is consistent with the fact that the process of creative destruction that should drive productivity growth and factor reallocation is severely attenuated in Tunisia—and the unfair competition discussed in this chapter has undoubtedly contributed to this outcome.
- We also discussed in Chapter One that the offshore sector is relatively better performing than the onshore sector, which is consistent with the discussion presented in this chapter, whereby cronies did not interfere much with the offshore and instead focused on extracting rents mainly in the onshore sector. The Investment Incentive Code stipulates which sectors are open to investors (discriminating between domestic and foreign) and grants a very generous tax regime and simplified regulatory burden for firms that export at least 70 percent of their output (offshore firms). At the same time, the duality in fact served as window dressing for regulatory capture by cronies. In this chapter we have found ample evidence that these restrictions are in fact abused by cronies to extract rents as a result of privileged access to onshore markets, at the expense of the entire country²³. This also explains why the onshore sector is rife with regulatory requirements and market access is heavily restricted, both of which constitute opportunities for unfair advantages and rents extraction.

3.5 / *Conclusions*

This chapter has substantiated that state interventions and barriers to competition have introduced severe distortions in the choices of private investors and created ample opportunities for rents extraction by cronies, severely hampering the performance of the private sector in Tunisia. The distortions have important consequences for firms' behaviors, repressing

enterprise growth and obstructing the process of structural transformation. Several tools were used to gain unfair competitive advantage and extract rents, such as the discretionary enforcement of regulations (notably barriers to market entry, tax administration, custom duties, and public procurement) and the (ab)use of public assets and public enterprises (including public banks). All of these practices undermine competition by favoring better connected firms and those who practice corruption.

In particular, our results show that regulatory requirements for prior authorization and restrictions on foreign investment have been abused as tools for rent redistribution. The business empire confiscated from the Ben Ali family was both extremely lucrative and significant from a macroeconomic perspective—a small group of 220 firms with ownership links to the Ben Ali clan accounts for less than one percent of jobs but over a fifth of net private sector profits. This extraordinary profitability of confiscated firms is to a large extent the result of regulatory capture. Firms owned by the Ben Ali family are much more likely to operate in lucrative sectors (such as air and maritime transport, telecoms, commerce and distribution, real estate, hotels and restoration, and financial services) where competition is restricted through the requirement of prior authorization by the government and/or where foreign investors are not allowed to own a majority share. Performance differences between confiscated firms and other firms are significantly larger in these highly regulated sectors.

We show how the existing regulatory architecture is, arguably more perniciously, itself a product of cronyism—which resulted in proliferation of regulations and restrictions. The probability that new authorization requirements and FDI restrictions are imposed was significantly higher when Ben Ali firms were operating in a particular sector, suggesting that Tunisia’s investment policy did not serve its purported objectives to create jobs and stimulate investment ²⁴. Instead, regulation served the personal interests of those in power, at the expense of providing fair opportunities to the vast majority of Tunisian entrepreneurs who lacked political connections ²⁵.

That said, the problem of crony capitalism is not just about Ben Ali and his clan—on the contrary it remains one of the key development challenges facing Tunisia today. Due to data limitations the analysis presented in this chapter has focused on the firms confiscated from President Ben Ali and his family. Cronyism is a widespread phenomenon in Tunisia, however, which pre-dates President Ben Ali and permeates private sector environment—and arguably a significant share of the private sector has benefited from the system to different degrees. In fact the Ben Ali clan owned only a fraction of the firms operating in markets protected by barriers to entry, such that other firms operating under these regulations continue to benefit from these privileges. Hence, it would be a mistake to assume that following the departure of President Ben Ali and his family the cronyism and rent seeking have disappeared in Tunisia. In fact, the system of laws and regulations that allowed the family to capture such a large share of the country’s wealth remains largely in place and prone to abuse ²⁶.

These regulations continue to enable the capture of the country’s wealth by a few privileged Tunisians at the expense of the majority, hampering investment and the creation of the well-paying jobs that Tunisians deserve. While regulatory barriers and authorizations are often presented as a way to protect Tunisian consumers, in fact in Tunisia they benefit a small elite at the expense of the vast majority of Tunisians ²⁷. The consequences of this use of regulations to extract rents (to appropriate wealth) is much worse than just the cost of the petty corruption: consumers pay monopolistic (that is, higher) prices, firms have no incentive to improve product quality, and the productivity gains and innovation that would come from new firms is halted. In other words, it undermines the competitiveness of the economy, hampering investment and the creation of jobs. In fact, most Tunisian businesses and unconnected firms continue to suffer

because they face barriers to market entry and their efforts are stymied by the unfair advantages enjoyed by privileged firms. Further, these regulations also perpetuate social exclusion, as unconnected Tunisians face very limited economic opportunity. A few people who have access to those in power and in the administration can capture these benefits, while those who do not have those contacts are excluded from the economic system. Hence this system generates deep social injustice and arguably it is at the root of the frustration of most Tunisians who felt and feel excluded from economic opportunity.

Beyond barriers to market contestability, some specific areas of regulation also appear to be more prone to cronies, notably the customs and tax administrations. The findings presented in this chapter underscore the merits of lean regulation, and the importance of having a customs and tax administration with adequate monitoring capacity and strong internal controls limiting the scope for opportunistic behavior. They also resonate with arguments in favor of uniform tariffs and a simplified tax system, as complex systems are more likely to invite corruption and favoritism of politically connected firms. More generally, in addition to reviewing the restrictions to investment and market access, it will be crucial also to pursue reforms aimed at reducing the scope for regulatory capture in the following areas: trade policy, investment subsidies and fiscal incentives, tax and customs, SOEs, and public procurement ²⁸. Most of the needed reforms are politically sensitive and therefore can be politically motivated or manipulated ²⁹.

It is critical for reforms to be undertaken quickly, as the policy infrastructure inherited from the Ben Ali era perpetuates social exclusion and invites corruption. In view of the legacy of corrupted state-business relationships, it is essential to rapidly remove barriers to market entry and reduce the room for regulatory discretion. Leveling the playing field and enhancing transparency are essential to avoid the risk of Tunisia's entrepreneurs falling prey to the same type of large-scale predation that debilitated their ability to catalyze growth and create jobs in the recent past. These reforms require political determination since they are likely to lead to organized resistance by vested interests. Therefore, it will be impossible to have a consensual approach as fierce resistance to change can be expected from the losers of rents and privileges. However, if reforms are not undertaken, the risk of suffering from the old predation tactics will be increasingly strengthened. Time increases the risks that vested interests will capture existing opportunities for rent seeking and be in a stronger position to prevent change and perpetuate social exclusion.

The next few chapters explore possible constraints that hinder the smooth operation of the economy, preventing free movement of economic factors (labor, capital, land, entrepreneurship) to the most productive activities. The chapters will explore specific policy-induced market failures and distortions in factor markets, notably in the fiscal and regulatory regime for investment, in the labor market and in the financial sector. As will be shown, economic policies in Tunisia have not achieved the desired outcomes (to attract investment, foster creation of good quality jobs, and reduce regional disparities), and instead have contributed to create an economic environment ripe with barriers to competition and distortions. Economic policies have distorted the allocation of resources and have stifled the process of creative destruction, such that resources remain stuck in low-productivity activities, dampening growth and ultimately job creation.

Notes

1. Cronyism was not new to Tunisia, but the distortions associated with the actions of the cronies evolved in the past decade. They existed under President Bourguiba but were generally limited to privileged access to resources and public contracts. However, rent-seeking behaviors developed over the years and eventually paved the way for the predation of the economy by President Ben Ali and his extended family. Respondents to a qualitative survey on cronyism carried out by the World Bank in 2012 agree that unfair competition, cronyism and predation rose dramatically during the last years of the Ben Ali regime (Chekir and Menard, 2012). Initially, the Ben Ali clan remained inhibited, with predatory behavior increasing but not pervasive. With the political strengthening of President Ben Ali since the early 2000s, cronyism and predation increasingly became pervasive. The power of the presidential cabinet became stronger after the 2004 elections and resulted in even more pervasive predation strategies with competition for the control over some key state assets developing among the cronies. This led to the rise of predation and political interferences, with an accompanying deterioration of institutional rules (which several interviewees identified as a sort of "institutional *laissez-faire*"). Almost all interviewees emphasized this shift, which had a particularly significant and negative impact on onshore firms.

2. Amongst the assets that were seized were over 400 enterprises (some of them abroad), 550 properties, 48 boats and yachts, 40 stock portfolios, and 367 bank accounts.

3. We investigate these issues using three main lines of analysis: (a) a qualitative survey and interviews of firms' top management to understand the impacts of Ben Ali's predation and cronyism on firms' behavior; (b) a quantitative analysis of the characteristics of 220 firms owned by 114 Ben Ali family members and their close confidantes confiscated in the aftermath of the 2011 revolution, compared to other firms in Tunisia; (c) A quantitative analysis of mirror trade statistics for issues related to customs performance. (See details in annex 3.1).

4. "The Economist" has built an index to gauge the extent of crony capitalism across countries and over time: <http://www.economist.com/news/leaders/21598996-political-connections-have-made-many-people-hugely-rich-recent-years-crony-capitalism-may>.

5. Our profits measure is operating profits as declared to the tax authorities, which are likely underreported and, moreover, may not accurately reflect real profits since firms are allowed spending toward investments from their tax obligations. Although not all of these firms were fully owned by the Ben Ali family (such that some of these profits accrue to non-family members), these numbers are perhaps best interpreted as a lower bound on the total profits made by politically connected firms because many firms do not report positive output, employment, or profits. Moreover, we do not observe firms that benefitted from cultivated, rather than family connections.

6. It should be noted, however, that this is in part due to many firms reporting losses. Even though they are much more profitable on average, a substantial number of Ben Ali firms report losses; in fact, Ben Ali firms are more likely to report losses than non-connected firms despite generating higher profits on average. In fact a striking feature of the data is the high rates of non-reporting among confiscated firms. In 2010, the most recent year for which we have data, only 122 firms reported hiring any paid workers, whereas only 91 firms reported positive profits and output. While there are myriad possible explanations for the larger heterogeneity in returns to running Ben Ali firms,

some of which will be explored later in this paper, one potential explanation for their higher propensity to incur losses is that this would minimize their tax obligations and because it may entitle them to various types of government support.

7. When we focus on the shares of output, employment, and profits that confiscated firms account for, we find that sheer numbers are not necessarily indicative of the economic significance of firms; even though there are only three confiscated firms in the telecommunications sector, these account for 87 percent of output and 93 percent of profits in that sector. Confiscated firms are also important in terms of output in the trade and transport sector. In fact, aggregate categorizations obscure important variability within broad sectors, as confiscated firms are often major market players that account for an important share of output, employment, and profits in their specific activity or market (for example, air transport and telecoms sectors were fully dominated by confiscated firms). The tables in annex 3.2 provide a broad overview of activities deployed by confiscated firms in terms of their share of output, employment, and profits across sectors at the 2-digit level and at the 5-digit level.

8. If we focus on firms engaged in activities covered by the investment code, we observe that in 2010 roughly two thirds (64 percent) of all confiscated firms are in sectors in which firms require an "authorization" to operate. Similarly two thirds of confiscated firms (64 percent) are active in sectors where foreign-owned firms are not allowed to operate. These shares are much higher than those for non-connected firms, which are 45 percent and 36 percent, respectively.

9. Of course, the list of mechanisms we test is by no means exhaustive. For example, the qualitative survey (and a number of newspaper articles) have reported collusion with SOEs and outright theft and extortion as mechanisms of predation and rent appropriation. As another example, connected firms may benefit from insider information and preferential treatment in public procurement. These practices are beyond the scope of our quantitative analysis, however.

10. To attempt to shed light on this question, we assemble a database documenting all changes to the investment code during 1994 and 2010 and assess whether revisions to the code are more likely when Ben Ali firms are undertaking a particular activity. During 1994 and 2010 there were a total of 22 decrees signed by Ben Ali introducing new authorization requirements in 45 different sectors and new FDI restrictions in 28 sectors.

11. While statistical power is limited due to the relatively small number of observations on both connected firms and regulatory changes, we document a few instances of striking simultaneity between regulatory changes and deployment of business activities by clan members. For example, Decree N° 96-1234 issued in 1996 amended the investment code by introducing authorization requirements for firms engaging in the handling and transfer of goods in ports, and the towing and rescue of ships. The decree also introduced restrictions on FDI for firms involved in the transport of red meat. That same year, Med Afif Chiboub, uncle of Ben Ali's son-in-law Mohammed Slim Chiboub, established *La Méditerranéenne pour le Commerce, le Transport et la Consignation*, a company focused on the transport of refrigerated products. As another example, the establishment of Carthage Cement by Belhassen Trabelsi, the brother of the President's second wife, followed on the heels of Decree N° 2007-2311 stipulating the need for government authorization for firms producing cement.

12. Each year 1.6 percent of all sectors in which Ben Ali firms are active are subjected to new authorization requirements, whereas only 0.8 percent of sectors in which Ben Ali firms are not present are subjected to new authorization requirements. For FDI restrictions the difference is even larger with two percent of sectors in which Ben Ali firms are active being subjected to new FDI restrictions each year, compared to 0.4 percent of sectors without Ben Ali firms.

13. Usually, when a particular tariff line appears “overvalued,” one can usually detect a significantly “undervalued” tariff line in the same heading or sub-heading (which seems to explain that misclassification could be the most important tool used to evade customs); however, using aggregated data one would not detect these discrepancies. In fact at an aggregate level the difference between reported (by exporters) and mirror imports values (reported by Tunisian customs) seem to be relatively small over the past decade, as “minuses” are usually compensated by “pluses” in the same trade chapter. The selective presence of misclassification gaps supports the hypothesis of substantial tariffs evasion. The fact that misclassification is limited to a few lines only is at odds with discrepancies between mirror statistics merely being a statistical artifact or reflecting limited administrative capacity in customs; if there were a systemic problem of statistical capacity or professionalism in customs, one would expect widespread discrepancies all over the tariff lines. That misclassification practices are rather sophisticated is also evidenced by the fact that these practices are difficult to detect with aggregate data. However, when the same difference between reported and mirror statistics is computed at the most disaggregated level (HS 6-digit) and added up in absolute values, differences are much higher.

14. Consistent with this, we also found that the standard deviation of trade gaps has increased steadily since 2000 (with a peak in 2008) and was higher in 2011 than in the previous three years (computed for the whole tariff schedule of over 4,800 tariff lines at 6-digit). Hence the level of tariffs evasion appears to have increased over the past decade, and remains very high in 2011.

15. Note that this likely underestimates the extent of tariffs evasion since our estimates only account for products for which we have information on tariffs.

16. Sekkat (2009) demonstrated that in Egypt the importance of an SOE in a given industry was negatively correlated with total factor productivity and argued this reflected SOEs’ rents irrespective of their productivity performance.

17. Examples mentioned during the interviews include the co-financing of a private jet, grants to the sport clubs in a city where one of the cronies was running for mayor, and the provision of unlimited free services and goods.

18. Klai and Omri (2011) note that, even for firms listed on the Tunis Stock Exchange during the period 1997–2007, the governance problems in Tunisia affected the reporting quality of financial information provided by the companies.

19. Several interlocutors mentioned that they were provided with extremely interesting merger opportunities but preferred to decline them because they were reluctant to increase collective action and/or because this would signal them to predators. Others stated that going public would have enabled them to significantly increase their activities and that they would have been able to endure such a process considering their reputation; however, they preferred to avoid such financing tools because of the communication and disclosure it required and the risk at stake with respect to exposure to the cronies.

20. Indeed the track record of financial transactions in Tunisia is limited: the number of mergers between industries with

high synergies is very limited, and the number of restructuring processes is also very small.

21. As foreign companies were spared from most predation practices, indicators such as Transparency International were relatively good for Tunisia because of the sample bias in favor of non-Tunisian firms.

22. Anecdotal, during the qualitative interviews, a major industrial group with a turnaround of circa TND 500 million estimated the loss deriving from arbitrariness was equivalent to 30 percent of its potential; another major housing group estimated its loss at approximately 50 percent.

23. Further, as will be discussed in the next few chapters, the onshore sector remains focused mainly on low-productivity low value added activities—which is arguably the result of a different set of policy-induced distortions.

24. Note that the success of Ben Ali firms in promoting employment and output growth is a positive attribute. And in fact it is quite possible that the President and his allies acquired the most productive and profitable firms in the economy and then reinforced their strong performance by introducing selective regulations. The important point is that the selective introduction of new regulations reinforced their monopoly position (to the detriment of consumers and the rest of the private sector).

25. The evidence we find is consistent with a large body of literature showing that countries with more extensive business entry regulations tend to grow more slowly and have higher levels of corruption (see Djankov et al. 2002). Our results demonstrate that, in addition to disrupting firm growth and creating opportunities for bribery, cumbersome entry regulations are also likely to be systematically abused by the state when institutions are weak (Rijkers, Freund and Nucifora 2014).

26. As discussed in Chapter Two, entry authorizations and restrictions to domestic and foreign investors remain the prevalent feature of the business environment in Tunisia. At present these barriers exist through several pieces of legislation, notably the Investment Incentives Code, the Commerce Code, many of the sectoral legislations regulating services sectors (notably telecommunications, health, education, and professional services), and the Competition Law.

27. As an example, consumer prices for telecommunications services, a sector that was dominated by the Ben Ali clan, remain dramatically higher than those in neighboring countries. As shown in Chapter Two, the price of incoming international calls to Tunisia is approximately 20 times the open market price, and outgoing international calls from Tunisia cost more than 10 times the open market price. Such steep prices benefit telecom companies at the expense of Tunisian consumers and firms.

28. For example, a lower level of fiscal incentives could be maintained for high value added activities but apply across the board for offshore and onshore firms and could be automatically approved so that no regulatory capture is possible (see Chapter Four).

29. A prominent first attempt to eliminate the predation problems that characterized the Ben Ali era has been to change heads of administrations, such as in customs. However, turnover of figureheads alone, unaccompanied by complementary reforms, may not lead to the expected results since corruption issues are systemic. International experience suggests that changing incentives and behavior within the agencies of the government undertaking reform will pay higher dividends (see Rajaram, Raballand, and Palale 2010).

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The investment policy has segmented the economy between Onshore and Offshore sectors, to the detriment of overall performance in both sectors of the economy



The Regulatory Environment | 04



The Regulatory Environment for Private Sector Investment

This chapter builds on the analysis of barriers to competition and cronyism by providing an extended example of how current policies also contribute to impede firms' productivity, and ultimately undermine growth and jobs creation. The chapter highlights the key elements of past efforts to attract investment and stimulate job creation—which have clearly failed. The chapter discusses the regulatory environment for investment, focusing mainly on the Investment Incentives Code (IIC). It argues that the Investment Incentives Code has become a major obstacle to faster growth and job creation in Tunisia. This is not mainly because of problems with the offshore sector itself, however. Rather the establishment of the offshore sector has solidified the protection and inefficiency in the onshore sector, which in turn limits the competitiveness of the offshore sector. The entire economy suffers as a result.

Beyond the investment code, the chapter underlines that the broader regulatory environment is difficult, and will severely hinder investment and firms' growth even if the investment code is entirely revamped. The chapter highlights two additional priority areas requiring reform in the business environment. The impact of the heavy regulatory burden has been discussed Chapter Two and Chapter Three, and here we highlight how it affects the environment for private investment. We also discuss aspects of corporate taxation, as it closely relates to the investment climate and characterizes the onshore-offshore dichotomy ¹.

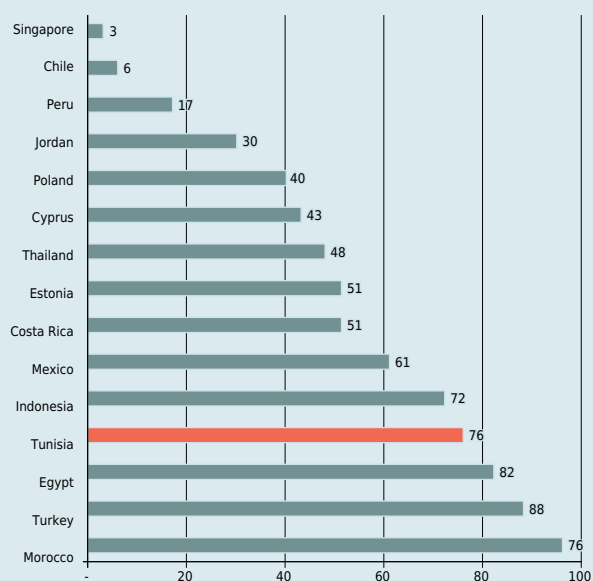
4.1 / Tunisia's Policy Framework for Investment

Tunisia current legal framework for investors is complex, is incomplete, is not transparent, and creates uncertainty. Tunisia has a highly complex investment and incentives framework, which has increased red tape and discretions. The investment framework is marred with procedural complexity and lack of certainty over how the incentives policy will be applied. An overview of Tunisia's investment regime is provided in annex 4.1 (see also box 1.4). As mentioned in Chapter One, Tunisia developed manufacturing exporting industries based on a generous package granted to export-oriented ("offshore") companies. In addition, Tunisia provides several types of incentives. Specific incentives are provided to promote regional development, technology, research and development (R&D), innovations, small and medium enterprises (SMEs), and investments in certain sectors (such as education, transport, health, and culture) and to protect the environment. Further, the authorities established two "free zones" that offer benefits similar to those provided to fully exporting companies ². Tunisia's multiple and overlapping customs, taxes, and financial incentive schemes are highly complex and difficult to understand for investors; and, as discussed in this chapter, their effectiveness and actual benefits to the economy remain unclear. As a comparison, Chile's successful investment promotion policy relies more on the transparent and non-discretionary regulations rather than on incentives (box 4.1).

Box 4.1: Chile's Investment Attractiveness

Chile is one of the countries most attractive to foreign direct investment (FDI), ranked 6th out of 181 countries in the UNCTAD 2011 FDI attractiveness index, while Tunisia is ranked 76th (figure B4.1.1). In Chile, Decree Law 600 (DL-600), known as the Foreign Investment Statute, which regulates foreign investment, guarantees foreign investors the same rights and guarantees as local investors (principle of non-discrimination) and the existence of clear, known, and transparent procedures that ensure fair and impartial treatment of foreign investors (principle of non-discretion). Under the DL-600, free market access is granted to foreign investors, subject to prevailing legal provisions. The rules and regulations of the DL-600 are constitutional and involve a contract between the state and the investor, with investor's rights and obligations. Chile has a flexible exchange rate regime, and under the DL-600 investors are guaranteed the right to repatriate the capital and net profit. In fact, the DL-600 focuses more on consistency, guarantees and investment security than on incentives. Chilean tax rates, incentive benefits, and exemptions are not as generous as many other emerging countries. Institutionally, Chilean investment promotion policy is implemented by only two public organizations, in a complementary way, and with clear mandates: the Foreign Investment Committee focuses on attracting FDI to traditional sectors, notably mining, and the *Corporación de Fomento de la Producción* (CORFO) focuses on nontraditional sectors, such as high technology, and is involved in a range of strategies and initiatives. The regulations were also further strengthened by FTA with the United States, which came into force in 2004. As a result, Chile's FDI increased by 216 percent during the 2000 decade, while Tunisia's FDI increased by only 77 percent during the same period. Similarly, per capita export in Chile increased by 19 percent in annual average between 2003 and 2011, against 11 percent for Tunisia.

Figure B4.1.1: Country Rankings by Inward FDI Attraction Index (rank in 2011)



Source: UNCTAD (2012)

Note: The Inward FDI Attraction Index ranking (out of 181 countries) is based on the average of a country's percentile rankings in FDI inflows and in FDI inflows as a share of GDP.

There remain large areas of the economy that are not open to investment, especially foreign investment, such as areas excluded from the Investment Incentives Code or subject to restriction and the numerous exemptions to the 1991 Competition Law (administered prices, monopolies, strategic sectors controlled by public entities, and so on; see Chapter Two) ³. As discussed in Chapter One and Chapter Two, while some restrictions to FDI exist in many countries, the number of sectors concerned is very high in Tunisia. These restrictions, combined with protective labor and capital control, prevent capitalizing on greater FDI opportunities, as foreign firms prefer remaining under the confined offshore regime with low value added industries or in the energy sector.

Tunisia also allows only very limited capital mobility. The country continues to tightly manage its currency through strict control of capital account. Even for non-resident (offshore) firms, retransfer of funds and capital income are subject to authorization. Although this tight capital account control protects Tunisia against spillover of financial crisis, it constitutes a heavy constraint for companies investing in Tunisia. It also prevents Tunisian firms from investing abroad or foreign firms from expanding into the regional market.

The Investment Incentives Code

Tunisia's investment policy and regulatory framework is centered on the 1993 Investment Incentives Code (Law 93-120 of December 1993), which in fact builds on the introduction of the offshore regime in 1972 (Law 72-38 of April 1972). As discussed in Chapter One, the Investment Incentives Code covers all sectors of activity except mining, energy, domestic commerce, and the financial sector, each of which are governed by specific legislation ⁴. Seven priority objectives are supported by an array of fiscal and financial incentives, of which some are awarded based on a simple declaration (notably the fiscal incentives), while others are subject to case-by-case approval (notably the financial incentives). Special additional incentives can be provided to specific investment projects (for example, for large projects or projects of national importance) and have to be published by decree. The IIC has been amended over sixty times throughout the years, making it difficult to navigate.

The Investment Incentives Code distinguishes between two basic regimes for “fully exporting” firms (or offshore) and for “non-exporting” or “partially exporting” firms (or onshore). Fully exporting firms benefit from tax exemptions on profit and income taxes during the first ten years of their activity, a 50-percent reduction for another ten years, and full tax deduction for reinvested profits ⁵. The state also grants duty-free access to all inputs and equipment. It also often provides the necessary infrastructure and assumes employers' social security contributions over five years. They also benefit from streamlined customs procedures, which correspond to significant cost savings since the local administration is complex, unpredictable, and burdensome. A fully exporting enterprise in fact may sell up to 30 percent of its turnover in the domestic market. Anecdotal evidence indicates that few enterprises choose this option, however, since the fraction of the production sold on the domestic market is exempt from the offshore benefits. This implies that the fraction sold on the domestic market is not only taxed under the general tax regime but also subject to standard local administrative procedures. Not fully exporting enterprises can export their production. Imported intermediate goods required for these exports are exempt from import taxes, if the corresponding exports take place within a three-month period. This results in costly administrative procedures, such as obtaining specific certificates of corresponding imported and exported goods from the custom officers confirming that they have actually seen the goods. As a result, domestic companies that start to export tend to divide themselves into two distinct entities: one dedicated to the onshore market and the other under the exporting offshore regime.

The onshore-offshore model initially contributed to Tunisia's development during the 1970s and 1980s. The onshore-offshore duality initially contributed to the economic transformation of Tunisia because the offshore sector attracted foreign investors and earned much-needed foreign exchange, while the heavily protected onshore sector facilitated the development of a local industrial base. In fact, the offshore regime has been an undeniable success in terms of attracting foreign investors, fostering new firms creation, and jobs creation, compared to the rest of the economy (see Chapter One). Approximately 45 percent of firms and 75 percent of jobs in industry are in the offshore sector. It is also worth noting that 40 percent of offshore firms are owned by Tunisian nationals, and therefore the direct benefits of the offshore do not benefit only the foreigners.

However, these outcomes have come at a very high cost—and, more important, the weak economic performance over the past decade has shown that the dual economy model is no longer adequate to support the development of the Tunisian economy. A literature review of (more than 70) studies on Tunisia's Investment Incentives Code reveals that most studies considered the IIC as outdated and in need of reform (IFC and Ernst & Young 2012). In fact, as discussed below, most studies consider that the dual system has become detrimental to Tunisia's development in several ways. As discussed in previous chapters, the offshore sector has remained trapped in low value added activities and cronies have captured the rents arising from the access restrictions in the onshore sector. Further, as discussed in this chapter, the onshore sector entails high fiscal costs (of incentives), which have given low returns in terms of attracting investment and jobs creation. Further, the IIC does not send a positive and clear message to the local and international business community; it is extremely complex and lacks transparency, which discourages potential investors, and it does not discuss the legal guarantees provided to investors. We briefly discuss its main shortcomings below.

Duality and Distortions: Failure to Support a Rapid and Inclusive Economic Growth

The Investment Incentives Code has introduced distortions and duality into the Tunisian economy. Chapter One provided evidence of significant duality between the onshore and offshore sectors, manifested in differences in the firm-size distribution, average productivity, and export performance. These differences reflect the fact that the separation between onshore and offshore has hampered smooth transfer of technology and know-how (that is, productivity spillovers) in the economy, resulting in a lower productivity in the onshore sector. Several factors contribute to this segmentation. The unequal tax treatment between exporters and others firms introduced distortions in the economy, preventing a level playing field for all investors. In addition the heavy regulatory burden prevented offshore firms from working with the onshore sector, such that the onshore sector has remained isolated from the rest of the economy, creating a domestic "enclave" rather than an engine that benefits the entire economy. Box 4.2 provides details of the bureaucratic barriers to interaction between the two regimes.

Box 4.2: Barriers to Trade between Onshore and Offshore Firms

Very little trade takes place between the onshore and offshore firms, despite the fact that nothing in the Investment Incentives Code explicitly prevents it. In fact, interviews with the private sector highlight constraints due to the asymmetry of taxes and to customs procedures (which do not appear in the IIC):

Asymmetry of Taxes. All offshore firms' transactions are considered as exports or imports. Hence, if an onshore firm wants to buy input from an offshore firm, it is considered an import for the onshore firm (which will pay tax on it) and as an export for the offshore firm. Conversely, if an offshore firm wants to buy its input from an onshore firm, it is considered an import for the offshore (which will not pay tax on it) and as an export for the onshore firm. This introduces a couple of distortions. First, the onshore firm will pay both import taxes and value added tax (VAT) to produce its good but will not receive any export taxes or VAT in exchange if it deals with an offshore firm. Hence, if an enterprise wants to deal both with offshore and onshore firms, it generally splits into two distinct structures (one offshore and one onshore) to avoid this problem. Second, as offshore firms purchase inputs without paying VAT, an onshore firm which would like to sell its production to an offshore firm has to ask the Ministry of Finance (Director General of the Tax Department) or an authorization to purchase its own inputs without paying VAT—and the private sector reports that this is a complex and long procedure, which can be faster for firms or CEOs having a close relationship with the Ministry of Finance. This procedure is especially difficult for smaller firms.

A possible solution would be to collect taxes and VAT when products are sold (and not when inputs are purchased). This could make it easier for onshore firms to sell their production to offshore firms. The reform of the Customs Code in 2009 created a new regime, *Régime de perfectionnement actif ou passif*, which allows onshore firms to import inputs without paying taxes or VAT—they only have to pay if they sell their production on the domestic market. Since this is fairly recent, its impact has not yet been assessed.

Customs Procedures. Offshore firms benefit from very streamlined customs procedures when they export abroad. However, procedures are different if firms “export” within Tunisia. In order to export within Tunisia, firms have to obtain an authorization from the regional Director General of the Customs and then request the approval of the central Director General of the Customs. Further, if an offshore firm located in a given region wants to deal with an onshore firm located in another region, two declarations have to be made. Moreover, the cargo has to be checked once before exiting the production area and once when it is delivered. Hence, if an offshore firm wants to sell its production in different places in Tunisia, it has to pay for separate trucks, road haulers, and so on—for each destination. Finally, although offshore firms are allowed to sell 30 percent of their production or turnover (50 percent during 2011-2012) on the domestic market, in practice the procedure to prove that this threshold has been respected is complex and thereby discourages many firms—such that only 39 percent of offshore firms actually used this possibility at all.

Source: Interviews with UTICA private sector representatives.

The best firms, notably the ones that are globally competitive, have chosen to settle in the offshore sector. These firms largely import their intermediary inputs from abroad—that is, they do not supply themselves from onshore—possibly due to a combination of the transaction costs (associated with the regulatory burden) and the low competitiveness of intermediates produced in the onshore sector. Analogously, as a result of the restrictions on the amount the offshore firms can sell in the domestic market and the fact that servicing foreign markets is cheaper or easier, offshore firms are inclined to sell their production almost exclusively abroad (box 4.2 and box 4.3). There is plenty of anecdotal evidence

about the paradox of Tunisian onshore firms often reimporting Tunisian goods that in fact were produced in Tunisia and exported abroad by offshore firms (see Box 4.3). This is an implicit measure of the high costs to the economy resulting from the excessive red tape. This unnecessary cost undermines the competitiveness of onshore firms, which are already at a disadvantage relative to offshore firms. Hence removing the onshore-offshore dichotomy is critical in order for Tunisia to realize the potential benefits of global integration and to boost productivity and economic performance.

Box 4.3: La Bonne Pratique: More Paperwork, Fewer Sales in Tunisia's Domestic Market

DIAR BEN SALEM, Nabeul-The large picture windows of the *La Pratique Electronique* headquarters have a view across Diar Ben Salem village to the Mediterranean beyond. In its grounds are four pointer dogs in a kennel, because when not at work, the company's chief executive, Walid Benamor, likes to hunt wild boar in the woods of the Cap Bon peninsula.

Although firmly grounded on Tunisian soil, *La Pratique Electronique* is an offshore company: it exports at least 70 percent of its production and imports its raw materials and components duty-free. The alarm systems and LED lighting units made here are used at car assembly plants, airports, and supermarkets, mainly in France.

The company's French 50:50 joint venture partner, SGAME, also sells to the Middle Eastern oil and gas sector, where sites with long perimeter fences need to be kept secure. *La Pratique Electronique*'s own marketing team has identified similar clients in the southern Tunisian desert, where security is a concern. The company is growing fast, from just two employees in 2001 to 70 at present. Annual sales are 500,000 euros, and Benamor sees them doubling by 2016.

However, regulations governing the offshore sector are, he argues, illogically taking a large chunk out of the business's revenue on domestic sales. *La Pratique Electronique* is entitled to make 30 percent of its sales within Tunisia, but current regulations make any such direct sales hopelessly complicated and difficult to price competitively.

He presents as an example a small rectangular lighting unit, designed to sit on a factory's perimeter wall. It is produced here in Diar Ben Salem. Before selling it directly to a Tunisian client, he would have to collate all relevant documents relating to how *La Pratique Electronique* imported each raw material or component. The company imports all its inputs, and this lighting unit contains more than 40 different items. That would mean more than 40 separate sets of paperwork.

Over several weeks, the Tunisian customs service would check the paperwork and through complicated calculations arrive at an amount of unpaid import tariff applicable to each input, and then total it up for the duty to be levied on each unit sold within Tunisia. The lighting unit would end up being more expensive than the same product imported from Europe.

La Pratique Electronique has found a solution, however unsatisfactory. It sells the lighting units, tariff-free, to a trading company in the French port of Marseilles. The trader ships them to the client in the Tunisian south as an import from Europe that does not attract heavy tariffs. The trading company's margin thus takes a substantial slice out of *La Pratique Electronique*'s earnings from the sale. Benamor calculates annual lost revenue to his company at 100,000 euros, equivalent to one fifth of its total annual sales.

These regulations inhibit domestic sales by other offshore companies in Tunisia, not just in the electronics sector but also in clothing and footwear, he says, adding, "Sooner or later these regulations will have to be amended if offshore companies are to meet growing domestic demand."

Source : Interview with La Pratique Electronique, April 2014.

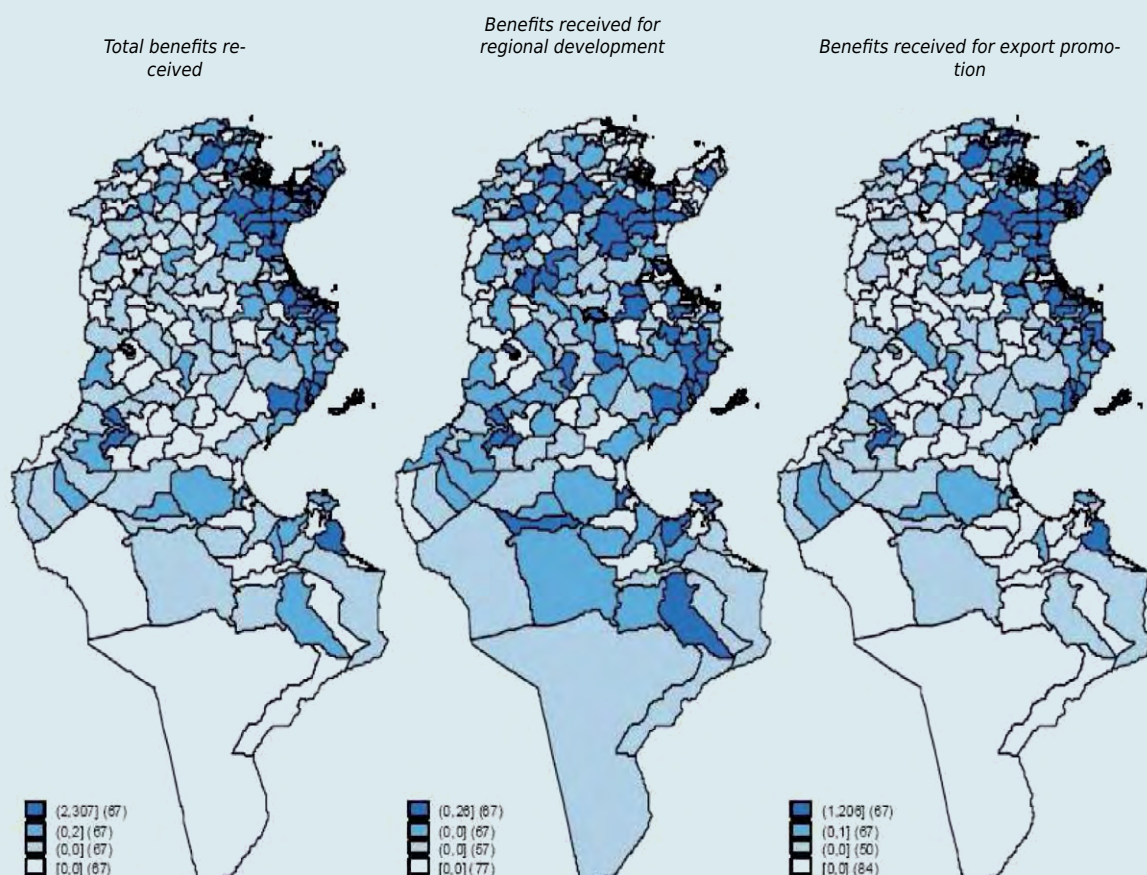
The dual economy model has kept most of Tunisian domestic economy (the onshore sector) highly protected and closed to foreign investors, with resulting loss of growth and jobs creation. Studies of the Tunisian investment climate and regulatory framework highlight that, although most comparable countries continue to protect their borders and regulate foreign investment, the level of protection and regulation in Tunisia remains significantly higher. As discussed in Chapter Two, market access regulations remain tight in multiple sectors with a lot of discretionary power with unclear regulations (for instance, the mandate of the *Commission Supérieure d'Investissement (CSI)*; the complex procedure for licensing authorizations; the separate regulations for activities related to domestic commerce and transport; and so on). As mentioned in Chapter Two, there are currently 15 sectors and 20 activities for which investment is restricted subject to authorization of the relevant ministries, including tourism, transport (road, air, and sea), handcraft, telecommunications, education and vocational training, health sector, advertising, and agricultural extension services. There are also a further 49 sectors or activities for which pre-authorization is required on a case by case basis by the *Commission Supérieure d'Investissement* if a foreigner is to hold more than 49 percent of the capital. Overall, as discussed in previous chapters, the level of protection and regulation in Tunisia remains significantly higher than in other neighboring countries, stifling competition and creating room for cronyism, privileges, and extraction of rents.

This dual economy structure has introduced deep distortions in the economy and is no longer helpful in addressing the developmental challenges facing Tunisia. It reduces incentives to invest in the onshore economy and represses the demand for labor by effectively subsidizing (foreign) inputs. Further, it has prevented a strong integration between the local market and the export sectors, which is critical to spread the benefits of trade integration, notably technological know-how and related productivity growth, across the economy. Instead, as discussed in previous chapters, the IIC has resulted in an economy segmented between an onshore sector that remains closed to competition and characterized by rents, cronyism, and low productivity, and an offshore sector trapped mainly in low value added activities—with no competition and limited spillovers of know-how between the two sectors.

In addition, the generous tax regime for offshore companies has attracted mostly footloose assembly-factory investments that have generated mainly low-skill insecure jobs. As discussed in Chapter One, the inefficiency in the onshore sector also undermined the competitiveness of the offshore sector, thereby discouraging investments in higher value added activities ⁶. In fact, as also shown in Chapter One, the FDI to Tunisia has been focused mainly on energy projects (which are capital intensive) and low value added manufacturing (notably in textiles and electrical cabling). As a result, Tunisia's economy continues to perform weakly, exports have low value added content, and what jobs have been created are mainly of low quality.

Fiscal incentives have also been ineffective in dealing with regional disparities and may even have exacerbated them, as investment was attracted largely to the coastal regions. Incentives largely benefited coastal regions, notably because export promotion incentives, which account by far for the most expenditure, benefited almost entirely the coastal regions (figure 4.1). Hence, the IIC focus on exporting firms contributed to exacerbate the economic disparity between the coast, where exporting activities are naturally located, and the much less developed interior regions, contributing to social tensions. Reflecting this distribution, only 13 percent of foreign firms and 16 percent of jobs were created in the interior regions. Further the focus on giving incentives has meant that the root causes of the disparity were not treated, notably limited infrastructure and poor living conditions. As discussed in Chapter Ten, a large body of international experience shows that incentives are not an effective policy tool to reduce regional disparities—and that instead the focus needs to be on improving social and physical infrastructure.

Figure 4.1: Geographic Distribution of Incentives Granted under the Investment Incentives Code, 2008-2011 (TND million)



Source: Ministère du développement et de la coopération internationale (MDCI)

Inefficient Use of Public Resources: High Redundancy of the Incentives

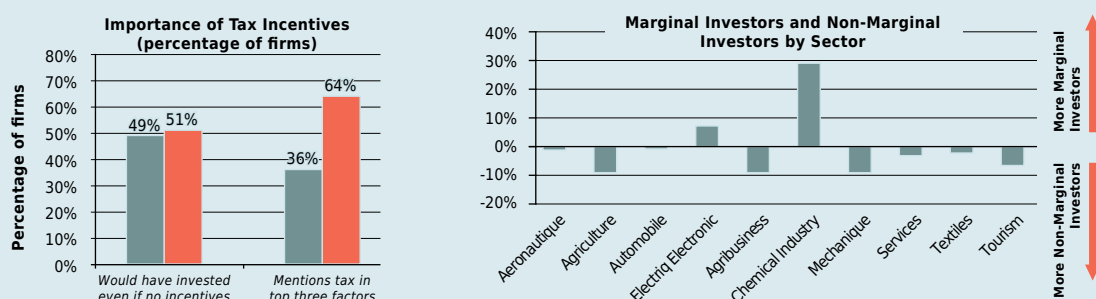
Tunisia attracts mainly low quality investment projects because it relies on fiscal incentives and cheap labor as its main selling points. The results of the Investors Motivation Survey carried out by the World Bank Group in 2012 in collaboration with the government explored the motivations of investors to come to Tunisia (annex 4.2). The results indicate that investors in Tunisia are mainly attracted by the availability of labor at low cost (27 percent), the generous tax incentives (21 percent), and the close proximity to Europe (12 percent) (figure 4.2). The fact that these are Tunisia's "strengths" in the eyes of investors explains why Tunisia has mainly attracted footloose investment into assembly and other low value added activities.

Table 4.1: Marginal and Non-Marginal Investors by Type of Firm

		Marginal Investors (Additional)	Non-Marginal Investors (Indifferent)
All firms	Fiscal incentives	21%	79%
	Financial incentives	14%	86%
	Fiscal and financial incentives	11%	89%
Offshore firms	Fiscal incentives	36%	64%
	Financial incentives	19%	81%
	Fiscal and financial incentives	19%	81%

Source: Authors' calculation using data from the 2012 Tunisia Investors Motivation Survey.

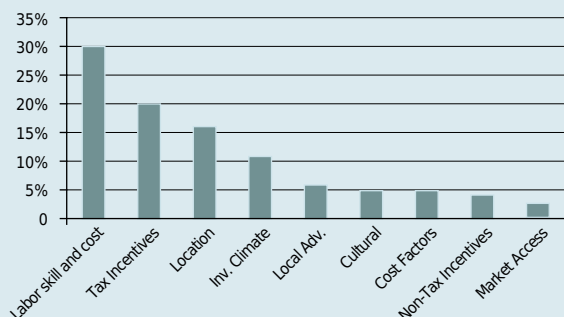
Figure 4.3: Importance of Tax Incentives in the Decision to Invest in Tunisia and Distribution of Marginal Investors by Sector



Source: Authors' calculation using data from the 2012 Tunisia Investors Motivation Survey.

Note: 'Non-marginal' investments are those investments that would have come in anyway. The chart on the right hand side is calculated as (a) - (b), where: (a) is the percentage of marginal investors (i.e., the number of marginal investors for each sector divided by total number of marginal investors); and similarly, (b) is the percentage of non-marginal investors (i.e., the number of non-marginal investors for each sector divided by total number of non-marginal investors).

Figure 4.2: Importance of Different Factors for Investors in Tunisia



Source: Authors' calculation using data from the 2012 Tunisia Investors Motivation Survey.

Nevertheless, most firms indicate that tax incentives were not a critical factor in their decision to invest in Tunisia. The Investor Motivation Survey includes various questions to evaluate the importance of tax incentives in investment decisions. When asked directly about the importance of tax incentives in their decision, as many as 49 percent of investors indicate they would have invested even in the absence of tax incentives while 51 percent indicate they would not have invested. A separate question is then used to verify the truthfulness of these answers by asking which are the three most important factors in the decision to invest. In Tunisia, the "truthful question" shows limited impact of tax on investment decisions, with only 21 percent of firms who would not have invested mentioning tax advantages as one of the three most important reasons in their investment decision (table 4.1 and figure 4.3)⁷. This finding is consistent with increasing international experience showing that investment incentives do not substitute for an attractive investment climate (box 4.4).

Box 4.4: International Evidence on the Impact of Investment Incentives

A study by the IFC (2009) in collaboration with the IMF and the OECD, on the effectiveness of tax incentives to attract investment compared to the total costs (by investors and the countries) required to establish and manage the incentives, has shown that: (a) tax incentives are not very effective as the main policy instrument to attract investment; (b) the costs of implementing these incentives are very high for the countries (and at times the investors do not even benefit from these policies); and (c) these tax incentive schemes do not ensure that the industry and investors attracted by these incentives will have desired impact on sustainable industrial development or economic activity in the long run. A key finding of this study is that the best “incentive” is to create a good climate for businesses. That said, the study does not necessarily recommend the abolition of all tax incentives. Rather it advocates: (a) the abolition of fiscal incentives such as “tax holidays”; (b) creating tax incentives in the form of tax credits on companies; and (c) the use of “Smart Incentives” or targeted tax incentives to obtain or encourage the investment. For instance, targeted tax incentives could be used to encourage: (a) the training of staff and ensure the improvement of skills in the labor market (incentives to training); (b) growth in some key sectors of the economy; and (c) the development of new sustainable industries such as renewable energy or Information and Communications Technology (ICT). Within this framework of recommending a targeted approach, the study also emphasizes the importance of transparency in the process of awarding the incentives, clarity and simplicity of legal texts and procedures to obtain these incentives, and the expiry of such incentives over time in order to ensure their effectiveness.

Source: IFC (2009)

As much as 79 percent of the fiscal costs of incentives (both benefits and loss of revenues) are wasted. The investment incentives code represents a very inefficient use of public resources, as the financial cost of incentives has a low return in terms of attracting investment. The results of the Investors Motivation Survey hence indicate that 79 percent of all firms would have invested even in the absence of incentives, and thereby the financial benefits they are receiving are redundant—that is, they are a waste of public resources. An in-depth look at the “marginal investors” (the 21 percent of firms that would not have invested in the absence of incentives) reveals that they are mainly in the electrical and electronic, automobile components, and chemical industries (figure 4.3). This suggests that in reforming the IIC Tunisia would need to carefully assess the impact of incentives on these sectors and possibly envisage tailored policies to retain those firms (and avoid a loss of employment).

High Fiscal Costs of Incentives, With Limited Benefits⁸

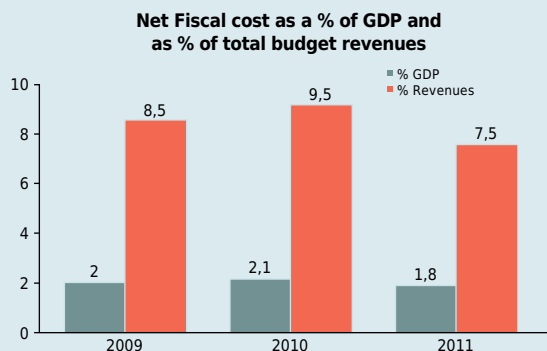
An assessment of the direct costs and benefits of the Investment Incentives Code suggests that the investment incentive scheme is highly costly and brings little benefit to Tunisia. A study by IFC and ECOPA (2012) measured the direct costs of the incentives system provided by the IIC in terms of direct costs and foregone fiscal revenues and compared them to the benefits generated in terms of job creation and investment generation.

Table 4.2: Net Total Cost of Incentives, 2009 (TND millions)

Tax Benefits	1 198	92%
Financial benefits APII	33	3%
Financial benefits APIA	54	4%
Financial benefits ONTT	11	1%
TOTAL	1 296	100%

Source: IFC and ECOPA (2012)

Figure 4.4: Net Cost of Tax Benefits, as Percent of GDP and Percent of Total Revenues



Source: IFC and ECOPA (2012)

The direct cost of the incentives is high at approximately 2.2 percent of GDP ⁹. The total cost of tax and financial incentives is estimated at 2.2 percent of GDP (or TND 1296 million; approx. US\$850 million) in 2009 or 8.5 percent of total revenues, which is a large amount (table 4.2 and figure 4.4) ¹⁰. The loss of revenues from fiscal incentives accounts for the largest share of the costs, with fiscal benefits accounting for 92 percent of total costs in 2009. Among these tax incentives, the benefits granted to exporting companies (offshore) are the most expensive, accounting for 67 percent of the total cost of tax and financial incentives (table 4.3) ¹¹. Interestingly, firms use only very few types of benefits—the first four types of incentives (out of 68 different types) account for nearly 85 percent of incentives (table 4.3). In fact, many incentives schemes are redundant as they duplicate support for similar objectives and remain unused.

A few firms receive most of the incentives; and these firms are concentrated in sectors that are not labor intensive, notably mining, energy, and banking. Over 90 percent of tax and customs incentives benefit only approximately 2,500 companies (or just over 10 percent of the total of approximately 24,000 receiving tax incentives). In terms of sectors, the mining sector is the primary beneficiary of tax incentives with 21 percent of the total, followed by the energy sector, and then a number of services sectors (notably banking is another major beneficiary) and industry (especially textiles) ¹². The fact that mining, energy, and banking—which are activities that benefit from considerable windfall profits in the economy—are among the sectors that also benefit the most from the incentives is consistent with the overall finding that the incentives have only a modest impact on the economy (and on jobs creation—see below). These results are consistent with results of the Investors Motivation Survey that the additional investment attracted by the incentives represent 21 percent of total investment, therefore highlighting that as much as 79 percent of the investments are indifferent to the incentives (that is, they would have invested anyway).

Tableau 4.3: Main Gross Tax Deductions, 2008-2011 (Annual Average)

Type of Incentive	IIC	Deductions (annual average 2008-2011 in TND million)	Percent	Cumulative Percent
Totally exporter (Corporate tax deduction)	Yes	826.8	67.0%	67.0%
Export (Deduction from the activity)	No	97.4	7.9%	74.9%
Partial exporter (Corporate tax deduction)	Yes	87.2	7.1%	82.0%
Public incentives (Firm's capital deduction)	Yes	25.9	2.1%	84.1%
Priority regional development (first 10 years) (Corporate tax deduction)	Yes	24.5	2.0%	86.1%
Revenues and profits in places funds priming	No	21.4	1.7%	87.8%
Priority Regional development (first 10 years) (Subscription)	Yes	17.0	1.4%	89.2%
Regional development (Zone 1) (Firm's capital deduction)	Yes	16.5	1.3%	90.5%
Development of agriculture or fishing (Corporate tax deduction)	Yes	15.8	1.3%	91.8%
Reinvest SICAR, or placement of capital risk funds (75 percent free)	No	11.8	1.0%	92.7%
Investment support (Firm's capital deduction)	Yes	11.7	1.0%	93.7%
Economic 'free zones' (Corporate tax deduction)	Yes	11.1	0.9%	94.6%

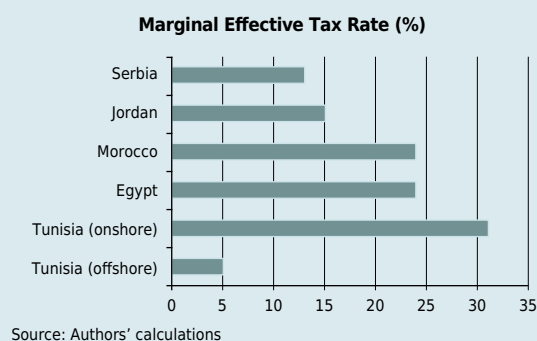
Source: IFC and ECOPA (2012)

The results in terms of jobs creation are very limited—and as a result the “cost” of each additional job created is very high. In light of the above costs, the benefits in terms of creating additional jobs¹³ appear to be very limited, accounting for only about two percent of total employment in services and industry. As a result, the cost of fiscal incentives is estimated at TND 6,362 per year per job created in companies that benefit from incentives (approximately US\$4,200 at the 2009 exchange rate). Further, if we consider only additional jobs (those which would not have been created without incentives), the cost increases to approximately TND 30,000 per year per job (approximately US\$20,000 at the 2009 exchange rate). This exceptionally high cost per job created reflects the overall low impact of the incentive system.

It is worth noting that similar results are obtained when focusing solely on the manufacturing sector. The share of marginal investors in manufacturing sectors using the “truthful question” is 28 percent (which is slightly above the share for the overall sample). The share of revenue costs for the manufacturing sector is 25 percent of the total fiscal costs, while the jobs created by the manufacturing sector account for approximately 64 percent of the total jobs. Hence, while the cost of each additional job created in manufacturing is lower than the cost for the overall sample, it remains very high at approximately TND 12,000 per year (or US\$8,000 per year) for each additional manufacturing job.

Several studies have also shown that Tunisia reaps low returns on the incentives it provides to the export sector. The government has over several decades used tax incentives to encourage the export sector. However, as discussed in Chapter One, Tunisia’s export performance has not been stellar. Further, exports growth has plateaued over the past decade, while the fiscal cost of incentives appears to have almost doubled (see above). In parallel, this has meant that the non-export sector has had to bear a higher tax burden to compensate for the small tax base. In fact, while the Marginal Effective Tax Rate (METR) for the offshore sector is around five percent, the METR for the onshore sector is approximately 31 percent¹⁴. Over time this has reduced the competitiveness of the non-export sector (figure 4.5) whose growth and employment generation potential have been stymied.

Figure 4.5: Marginal Effective Tax Rate for Investment Projects in Tunisia (Onshore and Offshore) Compared to Benchmark Countries



4.2 / Complex and Heavy Regulatory Burden for Investment and Private Sector Activity

Tunisia’s investment policy and its implementation are very complex and fragmented. The *Commission Supérieure d’Investissement* holds significant discretionary power in deciding on investment projects and was associated with notorious abuses under President Ben Ali. Further, at the operational level, a large number separate and overarching agencies deal with investment projects (APII, APIA, ONTT, FIPA, CEPEX, and so on) and a number of special funds for financing projects (FAMEX, FOPRODEX, and so on). This multitude of agencies and funding windows has brought significant complexity to the investment process in Tunisia. There is a need to streamline, restructure, and consolidate all the agencies, ideally into a one-stop shop “Investment Agency” and a “Fund of Funds” to consolidate all the various windows and programs for financial support.

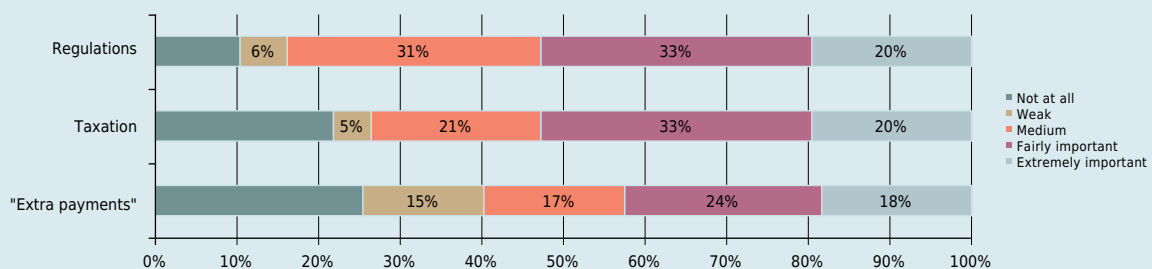
Creating investment projects in sectors and activities not subject to pre-authorization is fairly simple in Tunisia; however, when a project is subject to pre-authorization, the length of time is generally many months and could reach 1-2 years. In recent years, the establishment of a one-stop shop has facilitated significantly the

investment process for projects that do not require pre-authorization. However, the process remains complex and lengthy for projects that do require pre-authorization. The exact length will vary with the nature and importance of the project. Projects are subject to pre-authorization if (a) there are foreigners whose share of capital exceeds 49 percent for onshore projects; (b) the projects are on the list of restricted 15 sectors and 20 activities (discussed above); or (c) the project is requesting financial incentive under the *Fonds de Promotion et de Décentralisation Industrielle* (FOPRODI) and/or the scheme for regional development. Together these restrictions affect more than 60 percent of the economy. In practice, therefore, there remain substantial barriers to investment in most of the economy¹⁵. The time for applications is especially long for projects requesting access to land, which remains subject to significant restrictions¹⁶. Further, there remain significant delays for projects not covered by the investment code¹⁷. A schematic representation of the investment process in Tunisia is provided in annex 4.3.

A particularly difficult area of bureaucratic quagmire concerns acquisition of land, construction, and property markets, which hinders new investors, including in agriculture, and also constrains urban planning. While the problems related to access to land are extremely important in Tunisia, they are not discussed in this report because they have been assessed in detail in other studies. Notably, the recent "Tunisia Urbanization Review" (World Bank 2014g) recommends relaxing regulations governing land transactions and nurturing institutions for valuing land accurately and systematically. Regulations governing property registration and transactions make it difficult for poor people to own land and property. For example it costs 6.1 percent of the property's price to register the property, in addition to TND30 in government fees and TND30-300 in lawyer fees. In the OECD countries the registration cost is lower, at 4.5 percent of a property's price. As a comparison, in Georgia, a country that reduced transaction costs and red tape across the board, land registration involves a single procedure to register the title with a public registry and on average takes only two days and costs 0.1 percent of a property's price¹⁸.

Overall the regulatory burden is perceived to be hampering private sector activity in Tunisia, even more than the level of taxation or corruption. Inefficient government bureaucracy was highlighted as the most problematic factor for doing business in the Global Competitiveness Report 2011-2012. The World Bank 2012 Investors Motivation Survey explored the investors' perceptions of the barriers to investment in Tunisia. Interestingly, the private sector perceives that excessive regulatory burden is a greater barrier than taxation and corruption¹⁹. Approximately 84 percent of investors perceive the complexity of the regulatory burden to be a serious problem to firms' growth in Tunisia (figure 4.6). In most countries, the private sector tends to complain most about the level of taxation; what is remarkable in Tunisia is that the complaints against the weight of the bureaucracy are higher than those about taxation (see box 4.5).

Figure 4.6: Factors That Constitute an Obstacle to Firms' Growth in Tunisia



Source: Authors' calculations based on the World Bank Group 2012 Investors Motivation Survey in Tunisia.

Box 4.5: Bureaucracy a Hammer Blow for Tunisia's Rugby

CHARGUIA, Tunis-For clothing manufacturer Rugby, having some of the larger ministries as clients requires a lot of patience. Layers of bureaucracy before the company can get paid for a completed contract may mean a long wait that weighs heavily on cash flow—especially when times are as unsettled as they were in the three years following the 2011 revolution.

Rugby's managing director Samir Mallek recalls how in early 2013 the business teetered on the edge, and some 100 employees sat at home on half pay, after one ministry cancelled a major order for uniforms. On another order that had already been delivered, payment was delayed due to a hitch in approving the budget allocation at the ministry. Meanwhile he had to sell his own home and other assets, given as security for a bank loan.

Back in the 1930s, Rugby's founder no doubt had likewise to show patience over accounts receivable when he supplied cloth to the household of the monarch, Ahmed Bey. Mallek's father, who bought the business in 1947, focused on this secure niche market; and Rugby's entire business today consists of supplying uniforms for Tunisia's soldiers, police, customs officials, and forest wardens. A brief venture into subcontracted work for European clients' export did not survive strong competition from Romania and China.

Even at the best of times, officials at certain ministries (not the defense ministry, which is more speedy, Mallek says) may take between one and four months to decide whether goods meet specifications.

"Then, once we submit an invoice, this has to be sent over to the finance department at the ministry concerned. They transfer it to the treasury-general at the finance ministry, where it may 'sleep' a little longer," he says. The finance ministry eventually makes out a mandate to the central bank, which makes the payment. Rugby sometimes waits a year or 18 months to be paid.

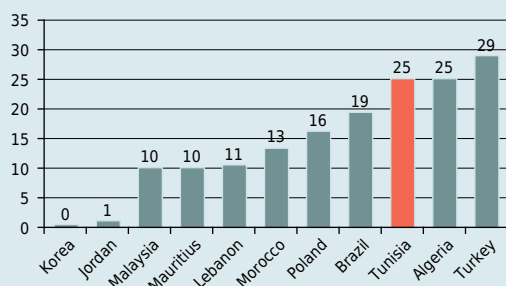
Before the revolution, annual sales peaked at 3 million dinars (about 1.35 million euros). By 2012 they had fallen to 700,000-800,000 dinars, as Rugby's workforce struck for more pay.

Rugby also resorts to factoring-style deals with its bank, which advances the cash only after deducting interest payments up front. "It's the interest payments that really hit us," Mallek says. And, if payment hasn't come through after six months, the factoring deal shows up as a non-performing loan on a company's credit history.

The tax authorities have shown flexibility, when necessary, over the re-scheduling of payments, he says. The CNSS (*Caisse Nationale de Sécurité Sociale*) is less flexible, and attempted to block one payment coming through from one of Rugby's public-sector clients—as it is entitled to under Tunisian law—after the company fell behind on its CNSS contributions. "It's a chicken-and-egg situation," Mallek says. "How can we possibly make good the contributions owing if our incoming payments get blocked?" He eventually got the funds released through an out-of-court settlement with the CNSS.

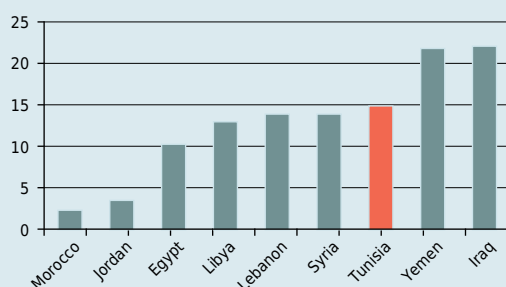
Source: Interview with Samir Mallek, Rugby's managing director, April 2014.

Figure 4.7: Percentage of Senior Management's Time Spent Dealing with Regulations



Source: World Bank (2014e), based on the World Bank's 2012 Enterprise Survey in Tunisia.

Figure 4.8: Losses Due to Investment Climate Weaknesses (in Percent of Sales)



Source: World Bank (2014e), based on the World Bank's 2012 Enterprise Survey in Tunisia.

In fact, the bureaucratic and regulatory environment imposes a heavy burden on businesses in Tunisia. The results of the World Bank 2012 Enterprise Survey highlight that managers spend close to 25 percent of their time on meeting regulatory and bureaucratic burdens, which is relatively high by international standards (figure 4.7; see annex 4.4 for details of the enterprise survey). In some instances, it is found through field interviews that firms have dedicated personnel whose sole responsibility is to ensure the firm fulfills all its administrative and bureaucratic requirements. This is especially the case for medium to large firms that can afford it. Interestingly, the time spent dealing with meeting the firm's bureaucratic requirements seems to be invariant to firms' characteristics (such as size or market orientation), except that there is significant variation by region. In the Greater Tunis area, firm managers spent close to 35 percent of their time meeting bureaucratic requirements while in other regions this figure can be as low as 7 percent. The quality of public services to firms is therefore impacted by the intensity of the demand, but possibly also the discretion with which regulations are applied may be an influencing factor.

The regulatory burden costs firms almost 13 percent of their turnover. The results of the World Bank 2012 Enterprise Survey highlight that overall the bureaucratic burden imposes a huge "tax" on firms' competitiveness. It is estimated that close to 13 percent of firm annual sales are spent dealing with regulations, which results from the cumulative cost interaction with the administration (direct and indirect costs, including compliance time). In fact, Tunisia is among the most costly environments when looking at MENA comparators, and significantly above Morocco and Jordan (figure 4.8).²⁰

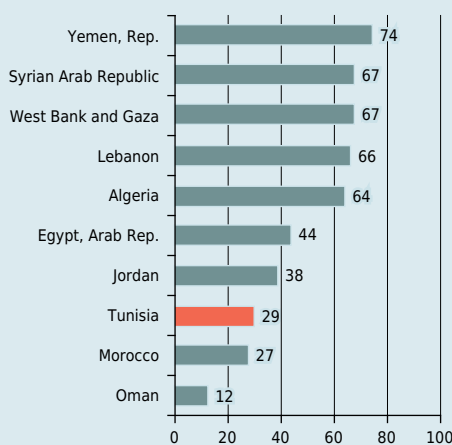
The high cost of compliance with the regulatory burden reflects in part the significant discretion in the application of the rules, which allows for corruption and cronyism. The high losses arising from weaknesses in the investment climate combined with the large share of senior management time is indicative of the need for frequent interaction to meet bureaucratic requirements. This reflects the complexity and discretion in the regulatory environment in Tunisia (and more generally in the region—see World Bank 2009a). While the regulations may appear simple on paper, in practice implementation is unpredictable, time consuming, and costly to firms. Many issues are solved through negotiations that reflect a high level of discretion, which in turn fosters cronyism and corruption (as discussed in Chapter Three).

The bureaucratic and regulatory environment is difficult for businesses in Tunisia. Close to a third of firms surveyed in the World Bank 2012 Enterprise Survey in Tunisia complain about corruption, with 29 percent of managers rating corruption as a severe or very important constraint (placing it as the sixth leading constraint identified from a list of twenty). On a regional basis, Tunisian firms tend to complain less than their peers about corruption (figure 4.9). However, the

prevalence of payments “to speed things up” in Tunisia is among the highest by international standards (figure 4.9). Nearly a quarter of all firms in the survey declared they have to provide some form of informal payment to accelerate some form of interaction with the administration (figure 4.10). These observations suggest that the prevalence of corruption is associated with the regulatory burden and points to the importance of discretion and arbitrary application of the rules. This observation resonates with the conclusions of the World Bank 2009 study “From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa” that one of the most important limitations to private sector growth and development in the MENA region is policy uncertainty, largely associated with discretion in implementing the rules where incumbents in the region have always had a prominent role (World Bank 2009a).

Figure 4.9: Perception of the Corruption Constraint among MENA Firms and Percentage of Informal Payment Requested to “Speed Things Up”

Percentage of managers who rate corruption as a major or severe constraint



Percentage of informal payment request to “speed things up”



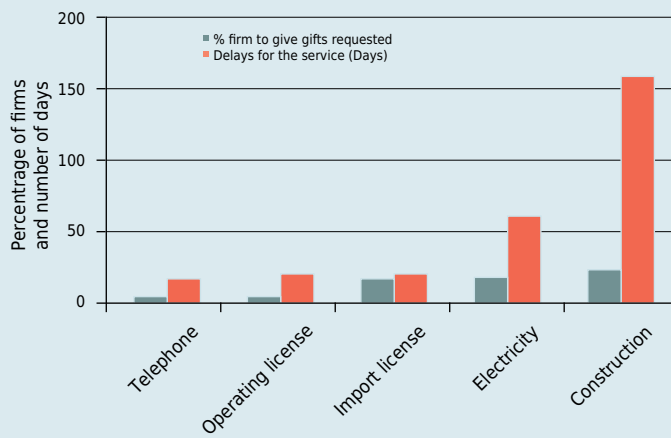
Source: World Bank (2014e), based on the World Bank’s 2012 Enterprise Survey in Tunisia.

There appears to be a lot of discretion in the application of the regulatory environment, which is conducive to petty corruption. For instance, it can take up to 60 days for an industrial electrical connection and almost six months for a construction permit (figure 4.10). Likewise many firms are subject to informal payment requests ranging from five percent for import licenses to 23 percent for construction permits. The results suggest that the frequency of informal payment requests varies by type of service, such that where long delays are frequent instances of informal payment are more important. For instance, 23 percent of firms were requested to make informal payments for building permits and 17 percent of firms were requested to make informal payments for electricity connections.

Many firms perceive that their competitors are not subject to the types of cost and regulations they themselves face-confirming the perception that regulations are not evenly applied across firms. According to the World Bank 2012 Enterprise Survey, only 27 percent of firms in Tunisia feel that the rules and regulation governing their main activity are unpredictable-yet as many

as 42 percent of firms feel that the significant discretion in the way these rules and regulations are applied negatively affects their activities (box 4.6). Interestingly, foreign-owned firms and exporters are much less concerned with the uneven application of regulations (only 30 percent and 32 percent respectively), which is consistent with the fact that these firms generally face a simplified regulatory environment but also points to discretion in the application of the rules.

Figure 4.10: Prevalence of Petty Corruption and Delays for Services

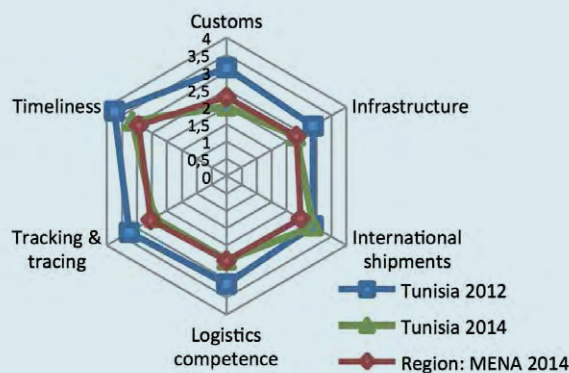


Source: World Bank (2014e), based on the World Bank's Enterprise Survey 2012

Box 4.6: Logistics is a Bottleneck in Tunisia

Tunisia has traditionally been perceived as an example of good practices in logistics in the MENA region. According to the Logistic Performance Index 2012, Tunisia was ranked 41st in the world and the best performer within the MENA region with a score of 3.17 over 5 (after United Arab Emirates and Saudi Arabia) when the Arab Republic of Egypt scored at 2.98, Morocco at 3.03, and Algeria at 2.41.ⁱ

Figure B4.6.1 Tunisia Logistic Performance Index 2012 and 2014



Source: <http://lpi.worldbank.org/>

However, it seems that global investment climate and logistics indicators may not capture reality on the ground in Tunisia. While global indicators give a positive image, at the same time many local importers in Tunisia complain about the inefficiency of the Port of Radès (main Tunisian port; see CONECT 2012), corruption in customs, and so on. They apparently had good reason: dwell time, which is a good proxy for logistics efficiency, is around three to four days in any benchmark in middle-income countries whereas in Radès, the main port of the country, dwell time is officially around six days and more than nine days according to the recent Tunisia investment climate assessment (World Bank, 2014e), which would make it comparable to Mombasa in Kenya and much worse than a port like Durban in South Africa.

How can one explain this disconnect? In the context of a dual economy and in an environment where political connections are so crucial, the results depend on who is interviewed. Hibou (2011) described how in Tunisia foreign companies (who operate almost only in the offshore sector) in general are exempted from predation practices.ⁱⁱ For domestic companies, as discussed in Chapter Three, cronyism and corruption play a significant role. Global indicators such as the Logistics Performance Index (LPI) are mainly dependent on information from global operators to have a worldwide coverage—but these global operators benefited from a fast track in Tunisia during the Ben Ali time. These observations explain why indicators such as the LPI or the Doing Business Index have been relatively good for Tunisia, as they have a sample bias in favor of non-Tunisian firms. As discussed in Chapter Three, the discretion and arbitrariness in the application of the regulations has particularly negative impact on onshore firms. In order to understand the business environment in Tunisia, therefore, it is important to hear from small and medium-size domestic (onshore) firms, as they are less likely to be protected politically and more likely to find it difficult to navigate the complex Tunisian bureaucracy.

Source: Raballand, Gael (2013), Global Indicators vs. Some Realities on the Ground. Blog on Future Development, October 16, 2013, World Bank, available on: <http://blogs.worldbank.org/futuredevelopment/global-indicators-vs-some-realities-ground>

Notes:

ⁱ For more details on the LPI, see:

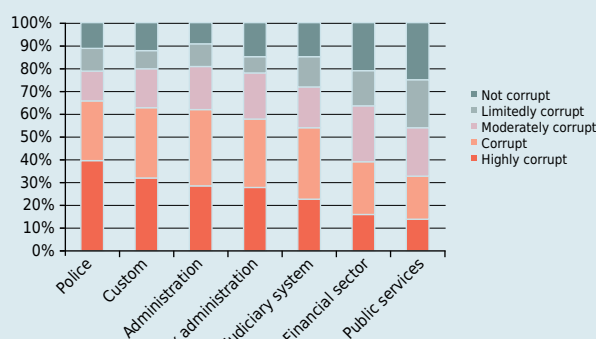
<http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTTRANSPORT/EXTTLF/0,,contentMDK:21514122~menuPK:3875957~-pagePK:210058~piPK:210062~theSitePK:515434,00.html>.

ⁱⁱ Hibou (2011) explained, “once [foreign firms] have passed the entrance gate into Tunisia, they are protected from the predatory activities of greedy intermediates. Since most firms were investing in sectors, which had been considered to be high priority by the central power, they would do everything to respect the rules and even distort or violate some of these rules in favor of foreigners.”

The discretion and arbitrary enforcement of regulations contributes to stifle competition by allowing room for inefficient firms to gain unfair advantages via privileges and corruption. As discussed in Chapter Three, these practices have a cost which goes beyond the corruption itself because they prevent the success of the best-performing firms and thereby lower the performance of the entire economy.

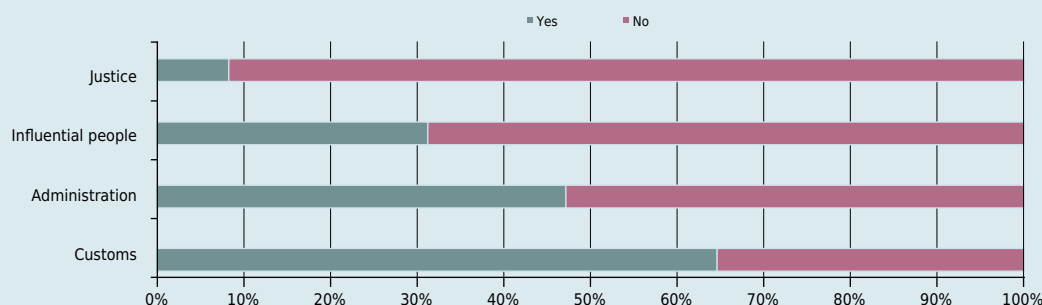
The perception of investors is that customs and the tax administration are the main institutions affected by corruption. The majority of the firms in the ITCEQ Investment Climate Survey 2012 perceive the public administrations as corrupt (figure 4.11). The results suggest the problem is most acute when dealing with the customs and tax administrations, likely a consequence of the proliferation of various fiscal regimes, which has increased the scope for discretion by administration officials. Similar results are reported from the 2012 Investors Motivation Survey—more than one-half of investors report having to pay “extras” to the customs and/or to the tax administration to be able to operate, with the cost amounting to between two and five percent of revenues (figure 4.12). The perception among investors is that political corruption and corruption in the justice system are less recurrent.

Figure 4.11: Corruption Perception among Tunisian Firms, 2010



Source: ITCEQ, Investment Climate Survey 2012

Figure 4.12: Identifying the Nature of Corruption



Source: Authors' calculations based on the World Bank Group 2012 Investors Motivation Survey in Tunisia.

As many as 49 percent of firms in the 2012 Enterprise Survey also complain about uneven application of the regulations by the tax administration. Perception of uneven application of the rules and regulations by customs is almost as high with 37 percent of firms (table 4.4). Customs duties evasion is less a problem for foreign-owned companies, while non-exporters perceive the problems to be much more severe, possibly because foreign-owned firms are mostly offshore and therefore benefit from duties exemption and streamlined procedures. Similarly, tax-related problems affect fewer foreign-owned firms. This distinction also reflects the experience with value added tax (VAT) reimbursements, which are characterized by long and cumbersome procedures. On average, VAT reimbursement occurs almost 200 days after the request has been lodged (accounting for 15 percent of total sales). It is likely that larger firms' applications for VAT reimbursement are associated with much larger sums, hence the longer delays for large firms (over 270 days) compared to small firms (66 days on average). This is counterintuitive since, for capacity reasons, large companies should be reimbursed earlier. At any rate, a ratio of 1 to 4 is hard to explain unless some discretion is exerted.

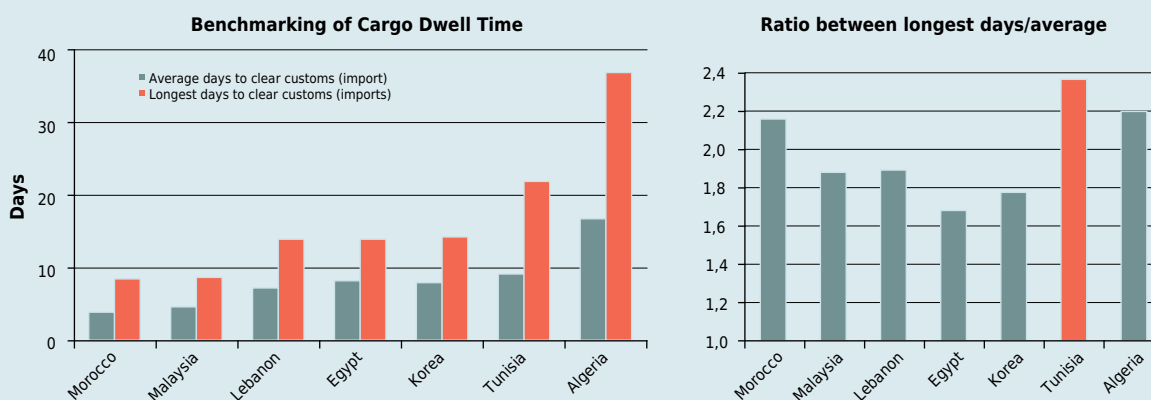
Table 4.4: Types of Competitors' Practices That Harm Your Company

	All firms	Foreign-owned	Non-exporter
Fiscal evasion	49	34	50
Customs duties evasion and trade-related regulations	37	17	35

Source: World Bank, Enterprise Survey 2012

Note: Percentage of companies stating this is a major or very severe constraint.

Another example of discretion and uneven enforcement of regulations is illustrated with the cargo dwell time, that is, the time for cargo to exit the main port of the country (figure 4.13). When compared to countries, including in the sub-region, cargo dwell time in Tunisia is, on average, the worst after Algeria (close to 10 days), much worse than Morocco (below five days) and no better than Lebanon and Egypt. Discretion and unpredictability seems also to play a role. The ratio between the longest dwell times with the average for all the companies surveyed should be rather close to one since most of the time importers have rather similar cargo to import. However, once again this ratio is the worst for Tunisia (figure 4.13). This means that it is possible for an importer to face a much longer dwell time than the average—and, while this could capture many factors, in general it is a proxy for some bargaining processes to reduce fees, bribes, and duties. It is important to note that the existence of discretion often hides a gap between de jure regulations and de facto performance in the business environment, which is not easily picked up by standard indicators (box 4.6). Tunisia also performed better than the regional benchmark countries in the ranking of the Doing Business indicator—trading across border ranking ²¹. According to this ranking, Tunisia is ranked at the 40th rank far before Turkey (67th rank), Morocco (72nd rank) and Algeria (122nd rank). Hence, the legal business environment (de jure regulations), measured by the World Bank Doing Business indicators, can at best only partly explain Tunisia's lackluster performance.

Figure 4.13: Benchmarking of Cargo Dwell Time and Ratio Between Longest Wait in Days (average)

Source: World Bank, Various Enterprise Surveys

Box 4.7: Tedious Regulations Leave Bitter Taste for Tunisian Candy Makers

ARIANA, Tunis—Great globs of sesame seeds mixed with nougat drop down into passing cans bearing a picture of a gazelle. Tunisian sugar beet and Sudanese sesame seeds are the main ingredients of the halwa (or Halva) candy produced at the factory of *Grand Fabrique de Confiserie Orientale* (GFCO), part of the family-owned Amen Group. The Turks left behind a taste for this traditional sweet in Libya and Algeria also, and GFCO's halwa has long had a modest presence on these two markets, the company's director, Moncef Ayoub, explains.

However the formalities associated with product testing prior to export have discouraged GFCO from developing direct exports to those markets. Instead, since the Tunisian and Libyan revolutions of 2011, indirect exports of halwa to those two markets have boomed, as "unofficial" cross-border traders—otherwise known as smugglers—have taken advantage of more lax border controls.

Just securing the right documentation for an official export can take two weeks and prove a considerable drain on company time, Mr Ayoub says. "First you produce the product, you put it into storage. You make an appointment for a trade ministry official to come and check it.

"Then the officials take samples," he continues. "They go and deposit those at the central laboratory for analysis. For some of these tests you have to wait a week or more for the results. Then we would have to go back to the trade ministry to apply for a certificate based on the tests," which would involve another wait.

The biological and chemicals analyses are required under a Tunisian-Libyan trade accord signed in the closing years of the Qaddafi regime. Ayoub has heard that on the Libyan side officials are not for now circumspect in enforcing the terms of the accord. GFCO's halwa has never been found to be contaminated, he says. If the halwa were being exported to Europe, any testing would be done on the product by the authorities of those countries, when the product was already on the market.

He criticizes a bureaucratic mentality that "thinks [its] role is to impose penalties, make demands, ask for papers, tell you to come back tomorrow." This attitude has declined a little bit, "but not enough," in recent years, he says.

Onerous bureaucratic procedures are a common complaint among Tunisian companies. A 'Doing Business' survey found that a Tunisian business needs to complete 19 different procedures, taking an average of 94 days to get a construction permit. Four procedures and 65 days are required to get an electricity hook-up.

GFCO sells its halwa in due form as a domestic sale, with 18 percent value added tax, to wholesalers in the south and west. How the wholesaler then makes the trade across the border is not clear, Ayoub says, adding. "We know it's not free, though."

Algeria and Libya absorb around 25 percent of GFCO's halwa, he estimates, up almost a third from 2010. Around 70 percent of this passes through the hands of "unofficial" cross-border traders, he estimates.

Source: Interview with Moncef Ayoub, GFCO director, April 2014.

Box 4.8: Pret à Importer—How Import Regulations Stifle Local Manufacturers

TUNIS—"Supposing I have a machine that breaks down because one small circuit board needs replacing," says Belhassen Gherab. "If I'm an offshore company, I call up DHL and have it delivered within 24 hours. If I'm an onshore business, on the other hand, I'll have to bring it in through customs. I may be waiting 30 days, with my entire production halted, just for that one circuit board."

He is sitting in an airy building in northern Tunis. Its central stairwell is adorned with huge posters showing models in fashion wear. The group Gherab heads, Aramys, is one of Tunisia's largest textile and clothing groups. It has both offshore and onshore manufacturing operations and has also moved into retail, with scores of shops on Tunisian high streets.

With imported clothing now taking up 80 percent, Gherab estimates, of the domestic market, Tunisia's onshore manufacturers need to become more competitive fast. Revised regulations could help.

He gives another example: "Why does a small local manufacturer have to go to the trouble of importing just five rolls of cloth that it needs when there's an offshore company nearby, a specialist importer, that has 1,000 rolls of that same fabric in stock?" Current regulations would make such a purchase prohibitively time-consuming and expensive, he says.

The ultimate absurdity is that, instead of protecting local manufacturers as they were designed to do decades ago, Tunisia's import tariffs now put at a disadvantage any Tunisian-made clothing reimported into the country.

Gherab explains: a European fashion brand may source sweaters from manufacturers in China, Morocco, Romania, Tunisia, and Turkey. It gathers the sweaters in its central warehouse in Europe, before dispatching them to its retail outlets worldwide, including one in Tunisia.

Due to various trade accords, the Moroccan-made sweater is nowadays subject to zero tariff at the Tunisian border, as is the Romanian-made sweater. But the Tunisian-made item is still subject to 30 percent tariff as it reenters the country!

"It's pointless trying to understand the logic of it. There is no logic," says Gherab.

After the 2011 revolution, he was elected to head a National Textile Federation that will be lobbying for regulations to be brought up to date. The surge in contraband imports seen in the closing years of the Ben Ali regime has been difficult to roll back.

But a start would be for official reference prices used in calculating tariffs on items of clothing to be revised upwards, Gherab says. He believes reference prices were kept artificially low "by a mafia-like system" that was oblivious to the interests of local manufacturers.

The regulatory framework is based on the protectionist needs of the 1970s, he adds. "The offshore-onshore model shouldn't be jettisoned, but we need to go back to the drawing-board and completely redraft it. The offshore idea has worked, but regulations for onshore manufacturers just don't meet our current needs."

Source: Interview with Belhassen Gherab, Aramys textiles, April 2014.

Uneven enforcement of regulations seems also prevalent between regions, to the disadvantage of lagging regions. For instance, in Tunis, more than 66 percent of the surveyed companies feel that regulations are enforced fairly while this ratio is around 40 percent in the less developed provinces of Jendouba, Beja, Kef, Siliana, Sidi Bouzid, Kasserine, and Kairouan. While additional research is required, it would appear that the unpredictability of the enforcement of regulations is higher in remote regions. Hence, not only do investors in the interior regions face weaker infrastructure and fewer services but they are also at a disadvantage as a result of the discretion in the application of the large burden of red tape.

4.3 / Reforms Agenda to Improve the Investment Environment

The Reform of the Investment Incentives Code

In mid-2012 the government announced its intention to revise the Investment Incentives Code ²². The new Code should set the scene for an enabling environment that drives economic growth and addresses the shortcomings identified in the past. As discussed in this chapter, the onshore-offshore dualism, while useful in the initial stages of Tunisia's development, has now become a barrier to faster economic development (see box 4.8). In fact, as will be discussed in Chapter Seven and Chapter Eight, the performance of several high potential sectors has been suppressed by the heavy regulation and barriers in the onshore sector—and in turn this has also suffocated the growth of the offshore firms themselves.

The characteristics of the offshore regime which makes it easy for firms to grow should be generalized to the entire economy. As discussed in Chapter One, it is important not to lose sight of the fact that offshore firms on average have a much better performance in terms of jobs creation, productivity, and exports than the firms in the protected onshore sector. Although the performance of the offshore sector has remained stunted, compared to the rest of the economy the offshore sector has been an engine of job creation and exports growth. This observation highlights the virtues of an open and competitive economic environment. The reform of the Investment Incentives Code, therefore, should aim to capitalize and extend to the entire economy the positive factors which have enabled offshore firms to perform better, notably easy market contestability and a level playing field, with substantially reduced regulation, low taxation and tariffs, and openness to foreign investment, while redressing the distortions it has created by segmenting the economy and favoring low value added activities and low quality jobs.

The new Investment Code also needs to address Tunisia's specific development challenges, notably by (a) fostering development in lagging regions, (b) promoting investments into higher value added activities, and (c) facilitating employment of graduates ²³. Based on the above discussion, it is suggested that the new Code should address four main aspects: (i) increase market access, (ii) simplify and reduce fiscal and financial incentives to investors, (iii) consolidate investor guarantees, and (iv) streamline the institutional framework governing investment. The key elements are discussed below (see details in annex 4.5):

i. Improve market access and allow investment freely. The Code should affirm the principle of freedom of investment and removing entry barriers for both local and international investors. It should remove barriers to investment into almost all sectors, including to foreigners, to foster competition, innovation, and quality enhancement. There is a need to reduce the number of activities requiring pre-authorizations for local and international investors (currently 15 sectors and 20 activities) to not more than a few activities of strategic importance related to arms fabrication, alcohol, and tobacco ²⁴. To simplify access, the Code should move from authorization

to declaration when possible, clearly stating the role of the state and limiting its discretionary powers (including the role of the *Commission Supérieure d'Investissement*). Additional restrictions pertain to foreigners only. Yet no more than a few activities ought to be restricted to foreigners, since it makes no sense to prevent investment and local job creation ²⁵. It is also recommended to review and reduce the current list of 49 restricted sectors to ensure that all activities with economic spillover effects are open to all investors (notably transport, telecommunications, education, advertising, legal, and audit services). Activities that can be reasonably restricted to foreign investors are those with limited spillover effects or with cultural and heritage elements (museums, libraries, theatre, and so on). In the case of Tunisia, notably services (such as banking and insurance, transport, telecommunications, tourism-related activities, and so on) should be opened to all private investors ²⁶. A number of multinational companies would like to invest in the country but have trouble identifying the right partner, for example in cosmetics. Hence the policy should be to authorize a foreign investor to hold a majority of the shares, even if limits on equity are maintained. In this context, it is also important to reduce the scope of application of Decree 14/1961, which reduces market access significantly for service—and commerce-related activities, limiting the ability of the Investment Code to affect large segments of the economy critical for Tunisia's economic development.

To facilitate investment projects the Investment Code should allow the recruitment of foreigners by multinationals, notably for managerial roles. International experience shows that the best results in terms of attracting investment and generating local jobs arise by imposing no limits to the hiring of foreigners. The limits on employment of foreigners do not result in greater number of jobs for Tunisians—rather they discourage foreign investment and reduce the number of jobs available to Tunisians. Skills required for performing certain tasks or providing certain types of services have become increasingly specialized. Temporary movement of key personnel should be allowed at critical stages of a firm's life—it could be accompanied by obligations of training local staff if the objective of the government is to build local capacities. An intermediate solution could be, for instance, to ease restrictions on hiring of foreign workers to allow up to 30 percent of total staff (to be reduced to 10 percent over five years) ²⁷.

Restrictions on access to land for foreigners unnecessarily discourage investors, with no benefit in terms of sovereignty for Tunisia. In several countries, land ownership is restricted to investors as it is considered a matter of national sovereignty, and in some countries the state can be the only owner of the land. In order not to discourage foreign investors, it is suggested that at the very least Tunisia should provide foreign investors with land leases of 50 years, renewable for a further 50 without cumbersome procedures ²⁸.

ii. Simplify and reduce fiscal and financial incentives to investors. It is important to drastically reduce and simplify the provision of financial incentives to arrive at a simple and transparent framework for investors, and avoid the bureaucratic quagmire of the past. The new tax regime should be simple and transparent with no discretionary power in the hands of government authorities. Moreover, it should address the problem of dichotomy between onshore and offshore regimes, creating a level playing field that can boost investment and foster good quality jobs creation and facilitate the integration of the Tunisian economy. Addressing the dichotomy in corporate tax rates is discussed separately below. All incentives could be eliminated with the exception of incentives that create positive externalities such as specific incentives to encourage R&D, and the hiring of qualified staff ²⁹. In order to avoid regulatory capture, incentives could be maintained at minimal levels for so-called high value added goods but apply across the board in offshore and onshore locations, and be automatically approved so that no regulatory capture is possible. While political expediency may demand the inclusion of regional incentives, in actual

fact the experience of using fiscal instruments to influence regional development has proved to be ineffective in the past because it does not treat the root cause of the problem (limited infrastructure and poor living conditions). At a maximum two main regions should be envisaged: developed regions and underdeveloped regions, providing a simple flat tax advantage to firms that set up in less developed regions. Similarly, while this is not recommended, the Investment Code could also envisage temporary and specific incentives to focus on strategic sectors (box 4.9) ³⁰.

iii. Consolidate and reinforce investor guarantees. The core investors' rights and guarantees, which are currently distributed in the various bilateral and multilateral agreements, should be consolidated and affirmed in the new Investment Code and apply to all investors. A major bottleneck in the enforcement of guarantees entails the procedures for capital and dividend repatriation that are complex and subject to discretion by the Central Bank administration. The difficulty in the repatriation of capital and dividend is one of the most recurrent complaints made by offshore investors in Tunisia. There is a need for the Central Bank of Tunisia to simplify the procedures of capital and dividend repatriation and make them as clear and automatic as possible (by reviewing Decree 77-608)

iv. Streamline the Institutional Framework. The Code should consolidate and simplify the institutional framework governing investment policy and its execution in the country. It should abolish the *Commission Supérieure d'Investissement*, which was associated with notorious abuses under President Ben Ali, and set up a new high-level institutional framework to govern investment decisions. A high-level committee, chaired by the government, with public and private sector participation, should be established to discuss policies that facilitate investment activities. At an operational level, the Code should streamline, restructure, and consolidate all the agencies and special funds for financing into a single *Instance Nationale d'Investissement*, responsible for both investor promotion functions and regulatory functions. The new institutional framework for investment should aim to improve the investor's experience, streamlining the different functions (regulation, policy-setting, promotion, incentive provision, and so on) and mapping them to institutions that have a clear mandate and governance structure.

Box 4.9: Lessons from Countries That Have Climbed "The Value Added Ladder": The Case of Malaysia

The experience of Asian countries in adapting their investment incentive policies can be of relevance to Tunisia. Malaysia, the Republic of Korea, Singapore, and Taiwan have all made clear changes in their incentive systems when they decided to change their growth models. Malaysia is probably the most relevant example for Tunisia as its income per capita (US\$6000 in 2010) is the closest to the level of Tunisia.

In 1991, Malaysia eliminated regional incentives and export subsidies and introduced strong incentives to encourage high-technology projects and strategic projects as well as incentives aimed at strengthening research and development and industrial training. The second Industrial Master Plan completed the system by introducing the promotion of technological parks, integration and unification of the services and manufacturing sectors in the code, and removing restrictions on foreign capital (foreign investors can now hold 100% of capital).

The incentives introduced to promote increased sophistication in production are:

The status of "strategic knowledge-based" which opens eligibility:

- A tax deduction of 60 percent to 100 percent on "knowledge-based" capital expenditures over five years made in any sector;
- A status of "pioneer" with a tax exemption for five years;

Specific incentives to strengthen research and marketing

- A company providing R & D services to third companies (domestic or foreign) and whose income is at least 70 percent of R & D is eligible for:
 - A status of "pioneer" with a tax exemption for five years;
 - A tax deduction of 100 percent of capital expenditure qualified for 10 years;
- To encourage commercialization of the research output of public institutions:
 - A company that invests in a subsidiary engaged in the commercialization of the research output is eligible for a tax deduction equal to the amount invested in that subsidiary;
 - A subsidiary engaged in the commercialization of the research output is eligible for "pioneer" status with a corporate income tax exemption of 100 percent for 10 years.
- The above incentives are subject to the following conditions:
 - At least 70 percent of the parent company and the subsidiary belong to Malaysians;
 - The parent must hold at least 70 percent stake in the subsidiary company (which markets the results of the research);
 - The commercialization of research must be carried out within one year from the date of approval of the incentives.

Specific incentives to promote ICT

- Eligibility for a tax deduction "accelerated" on expenditures for the acquisition of computers and ICT equipment, including software (20 percent in the first year and 40 percent thereafter);
- Exemption from corporate income tax for 50 percent of the increase in exports of ICT value.

Although Malaysia is still far behind Japan, Korea, and Singapore in terms of effort and investment in innovation, it is known to be one of the countries that have experienced the most dramatic structural changes in the world over the past 25 years. For example, the Malaysian electronics industry has become one of the world's largest exporters providing semiconductors, electrical equipment, and appliances. Similarly, the Malaysian palm oil industry has become a world leader in oil and grease after more than 30 years exporting unprocessed and not packaged products.

The Reform of the (Corporate) Tax System

The Tunisian tax system continues to exhibit major shortcomings, thereby adversely impacting the performance of the economy. The overall burden of corporate taxes after adjusting for necessary exemptions (also referred to as Total Tax Rate or TTR) in Tunisia is estimated to be as high as 62.9 percent in the World Bank Doing Business 2012. Tunisia ranks at 158 out of the 183 countries, indicating that its TTR is extraordinarily high by international standards. Similarly, the corporate tax system is characterized by several exemptions and incentives, eroding the tax base and generating many distortions. Since a distorted tax system has the potential to generate significant loss of economic efficiency, it is important for Tunisia to undertake comprehensive

tax reform as an integral part of its review of the Investment Code. Most notably, the burden of a high corporate tax rate is unevenly distributed across companies-and as discussed above it is paramount to gradually remove this onshore-offshore dichotomy by equalizing the tax rates paid by onshore and offshore regimes.

The current system implicitly represses the demand for labor by raising the cost of labor relative to other inputs. The burden of personal income tax (PIT) along with payroll taxes is relatively high, thereby undermining the competitiveness of Tunisian labor. Further, material inputs imported from abroad are not taxed if used to produce exports, while labor is taxed. This represses the demand for labor ³¹. It is feasible to increase the demand for labor without reducing investment and output by redressing this distortion in the relative cost of labor, which would entail reducing labor taxes and social security contributions and reducing implicit subsidies on material inputs such as fuel. Because most labor is provided by Tunisians, this could have significant multiplier effects on the domestic economy as increased labor demand would raise domestic demand.

A reduction in corporate taxes can also be expected to boost investment. The decision to invest is determined by the net present value of equity investment (NPV). The adverse impact of a high fiscal deficit on NPV flows from two sources: a higher discount rate and a reduced net benefit due to higher interest payout. The discount rate for determining the NPV of equity is dependent on the Marginal Effective Tax Rate (METR) on equity ³², post-tax return on debt, and risk premium for equity investment. It increases with increase in the METR on equity and post-tax return on debt (that is, interest net of tax). Similarly, METR increases with increase in the corporate tax rate. However, any reduction in corporate tax rate will improve Net Present Value (NPV) and Internal Rate of Return (IRR) of equity investment thereby triggering private investment. Further, under the existing tax law in Tunisia, interest is deductible in determining profit while dividend payout is not. As a result, the METR on equity financing is relatively higher than the METR on debt, and there is an inherent bias against equity. A reduction in corporate tax rate will reduce this bias. In the last couple of years, corporate tax rates have registered a general decline; the corporate tax rate in most countries has gravitated to under 25 percent. The corporate tax rate in some East European Countries is below 20 percent. Tunisia must move to a competitive corporate rate to become a favorable investment destination.

A convergence to a single corporate tax rate of approximately 15-20 percent would ensure that Tunisia remains competitive while reducing distortions and removing the duality. Based on tax revenue simulations carried out in 2013, it is possible to eliminate the dualistic economic structure and adopt a single corporate tax rate for both onshore and offshore regimes, which could be set around 15 to 20 percent, to which the two sectors would converge over a period of two years. In fact, the revenue simulations indicate that the proposed corporate tax rate reform could be revenue neutral on an onshore-offshore single corporate tax rate as low as 15 percent. It may, however, be appropriate to converge to a rate of 20 percent initially, as this would allow in parallel the reduction of social security contributions (as discussed in Chapter Five), thereby incentivizing employment creation. This reform of the corporate tax system would reduce the existing distortions, significantly improve NPV and IRR, eliminate or reduce the bias against equity, and stimulate the demand for labor, which in turn would have significant multiplier effects on the economy as a whole. For instance, in 2014 the onshore to 25 percent and offshore to 10 percent and in 2015 onshore and offshore converge to 20 percent (or less) ³³. This rate would imply a METR of 21 percent for both the onshore and offshore sectors such that the entire Tunisian economy would remain more competitive than regional peers (see figure 4.5 above) ³⁴. The single corporate tax rate could be revised further in three to five years, once the initial effects of the reform become clear. Existing incentives already granted should be grandfathered (that

is, no retroactive removal of incentives), such that in practice very few of the existing offshore exporters will start paying taxes in the near future ³⁵. Moving gradually toward simplification and unification of regulations and taxes across the offshore and onshore sectors is in line with best practice and has been followed by a number of countries, including most recently China, which eliminated tax holidays for foreign investors to level the playing field. A detailed note on the proposed corporate tax reform in Tunisia is presented in annex 4.6.

While the elements above could constitute a core part of a tax reform, it is important to regard and reform the tax system in its entirety. In this report we only provide a partial view of the required reforms, focusing on the Investment Code. A comprehensive assessment of the tax system has been prepared by the IMF in 2012 (IMF 2012). There are significant aspects of the Personal Income Tax and VAT which are also in need of urgent reform. Most notably, the *Regime Forfettaire*, which is supposed to provide a small flat tax for microfirms, appears to be severely abused with 98 percent of tax payers hiding behind this flat rate scheme (for individuals with turnover below TND100,000). The reform of the *Regime Forfettaire* to reduce the room for its abuse would increase tax compliance and reduce the regulatory bias towards small-scale production. Also, the tax system uses extensive withholding to collect taxes. This has resulted in huge (and increasing) liabilities for the government that now amount close to the entire corporate tax collection in a year. While the government has sufficient fiscal reserves to repay these “debts,” in practice these withheld taxes are not refunded to taxpayers but carried forward. The large amount of liabilities is increasingly an (unnecessary) constraint to refinancing of firms’ activities.

The Simplification of Regulatory Procedures

It should be emphasized that the convergence of corporate tax rates will not provide the necessary impact in boosting investment and jobs creation unless accompanied by significant regulatory simplification to foster integration between onshore and offshore sectors. Investor surveys show that investors worry more about dealing with the administration than about paying taxes. The onshore regime is currently dealing with complex procedures and is burdened by the weight of paperwork and discretion in the application of the regulation (leading at times to corruption), including taxation and customs, but also related to other licenses, permits, and formalities. Therefore, as discussed below, it is essential to radically simplify the regulatory environment in Tunisia.

A mammoth effort to further simplify lower-level licenses and permits at sector level will be required to effectively remove barriers to entry in Tunisia. For over a decade, Tunisia has implemented a significant number of reforms to simplify administrative burdens, with limited results ³⁶. The process by which such reforms were designed also limited their impact and credibility in the eyes of investors and citizens: weak participation by users, lack of a systemic and coordinated approach, as well as insufficient communication and transparency in measuring outcomes and the quality of service. Moreover, attention was often focused on simplifying procedures without systematically questioning the social objective behind existing regulations. As a result, the regulatory framework continues to suffer from the unequal and discretionary application of rules, cronyism and privilege both in the economic and administrative spheres. In the wake of the revolution, reducing discretion, cronyism, and arbitrariness in the administrative and regulatory environment is a priority; and expectations are especially high.

Simplification of the regulation is a critical component of the overall investment framework reform. While the problems of discretion and arbitrariness in the enforcement of regulations will require deeper and longer-term institutional reforms, simplifying regulations to reduce

opportunities for discretion will substantially help address this problem³⁷. In 2012 the government launched a comprehensive and participatory regulatory simplification reform (the “guillotine”) in nine ministries that have large interface with the private sector. The reform is inspired by similar experiences in the OECD (Mexico, the Netherlands, or Sweden) and in countries that have experienced substantial economic or political transitions (Croatia, the Czech Republic, the Republic of Korea, or Ukraine). The goal is to streamline procedures, increase transparency, and reduce the scope for arbitrary and discretionary behavior in the areas related to private investment³⁸.

4.4 / Conclusions

The onshore-offshore model initially contributed to Tunisia’s development in the 1970s and 1980s, but the weak economic performance over the past decade has shown that the dual economy model is no longer adequate to support the development of the Tunisian economy. The offshore sector attracted foreign investors and earned much-needed foreign exchange, while the heavily protected onshore sector facilitated the development of a local industrial base. The offshore regime successfully attracted foreign investors, fostering new firms entry and jobs creation, compared to the rest of the economy (see Chapter One)—and the relatively superior performance of the offshore sector proves Tunisia has the potential to catch up with developed countries and to grow quickly—provided incentives are aligned. As shown in this chapter however (and as also supported by a literature review of more than 70 studies on Tunisia’s Investment Incentives Code; IFC and Ernst & Young, 2012), besides having very high financial costs, the dual system has also introduced a series of profound distortions that have increasingly become detrimental to Tunisia’s development in several ways.

This chapter has explained how the Investment Code has segmented the economy between the onshore and offshore sectors, limiting the interaction between firms and thereby restricting competition. The dual corporate tax regime has contributed to this segmentation. Also the focus on fiscal and financial incentives has attracted mainly footloose investment in low value added activities. The analysis has highlighted several points:

- The duality introduced by the Investment Code is at the heart of many of the failed development outcomes that Tunisia is experiencing today, notably the persistent regional disparities and the focus on low value added activities and low quality jobs. Over 85 percent of projects and jobs benefiting from the incentives were created in the coastal regions, exacerbating the disparities with the interior regions. Further, it was shown that approximately 10 percent of eligible firms receive over 90 percent of the incentives. Further, these firms are concentrated in sectors that are not labor intensive, notably mining, energy, and banking.
- As a result of the segmentation between onshore and offshore, a few cronies have captured the substantial rents arising from market access restrictions to the onshore sectors, while firms in the offshore sector have remained trapped in low-value added activities. More than 60 percent of the Tunisian economy at present remains de facto closed to competition, fostering a system of cronyism and rent seeking.
- The offshore incentives entail high fiscal costs, which have given low returns in terms of attracting investment and jobs creation. The analysis of the costs and benefits of the Code has shown that the total cost of incentives is approximately 2.2 percent of GDO and that 79 percent of this amount is wasted, in that it benefits companies that would have invested even in the absence of incentives. In fact, the cost of each additional job created is extremely high for Tunisia, at approximately US\$20,000 per additional job.

- There is a need to drastically simplify the system of incentives, by removing incentives of little or no use (which however are expensive in terms of readability and administration). In fact the first four types of incentives (out of 68 different types) account for nearly 85 percent of incentives, as many incentives schemes are redundant and remain unused.
- Finally, the discussion in this chapter has highlighted that the success of the reform of the Investment Code is closely linked to at least two parallel reforms which are also at the core for the investment framework: the reforms of corporate taxation and the simplification of regulatory burden afflicting investment and private sector activities.

Revising the Investment Incentives Code to remove the onshore-offshore dichotomy and level the playing field would boost investment and jobs creation. It is important to substantially open up market access to investors, and to align the procedures to those used for sectors and activities that do not require authorization—in other words there is a need to make the onshore more like the offshore, and not vice versa. In addition, reform should remove the onshore-offshore dichotomy. Reducing the generosity of the incentives is also justified, as the incentives are very expensive compared to their limited impact—and of course there appears to be ample scope to drastically simplify the system by removing incentives of little or no use (which however are expensive in terms of readability and administration). The ongoing reform of the Investment Code has made some progress, but the fundamental problems have not been addressed. An ambitious overhaul of the Investment Code to create an open and investor friendly economic environment with a competitive tax rate and simple and transparent procedures would go a long way toward increasing investment and jobs creation in Tunisia. The proposed gradual unification and simplification of the tax code is in line with current best practice and has been followed by a number of countries, including most recently China, which eliminated tax holidays for foreign investors to level the playing field.

This chapter has also shown that the heavy regulatory and bureaucratic burden imposes a substantial cost on firms, which is partly the result of significant discretion in how policies and regulations are applied. The regulatory burden costs firms almost 13 percent of their turnover on average—and this amount is even higher for onshore firms. As also discussed in Chapter Two, the excessive regulatory environment stifles competition, by allowing inefficient firms to gain unfair advantages via privileges and corruption. And, as shown in Chapter One, these practices have a cost which goes beyond the corruption itself—they prevent the success of the best-performing firms and disincentivize the entry of new firms such that, more generally, they obstruct the process of creative destruction and thereby lower the performance of the entire economy. Discretionary application of the regulations appears to be most prevalent in the customs and the tax administration, suggesting these services are in urgent need of a significant regulatory simplification reform aiming to reduce the room for discretion. More generally a drastic simplification of the stock of regulations with a view to reducing discretion in their implementation is critical to improve the private sector environment in Tunisia. This should be pursued in parallel to the reform of the Investment Code ³⁹.

The next two chapters will explore specific policy-induced distortions in the labor market and in the financial sector, respectively. As discussed in Chapter Two and Chapter Three, the existence of widespread barriers to market contestability hampers productivity and gives rise to rent-seeking opportunities. As discussed in this chapter, Tunisia's investment policies have introduced additional distortions, which helped the development of the country in the 1970s but have now become an obstacle. The next two chapters will discuss how the policies regulating labor markets and the financial sector also undermine Tunisia's economic performance and contribute to hinder the creation of good quality jobs.

Notes

1. We do not assess the enforcement of the rule of law (for example, enforcing contracts and property rights), which has been examined by the 2013 AfDB/MCC/MDCI report on Growth Diagnostics—that report makes a compelling case that shortcomings in the legal environment constitute a real barrier to investment and growth.

2. Economic free zones (*zones franches*) are located in Zarzis and in Bizerte. Firms operating in these zones are under the same tax and foreign exchange regimes than fully exporting companies.

3. In addition, as discussed in Chapter Three, cronyism under the former regime allowed companies owned by relatives of the former regime to benefit from significant exemptions and incentives.

4. It is worth pointing out that these sector-specific laws often impose heavy restrictions to investment and the operations of markets in the sectors; the retail sector is a case in point as it imposes draconian restrictions on the establishment of large retailers (see also Chapter Two).

5. Corporate taxes for onshore firms are currently set at 30 percent of profits in most sectors, except in the financial sector, telecoms and oil sector with a tax rate of 35 percent, and in agriculture, fisheries, and handcraft with a rate of 10 percent.

6. As discussed in Chapter Five, the labor code has also contributed to this mismatch as it allows for fully flexible short-term contracts up to four years but introduces extreme rigidity for firing of workers under open-ended contracts, thus implicitly favoring short-term and low-skill jobs.

7. Similar results are obtained when focusing solely on the manufacturing sector. The share of investors in manufacturing sectors who said they would not have invested without incentives (marginal investors) is 52 percent (which is slightly above the share for the overall sample). Using the “truthful question” shows that 28 percent of manufacturing firms would not have invested (as they mention tax advantages as one of the three most important reasons in their Investment decision).

8. This sub-section draws on study by IFC and ECOPA (2012).

9. It is worth noting that these are only the direct costs. The overall economic costs might be higher still because of indirect costs in terms of distorting incentives.

10. No comprehensive evaluation was carried out prior to 2012, but a few studies sought to quantify the costs of incentives. The WTO (2001) estimates the fiscal costs of incentives at TND 557 million for the year 2000 (or approximately two percent of GDP). The IMF (2005 and 2012) estimates the tax expenditure on incentives at approximately 0.75 percent of GDP in 2005. Ghazouani (2011) estimates the cost of incentives at 2.9 percent of GDP.

11. These amounts are closely related to the “success” of the offshore regime. The tax benefits are widely used since they entail a simple application on the part of the investor. In fact the proportion of offshore firms that give a positive evaluation of Tunisia’s administration and tax system is much larger than the percentage of onshore firms (70 percent vs. 38 percent).

12. While the extractive/mining, energy, and financial

sectors are not covered by the Investment Incentives Code, in fact the legislation governing such sectors provides them with a very similar incentive structure.

13. That is only counting those investments that would not have been created without incentives.

14. The marginal effective tax rate is a forward-looking measure that summarizes the incentives to invest in a particular asset as provided by complicated tax laws. The marginal effective tax rate on capital income is the expected pretax rate of return minus the expected after-tax rate of return on a new marginal investment, divided by the pretax rate of return.

15. In fact, 33 percent of value added is in sectors for which prior approval is required by the CSI and a further 18 percent is open to Tunisian nationals but restricted to foreigners (only a minority control is allowed).

16. Investment is allowed only in certain areas and land ownership or lease holding by foreigners is heavily restricted. In fact the text of the Code regarding land ownership by foreigners is unclear and may affect the predictability for investors: “the ownership of land and premises by foreign investors in areas other than those mentioned above is governed by the laws in force.”

17. The *Agence de Promotion de l'Industrie et de l'Innovation* (APII) is exploring the possibility of having a one-stop shop for companies not subject to declaration.

18. For a detailed discussion of access to agricultural land, see this note prepared by the FAO: Private, Collective and State Tenure in Tunisia; available at <http://www.fao.org/docrep/w8101t/w8101t07.htm#TopOfPage>; For a discussion of access to land in urban areas see the discussion promoted by the Center for Mediterranean Integration (CMI) available at http://cmimarseille.org/FR/E-letter_16-4.php#sthash.BTpc6U1g.dpuf

19. Still, in the 2012 Investors Motivation Survey, approximately 42 percent of firms report that corruption is a very or fairly important obstacle to their growth. Tunisia ranked 77 out of 177 economies in Transparency International’s Corruption Perception Index in 2013.

20. It should be noted that over half of the costs are triggered by losses associated with theft and spoilage (a widespread phenomenon after the revolution). In the absence of this, Tunisia would be slightly lower than regional peers, in line with Egypt but still above Morocco and Jordan.

21. This ranking is based on several indicators, such as the number of days and documents both to export and import as well as the relative costs based on the surveys of several professionals in the country.

22. Indeed several of the studies and analyses discussed in this Chapter have been produced as part of the preparatory work led by Ministry of Development and International Cooperation, with technical advice by IFC.

23. Sectoral priorities are much less easy to determine, but there is increasing talk about developing strategic high potential and high-value added sectors, notably in electric, mechanical, and electronic manufacturing industry, in ICT (notably offshoring and possibly software development), and in tourism.

24. For instance, Poland opted for the freedom of investment in all sectors, with prior ministerial authorization required only for five sectors (negative list).

25. Although some neighboring countries have a system similar to Tunisia, the number of sectors with restricted ownership is much lower than in Tunisia.

26. Multiple studies have advocated the benefits that would arise to Tunisia from opening the services sectors, by removing existing constraints in terms of the need for authorizations and the limits on the share of foreign ownership, which constitute barriers to foreign investors. Sector lobbies have been successfully fighting to keep privileges and rents at the expense of greater investment across the country and faster growth and jobs creation. Another argument frequently used is that government cannot open markets because this will hinder the free trade agreement negotiation process with the EU. However, multiple studies have shown that in several of these sectors Tunisia has a strong growth potential and should have an “offensive” trade policy, and not continue to remain passive waiting for negotiations with the EU (World Bank 2008). In fact, Morocco recently opened investment in services to foreign investors (financial sector, housing, import-export, industry, handicrafts, education, transport, and film production) and has seen a rapid increase in investment in the country.

27. Offshore firms are currently allowed to have only four non-Tunisian employees as supervisors, and are obliged to have Tunisian employees in the governance bodies in many activities. While skills and know-how transfer are becoming a key factor in global competition for innovation, Tunisia’s restrictive regulations against foreigners limit the attraction of expertise. The favorable position enjoyed by Eastern European countries for technological investment is partly due to the strong mobility of labor with Western Europe, while many East Asian countries have implemented specific and selective incentives that attracted expertise and promoted know-how transfer. For instance, Singapore has built a comprehensive strategy to attract talented people to develop R&D.

28. In Morocco, while the ownership of land for agricultural use by foreigners is prohibited as it is in Tunisia, it allows 99-year leases (against 40-year leases in Tunisia).

29. In this context, in line with best international practice, it is also recommended that all the fiscal and financial incentives would be best moved out of the new Investment Code and into the *droit commune*, such that in future they can be revised in the annual budget law.

30. Strategically incentivizing onshore firms to export could increase both output and revenue. In order for onshore firms to compete in export markets, it would be desirable to enhance incentives to invest for these firms—for example by enabling cheaper access to foreign inputs. To ensure that these incentives are cost-neutral, it is important to target them to sectors and activities which are currently dominated by offshore firms—and ones in which Tunisia has a latent potential that is currently not realized—since in such sectors there would not be significant loss of net tax revenue.

31. Further, as discussed in Chapter Five, the Social Security system is increasingly loss making. Social security contributions are raised from a narrow base with high rates, and include financing of several items (for example, training funds), which should not be financed through labor taxation. There is a need to reform the system to ensure its fiscal

sustainability, while decreasing labor taxes to favor greater jobs creation.

32. The METR on equity is the aggregate of tax on corporate profits and dividend distribution tax on marginal income from equity investment, expressed as a percentage of the marginal income.

33. In cooperation with the Ministry of Finance, the World Bank Group and IMF tax experts have conducted simulations on data of more than 55,000 enterprises in Tunisia to ensure that the convergence of the offshore and onshore rates is possible and will be revenue-neutral from the first year of the reform. This requires the introduction of complementary measures, notably introduction of dividend tax at source and a larger carry-forward alternative minimum tax (MAT) on turnover. Annex 4.6 provides a detailed explanation of the proposed reform of corporate taxation.

34. Tunisia METR after the reform would be 21 percent, compared to 24 percent in Morocco and Egypt. In terms of incentives for exporters, however, Morocco would become marginally more attractive. The tax incentives for exporting firms in Morocco include full tax exemption for the first five years of operation and a reduced rate of 8.75 percent for the 20 years thereafter for companies operating in export free zones. Regular investors pay a tax rate of 30 percent. Hence at present exporters in Tunisia have more generous tax incentives than exporters in Morocco, but under the proposed regime new exporters in Tunisia would be somewhat worse off.

35. Because the incentives already granted will be grandfathered, there will be no immediate revenue gains from the elimination of incentives. However, the sharp reduction in corporate tax rates will lead to an immediate drop in tax revenue that the government cannot afford. Therefore, to neutralize the erosion of the tax base, it is necessary to introduce dividend taxes at source and an alternative minimum tax (MAT) on turnover. The rate of MAT is calibrated so as to ensure that there is no loss of revenue, even in the first year of the reform. In addition, the sharp reduction in tax rates on corporations will significantly improve the competitiveness of the Tunisian economy, and can be considered as a large step toward establishing a modern tax system, creating a climate conducive to investment, and ensuring its long-term viability. The proposed reform is primarily focused on broadening the tax base and reducing the corporate tax rate for all firms to eliminate distortions in the economy, improve tax fairness, and improve compliance. The reform should be coupled with tax on dividends and a minimum alternate tax on turnover in order to maintain revenue neutrality.

36. This includes the development of e-government initiatives, or the replacement of prior authorizations for business entry with declarative systems subject to predefined sectoral specifications.

37. Transparency and simplicity can help curb corruption—the political economy context may imply that relatively sophisticated rules, while theoretically superior, might in practice prove inferior to simpler rules which are easier to monitor and enforce (and less vulnerable to corruption).

38. A first round of reforms was started in May 2011, when the Ministry of Finance launched a systemic, participatory, regulatory reform process to simplify administrative procedures and red-tape and reduce discretion and arbitrariness in the customs and the tax authorities. Out

of 446 “formalities” identified in the tax and customs, only seven percent will remain untouched, while approximately eight percent will be eliminated, and a further 85 percent are to be significantly simplified. The same methodological approach has now been extended to an additional eight ministries that deal with private investors, bringing the total of formalities identified for simplification to over 1,500. Following this listing of procedures, in partnership with private sector the administration plans to review each of them with the objective of elimination or simplification. Each concerned agency will have to provide justification for each regulation or procedure it administers, within a timeframe monitored by the Prime Minister’s office. The same justification will then in turn be asked of the private sector. Based on a synthesis

of the two points of view, a report will be provided with recommendations for regulatory simplification.

39. An argument can be made that the removal of the offshore tax incentives should take place after the problems with the business environment have been removed. In fact, given the vested interests that seek to perpetuate the tax-free regime for offshore firms, it is recommended that the two aspects of the reform proceed hand in hand, via a gradual convergence in the tax rates between onshore and offshore sectors, which will also increase the demand for significant progress in regulatory simplification.

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Dysfunctions of the Labor Market

05

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The labor code
paradoxically contributes
to exploitation of workers
and job insecurity

||

The Tunisian labor market is characterized by deep dysfunctions, which have contributed to keep the economy in low productive activities and generate mainly low-quality, insecure jobs. Tunisia's economy needs to create more jobs—in particular there is a need for skilled jobs to employ the growing number of university graduates. The growing graduate unemployment over the past decade reflects the structural mismatch between the increasingly skilled labor force and an economy that has remained stuck in low productive activities (as discussed in Chapter One). Available jobs have been of low quality, both in terms of value added (and therefore pay) and also in terms of low job security. In fact, jobs have increasingly been informal or in fixed-term contracts, which entail no workers' protection, and have translated into an overly high level of turnover—in its worst manifestations, notably those linked to the infamous working arrangements often associated with outsourcing to Tunisia of assembly activities, this economic system has allowed the exploitation of workers—which Tunisians refer to as the phenomenon of the *sous-traitance*. The resulting large rates of unemployment and informality, as well as high mismatch and underemployment, underpin the great social discontent that has been violently expressed by Tunisia's youth.

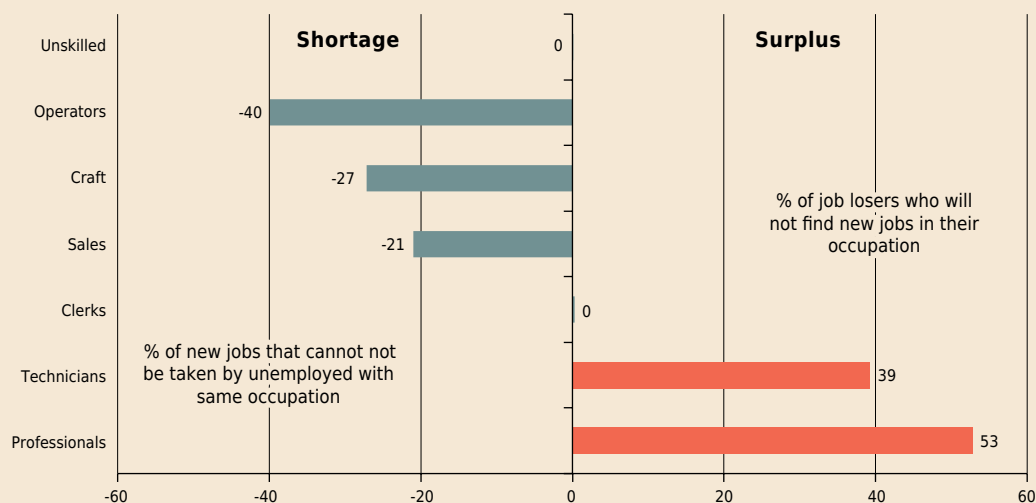
These outcomes are in part the result of the policies regulating the labor market in Tunisia. As discussed in previous chapters, the weak economic performance and insufficient and low-quality jobs creation is the result of an economic environment permeated by distortions, barriers to competition, and excessive red tape, resulting in low productivity and pervasive rent-extraction for cronies. Nevertheless, while labor market policies do not appear to be the key constraint to jobs creation in Tunisia, this chapter argues that the creation of good quality jobs is exacerbated by the policies regulating the labor market in Tunisia and the distortions introduced by the labor code, the social insurance system, and the wage negotiation mechanisms. The social insurance system in Tunisia fails to protect workers and exacerbates unemployment. Labor regulations and institutions in Tunisia promote job insecurity and the bias toward low-skill jobs. The chapter shows that the rules and institutions regulating the labor markets in Tunisia, while introduced with the best possible intentions, are in fact counterproductive, as the mix of rigidity and flexibility has hindered investment in higher value added activities and innovation, while resulting in abusive types of labor arrangements. In no small way, hence, the labor code, the social insurance system, and the wage negotiation mechanisms in Tunisia today contribute to create and perpetuate inequities, especially for youth.

This chapter discusses how to enable faster and better quality jobs creation, while ensuring better protection for the unemployed. The chapter starts by highlighting the shortcomings that characterize the Tunisian labor market in terms of insufficient and low-quality jobs creation, as well as the increasing skills mismatches and patterns of high labor mobility. It then discusses the system of social insurance, labor regulations and institutions, and the role of the public sector, highlighting the way in which these have distorted labor markets outcomes and resulted in greater, not lower, unemployment.

5.1 / A Labor Market Characterized by Low-Quality and Insecure Jobs

The Tunisian labor market is characterized by a significant amount of mismatch, notably a surplus of skilled labor and a shortage of unskilled and semi-skilled ones. To quantify skills mismatches in the economy, one can compare the new jobs created by the economy by occupation with the occupation declared by the stock of unemployed¹. The results indicate that unskilled and semi-skilled (manual and non-manual) workers in Tunisia are in shortage, while technicians and professionals are in surplus (figure 5.1)². Obviously, at present there is no shortage of unskilled and semi-skilled labor in Tunisia, and there will not be one in the near future. What the chart is meant to show, however, is that there is a skills mismatch: the occupational structure of unemployment is different from that of employment or jobs being created (that is, labor demand). This implies that there will be unemployment (structural) even if the economy creates more jobs. In particular, there still will be excess supply of highly educated workers, because currently the economy demands mostly less skilled manual labor³.

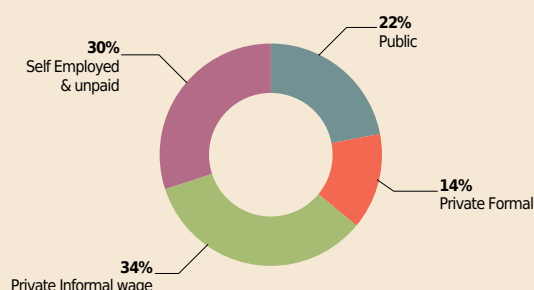
Figure 5.1: Labor Surplus and Shortages by Occupation in Tunisia, 2011



Source: Authors' calculations using the Tunisia 2011 Labor Force Survey

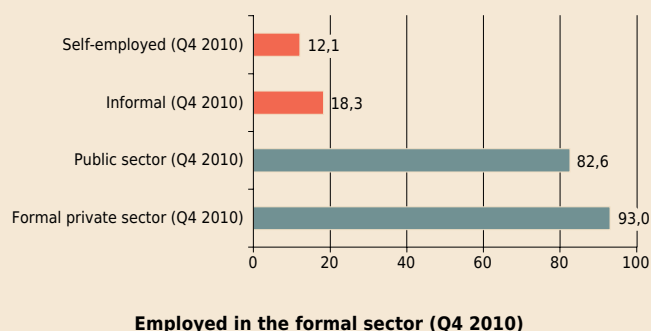
Not only there are few jobs for skilled workers but the quality of available jobs also remains low and informal employment is wide spread in Tunisia. About half of all wage earners (45 percent) work without an employment contract. Not surprisingly, informality rates are higher among younger and less educated individuals⁴. The large majority of all employed individuals (about 64 percent) are either informal wage earner or self-employed (figure 5.2). Formal employment accounts for only 36 percent of overall employment, and the public sector remains the main source of formal employment in Tunisia⁵. Only 14 percent of all employed individuals are so in the private formal sector, which traditionally is considered as the high-productivity sector—as a comparison, this share oscillates between 20 and 40 percent in middle-income countries in Europe and Central Asia (ECA) and Latin America (World Bank 2013a)⁶. In addition, most of these workers have fixed-term contracts (which, as will be explained below, in Tunisia are necessarily also short-term contracts), and this type of contract in Tunisia entails no job security⁷.

Figure 5.2: Work Status of Employed Individuals in 2010



Source: Authors' calculations using Tunisia's 2010 Labor Force Survey

Figure 5.3: Transitions of the Employed Population Between 2010 and 2011



Source: Authors' calculations using Tunisia's 2010 and 2011 Labor Force Surveys

Labor mobility in and out of joblessness is significant, signaling that available jobs have relatively short duration and result in a high rate of jobs turnover and more generally reflecting the precarious nature of employment in Tunisia⁸. As indicated by table 5.1, mobility in and out of joblessness during the period of study was limited. Only about a third of all individuals unemployed in year 2010 found a job in year 2011, while almost two-thirds of the unemployed remained unemployed or become inactive in 2011. In fact it is concerning that more than half of all individuals unemployed in 2010 became inactive in 2011, suggesting high rates of discouragement—that is, many unemployed opted out of the labor force. The majority of individuals employed in 2010 remained employed in 2011; only a minority became unemployed (2.7 percent) and 26.3 percent entered into inactivity, many of which could be new retirees. Inactivity was somehow stickier, as 81 percent of those individuals inactive in 2010 remained inactive in 2011. Only 14.5 percent of all inactive in 2010 found employment in 2011.

Workers with fixed-term contracts are more mobile. As expected, workers with fixed-term contracts display higher patterns of mobility than workers with open-ended contracts (table 5.2). About 25 percent of all workers who had a fixed-term contract in 2010 became informal in 2011⁹. This observation may have been driven by the adjustments in private sector employment in response to the economic shock after the January 2011 revolution, but as discussed below also reflects a deeper dysfunction with the use of fixed-term contracts. As expected, mobility across contract types was less pronounced among workers with open-ended contracts. Surprisingly they are also more mobile than workers with no contract, however. A significant share of informal workers in 2010 became formally employed in 2011 (3.5 percent obtained fixed-term contracts and 11.3 percent an open-ended contract). Results using the Tunisia graduate tracer survey (2004-2008) confirm the mobility patterns identified above (for details see DPR background report on "Creating Good Jobs in Tunisia", World Bank 2014c)

The very high mobility is symptomatic of the dysfunction of the Tunisian labor market, which has resulted in exploitative forms of labor. While the high mobility registered in 2010-2011 partially reflects adjustments following the economic shock in early 2011, in fact it is largely symptomatic

Table 5.1: Transition Matrix: Change in Employment Status of Workforce (aged 15-64) Between 2010 and 2011

	Employed in Q4 2011	Unemployed in Q4 2011	Inactive in Q4 2011	All
Employed in Q4 2010	71.0 %	2.7 %	26.3 %	100 %
Unemployed in Q4 2010	34.5 %	11.5 %	54.0 %	100 %
Inactive in Q4 2010	14.5 %	4.7 %	80.8 %	100 %

Source: Authors' calculations using the Tunisia Labor Force Survey (2010, 2011)

Table 5.2: Transition Matrix: Change in Type of Contract Between 2010 and 2011

	Fixed term in Q4 2011	Open-ended in Q4 2011	No contract in Q4 2011
Fixed term in Q4 2010	42.3%	32.9%	24.8%
Open-ended in Q4 2010	7.3%	79.4%	13.3%
No contract in Q4 2010	3.5%	11.3%	85.2%

Source: Authors' calculations using the Tunisia Labor Force Survey (2010, 2011)

of a deeper dysfunction affecting the Tunisian labor market, which is known in Tunisia as the phenomenon of the *sous-traitance*. *Sous-traitance* refers to out-sourcing of jobs (to Tunisia), which of course should be a positive development. In practice, however, this outsourcing has entailed mainly low-value added tasks (notably assembly) to Tunisian workers who have been kept under permanent job insecurity through informality and the abuse of fixed-term contracts. As will be discussed below, fixed-term contracts entail almost no job security. This type of contract was intended to provide a four-year window of flexibility to the employer following which good workers would be converted into open-ended contracts (or would have to be dismissed). In actual fact, however, some firms have used legally opaque arrangements to circumvent the four-year limit and keep the workforce in permanent job insecurity (UGTT 2009). The results of the 2012 Enterprise Survey in Tunisia highlight that the services and tourism sectors in particular make extensive use of temporary workers—on average nearly 50 percent of the labor force is in fixed term contracts (World Bank 2014c). In practice, therefore, the use of fixed-term contracts has resulted in a legalized exploitative system, which exacerbates the already high levels of informality.

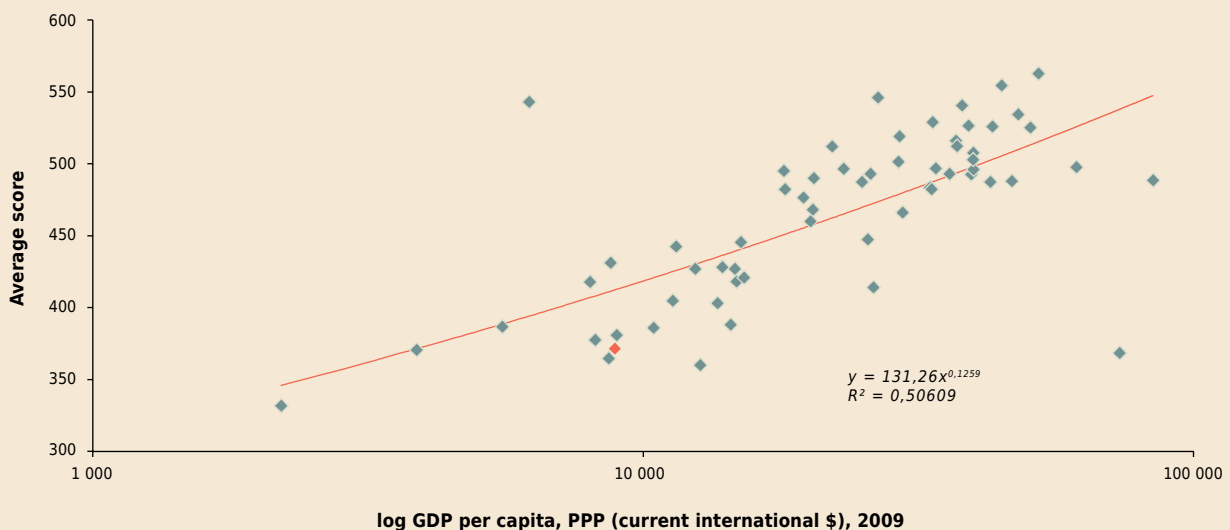
5.2 / Improving the Quality of Education is Key to Future Growth

Concerns about the skills of the workforce have become increasingly prominent in recent years. The levels of secondary education of the Tunisian workforce are among the highest in the region (and 47 percent of the workforce surveyed has a minimum of 10 years education). Nevertheless, irrespective of formal degrees, the Tunisian labor force may not have the skills the private sector needs. While the availability and cheap cost of labor is often cited by investors as a key attractive

feature of the business environment in Tunisia (see Chapter Four), at the same time some employers complain that the technical and “soft skills”¹⁰ of the workforce are inadequate (see World Bank 2008a; ETF and World Bank 2005). The quality of workers’ skills is identified as a leading constraint to firm operations by 39 percent of employers interviewed in the 2012 Enterprise Survey (annex 4.4; see also World Bank 2014e). The concern expressed by businesses appears to reflect the difficulty of finding skilled workers to meet the specific demands of the workplace. For instance, it takes on average eight to nine weeks to find workers with specific qualifications of a technician or an engineer. The problem is even more pronounced with professionals whose qualifications require “soft skills”—businesses report needing upward of 11 weeks to find a suitably qualified candidate. Further, many firms indicated that candidates do not meet their expectations with regard to required qualifications—70 percent of respondents stated that the types of engineers and/or professionals available on the job market do not possess the adequate skills required for the position.

Although little data is available to measure objectively the quality of Tunisian university graduates, the available information suggests that learning outcomes may be weak. As discussed in Chapter One, Tunisia rapidly expanded access to education over the past 20 years, and especially to higher education. However, evidence on learning outcomes—as measured by Trends in International Mathematics and Science Studies (TIMSS) among 8th graders and by the Program for International Student Assessment (PISA) among 15 year olds—points to a relatively low quality of education. The 2007 TIMSS indicates that 80 percent of 8th graders in Tunisia displayed “low” and “below low” performance in mathematics, suggesting that secondary school students may not have even basic mathematical knowledge (based on international benchmarks; World Bank 2014c)¹¹. Similarly, data from the 2009 PISA suggests that Tunisian pupils’ performance in sciences and mathematics is low (given the country’s level of development) (figure 5.4). While these data look only at performance in secondary education, nevertheless they signal that the education system is not producing a critical mass of students who have the fundamental quantitative skills to perform well in labor markets¹².

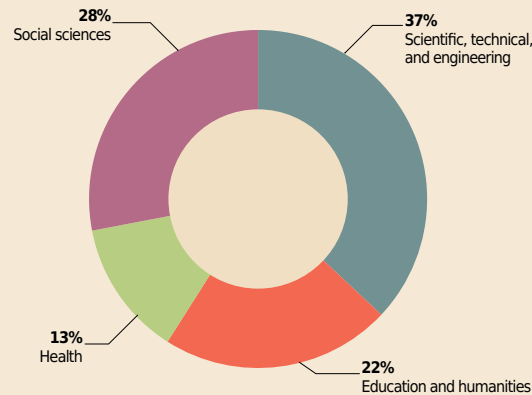
Figure 5.4: Math Skills and Log GDP Per Capita, PISA Results 2009



Source: Program for International Student Assessment (PISA), Organization for Economic Cooperation and Development (OECD), 2009. World Development Indicators, World Bank, 2013.
Note: Red dot denotes Tunisia

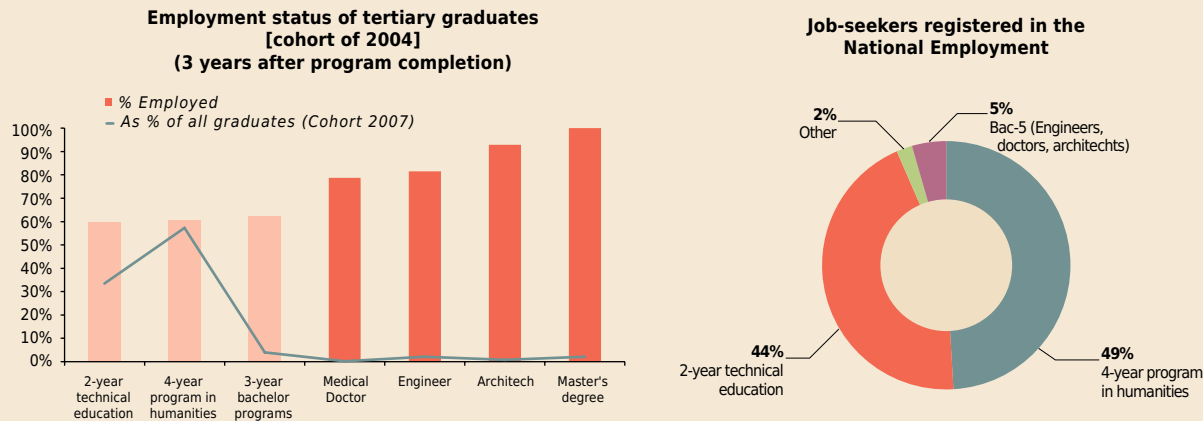
More important, the skills and competencies acquired by graduates do not seem aligned with those in demand by the private sector. In addition to the quality of education, the relevance of graduates' skills is crucial for employability. Ideally, the skills and competencies available among job seekers and those required by available jobs in the labor markets should match in order to make graduates employable. This, however, is not the case in Tunisia. About 63 percent of all students enrolled in tertiary education institutions in the academic year 2010/11 were in the fields of humanities, health, and social sciences (figure 5.5). Such skills, however, are not very attractive in sectors where employment demand for graduates is highest, such as financial services and telecommunications. In fact, graduates of humanities and technical education programs—the large majority of all graduates in Tunisia—appear to be the least employable. Nominally, about 90 percent of all graduates have diplomas in humanities (BAC+4) or technical education (BAC+2) (figure 5.6). Data from Tunisia's most recent graduate tracer survey indicate that graduates from technical education and 4-year programs in humanities face more difficulties enter the labor market after having obtained their degrees. Indeed, only 60 percent of all these graduates were employed three years after having obtained their diploma, compared to a level of 90 percent among BAC+5 graduates (World Bank 2010a). The public sector was still the principal employer, providing 54 percent of salaried employment for all graduates in the sample ¹³. These findings suggest that the skills and competencies of a significant share of graduates are not aligned with the demand of the private sector and, thus, are likely undervalued by the labor market.

Figure 5.5: Distribution of Students Enrolled in Tertiary Education Institutions, Academic Year 2010/11



Source: Data from the Ministry of Higher Education, school year 2010-11; Department of Studies, Planning, and Programming .

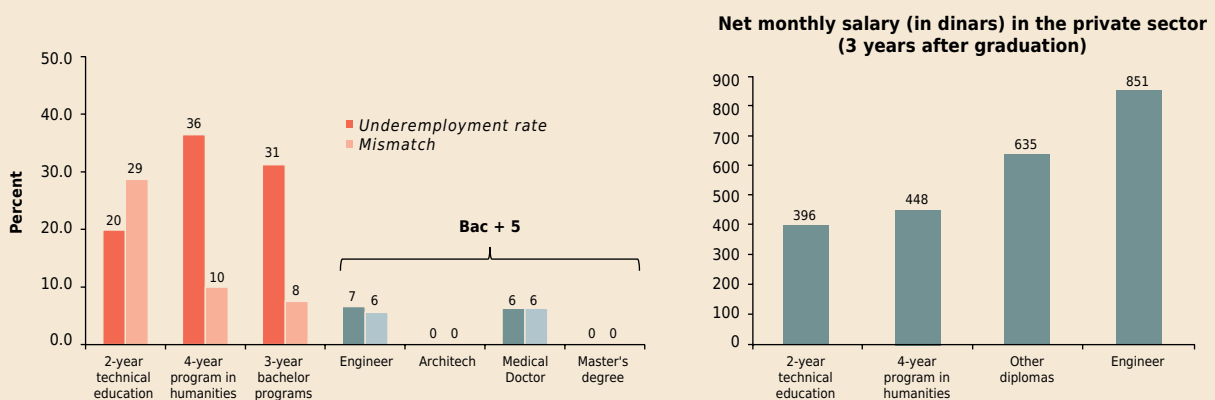
Figure 5.6: Employment Status by Type of Diploma (of a 2004 Cohort of Tunisian Graduates)



Source: Left panel: World Bank 2004 Tracer Survey of Graduates in Tunisia; Right Panel: Administrative data from the Tunisian National Employment Agency, ANETI

In fact many graduates of humanities and technical education programs who find employment do so under precarious working conditions. Besides displaying lower employment rates three years after program completion, graduates of humanities and technical education programs who find jobs tend to be under-employed, work in a different field from that of their specialization, and earn lower wages as compared to BAC+5 graduates. Figure 5.7 (left panel) plots mismatch rates (the share of graduates who work in a field that is different from that of his or her academic specialization) and underemployment rates (the share of graduates who are overqualified for a certain position) by type of diploma, three years after graduation for a cohort of tertiary graduates. Results indicate that: (a) about 30 percent of all graduates of technical education (BAC+2) are employed in fields that are unrelated to their specialization; and (b) between 20 percent and 36 percent of all graduates in humanities are underemployed (that is, they are overqualified for the position they hold). Furthermore, monthly wages earned by humanities and technical education graduates are significantly lower than those earned by BAC+5 graduates and by those who hold other diplomas (figure 5.7, right panel) ¹⁴.

Figure 5.7: Employment Outcomes by Type of Diploma (of a 2004 Cohort of Tunisian Graduates)



Source: World Bank 2004 Tracer Survey of Graduates in Tunisia.

These findings reflect the fact that in Tunisia, as in many countries in the region, the private sector and the education sector tend to operate in isolation, resulting in skills gaps and mismatches (ETF and World Bank 2005, IFC and ISDB 2011, World Bank 2008b). The lack of communication and coordination between the sectors is both cause and consequence of information and knowledge gaps on both sides. As a result, the education and training system lacks the information necessary to become responsive to the needs of the private sector, whereas the private sector lacks the capacity and/or interest to play its role in a demand-driven skill development system. This is particularly relevant in the Technical and Vocational Education and Training (TVET) subsector, where the role of employers is by definition crucial in ensuring that the skills acquired are relevant for access to the labor market. The recent successful experiment of public-private collaboration in the information and communications technology (ICT) sector in Tunisia may provide a model to extend to other sectors of the economy (box 5.1).

Box 5.1: A Successful Model for Public-Private Partnership in Higher Education

The *Association Tunisienne Pour la Communication et la Technologie* (TACT) is a business association that was formed in Tunisia to promote Offshoring, a sector identified by several studies by the government and leading consulting firms as having high potential for growth and job creation. TACT includes representatives from major IT companies. It has launched a pilot program called TACT Academy to retrain unemployed IT graduates and place them in the Offshoring field. After successful completion of training and certification, chosen candidates are assured positions in TACT's group of companies.

Only 200 unemployed university graduates with a background in ICT were selected to take part in the first TACT pilot in 2011/2012 (out of an estimated 30,000 unemployed ICT graduates in circulation). In order for them to become rapidly "offshore-ready," they were provided a training of 10 months, broken down into components in the following way: a 24-week (6-month) curriculum that included four blocks of instruction of 180 hours in ICT fundamentals, ICT environments, languages (English and French), and communication. This was combined with 16 weeks (4 months) of on-the-job training, six weeks of which also included a 5th module (with training in finance, computer science, project management, and other skills). The 10-month program allowed each trainee to take a series of certifications: one or more IT certifications (in Java, .net, etc.) and in language (the TOEIC or TOESL).

TACT functions as a charitable trust, offering all managerial and administrative services related to this program free of charge. When candidates are selected to take the program, their TND3,000 tuition (approximately US\$2,000) is paid by the government.

There are three interesting features to this initiative. First, it is an excellent example of a functioning Public Private Partnership (PPP) for job training and labor market reintegration, as the TACT Academy brings together government and the private sector, both of whom are interested in seeing unemployed IT graduates retrained and placed in a vibrant expanding employment sector. Second, the initiative exploits a results-based approach to financing: the TACT Academy takes all responsibility for selecting and training the unemployed candidates and will only request the reimbursement of training costs from the government once the candidate is successfully placed. This is a win-win situation as the TACT group obtains the skilled candidates it requires, while the government pays only for those who are successfully retrained (and so not those who drop out or are lost from attrition). Third, this is a model that has a clear potential for use in other sectors and other countries.

Source: <http://www.esprit.ens.tn/fr/info/TACT2011.htm>

Overall, while the supply of graduate skills is not well aligned with the demands of the private sector, this does not presently appear to be the binding constraint for firms' growth in Tunisia. As discussed in previous chapters, the Tunisian economy is currently focused on low-skill activities and the vast majority of jobs created are low skilled. Indeed the level of wages offered for engineers and other skills in short supply remains very competitive by international standards. Nevertheless, as Tunisia seeks to move up the value chain into higher value added activities, it will be important to reform the education system to improve learning outcomes and to ensure a closer alignment between the skills and competencies acquired by graduates and the demands of the private sector.

5.3 / Labor Market Policies and Institutions are Part of the Problem

The Social Insurance System Fails to Protect Workers and Exacerbates the Unemployment Problem

The problems of low job quality and high insecurity discussed in the previous sections are exacerbated by the social insurance system, which fails to protect workers. Tunisia's social insurance system today (which comprises mainly the pensions system, unemployment benefits, and medical insurance) is facing several design problems. In terms of workers' protection, current programs have failed to reach around 50 percent of workers. In addition, inappropriate financing arrangements and weak management and administration threaten the ability of the system, particularly pensions, to deliver benefits over the long term, even to workers who today are covered. Indeed, schemes for both public and private sector workers are insolvent, and the former is already generating cash deficits (box 5.2 and World Bank 2012f). At the same time, the social insurance system is negatively affecting the ability of the economy to create good jobs because it imposes a high tax on labor (see figure 5.8), reduces incentives to offer or take formal jobs, and hinders labor mobility ¹⁵.

Box 5.2: The Financial Sustainability of the Tunisian Pensions System

The pensions system in Tunisia is increasingly insolvent and faces serious difficulties and challenges. In Tunisia, separate pension systems exist for public sector workers (who are covered under the *Caisse Nationale de Retraite et de Prévoyance Sociale*, CNRPS), and private sector workers (covered under *Caisse Nationale de Sécurité Sociale*, CNSS). Total pension expenditures represent around five percent of GDP while around only 37 percent of the working age population contributes to one of these two pension funds. The population covered by the CNSS is divided into eight regimes, of which by far the largest is the regime for non-agricultural workers (*Régime des Salariés Non-Agricoles*, RNSA). Both funds are in deficit or are projected to face deficits in the next two or three years. This situation imposes a heavy pressure to assure continuity of pension payments while the revenues are insufficient to provide adequate financing.

The regime for the public sector (CNRPS) is already in deficit since 2010 and requires support from the state budget, given the fact that its revenues plus reserves do not cover expenditures. The deficit of CNRPS was estimated at TND128 million in 2010 (used as base year); and, given the remaining reserves of 27 million in that year, the state budget had to finance the difference of TND100 million (table B5.2.1). With all reserves depleted, projections show that the state budget will need to finance TND500 million in 2014 (representing 0.5 percent of GDP) and almost TND1,160 million by 2018. These expenditures will help benefit the pensions of around only 250,000 beneficiaries, thus raising questions about the equity of this use of state resources. The situation of the private sector regime, and specifically of the RNSA, appears to be less serious, but this fund too will be in deficit as of 2014. This institution has not yet depleted its reserves, and not all its schemes are yet facing deficits. However, RNSA's deficit is even higher than CNRPS's, and the need for budget transfers to finance these deficits is projected to appear as soon as 2014 for TND97 million which will grow to TND713 million by 2018. Hence, under reasonable assumptions and with no reform, by 2014 reserves in both schemes would be completely depleted and the deficit of both schemes would already represent almost one percent of GDP, and it would increase rapidly to reach almost two percent of GDP by the year 2018.

The sources to finance these deficits are still unclear, since the Ministry of Finance is not expecting to have to attend to financing needs of the CNSS. However, while the CNSS is in fact a financially autonomous agency, an eventual default will become a public policy issue given the social implications; and political economy considerations will impose the need for fiscal support in spite of the legal status of CNSS.

Not only are the current pension benefits are unaffordable but the system is also regressive. Therefore any budget support to rescue the funds will transfer resources from the poorer to the higher income earners.

Table B5.2.1 Reserves and Financial Flows of CNRPS and RSNA 2010 (million TND)

	CNRPS	RSNA	CNRPS	RSNA	CNRPS	RSNA
	2010		2014		2018	
Initial reserves	154.9	1,660.0	-	146.5	-	-
Revenues:						
From contribution	1,530.7	945.8	2,014.5	1,269.4	2,542.1	1,680.85
Investment Returns	6.4	43.9	-	19.5	-	-
Expenditures:						
Pensions Payments	1,623.4	1,142.3	2,460.0	1,436.8	3,633.0	2,295.4
Administrative Costs	41.4	56.6	55.5	74.2	68.8	98.1
Total Current Balance	(127.7)	(209.2)	(501.1)	(222.1)	(1,159.8)	(713.0)
As % of GDP	-0.20%	-0.33%	-0.56%	-0.25%	-0.90%	-0.55%
Final Reserves	27.2	1,450.8	-	125.4	-	-
Deficit to be financed	(100.5)	-	(501.1)	(96.7)	(1,159.8)	(713.0)
As % of GDP	-0.16%	-	-0.56%	-0.11%	-0.90%	-0.55%

Source: World Bank (2012f).

There are several problems with the current design of the system. The schemes do not adequately penalize early retirement, and therefore a considerable number of people retire before the legal retirement age. The actual average retirement age is 55, well below the normal retirement age, inducing a fast increase in system dependency ratios (around 60 percent in the fund that covers public employees retire before the age of 60 and around 33 do it in the fund that covers private sector workers). Other wrong incentives include late enrollment and strategic manipulation of wages and promotions, particularly in the public sector, where pensions are calculated as a percentage of the last salary (the private sector, in turn, computes pensions as a percentage of the average of last years of salaries), resulting in replacement rates that rank among the highest in the world. Further, the schemes are very fragmented and complex in design, and different groups of workers not only benefit differently from the social insurance programs but are also exposed differently to the risks of systemic default.

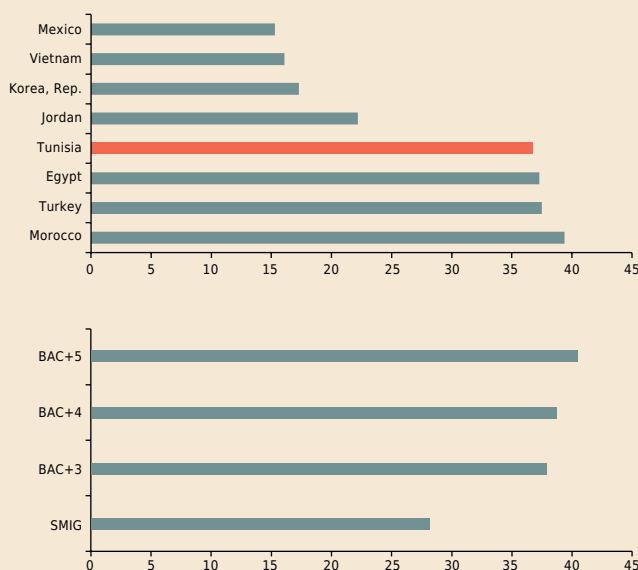
The current situation is not new: deficits in public sector pensions also happened in the past, but they were corrected with ad-hoc increases in contribution rates. There is awareness among policy makers that further increases in contribution rates are not acceptable on economic and social grounds and there is a need to rethink the system in its entirety.

Source: World Bank, 2012f, *Social Insurance in Tunisia: Sustainability, Equitability, Integration*. The World Bank, Internal Mimeo.

Tunisia's social insurance coverage is highly fragmented and too expensive, resulting in low coverage. Part of the problem is that most social security programs rely on a labor contract and contributions from employers and employees. Therefore, they automatically exclude the self-employed, farmers, or seasonal workers in the agricultural sector. Tunisia has attempted to create specific schemes for these workers, but these have had limited impact while contributing to fragment the social insurance system. Administrative data suggest that the schemes cover around 10 percent of the labor force. The second problem is that many low-income workers and small low-productivity firms simply may not be able to finance current contributions, especially if their level of productivity (value added per capita) is below the minimum cost of labor, given by the minimum wage plus payroll taxes.

Further, current arrangements to protect workers from unemployment risks are also inadequate. Tunisia's regulations envisage severance pay of up to three months of salary regardless of the length of the employment period to workers with open-ended contracts¹⁶. Compared to countries such as Egypt and Morocco, severance payments in Tunisia are low and probably not sufficient to support transitions between jobs¹⁷. As discussed below, however, while regular severance pay for dismissal is modest, in cases of wrongful dismissal the payment can exceed three years of salary, which is extremely high. In fact, as discussed below, however, it seems that a verdict of wrongful dismissal is the outcome of legal disputes in most occasions, such that the cost of dismissal becomes very high. Tunisia also has a "loss of employment" assistance program that offers 12 weeks of minimum wage for workers who have been dismissed for economic reasons. The program is financed by a 0.9 percent tax on wages. In practice, however, only around 6 percent of dismissed workers receive benefits, such that very few workers are covered by such a scheme (World Bank 2014c).

Figure 5.8: Tax wedge in selected countries and by education level in Tunisia



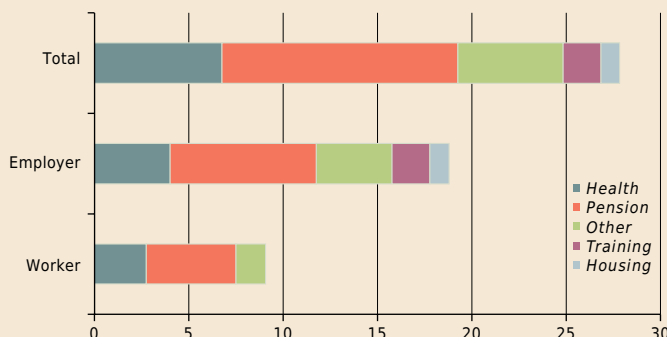
Source: Processed from World Bank (2013a) (top) and Belghazi (2012) (bottom).

Tunisia's Social Insurance system entails a very high level of tax-wedge, which is contributing to the high level of informality, and discourages creation of high-skills jobs. The tax wedge is defined as the difference between the total cost of labor, take-home pay, and the valuation of social insurance benefits. Evidence across countries shows that, as the tax-wedge increases, formal employment declines¹⁸. In Tunisia payroll taxes (paid by employers) and social security contributions (paid by employees) approach 29 percent of wages. Depending on how much workers value the bundle of social insurance benefits, the average tax-wedge in Tunisia could be as high as 38 percent, and is certainly acting as a barrier to the creation of more formal employment, particularly among medium and small firms. Due to the progressivity of the income tax, the tax-wedge is higher for skilled than unskilled workers (figure 5.8)¹⁹.

The high tax wedge is due to the fact that the payments made by employers and employees are not linked to their own benefits. These

taxes finance, in part, implicit subsidies to others (risk pooling) that take the form of minimum pension guarantees, family allowances, or health insurance for low-income workers. In Tunisia, for example, social contributions finance training and housing allowances that are not necessarily allocated to the contributors (figure 5.9). Social security contributions then can be perceived—depending on the beneficiaries—as pure taxes, resulting in avoidance and informality (see box 5.3).

Figure 5.9: Contributions to Social Security by Type



Source: Author's elaboration using administrative data provided by the CNSS.

Box 5.3: Streamlined Process Helps Tunisian Entrepreneurs Go Formal

BARDO, Tunis—When his parents are at work and his sisters at school, Samir can spread out at the dining-room table. When they are at home, he takes his web-design business into his bedroom (or, rather, into that part of it that he has designated an enterprise zone).

The 24 year old is simultaneously studying to become a commercial pilot. The web design started two years ago as a way to cover his fees at pilot school. He teamed up with three fellow students he had met at another college, where had previously been studying marketing and web design before switching flight paths.

The three now offer web-marketing advice and advertising design. They keep their prices competitive in a crowded field and all work from home. Jobs completed so far have been priced at 600 dinars (270 euros) to 1,200 dinars (538 euros), says Samir (not his real name).

At first, their business was undeclared—or “underground” as he puts it. “But we worked with proper companies. We did some good work income-wise,” he says proudly.

The authorities' relaxed attitude toward tax helps start-ups, he adds. “It gives you more freedom. You say, ‘I’m a small company, no one will notice me.’ Anyway, there are companies who make millions and they don't pay taxes.” Many of his clients appear not to be paying tax either; they certainly don't ask for formal invoices.

A recent encounter with a Turkish airport operator as a client gave them the push toward establishing a legal company, however. With the Turkish client, “Everything was legal from A to Z.” He decided it was time to take his business up a level. “As an official company you have a logo, you can price more expensively” and take on work from more serious clients.

He was pleasantly surprised by how easy it was to register the company in early 2014, at the one-stop office (*guichet unique*) at a Tunis branch of the industry promotion agency (*Agence de Promotion de l'Industrie et de l'Innovation*, API).

“I had friends who started companies three or four years ago, before the revolution, and they said it was very complicated,” he said. “That's one of the reasons I had delayed starting my own company. I had this idea about the Tunisian administration....”

Source: Interview, April 2014.

Not linking contributions to benefits endangers the financial sustainability of the social security system. For instance, the current contribution rate for pensions (at 12.5 percent) is not enough to finance a pension equivalent to 80 percent of wages after 40 years of contributions—even though there is an (arbitrary) ceiling of four times the minimum wage on the salaries used to calculate the pension. To keep the current level of benefits untouched, social security contributions (and therefore the tax-wedge) would need to increase to 18 percent by 2020 and to over 50 percent in the long run to be financially sustainable.

Labor Regulations and Institutions Encourage Job Insecurity and the Bias Toward Low-Skill Jobs

While labor regulations in Tunisia are not likely to be the main cause of unemployment, they contribute to the high level of informality and job insecurity and to the focus of the economy toward low-skill jobs. Although more than 22 percent of companies in the 2012 Enterprise Survey declared that labor legislation is a major constraint to firms operation and growth, overall this was ranked as the 12th constraint facing firms. Because of their low coverage and weak enforcement, labor market institutions are not likely to be the main cause of the observed labor market outcomes in Tunisia. Some provisions in the Tunisian Labor Code, such as working time arrangements, are relatively flexible. Also some entitlements such as annual and maternity leave in Tunisia are below internationally accepted ILO standards (and ought to be increased or aligned to ILO standards). However, as is discussed below, several other provisions, especially administrative arrangements for contract termination, regulations on fixed-term contracts, and the collective wage agreements might need revisions. High payroll taxes and rigid dismissal procedures may be affecting the ability of firms to manage human resources efficiently and giving them incentives to use mainly fixed-term contracts and/or to hire workers informally. In addition, collective wage agreements in certain industries and sectors set wages that can be high relative to labor productivity, constraining labor demand for high-skilled youth. Active labor market programs, on the other hand, have been ineffective and the government has been trying to address these shortcomings. We discuss the main aspects of labor regulations below.

Rigid contract termination (dismissal) procedures for open-ended contracts severely constrain the ability of firms to manage their human resources to the detriment of productivity and competitiveness (and encourage the use of fixed-term contracts—see above). As discussed above, an inadequate system of income protection in the case of loss of job has evolved, in parallel, with rigid regulations on dismissals. Indeed, today it is difficult to dismiss workers for economic (if a company needs to downsize to avoid shutting down operations) or technical reasons (if a company adopts a technology that increases overall productivity and output but requires fewer and/or different workers). In fact, dismissal for economic reasons is legally not allowed in Tunisia and procedural inconveniences for employers to dismiss redundant workers are extremely cumbersome and costly ²⁰. Only one out of seven cases of dismissals ends up being accepted, and employers perceive that dismissal processes have a de-facto bias toward workers. As a result, annual layoffs are less than 1 percent of the workforce, compared with more than 10 percent in the average OECD country. Further, while regular severance pay for dismissal is modest (three months maximum—see previous section), in cases of wrongful dismissal, which seems to be the outcome in most occasions, the payment can exceed a three-year salary, which is extremely high ²¹. In practice, therefore, firing workers on open-ended contracts is extremely expensive in Tunisia (in terms of procedures and punitive severance pay), thereby imposing significant rigidity on firms.

It has been shown empirically that these rigidities protect existing jobs but probably at the expense of labor productivity and growth ²². As shown below, in Tunisia these regulations have had the result of pushing firms toward increased use of fixed-term contracts and informal working arrangements.

In addition, this rigidity has also the effect of discouraging investments, which require retention of the labor force, and therefore open-ended contracts. This is normally the case in higher value added activities, which require experienced or skilled labor and constant innovation. In sum, while these rules are well intentioned to protect workers (in the absence of effective loss of employment insurance), they end up contributing to undesirable labor market outcomes. Further, as discussed in the next paragraphs, they also contribute to an economic model that perpetuates inequities.

In Tunisia, fixed-term contracts have become the standard mechanism to hire workers, given rigidities with open-ended contracts—introducing a bias toward low value added activities and contributing to excessive labor mobility in the labor market ²³. According to the Labor Code, the fixed-term contract can be concluded upon agreement between employer and employee, provided that its duration does not exceed four years including renewals. In order to keep the staff beyond four years, firms need to enter into an open-ended contract, which as discussed above entails significant firing rigidity. As a result, in order to avoid cumbersome procedures on layoffs, many employers hire workers only on fixed-term contracts and lay off the workers and hire new workers prior to the expiry of the cumulative four-year limit (see box 5.4). These contracts provide precarious employment for the workers, thus contributing to excessive mobility of labor, and are convenient only for firms which can rotate their workforce with limited costs, thus encouraging a bias toward low value added firms employing low-skill workers ²⁴.

Box 5.4: Striking a Balance—Businesses Adapt to Newly Assertive Labor in Tunisia

BIZERTE, northern Tunisia—"We're all the same here. We don't distinguish between permanent workers and contract workers," the warehouse man says emphatically. "When there's work, we share it around. We're like family."

We are in an Italian-owned factory in Bizerte's industrial zone. It finishes garments produced by other Tunisian offshore companies for export, mainly to Europe. Smaller volumes go to the United States, Turkey and South Africa.

When business is slow, in spring or in early autumn, the factory's managers resort to using "technical unemployment" (*chomage technique*), meaning employees stay at home on half pay for days or even weeks. Some may be put onto half time, likewise getting paid for just four hours daily.

This is a low-skilled operation. The company dyes and accessorizes garments, and creates special effects such as stone washing, or the "distressed" look of fraying denim jeans. The clothing is marketed to young European consumers under brands including Diesel, Max Mara, Armani Jeans, Benetton, and Trussardi.

With average net monthly pay at 390 dinars (around 175 euros), even a few days on half time can severely strain household budgets: workers earning 2 dinars an hour find their daily income falling to the equivalent of 3.6 euros.

Lilia (not her real name), 28, gives garments the final review, checking color, labeling, seam stitching, buttons, zipper, and the alignment of any special effects.

She has been doing this for 18 months, on a so-far uninterrupted series of short-term contracts.

She is mother of a small daughter, and her husband is likewise on short-term contracts at a nearby factory. Like most on such contracts (of one month, three months, or six months), she hopes that

once she has completed four years she will achieve permanent status, in line with Tunisian labor law. And if for some reason she doesn't reach the four years to qualify? "Then I'll just have to look elsewhere," she says.

She is optimistic, however. Since the revolution of 2011, the business has stopped using *sous-traitance*, the practice under which agents supplied temporary workers who were never permitted to complete the four years.

This is still a non-unionized workplace, but there is a new assertiveness among employees. "The short-term contracts were always an issue among the shop-floor workers," said the company's financial director. Before the revolution, however, it was a topic they "only talked about in corners".

In 2012, workers in the "special effects" unit mounted an unofficial strike. Among their demands: for three-month contracts to be replaced with six-month ones. The company agreed to a 15-percent pay hike, but when the strikers also sought the dismissal of a supervisor, it decided it had given enough ground. Around 100 employees were told they were no longer needed. Some tried unsuccessfully to sue for unfair dismissal; around 20 of the group are still pursuing demands for redundancy payments through the courts.

The company has since given out about 100 permanent contracts and is considering abandoning the use of one-month contracts altogether, the financial director said. Permanent employees could rise to 60 percent of the total, but not more, he added. As long as demand continues to stay low in Europe, and with stiff competition from Asia, Morocco, and Turkey, things will continue to be difficult.

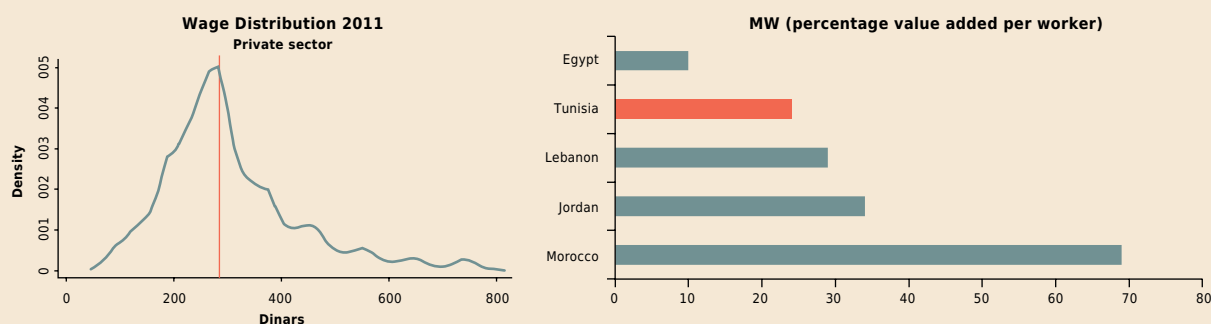
Source: Interviews in Bizerte industrial zone, April 2014.

Not only does this entail high levels of job insecurity but in fact there is also evidence that the system has been abused to keep workers in perpetually precarious jobs in Tunisia. In fact, workers under fixed-term contracts can be fired without notice and do not have access to severance payments or unemployment assistance (but need to be paid the remaining amount of their contract). These exploitative labor practices are often associated with the outsourcing of assembly and other low skill tasks from European firms to Tunisia, such that these practices are commonly referred to in Tunisia as the phenomenon of the *sous-traitance* (UGTT 2009).

Annual leave and maternity leave are too low in Tunisia and need revising in line with accepted ILO international standards. Tunisia has by far the lowest number of paid annual leave days in the region—from 12 working days for one year of job tenure to up to 16 days for 20 years of job tenure. According to ILO standards, holidays shall in no case be less than three working weeks for one year of service. Similarly, Tunisia has one of the shortest maternity leaves in the world: females shall be entitled at the time of childbirth, upon submittal of a medical certificate, to a maternity leave of 30 days. However, this leave may be extended each time by a period of 15 days, upon proof of medical certificates, thus resulting in an unnecessarily complicated maternity leave system. The amount of the maternity benefit is also relatively low: two-thirds (67 percent) of the average daily wage, financed from the National Social Security Fund.

In Tunisia the minimum wage for formal sector workers in non-farm activities is modest by international standards, and unlikely to be binding except perhaps for youth or low productivity workers²⁵. Today, the minimum wage represents only 24 percent of value added per worker, a low ratio compared to countries such as Jordan and Morocco (figure 5.10)²⁶. Nevertheless, even at this level, the minimum wage could still be a barrier to formality or could discourage the hiring of youth who, other things being equal, have less work experience than adult workers²⁷. In fact, there appear

Figure 5.10: The Minimum Wage in Tunisia and in Comparator Countries



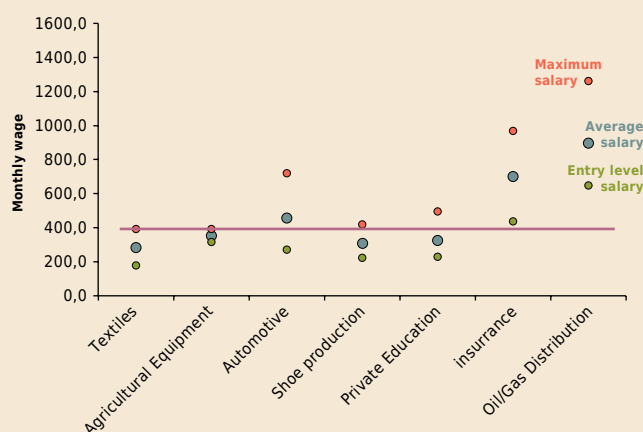
Source: Rutkowski (2013) (left panel) and Kuddo (2013) (right panel)
 Note: Red line in left panel represents the minimum wage

to be many workers in the private sector who earn less than the minimum wage, presumably workers in low productivity firms often in the informal sector (figure 5.10).

Collective Agreements may introduce binding wage floors, which are detrimental to labor demand for graduate jobseekers. In around 70 sectors and industries in Tunisia, centralized employer and employee representatives agree on Collective Agreements (CAs) that regulate worker relations with firms beyond the labor code and also entail a country-wide pay scale with wage floors for different professional levels²⁸. These sectorial CAs are generally negotiated between the UTICA (main employer representation) and the UGTT (main general trade union). Individual companies can deviate if needed, within a regulated negotiation ritual, but only in agreement with their worker representatives. Collective Agreements in Tunisia are not

necessarily much more generous than the labor code in terms of work arrangements, entitlements, and severance pay²⁹. However, an analysis of CAs in selected sectors for professionals and technicians (BAC+) indicates that minimum wage floors for BAC+ graduates are at least 30 to 40 percent higher than the minimum wage—which is often the benchmark wage for youth (figure 5.11). Also, wage floors differ by industry and are particularly high in the insurance and oil sectors. If the wage floors for BAC+ individuals are set, on average, higher than youth average productivity, CAs would constrain labor demand for high-skilled youth in the private sector. Further, the process of CAs entails a few additional risks. First, the bargaining process is generally dominated by larger firms, which can afford to set the wage floors at levels that exclude smaller competitors who achieve fewer economies of scale. Second, CAs in Tunisia normally specify wages by educational attainment, thus contributing to set up wage floors for graduates

Figure 5.11: Collective Wage Agreements for Professionals and Technicians (BAC+) for Selected Sectors, 2011



Source: Authors' own elaboration based on available sector Collective Agreements for the year 2011

of higher education. Third, because the same pay scales apply country wide, these agreements may hamper the competitiveness of interior regions as they undermine the possibility for these regions to attract investors by offering lower labor costs. Assuming the challenges and costs of setting up a business in interior regions are higher compared to the coastal regions, it can be expected that if wages are the same across the country investors will naturally choose not to set up their firm in the interior—hence paradoxically the CAs may end up exacerbating regional disparities.

Public-Private Labor Market Segmentation and Distortions

Preliminary evidence suggests that the relatively higher remuneration package for public sector employees exacerbates the distortions affecting the labor market and, paradoxically, may result in greater graduate unemployment. In Tunisia the public sector accounts for 22 percent of all employment. Labor market segmentation between the public and private sectors exist if differences in compensation and other employment conditions between these sectors originate on the demand side rather than being explained by individual workers' productivity. This is often characterized by the existence of a sector (or sectors) that rewards human capital better than others or in cases where labor market institutions (such as a minimum wage) oblige employers to pay wages above productivity. The Tunisian labor market displays some symptoms of labor market segmentation between the public and private sectors, mainly because employment conditions in the public sector—such as wages, job safety, and social security—are superior to those offered in the private sector (annex 5.2) ³⁰. As such, the majority of all job seekers in Tunisia (56 percent) between 15 and 34 years old would prefer to work for the public sector (Gallup World Poll 2010 Survey, data available from Gallup: <http://www.gallup.com>). While additional research is required, if confirmed this feature of the labor market may contribute to increase graduate unemployment. In fact, the artificially high remuneration for the public sector could crowd out private sector employment because it causes individuals to queue for public sector jobs (which translates into higher levels of unemployment) and promotes the inefficient use of human capital (as the most talented workers are absorbed in less productive sectors).

In addition, the regulations for the hiring process for jobs in the public sector also exacerbate graduate unemployment. Strikingly, recruitment is possible for unemployed people only and the selection criteria clearly favor long-term unemployed. Providing an attestation of unemployment is mandatory (and it has to indicate the date of registration at the unemployment agency). Recruitment is based mainly on personal criteria ³¹. A written test of competencies is not required, at the discretion of the relevant minister—but even when a written test is required its results count for only 30 percent of the evaluation, while the personal criteria count for the remaining 70 percent. These personal criteria used in the evaluation of the candidates are: the year of diploma (with each year counting two points, up to 30 points max); the level of distinction of the diploma (up to 20 points); the age of the candidate (increasing with age, up to 20 points for anyone who is 40 and above); the family status (ten points, increasing with number of dependents); and any internship and training not included in the CV (0.5 point for each month of internship and/or training, up to 20 points). In sum, the calculation of the score clearly favors long-term unemployed. In fact, in addition to the requirement that applicants be unemployed, the most important criterion is the date of diploma. Hence the rules for getting a job in the civil service privilege the years of unemployment instead of valuing the years of work experience. Although the objective of this policy is clearly to mitigate unemployment and particularly to help the long-term unemployed, paradoxically the result is that graduates prefer to wait in unemployment in order to get public sector jobs instead of actively seeking and accepting lower paying jobs in the private sector—hence increasing the pool of the graduate unemployed.

5.4 / Reforms Agenda to Improve Labor Market Outcomes: Toward a New “Social Pact”

The evidence presented in this chapter has highlighted the opportunity of comprehensive labor market reform, building on the process that Tunisia has started with the tripartite social dialogue and the signing of the “Social Pact” in January 2013. International experience shows that labor market reforms are most successful when carried out in the context of a national social dialogue, most commonly a tripartite dialogue between the government, unions, and employers’ organizations. Tunisia is well advanced on this front and has an established tradition of tripartite dialogue. Most notably in January 2013, following a 10-month dialogue process supported by the ILO, the government, the UTICA, and the UGTT signed a landmark Social Pact which should pave the way for improvements in areas such as labor legislation and industrial relations, employment policies, vocational training and education, social protection, and balanced regional development. The Social Pact is an excellent document that outlines the broad approach and perimeter of the reforms—its signing marks the start of a process of in-depth preparation on the actual reforms. It proposes a comprehensive approach to reform of labor market rules and institutions to better protect all workers while giving firms the flexibility required to be competitive and to adjust to the changing global markets.

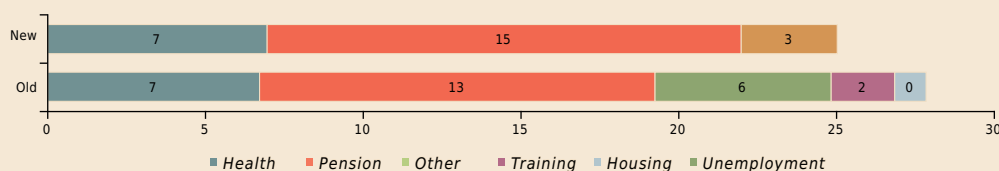
Several key aspects in need of reform have been highlighted in this chapter, notably related to social insurance and labor market rules and regulations—together these could form the basis of a “grand bargain” to realize the program envisioned in the Social Pact signed in January 2013. As discussed, there is a need to boost labor demand by lowering the tax wedge on labor, while reforming the pensions system to ensure its sustainability. There is also a need to converge the firing rules of open-ended and fixed-term contracts to remove the existing dichotomy and to remove the existing barriers to investing in higher value added activities by giving firms the required flexibility to be competitive, while in parallel strengthening workers’ protection by providing social insurance against the loss of a job. It is also important to have policies that can actively promote women’s participation in the labor force. This core set of reforms is discussed below.

Reform Social Insurance to Introduce an Effective “Loss of Employment” Insurance and Ensure the Financial Sustainability of the Pensions System

A key principle of the reforms should be to link contributions by each worker to the benefits received by that worker and to finance explicit subsidies (redistribution) through general revenues. One of the options for reducing the tax wedge to create more formal wage employment (while addressing problems of financial sustainability—as discussed in box 5.2) is to link social security contributions to benefits while financing redistribution and transfers to ad hoc programs through general revenues. Alternative options can then be considered to create the necessary fiscal space³². As discussed in Chapter Four, a reform of corporate tax to expand the tax base to exporters (who are currently exempt) and to introduce a common lower corporate tax rate for all firms could provide the fiscal space to finance some of these costs. Essentially, the social insurance system could focus on covering essential risks: sickness, disability, death, old age, and unemployment. The total contribution rate to the various programs could be capped at 25 percent (see figure 5.12).

Further, it is possible to conceive a reform that achieves a lower rate of social contribution and still is able to finance a loss of employment insurance scheme. If the payroll taxes to finance other transfers (for instance, training and housing) are removed and financed through general revenues, there would be room to both increase the contribution rate for pensions and set up a larger loss of employment benefit system (figure 5.12).

Figure 5.12: Proposed Reform of Social Security Contributions



Source: Authors' own elaboration

The reform of the pensions system should ensure fairness, transparency, and financial sustainability. In the case of pensions, for instance, the first step would be to define a target for the replacement rate at the statutory retirement age (without a ceiling on the salary used to calculate pensions) and then set the contribution rate that is needed. In the case of a pay-as-you system such as in Tunisia, a contribution rate of 15 percent could finance a replacement rate of 50 percent after 40 years of contributions ³³. The second decision is to decide whether to subsidize benefits for those workers who are not able to contribute enough to accumulate a decent pension (to be defined), and to decide how to subsidize these transfers (via general revenues) ³⁴.

It is possible to introduce a loss of employment insurance and reform severance pay to improve workers' protection and facilitate labor mobility. The current unemployment benefit system and severance pay could be replaced by a scheme that offers a higher replacement rate, wider coverage, and reduced distortions in labor markets. As in the case of pensions, the first decision would be in terms of the level of benefits: a replacement rate could range between 50 to 70 percent with duration of 3 to 12 months. The contribution rate would be set accordingly, taking into account the unemployment rate of the population of beneficiaries ³⁵. The second decision is about how to subsidize benefits for those workers who are not able to contribute enough. In the case of classic unemployment insurance schemes, this is done by imposing a 100 percent tax on the contributions of plan members who have a lower unemployment risk and therefore contribute more than they get out of the system ³⁶. An alternative is to reduce the tax on savings and, as in the case of pensions, replace it by general revenues (see discussion above; some Tunisian academics have recommended the use of part of the VAT receipts for this purpose). Workers, for instance, could be allowed to withdraw upon retirement up to 50 percent of the contributions (plus interest) that were not used to finance unemployment benefits. Reducing the tax on savings could increase incentives to seek, take, and keep jobs (see Robalino and Weber, 2013) ³⁷.

In parallel it is important to gradually integrate or at least to harmonize the various social insurance programs while expanding coverage in such a way as to ensure a minimum level of protection for all Tunisian residents. The guiding principle would be that all Tunisian residents, regardless of where they work would have access to the same system under the same rules. Self-employed workers or wage employees in the agricultural sector, for instance, would also join the current system for private sector workers. Like them, they would benefit from the basic pension and be allowed to make additional contributions. In the case of civil servants, it would be disruptive to integrate them into the scheme for private sector workers and dramatically change their entitlements. An alternative approach would be to set a date when new civil servants would enroll in the schemes for private sector workers. Jordan achieved this in the year 2000 (ETF and World Bank 2005).

Improve Labor Regulations to Increase Protection for Fixed-Term workers and Give More Flexibility to Firms That Use Open-Ended Contracts

It is important to align entitlements and dismissal rules with international standards. The main recommendation when it comes to the labor code is to align maternity and annual leave entitlements (with explicit financing by employers and employees) with international standards while introducing more flexibility in dismissal procedures, extending the benefits that come with fixed-term contracts, and modernizing minimum wage policy. It is important to allow employers to dismiss workers for economic or technical reasons without requiring third-party authorization but still reinforce controls and penalties for wrongful dismissals. This can be done if an adequate unemployment insurance program is put in place, as discussed in the previous section. The main condition regulating dismissal would be to provide an adequate advance notice (for example, at least three months), a period during which the workers continue to receive their salaries but are allowed to engage in job search activities. In addition, workers should be allowed to present complaints in cases of wrongful dismissal (for instance, if linked to discrimination). Efficient mechanisms should be in place to expedite the processing of these complaints while enforcing penalties on employers that are found at fault. In parallel, the benefits in terms of social insurance should be extended to fixed-term contracts. The goal, eventually, should be to blur the line between fixed and open-ended contracts ³⁹.

Adopting an official formula can reduce discretion in the annual setting of the minimum wage(s), and acts as a benchmark for collective wage agreements. Minimum wages today are the result of an annual negotiation between employers and unions, which are overseen by the government. Although the process already works fairly well, to strengthen this process Tunisia could consider setting an independent technical commission in charge of recommending to the three parties periodic adjustments (perhaps annual) to the minimum wage, based on an objective approach (see World Bank 2011, for an application to Malaysia). The commission would be in charge of defining a simple formula linking a reference adjustment of the minimum wage to key economic aggregates (such as the cost of living, productivity growth, and the unemployment rate). At pre-specified dates (for example, the first Monday of December of every year) the commission would announce a suggested adjustment (that could be zero) to the minimum wage, which would become effective in the first day of the new year. The tripartite negotiations then would take as the starting point the minimum wage calculated with the objective formula, but also analyze and consider the potential economic and social impacts of implementing the reference adjustment and establish whether a lower or higher level is required ⁴⁰. The country also needs to work on improving enforcement mechanisms and having in place a transparent system to accommodate low-productivity firms that are unable to finance the minimum cost of labor. Tunisia should also assess whether a lower minimum wage should apply to first-time young job seekers who today might not be able to compete with more experienced workers at the current level of the minimum wage.

Allowing greater flexibility in the setting of industry-wide collective agreements could be beneficial to jobs creation in interior regions. Wage floors should be negotiated, taking into account information about costs of living but also the financial situation of the firms. It may also be appropriate for the agreements to specify regional variations in wages based on the results of the negotiations. Also, in case of a rapidly changing economic environment, it would be advised for the collective agreements to be revisited every two years (compared to the current five years), with possibility of extension, by consent of the parties to the agreement. Collective agreements should apply to employers that are members of employers' associations and are signatories of the collective agreement, but not to those firms that are not signatories of the collective agreement. Notably, there are many small firms who may be unable to afford these entitlements. In fact, it would also be appropriate to consider raising the requirement's threshold to companies with at least 10 employees in which the standard

redundancy arrangements, such as a severance pay, apply—which would lessen the burden on small businesses. This approach has been applied in many countries (for example, Germany, Greece, and so on).

Strengthen Active Labor Market Programs

The Active Labor Market Policies (ALMPs) also require fundamental reform to achieve the objective to support the unemployed and to reduce labor market mismatch. While not discussed in this report, an analysis of the main strengths and weaknesses of ALMPs, as well as the main recommendations for improving their effectiveness, is presented in the DPR background report "Creating Good Jobs in Tunisia" (World Bank 2014c). Active labor market policies appear to have a very limited impact on labor markets in Tunisia, as reflected by low insertion rates. Part of the problem is that the supply of employment services is a monopoly of ANETI, but ANETI's capacity to provide effective intermediation services is limited. To address these problems it would be important to integrate the special programs around four sets of interventions: (a) training and job-search assistance, (b) wage subsidies, (c) support to entrepreneurship, and (d) regional employment support programs (notably public works or workfare programs). Within these programs, it will be important to ensure that proactive policies are adopted to facilitate employment of women as well as their participation in the labor force.

Reform the Education System

In parallel to the reform of labor market regulations and institutions, there is a need to undertake a profound rethinking of the education system, starting with primary and secondary education. As discussed in this chapter, the learning outcomes of Tunisian secondary school pupils are below the level expected given Tunisia's level of income. This highlights the need to take action to improve the quality, efficiency, and integrity of primary and secondary education institutions. The first step may be commissioning an independent analysis of the reasons for the weak quality and low learning outcomes. As part of this process, it may be valuable to adopt a criteria-based assessment of quality assurance in all pre-university education and to introduce mechanisms to strengthen the accountability of teachers and schools vis-à-vis the education authorities and stakeholders (for example, a code of professional conduct, a school inspection system, and promoting the use of scorecards and other community accountability instruments).

The quality of higher education also requires improvement. A first step would be to apply the 2008 Law to grant more autonomy to higher education institutions and also to introduce mechanisms that facilitate partnership with the private sector. There should also be more merit-based funding allocation, for instance based on the number of students attracted and also based on an independent evaluation of the research output of each institution using international standards. In this context it is also essential to operationalize the recently established National Evaluation and Accreditation Agency, to consider enhancing its independence from the Ministry of Higher Education, and to adopt international certification standards.

It is also important to strengthen the relevance and the quality of the Vocational Education and Training (VET) system. This requires refocusing the role of vocational training to integrate the VET system with private sector demands by facilitating private sector participation in the design and delivery of training—and to develop and extend the pilots for decentralized management models for training centers throughout the VET system. In this context the management of the vocational training should no longer remain the monopoly of the state. In parallel there is a need to also diversify sources of vocational training financing to allow for increased cost recovery and greater financial participation by firms.

5.5 / Conclusions

This chapter has highlighted several shortcomings with labor market policies and institutions in Tunisia; however, it is important to emphasize that these problems do not constitute the key constraint to solving the jobs challenge in Tunisia. The main obstacles to job creation (including to good job creation) lie instead in creating an open and competitive environment which encourages entry of new firms and the growth of the most productive firms, as discussed in previous chapters. That said, although not the main priority, improving labor market policies and institutions can contribute to make firms more competitive, while at the same time reinforcing the security of workers and thereby moving the economy toward creating more and better quality jobs.

This chapter has emphasized that the challenge for Tunisia is not simply to reduce the high level of unemployment but also to improve the quality of available jobs. At present the few jobs available to Tunisians are mainly low quality jobs for low-skilled workers, such that the level of remuneration is low and job insecurity is high. The mismatch with the increasing levels of education goes well beyond the visible rates of unemployment, and of graduate unemployment especially. Further, the abuse of these rules enabled exploitative forms of labor—which Tunisians refer to as the phenomenon of the *sous-traitance*—which fuelled the social discontent violently expressed by Tunisia’s youth.

The evidence presented in this chapter has shown that current labor market rules and institutions, while well intentioned, in fact have exacerbated these problems. The lack of adequate social insurance has been compensated with rigid firing rules for open-ended contracts, resulting in greater levels of informality and job insecurity, and itself favoring creation of low-skills jobs. The rigid firing rules for open-ended contracts contrast sharply with the “savage flexibility” of fixed-term contracts. This dichotomy between fixed-term and open-ended contracts indirectly promotes informality and job insecurity as firms avoid giving workers open-ended contracts to maintain flexibility. Further, by making it very expensive to terminate open-ended contracts and thereby favoring informality and fixed-term contracts, which are more suited for low-skilled jobs, labor regulations have de facto contributed to direct private investment toward low value added activities. As discussed in this chapter, this mix of too much flexibility in fixed-term contracts (which entail no job protection) and too much rigidity in open-ended contracts (which are extremely expensive to terminate) has created deep dysfunctions in labor market outcomes. In addition, preliminary evidence presented in this report suggests that the relatively more generous remuneration package in the public sector and the criteria and regulations to hire personnel in the public sector paradoxically also exacerbate graduate unemployment.

Several key areas in need of reform have been highlighted above, notably related to social insurance and labor market rules and regulations—together these could form the basis of a grand bargain to realize the program envisioned in the Social Pact signed in January 2013. It is critical to change these rules in a comprehensive manner and adopt a different system that better protects all workers while giving firms the flexibility to stay competitive and adjust to changing global markets. Tunisia has already started a process of preparation reform with the establishment of the tripartite dialogue process and the signing of the Social Pact in January 2013, which outlined the overall framework for a package of comprehensive reforms. The challenge now is to agree on the specific reforms to adjust the social insurance system and labor regulations, striking a balance to bring better protection to workers and more flexibility to firms. There are a number of countries that have successfully adopted “flexicurity” arrangements, and Tunisia should seek to learn from their experience.

Finally the chapter has also highlighted the need for a comprehensive reform of the education system. Preliminary evidence suggests that on average the quality of Tunisian graduates is below the level expected given Tunisia level of income. Just as important, there is a strong mismatch between the supply of graduate skills and the demands of the private sector. However, overall the low quality of the workforce does not presently appear to be the binding constraint for firms' growth in Tunisia. As discussed in previous chapters the Tunisian economy is currently focused on low-skill activities—such that low demand for skilled labor remains the principal challenge facing Tunisia today. Adjusting the education system and producing high quality graduates is a long term process, however. Hence, in parallel with other reforms to open up the economy (and enable a structural transformation towards higher productivity and value added activities), it is important for Tunisia to start the reform of its education system to ensure that tomorrow's graduates will be ready to fulfill the demand for high skill jobs.

The next chapter discusses how the financial sector also suffers from deep dysfunctions. As discussed in this chapter, labor market policies have contributed to hamper the structural transformation of the economy. Chapter Six focuses on another essential component of a well-functioning economy. As will be discussed, the financial sector in Tunisia has been unable to direct resources toward the most productive projects, thereby also contributing to entrench the misallocation of resources that is at the root of the weak economic performance and feeble jobs creation.

Notes

1. By doing such comparison, results indicate that 53 percent of unemployed professionals—categorized as professionals based on their occupation prior to unemployment—would not be able to find jobs requiring professional skills. At the same time, 40 percent of newly created jobs for operators and 27 percent of new jobs craft workers will not be filled by the unemployed who worked as operator and craftsmen.

2. As discussed below, this mismatch also results in educated workers in the private sector generally being underemployed.

3. The hypothetical shortage of manual labor would materialize only if the economy created a large number of new jobs, replicating the existing occupational structure of labor demand.

4. At the risk of stating the obvious, it is important to state clearly that informal workers create value and contribute to the overall wellbeing of the country. The main problem with informality is for these workers themselves, as they have to live in permanent uncertainty and do not have any social security coverage.

5. It is worth clarifying that hiring graduates in the public sector was not needed in terms of the requirements of the public sector; however, in the absence of sufficient private sector demand for graduates, the government has felt compelled to absorb an increasing number of graduates in the civil service.

6. According to Loayza and Wada (2010), already in 2004 Tunisia produced about 38 percent of its GDP and employed about 54 percent of its labor force informally (using the Schneider Index and the share of the labor force with pension coverage, respectively). These results indicate that about half of all the workers in the country may not have access to health insurance and/or are not contributing to a pension system that would provide them with income security after their retirement. From a fiscal perspective, these results indicate that more than one-third of total economic output in the country remains undeclared and therefore not registered for tax purposes.

7. As discussed below, these are fixed-term contracts renewable up to a cumulated total maximum of four years, following which the worker has to be hired under an open-ended contract or must be replaced.

8. In order to assess labor mobility, it is necessary to use data that allow for tracking individuals across time. To do so, we rely on simple Markov transition matrixes using the panel component of the Labor Force Survey for years 2010 and 2011—last quarter (for the entire workforce)—and the Tunisia Graduate Tracer survey developed by the National Observatory of Employment and Qualification for the years 2004 to 2008 (for tertiary education graduates). It is worth noting that the period between the last quarters of 2010 and 2011 coincides with Tunisia's political transition, which was characterized by a rapid deterioration in labor market outcomes and economic growth. As such, results presented here need to be regarded with care and may not be representative of normal economic and political times. Unfortunately, these were the only data available for this analysis.

9. A significant share (approximately 33 percent) of workers with fixed-term contracts in 2010 became open ended in 2011. Nevertheless, this may likely reflect the policy response to the post-revolution economic crisis, whereby the government decided to regularize a significant number of public sector workers in 2011.

10. "Soft skills" include for instance the ability to communicate

clearly, creativity, problem-solving, and interpersonal skills for success in the workplace.

11. TIMSS uses five points on the scale as international benchmarks: "advanced" (>625), "high" (550-624), "intermediate" (477-554), "low" (400-474), and "below low" (<400). According to this definition, high means "students can apply their understanding and knowledge in a variety of relatively complex situations and explain their reasoning," whereas low indicates that "students have some basic mathematical knowledge."

12. In fact, critical reasoning skills are increasingly seen as central to success in high-value added jobs (Autor, Levy, and Murnane 2003).

13. While it is somehow expected that graduates in humanities are harder to place, since there is not appetite for these diplomas in the private sector, it is less clear why BAC+2 graduates in technical education face similar challenges finding jobs. One hypothesis is that the technical skills acquired by these graduates are not aligned with the technical skills in demand in the private sector or that these technical positions are often filled by individuals with more developed skills (such as BAC+5).

14. It is worth mentioning that entrance to BAC+5 diplomas is regulated in Tunisia. Access to faculties that issue these diplomas (for example, architecture, engineering, medicine, and pharmacy) is subject to annual entry exams while access is open to diplomas in law, humanities, and social sciences.

15. High tax and contribution rates inflate firms' labor costs and at the margin reduce Tunisia's labor competitiveness. Nevertheless, labor costs in Tunisia remain highly competitive, as confirmed by the findings of the 2012 Investor Motivation Survey (see Chapter Four).

16. As discussed below, however, in practice most dismissals are ruled as wrongful so that the level of severance payment jumps to 36 months.

17. Moreover, employers often do not create cash reserves to pay for severance payments. Indeed, in many cases businesses dismissing workers for economic reasons (and obliged as such to pay severance) might not have the necessary liquidity to pay these obligations. Finally, international experiences show that enforcing the payment of severance pay is not easy and that receiving benefits can be a lengthy process often involving courts. As a consequence, across middle- and low-income countries only a small percentage of eligible workers receive severance (see Ribe, et al., 2012).

18. It is estimated that a 10 percentage point increase in the tax wedge can reduce formal employment by between one and five percentage points, with the effects being larger among low-skilled workers (Lehmann and Muravyev, 2014). This occurs as firms substitute labor with capital in the formal sector (that is, they reduce hiring) and as lower-productivity firms and jobs move into the informal sector.

19. We do not have direct evidence in Tunisia on how the demand for both types of skills changes as a result of the tax wedge—and relative to each other. In fact, even if the tax wedge is higher for skilled labor, low-skilled labor is likely to be more affected, as the demand for low-skill labor is generally more elastic (more price responsive). The demand for skilled labor is not inelastic either, however, and in the presence of a large informal sector the substitution is not only between labor

and capital but also between formal and informal contracts. For a range of businesses, the tax wedge could be a barrier to formalization even for high-skills labor (for example, university graduates).

20. In particular, companies must notify the labor inspector of planned dismissals, individual or collective, in writing one month ahead, indicating the reasons and the workers affected. The Labor Inspectorate with territorial jurisdiction or the Directorate General of Labor Inspection (DGI), as applicable, shall, within fifteen days from the date of referral, conduct an investigation concerning the request for dismissal or for putting employees on short time and attempt to reconcile the two parties. If it fails to reconcile the two parties, the Labor Inspectorate or the DGI shall refer the case of dismissal to the regional commission or the Central Commission on Control of Redundancies, within three days from completing the reconciliation attempt. The regional commission or the Central Commission on Control of Redundancies shall be required to advise on the issue of dismissal. The commission decides by a majority vote: if the inspector and union reject the proposal, no dismissal is possible.

21. In addition, the Labor Code stipulates a retraining or reassignment obligation before an employer can make a worker redundant; there are priority rules that apply to redundancy dismissals or lay-offs associated with seniority, family situation, and professional values; and there are priority rules that apply to reemployment, neither of which are based on the worker's productivity.

22. A recent review of the literature shows that adequate labor regulations can protect workers without having negative effects on employment levels or the type of jobs (see World Bank 2013a; Betcherman 2014). It also shows that these policies tend to have two distributional impacts: they have an equalizing effect among covered workers but tend to result in the exclusion (that is, no coverage) of youth, women, and the less skilled. Further, in some cases, overregulated labor markets can have an adverse effect on unemployment and formal employment. For instance, excessively high payroll taxes can be associated with higher unemployment rates (Elmeskov, Martin, and Scarpetta 1998) and overprotective employment protection regulation could slow down the reallocation of labor from low- to high-productivity activities if well enforced (Besley and Burgess 2004; Boeri and Jimeno 2005; Haltiwanger, Scarpetta, and Schweiger 2010).

23. There is nothing inherently wrong in the use of short-term contracts, and indeed these are part of the standard set of contracts available in most countries. Fixed-term work contributes to making labor markets more flexible. It provides a buffer for cyclical fluctuations of demand, allowing companies to adjust employment levels without incurring high firing costs. Research has pointed out a number of risks associated with the use of fixed-term work, especially for workers but also for employers. For instance, fixed-term workers are subject to higher turnover, earn lower wages on average, and receive less training. In addition, the expansion of temporary employment may reinforce labor market duality. In particular, when firms can easily hire temporary workers but it is costly to dismiss regular ones, they do not have any incentives to convert workers from temporary to permanent contracts. The problem in Tunisia arises because of the extreme dichotomy created between highly flexible fixed-term (short-term) contracts and highly rigid open-ended contracts.

24. It is worth clarifying that fixed-term (which in Tunisia are necessarily also short-term) contracts do not constitute an incentive toward low-value added jobs. Rather the problem is that in Tunisia the rigidity introduced in the use of fixed-term contracts (which cannot be renewed beyond a cumulative total of four years), combined with the rigidity in the use of open-

ended contracts (which de facto are difficult to terminate even in case of serious economic distress to the firm), results in a set of choices open to the entrepreneur allowing the use of short-term labor that can be dismissed and replaced every few years—and this type of labor force profile is most easily suitable for low-value added activities.

25. Minimum wages can have a role in protecting workers in labor markets that are not perfectly competitive and where employers have market power and are able to impose wages that are too low relative to productivity. In these situations, a minimum wage set at the right level does not increase unemployment and can, on the contrary, increase employment as more workers participate in the labor market. Minimum wages that are too high, however, can reduce formal employment.

26. Wages increased by 2.1 percent on average during 2000-2009 (ILO 2010), which is below the increase in labor productivity over the period of approximately 2.5 percent per year (as discussed in Chapter One). The wage restraint increased the competitiveness of Tunisian firms, contributing to attract investments in the offshore sector (see Chapter Four). At the same time, the state provided an environment where low salaries could be maintained by reducing the cost of basic necessities for the population, through a mix of direct and indirect interventions. The government heavily subsidized and/or controlled the price of basic food and fuel products and kept affordable the price of basic utilities, notably public transport, water, electricity, and gas. In addition, pensions were relatively generous (compared to contributions) and access to health care was reasonably priced.

27. According to the labor code, there is a special minimum wage for youth in Tunisia, but it does not seem to be respected. Youth, therefore, are subject to the same minimum wage as adults. To a certain extent, having a lower minimum wage for young workers could reduce the need for wage subsidies. Results based on a search model calibrated for Tunisia using data from the 2011 labor force survey suggest that with a lower minimum wage employers could be more likely to hire first time job-seekers who are expected to have, at least initially, lower productivity and require more investments in training. The model simulates the speed at which vacancies become available and job matches occur in a dual (formal vs. informal) labor market and allows for quantifying the effects of labor market institutions (notably minimum wages and subsidies) in labor market outcomes, notably unemployment and formal employment. Simulations for Tunisia show that in the absence of a minimum wage: (a) the unemployment rate for youth could be reduced by close to 6 percentage points; (b) self-employment (probably low quality and low pay) would decrease by nearly 2.5 percentage points, and (c) formal employment could increase by six percentage points (see Robalino, et al. 2013).

28. These collective agreements entail wage matrixes that set pay brackets for workers for a certain level of competence, responsibility level, educational level, experience, or a combination of these factors. Each bracket of the matrix contains a minimum-to-maximum wage range (or only a minimum in some cases).

29. While there is a general perception in Tunisia that collective agreements are much more generous than the labor code concerning employment protection and entitlements, analysis indicates that in many aspects the collective agreements largely converge with labor code stipulations.

30. Public sector jobs, notably in SOEs, are better paid than formal private sector ones (for all types of skills, except managerial); they offer better conditions and, very important, offer extremely good job security. New labor market entrants in the public sector earn wages that are on average nearly 50 percent higher than in the formal private sector. In addition,

workers in the public sector benefit from more generous pension and other entitlements, and have better job security. Many of the entitlements given to civil servants, such as annual leave policies, are also better than those regulated in the labor code for the private sector.

31. The process and criteria for hiring in the public sector are defined in the Decree-Law 2011-32 (of April 2011) and its implementation Decree 2011-544 (of May 14, 2011).

32. Clearly, financing part of the social insurance through explicit transfers from general revenues raises questions about fiscal sustainability and equity. If the current government budget cannot be reallocated, reducing or changing the composition of payroll taxes, would require raising additional revenues—basically increasing other taxes. As discussed in Chapter Four, the ongoing discussions on the reform of corporate tax could provide some fiscal space to finance some of these costs. Alternatively the reduction of fuel subsidies (which are highly regressive) could help finance a reform of the state's redistribution programs, strengthening the security and social protection systems. While this issue is not discussed in detail in this report, there are various possibilities: consumption taxes, taxes on corporate profits, taxes on property, and others. The fiscal and economic implications of the various options would need to be assessed in the context of the overall tax reform (see Chapter Four and IMF 2012). It is worth highlighting, however, that some recent research shows that for the same level of distortions payroll taxes raise fewer revenues (see Bird and Smart 2014). In terms of equity issues, an argument against moving toward general revenue financing is that it could lead to a regressive redistribution of income. This is because the social insurance programs today benefit mainly formal sector workers who are likely, on average, to be better off than self-employed and informal wage employees. If the general revenues needed are higher than those mobilized today through payroll taxes, that would be the case. This issue could be resolved, however, if the coverage of social insurance programs is extended to all workers. For instance, if the minimum pension guarantee also applies to the self-employed and wage employees in the agricultural sector (see discussion below).

33. Contribution Rate = $\alpha * G(r,i)$. Where α is the accrual rate (the percentage of the reference salary received for each year of contributions and G is an annuity factor that depends on the retirement age (R) and the discount rate (i). When the discount rate is zero, the annuity factor is equal to life expectancy at retirement. Hence, the higher the retirement age, the lower the annuity factor and the higher the pension. Similarly, as the discount rate increases, the value of the pension increases. In Tunisia, it is assumed that the discount rate can be close to three percent per year. Countries often delink contributions from benefits to protect workers who do not contribute for 40 years and therefore would receive lower replacement rates and pensions that are too low. This problem could be better addressed, however, by having a minimum pension guarantee that would be set as a percentage of the minimum wage. For instance, a worker earning the minimum wage and who has contributed for only 20 years could receive a base pension of 60 percent of the minimum wage, plus a contributory pension worth 25 percent of his or her last salary (that is, a total 75 percent replacement rate). The minimum pension guarantee could be the same for all workers or, in order to reduce costs, lower for those who are able to accumulate a higher pension through their contributions. In all cases, however, the cost of this minimum pension guarantee would not be financed through payroll taxes but through general revenues.

34. The use of (part of) VAT tax receipts for this purpose is advocated by several academics (see for instance <http://www.cercle-economistes-tunisie.org/publications/lettre/1-la-tva-sociale-une-piste-de-lutte-contre-le-chomage-en-tunisie/la-tva-sociale-lettre-du-cercle-numero-1/>)

sociale-lettre-du-cercle-numero-1/)

35. For instance, the contribution rate necessary to finance a 50-percent replacement rate during a period of three months could vary between 1.5 and 5.5 percent depending on the level of the unemployment rate. The contribution rate necessary to equilibrate the system is given by:

$$\beta = \alpha * u/e$$

where α is the replacement rate and u and e respectively the unemployment and employment rates. Thus, the lower (higher) the unemployment (employment) rate the lower the contribution rate.

36. The problem with this system, however, is that it can provide incentives to delay exit from unemployment (see Robalino, et al. 2013). For instance, workers can take informal jobs and maximize the amount of benefits they receive from the system. Controlling this is, institutionally, very difficult.

37. To replace the forgone revenue from the savings tax, one important alternative to consider, if severance pay is reformed, is a dismissal tax. Employers dismissing a worker, for any reason, would pay a given percentage of the worker's salary to a common pool that would then finance redistribution. The dismissal tax would internalize part of the social costs of unemployment (see Ribe, et al. 2012).

38. Because it is difficult to observe their earnings—and for many these earnings fluctuate seasonally—the system would give them more flexibility in terms of the level and frequency of their contributions. The contributions, for instance, do not have to be set up as a percentage of earnings but can be made in absolute terms subject to a minimum floor (for example, five percent of the SMIG). What is important is that these contributions receive the same, implicit, interest rate paid on the contributions of private-sector workers (see above). So, for example, if a self-employed worker contributes, on average, 30 dinars per month during a period of 20 years (the equivalent of a 15 percent contribution for a salary of 200 dinars), his or her pension would be equivalent to 50 dinars (25-percent replacement rate over 200, since a 15-percent contribution rate finances a 50-percent replacement rate only after 40 years). Workers contributing more than 30 dinars would, of course, receive higher pensions. Again, as discussed above, this pension would come on top of the minimum pension guarantee.

39. It is worth noting that there is nothing wrong inherently with the use of short-term contracts, and indeed these are part of the standard set of tools in most countries. The problem in Tunisia arises because of the extreme dichotomy created between highly flexible fixed-term (short-term) contracts and highly rigid open-ended contracts. There is a need therefore to reduce the gap between these so as to increase protection and predictability of fixed-term (short-term) contracts while introducing some flexibility for firms in the de facto rigid system for dismissals of open-ended contracts.

40. To inform the negotiation it is also recommended to commission an independent technical assessment of the economic and social impacts of any change to the minimum wage.

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A Financial Sector in Disarray | 06



Tunisian banks are ineffective
at channeling resources to the
private sector



The financial sector is a critical component of the economy and its ability to create jobs. How well it works is a key factor in determining how the rest of the economy functions, as was clearly demonstrated when the recent financial crisis plunged economies into recession around the globe. What distinguishes the financial sector from other sectors of the economy is that, while the direct impact of financial institutions on the real economy (in terms of direct employment or GDP) is relatively minor, the indirect impact of financial markets and institutions on economic performance is extraordinarily important. The financial sector mobilizes savings and allocates credit across space and time, optimizing the allocation of capital. It therefore plays a pivotal role in enhancing the productivity of the economy, and therefore its ability to generate higher income and create more and better jobs (Herring and Santomero 1991) ¹.

The financial sector in Tunisia suffers from deep dysfunctions and has been unable to channel resources towards the most productive activities and projects ². The Tunisian financial sector is small and dominated by public-controlled banks but also presents a significant number of private banks, both large and small, and a substantial foreign presence (box 6.1). The ability to provide credit to the economy remains weak, especially when compared to banks in neighboring economies such as Morocco. As discussed in this chapter, the weak credit intermediation is a brake to economic performance in Tunisia. Further, while ordinary businesses struggle to gain access to finance, cronies have had easy access to finance (at convenient rates and low collateral or guarantees). As a result banks have accumulated large liabilities (which will have to be repaid by taxing economic performance in Tunisia) and have undermined competition (by favoring crony firms), thereby entrenching the misallocation of resources and contributing to the weak performance of the economy. In parallel the nonbank financial sector remains small and does not play its critical role in fostering investment and innovation.

This chapter discusses how to make the financial sector support faster economic growth in Tunisia. It argues that, just as the rest of the economy, the financial sector suffers from limited competition and weak governance, in large part as a result of the problems affecting the large state-owned banks. The chapter does not discuss the problems with innovation and risk—financing instruments in Tunisia, as this issue was already discussed in the 2010 Development Policy Review “Towards Innovation-Driven Growth in Tunisia” (World Bank 2010a).

6.1 / The Feeble Performance of the Financial Sector

Persistent Inefficiency, Especially in State-Owned Banks

An analysis of net-interest margins suggests that Tunisian banks remain relatively inefficient. The net-interest margins are a measure of competition and efficiency of the banking sector. The margin declined in recent years to reach 2.5 percent in 2010 (figure 6.1). This level is somewhat better than Morocco and Turkey, and is comparable to the Arab Republic of Egypt and to Jordan (figure 6.2), but remains higher than in developed countries where the ratio is generally below two percent. As discussed below, the decrease in net-interest margin in recent years is explained by the decline in overhead cost over total assets (except in large state-owned banks). This suggests that banks have been improving their efficiency and therefore need less interest margin to cover their overhead costs. In fact as discussed below this is driven by the performance of the middle-size and small-size private banks.

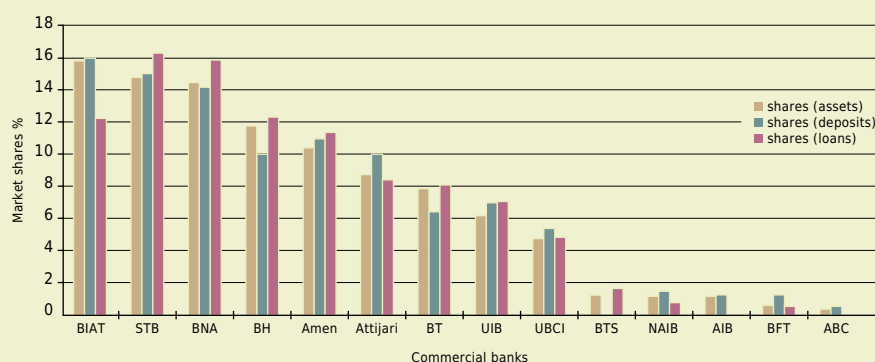
Box 6.1: The Structure of the Tunisian Financial System

In 2012, the Tunisian financial sector was small and dominated by banks, with assets equal to about 115 percent of GDP. This figure is somewhat lower than that of its regional peers such as Jordan, Lebanon, and Morocco.

Tunisia's banking sector is dominated by public-controlled banks, but also presents a significant number of private banks, both large and small, and a substantial foreign presence. As of 2012, there were 21 onshore credit institutions divided between five state-owned commercial banks (accounting for 39 percent of total banking assets in June 2011), ten private commercial banks (33 percent of assets), and six foreign banks (28 percent of assets). The three largest state-owned banks account for 37 percent of banking sector assets, namely the *Société Tunisienne de Banque* (STB), with 52.5 percent of public capital; the *Banque Nationale Agricole* (BNA), with 66.2 percent of public capital; and the *Banque de l'Habitat* (BH), with 57 percent of public capital. Similarly the three large private domestic banks account for 28 percent of total assets (*Banque Internationale Arabe de Tunisie*, BIAT; *Amen*; and *Banque de Tunisie*, BT). Three of the largest foreign banks (from France, Jordan, and Morocco) are former state-owned banks, only one of which appears to have completed its restructuring. There are five small banks set up as development banks, partially with funds from the Gulf States, which enjoy universal banking licenses. No major changes in the number of market players have occurred during the last five years except the setting up of a second Islamic bank (*Zitouna Bank*).

This fragmentation leads to a division of market shares with no institution having a market share greater than 14 percent in terms of total assets or loans and 16 percent in terms of deposits. The three largest banks—BIAT, BNA and STB—concentrate almost 50 percent of total assets with approximately equal weight. This situation is unusual in the Middle East and North Africa region (MENA), where the concentration of the banking sector is generally much higher. In Morocco, for example, the top three banks accounted for 62 percent of loans to the economy while the first five concentrated 81 percent in 2012.

Figure B6.1.1 Market Shares of Largest Fourteen Tunisian Banks in 2010



Source: Bankscope database.

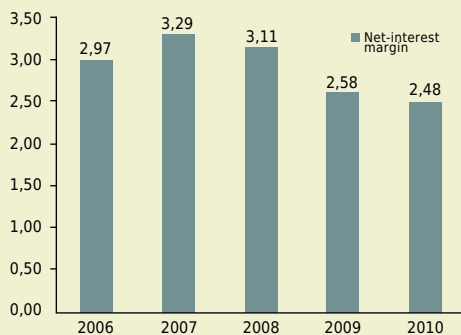
The nonbank financial sector is small and accounts for only about 20 percent of all financial system assets. Tunisia has a nascent insurance sector, with 19 companies primarily focused on nonlife activities (85 percent of premiums) and annual premiums to GDP of about 2 percent. The equity and fixed-income markets are still relatively modest, with a market capitalization equal to 24 percent of GDP, lower than in regional peer countries such as Jordan (112 percent) and Morocco (76 percent). Private equity remains small and the leasing sector, with nine institutions, accounted for 15.5 percent of private gross fixed capital formation in 2010.

Source: World Bank and IMF 2012; Khanfir 2013

The analysis of overheads indicates that large banks in particular are not very efficient and have been shielded from competition. Overhead costs of Tunisian banks are higher than those in other MENA countries, with the exception of Turkey (figure 6.3). On the one hand, the high overheads reflect the atomized structure of the Tunisian banking sector that may limit scale economies. On the other hand, the large banks (which are mostly state-owned banks—see box 6.1) do not have the lowest overhead costs (figure 6.4)—which reflects the weak performance of the large state-owned banks. The persistently high level of overheads in large banks indicates limited efficiency, which would be consistent with low competition in the banking sector. Middle-size and smaller banks, however, have been reducing their overheads quite substantially (figure 6.4), suggesting that there is competitive pressure in this segment of the market. Overheads for small banks have decreased the most over the period but remain the largest—suggesting that smaller banks may not be able to realize scale economies.

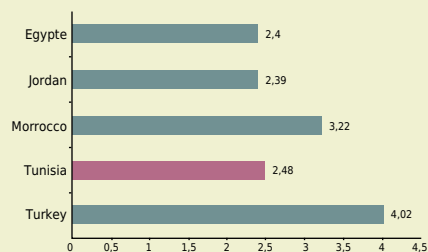
Overall, medium-sized banks have the best financial performance in Tunisia. Higher overheads in large banks are mainly driven by higher wages per employee, which reflects the generally higher pay offered by the public banks (figure 6.5). The income-to-overhead costs ratio has been highest for the medium-sized banks (figure 6.6). These findings

Figure 6.1: Net-Interest Margin in Tunisia, 2006-2012 (%)



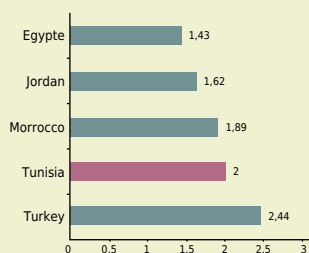
Source: The Global Finance Database (World Bank, 2012).

Figure 6.2: Net-Interest Margin in Various Countries in 2010 (%)



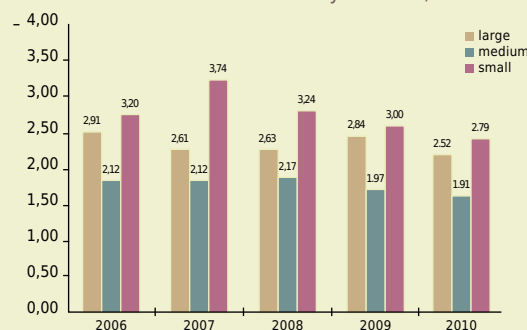
Source: The Global Finance Database (World Bank, 2012).

Figure 6.3: Overhead Costs to Total Assets in 2010 (%)



Source: The Global Finance Database (World Bank, 2012).

Figure 6.4: Overhead Costs to Total Assets by Bank Size, 2006–2010 (%)



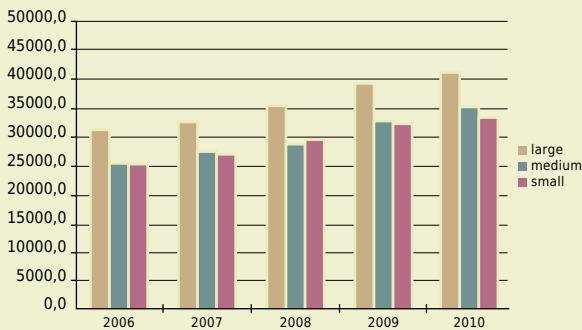
Source: Bankscope

Note: ATB is dropped out due to lack of data (missing values for some items for years 2009 and 2010).

suggest that medium-sized banks are the best performers in Tunisia—they are not afflicted by the corporate governance problems affecting large state-owned banks (see below) and they appear to be driving efficiency gains, possibly because they are large enough to realize scale economies.

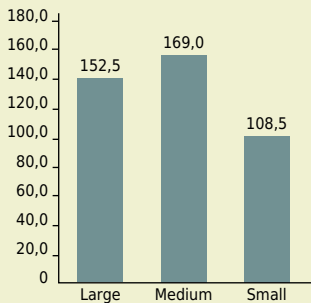
Reflecting the inefficiency of the sector, the profitability of banks in Tunisia is lower than in comparator countries. It is worth clarifying that we are interested in the profitability of the banking sector in as much as it may be indicative of the efficiency and performance of the sector—that is, to assess how efficiently financial services allocate resources to productive projects that can create wealth and jobs for Tunisians. The average return on assets (ROA) was 0.9 percent and

Figure 6.5: Wages per Employee by Bank Size, 2006-2010 (TND)



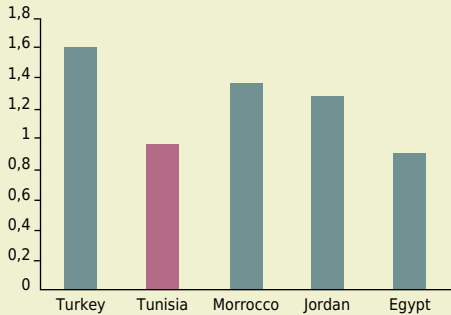
Source: Bankscope
 Note: Large banks = BIAT, STB, BNA; Medium banks = BH, Amen, Attijari, BT; Small banks = UIB, UBCI. NAIB and ATB are left out due to lack of data.

Figure 6.6: Income to Overhead Costs by Bank Size in 2010 (%)



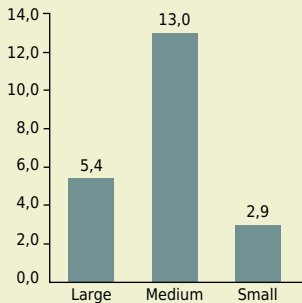
Source: Bankscope
 Note: ATB is dropped out due to lack of data (missing values for some items for years 2009 and 2010).

Figure 6.7: Return on Average Assets for Some MENA Countries in 2010 (%)



Source: Bankscope
 Note: Large banks = BIAT, STB, BNA; Medium banks = BH, Amen, Attijari, BT; Small banks = UIB, UBCI, NAIB. ATB is dropped out due to lack of data (missing values for some items for years 2009 and 2010).

Figure 6.8: Return on Average Capital (ROAC) by Bank Size in 2010 (%)



Source: Bankscope
 Note: Large banks = BIAT, STB, BNA; Medium banks = BH, Amen, Attijari, BT; Small banks = UIB, UBCI, NAIB. ATB is dropped out due to lack of data (missing values for some items for years 2009 and 2010).

the average return on equity (ROE) was 9.9 percent in 2012, which are low compared to returns observed in comparator countries (figure 6.7) ³. Profitability has been highest in medium-sized banks (as shown by the return on average capital, ROAC), reflecting their lower overhead costs and higher income (figure 6.8). In principle, in line with our discussion in Chapter Two, the low profit margins could be indicative of a high level of competition. However, as we have seen, the relatively low profitability is the result of relatively high margins and persistently high overheads in large banks. This suggests that low profit margins are not the result of high competition driving efficiency—rather the problem in the banking sector seems to be that low competition allows inefficiency in large banks to continue.

Weak Intermediation of the Banking Sector, Both in Quantity and in the Selection of Projects

The level of intermediation in Tunisia remains very low, and an international benchmarking signals significant potential to increase the quantity of financing available to the private sector for investments. Consistent with their feeble financial performance and limited efficiency, Tunisian banks are ineffective at channeling resources to the private sector. The share of credit to GDP remained almost constant at around 60 percent throughout the past decade and, despite an increase in recent years ⁴, the level of private credit to GDP remains below the potential for Tunisia (figure 6.9) ⁵. Credit to the private sector as a percentage of GDP remains much below high-income Organization for Economic Cooperation and Development (OECD) countries and also well below neighbouring Jordan and Morocco (figure 6.10). The low level of intermediation of the Tunisian financial sector has significant implications. An increase in the share of credit to GDP from the current 70 percent to its potential level of 80 to 90 percent could generate in excess of US\$10 billion in additional credits that could be injected in the economy, over say a period of 10 years, to finance private investment. Such an increase in investment corresponds roughly to an additional 380,000 jobs in total (that is, approximately 38,000 additional jobs per year).

Figure 6.9: Actual vs. “Benchmark” Private Credit to GDP, 2000-2010 (%)

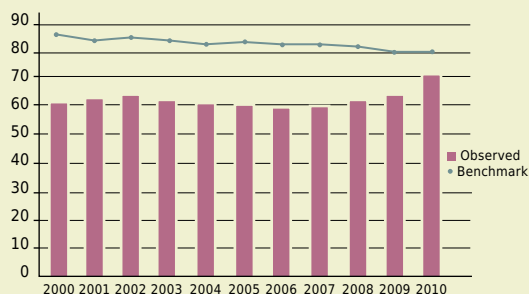
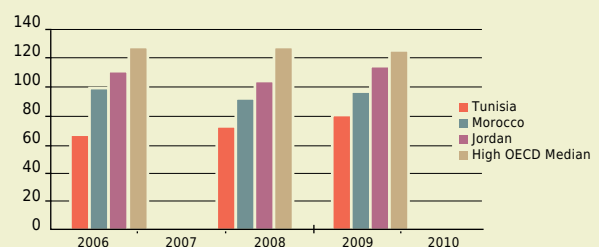


Figure 6.10: Credit to Private and Public Sector as Percent of GDP in Jordan, Morocco, Tunisia, and High-Income OECD Countries, 2009 to 2011



Source: World Development Indicators (WDI).

Note: Benchmark values of private credit to GDP are obtained following the methodology of the ‘benchmark’ model as developed by Beck et al. (2008). Indeed, ‘benchmark’ values are obtained from the estimation of a pooled Ordinary Least Squares (OLS) regression for the period 1985-2010 where the dependent variable is the log of domestic credit to GDP. The explanatory variables include the logs of GDP per capita, population size and density, the value of fuel exports to merchandise exports, the poverty gap, and an interaction variable which is the product of GDP per capita and population size.

In fact firms’ complain that access to finance is a major constraint in Tunisia. According to the World Bank 2012 Enterprise Survey (see annex 4.4), approximately 55 percent of firms have a loan, which is high by regional standards. Nevertheless access to finance was indicated as a major or severe constraint by 34 percent of Tunisian firms in the survey, which is also high by regional comparison (Investment Climate

Assessment, World Bank 2014e). The problem is greatest for medium-size firms, which flag it as their most important constraint. These data pose somewhat of a paradox, as access to finance is perceived to be restricted, while in fact most firms have had access to bank loans ⁶. The perceived difficulty in access to credit may reflect the extreme prudence of banks in Tunisia, which results in an over-collateralization of the loan (which at 177 percent is the highest in the entire MENA region). Also the length of time required to get a loan from a bank is very high. These aspects of weak performance of the banks can be attributed to the lack of competition ⁷. The result is that many small entrepreneurs who have a great project are unable to create it or to expand because of difficulties in finding access to finance (box 6.2).

Box 6.2: Cautious Lending a Hurdle for Tunisian Startups

BEN AROUS, northern Tunisia—On a greenfield site south of the capital, this medium-sized company produces plastic granules for some of the hundreds of firms across Tunisia that work with injection molding. They will transform the plastics into anything from garden furniture (the omnipresent white plastic chairs of village cafés) to auto parts or electrical components for sophisticated European manufacturers.

The business's founder and chief executive derives some satisfaction from having introduced a new industrial process into Tunisia. Until he started the company, all those manufacturers had to source their polymer granules from abroad. After five years in operation, his plant is still the only one of its kind in the country. Sales have risen eightfold to 7.3 million dinars (about 3.3 million euros), and in 2014 are expected to approach 13.5 million dinars with the help of two more production lines. The workforce—around 30 people at present, mainly graduates—is set to increase.

However, he is less happy with the banking system. Its mindset on lending to startups needs some fresh air, he believes. "A bank needs to understand the nature of a business so that when it is asked to invest further, it's ready to lend." Some banks that lent to him in the past never even made a site visit.

His company initially secured funding from FOPRODI, an official industrial development fund, and took on the relatively high level of borrowing that was tolerated by banks in those days. Banks are now showing a new cautiousness in their lending, plus the lack of engagement with start-ups continues, he says.

Working in plastics, a low-margin area of manufacturing, the business has needed successive top-ups to working capital for investments that have allowed it to comply with the requirements of its European end users. Car assemblers working round the clock require suppliers to have a back-up production line, for example. This is not something Tunisian bank managers always understand. "Why does the company need a second production line if the first is not yet used at full capacity?" they ask. Another major investment has been a water sprinkler system for fire protection in its warehousing facility, as required by International Organization for Standardization (ISO) standards.

The business has found a more understanding partner in private equity firm Tuninvest, which supplied crucial cash in the form of successive capital increases, leaving Tuninvest with a 72-percent stake in the business. "They believed in the project," says the chief executive. "They know that in this line of business you don't get a return on investment in just six months."

Other Tunisian entrepreneurs, however, possessive of their start-ups and failing to secure bank loans, choose not to grow rather than accept new shareholders, he says. "They have the ideas, competence, a little bit of know-how and the enthusiasm to throw themselves into a project." But they don't find banks that understand their needs: "For many of our bank managers, a loan is just a file. It's a set of papers. It's movements of cash through an account. They still think like civil servants."

Source: Interview with chief executive, April 2014.

Performance is also quite disappointing in terms of credit quality as measured by the rate of non-performing loans and provisioning rates. Between 2006 and 2011, the official non-performing loans (NPL) ratio improved from 19.3 percent to 13.3 percent, which however remains high by international standards ⁸. The weak performance of the loan portfolio reflects corporate governance failures that result in the inability of banks to select good performing investment projects. It also reflects a bankruptcy regime that favors debtors at the expense of creditors, hampering competition as well as hindering the efficient operation of the banking sector.

Mounting Fiscal Liabilities in the Public Banks: The Price of Inefficiency and Crony Privileges

The banking sector has been a tool for privileged access to finance by cronies. Instead of allocating resources toward the most productive projects, the banking sector, and public banks in particular, have been providing financing to the cronies and well connected. While there is abundant anecdotal information, the most visible evidence of these practices regards the loans granted to the family of Ben Ali. Tunisian banks funded businesses linked to the family of President Ben Ali to the tune of TND1.75 billion (or approximately 2.5 percent of GDP), the equivalent of five percent of all financing by the Tunisian banking sector, and nearly 30 percent of the cash was provided with no guarantees of repayment ⁹. Beyond Ben Ali, connections play a very large role in gaining access to credit in Tunisia. As a result, Tunisian banks (mainly, but not only, the public banks) have imposed a significant cost on the economy both directly as they have accumulated significant losses such that they now require recapitalization from the state budget (see below) and indirectly by reinforcing the anticompetitive environment for private sector (as discussed in Chapter two and Chapter Three).

Beyond the weak financial performance and weak intermediation, the vulnerabilities in the banking sector have translated into a large fiscal liability. The results of stress tests carried out in January 2012 indicate that the banking sector has accumulated large recapitalization needs even to meet the current eight percent regulatory minimum (which is below international norms) (World Bank and IMF, 2012). The solvency tests simulated bank performance under a baseline scenario and an adverse scenario for the period 2012 to 2014 ¹⁰. Even under the baseline scenario, there is a projected recapitalization need of almost three percent of GDP within two years, while under the adverse scenario it is projected at five percent of GDP ¹¹.

The performance of public banks is much weaker than that of private banks. Another key aspect to consider is the role played by the large public ownership of the sector. As mentioned above, the financial performance and efficiency of the public banks appear to be much lower than of other banks. Indeed, the results of the stress test also highlight that the three largest public banks have an average solvency ratio of nine percent, an average official NPL ratio of about 15 percent, an average provisioning ratio of less than 50 percent, and an average ROE of about six percent. These figures are significantly worse than the comparable averages for the private banks ¹².

The large debt of the tourism sector is emblematic of the financial sector failures in Tunisia. Tourism deserves a special mention as it accounts for over 25 percent of total NPLs. The weakness of public banks tended to both mask the problems in the tourism sector but also contributed to them by channeling credit to less productive entrepreneurs and by freezing liquidity that would otherwise have circulated in the sector (box 6.3). Notably, under the prior regime, there was a high risk of directed and related credits to members of the ruling elite and their cronies. Several structural and governance issues magnified the level of financial distress in the tourism sector, notably the sector strategy that promoted overreliance on debt, the role of the state-owned banks, the lax central bank regulation, and the ineffective insolvency and creditor rights system.

Box 6.3: The Tourism Sector in Tunisia: Chronicle of a Death Foretold?

Tourism plays a major role in the Tunisian economy, accounting for at least seven percent of GDP (in 2010), about 14 percent of jobs (direct and indirect), and over 10 percent of total exports (and is therefore a major earner of foreign exchange). Over the last 25 years, however, multiple structural issues have undermined the competitiveness and financial soundness of the sector, such that tourism has witnessed a steady decline.

In the early 1980s, the Tunisian government launched an ambitious program to develop the tourism sector, with a strong emphasis on coastal development in a few select beach areas. As part of this effort, the government deeply engaged the public banking system to subsidize the expansion of the tourism sector. The Tunisian government, like many others in the 1980s, decided to help overcome the size limitations of the domestic financial markets by setting up a series of subsidized financing mechanisms. Subsidies aimed at the tourism sector specifically included provision of below-market land, looser credit requirements, loan guarantees and preferential interest rates, as well as the directed support of the state-owned financial institutions.

Through the 1980s and 1990s, the effort seemed to succeed as Tunisian hotels tapped the European beach vacation market. Over two decades, the effort tripled hotel space while tourism revenues grew twentyfold and Tunisia became a major mass tourism destination.

However, as the initial low-cost all-inclusive model became saturated, the sector started suffering from critical rigidity. In the early 2000s, at a time when new and more sophisticated competitors were entering the market, the “beds only” strategy became less and less relevant. The abundance of hotel beds (now over 250,000 in over 850 hotels, creating a total capacity of over 91 million bed nights) and the pressure on their owners (most of whom have monthly debt to service and bills and salaries to pay) to sell this perishable product gave gradually more market power to a handful of large tour operators (with access to markets) and put them in a position to dictate room rates and market positioning to hotel owners.

The terrorist attacks of September 2001 in the United States and April 2002 in Tunisia (at the synagogue in Djerba) led to severe revenue shocks that revealed these mounting structural weaknesses. While it was clear that policy reforms were needed to encourage innovation, diversify, and improve quality, nevertheless the government continued to subsidize less qualified investors and to add undifferentiated additional capacity, resulting in a further downward economic and financial spiral. As a result room rates have been declining over the past 10 years. Economic benefits to the country, particularly employment, are low relative to the number of tourists and the number of hotel rooms.

As of the end of 2010, the outstanding credit to the sector amounted to TND 4 billion (or almost six percent of GDP), and total tourism sector NPLs amount to an estimated TND 1.5 to 2 billion (or approximately 2.5 percent of GDP) but this figure may significantly understate the problem. State-owned banks are by far the largest providers of credit to the tourism industry, but the problem is widespread with 15 out of the 21 commercial banks operating in Tunisia exposed to the tourism sector.

The heavy weight of debt on many hotel borrowers has led them to give short shrift to renovation and to operational necessities, further continuing the downward spiral in quality and prices that has hurt the whole sector. More recently, political instability and security concerns have pushed the sector into a severe recession with tourism revenues falling by about 40 percent in 2011. Indeed, out of the 850 hotels, it is reported that over one-third went into severe financial distress in 2011. As a result tourism NPLs have increased further at a very fast pace since the revolution.

6.2 / Challenges affecting the financial sector: Limited competition and weak corporate governance of State Owned Banks

The analysis above has highlighted the poor performance of the Tunisian banking sector in terms of profitability, efficiency, intermediation, and financial stability ¹³. Overall it is clear that the financial sector has not played the role of “lubricator” in the economy to effectively channel resources to the most profitable activities. On the contrary it appears to be misdirecting the resources, favoring cronies, and as a result it has accumulated large liabilities that undermine the economic performance of Tunisia. We now turn to explore the factors that may explain such poor performance.

The Paradox of the Tunisian Financial Sector: Many Banks, but Little Competition

Despite the large number of banks, several indicators suggest that the Tunisian banking sector suffers from low competition. The fragmentation of the Tunisian banking system and the small size of many Tunisian banks could explain the disappointing performance of the sector, as they prevent the efficiencies associated with scale economies. Nevertheless, a previous World Bank study has argued that the fragmentation does not by itself explain this disappointing performance and that, on the contrary, weak competitive pressure is at the root of the feeble performance of the Tunisian banking sector (Anzoategui, Martinez Peria, and Rocha 2010) ¹⁴. A formal Ross-Panzar test for Tunisia indicates an H-coefficient of 0.32, suggesting that indeed the banking sector operates under “monopolistic competition” ¹⁵. Comparing this result with the available data for the region shows that Tunisia performs rather poorly: Egypt has an H coefficient of 0.62 in 2010; Morocco of 0.59, indicating much greater competition; Turkey of 0.61; and only Jordan exhibits an H of 0.32, which is the same as Tunisia. Two additional indicators of competition, the Lerner index and the Boone indicator, suggest broadly similar conclusions (table 6.1) ¹⁶. Hence it seems that the Tunisian financial sector suffers from low competition, despite the larger number of banks. As discussed below, several factors explain the low level of competition in Tunisia.¹⁷

Table 6.1: Competition Indicators for Some MENA Countries

Country	H-Statistic	Lerner index	Boone indicator
Egypt	0.62*	0.19*	-0.08
Jordan	0.32	0.34	-0.05
Morocco	0.59*	0.69	-0.07
Tunisia	0.32	0.29	0.01
Turkey	0.61	0.27	-0.01

Source: The Global Finance Database (World Bank, 2012).
Note: Figures with * come from Anzoategui et al. (2010) for the year 2008.

An Inadequate Regulatory and Supervision Framework

The lack of control and sanctions for violations undermines fair competition between banks, as those banks that strive to comply with the prudential rules are disadvantaged compared to the others. The 2012 Financial Sector Assessment Program (FSAP) report noted that banking supervision is inadequate, particularly with regard to public banks (IMF and World Bank 2012). Despite recent progress, the regulatory framework remains short of international standards. In

addition, infringements of prudential rules have so far not resulted in sanctions by the Central Bank ¹⁸. In extreme cases non-viable banks can continue to operate even in violation of the rules and generating credit losses. Such situations lead to significant distortions of competition because experience shows that such institutions in trouble cannot survive in the market by exercising a downward pressure on tariffs, lowering their selection criteria and management risk and using funding guaranteed by the state or granted by the Central Bank.

Weak standards also lead to systematic underestimation of risk, which has contributed to the high rate of bad debts. In addition to weak financial soundness, some prudential rules have also led to distorted lending policies, as illustrated by the example of the overreliance of banks on mortgage collateral (see below) ¹⁹. In addition, the weakness of the prudential framework and supervisory system does not encourage banks to focus on their comparative advantage and to invest in innovation.

Limitations on Interest Rate Artificially Restrict Competition and Access to Finance

Further, the CBT regulations on interest rates restrict banks' ability to compete. The Central Bank has long established a maximum limit on lending interest rates (at 1.2 times the average lending rate observed during the last semester) ²⁰, which results in undesirable effects. First, the cap excludes otherwise viable companies, mostly small and medium-sized enterprises that do not have adequate collateral. Second, loans with longer maturities must carry more or less the same price tag as short-term loans ²¹. These restrictions limit competition and at the same time prevent banks from pricing credit according to the level of risk (by clients or by maturity). As a result Tunisian banks compete only for a limited pool of clients (low risk, high collateral)—as reflected by the fact that interest rates charged are fairly low and that banks do not seek higher-risk profitable projects. In fact they would not be able to charge them for the higher risks. The cap on bank interest rates imposed by the Central Bank aims to protect bank customers from possible abuse. In doing so, however, this cap excludes many companies, such as startups or businesses that do not have sufficient guarantees, and to whom banks cannot offer rates that would allow them to cover their additional risk. Hence, there is a need to find other means to protect customers without limiting access to credit.

Poor Corporate Governance of State-Owned Banks

The weak performance of public banks reflects severe corporate governance failures. As mentioned above, there is significant evidence of abuse of public banks for the benefit of cronies, reflecting the fact that the governance arrangements of public banks do not provide independent management from political power. Beyond the role of corruption, however, the corporate governance environment for public banks is full of conflicts of interest. The state is a dominant player, the largest customer, and the regulator of the banking sector. These multiple roles generate conflicts of interest that interfere with normal market operation and limit competition between the players. For instance, as a shareholder the government has no interest to grant licenses to new players; as a lender it will seek the best price conditions at the expense of bank profitability; and as borrower it pursues the most flexible and least secure conditions for the banks. Hence the public banks have been subject for a long time to conflicting demands resulting in poor performance. They have been required to lend to cronies and to poorly performing state-owned enterprises (SOEs), to be profitable, to diversify, to compete with private banks, and to fulfill missions on behalf of the state (for which they might or might not be compensated).

The weak governance of public banks also contributes to reducing competition. As a result of the weak governance environment, public banks have felt no pressure to improve their management, their internal organization, or even their economic and financial performance. For instance, until

now, no public bank has implemented a rating system of its debtors. Similarly, accounting and risk management are poorly developed in public banks, even though such functions are at the heart of good management of any bank.

Further, state involvement in the banking sector has created additional competitive distortions. Notably, past recapitalization of public banks initiated by the state without changing their governance structure has created distortions vis-à-vis other commercial banks. Several times over the past two decades public banks received significant recapitalization without requirements in terms of restructuring and corporate governance—such as would be standard requirement in EU countries. Such unconditional transfers of public resources create significant distortions of competition and undermine the performance of good banks.

Structural Inefficiencies in the Bankruptcy and Collateral Regime

Tunisia suffers from very weak bankruptcy procedures, enabling inefficient and crony firms not to repay their debts and yet to survive instead of having to restructure or exit ²². Tunisia's bankruptcy regime is fragmented with duplicate and overly lengthy processes for business rescue and business exit. The result is that it allows inefficient firms to survive instead of having to restructure or exit. Although some protection is necessary for companies in difficulty, an overprotective law, such as is the case in Tunisia, has perverse effects. It is harmful to economic actors because defaulters continue to operate their businesses and impose unfair competition to other actors. As discussed above, the tourism sector is a good example of this phenomenon of self-destruction. In addition, an effective bankruptcy framework is of critical importance for the smooth operation of the banking sector, and indeed the private sector as a whole, as it improves stakeholders' recovery, reduces creditor risk, and facilitates asset disposal. These elements determine banks' lending policy, and therefore an ineffective bankruptcy regime hinders access to finance. A weak bankruptcy system acts like a scarecrow for banks that have no other choice but to adopt an ultraconservative attitude with respect to the distribution of credit. Finally, beyond promoting unfair competition and discouraging banks from financing good projects, ineffective bankruptcy procedures also impede the rechanneling of resources toward more productive uses in the form of new loans and therefore prevent the development of more productive firms—thus contributing to the structural stagnation discussed in Chapter One. In fact a well-functioning bankruptcy system is at the heart of instilling efficiency in the economy via the process of creative destruction discussed in Chapter One.

A well-functioning bankruptcy framework could lead to very significant financial gains in Tunisia. Given the current aggregate level of NPLs of around US\$7 billion (in 2011) and using the Doing Business 2012 recovery rate of 0.52 cents on the dollar, we can calculate that stakeholders will recover only around US\$3.7 billion on existing outstanding loans, leaving less than half in unrecovered funds or value destroyed. A reform of the bankruptcy system could help improve the recovery rates. Based on international experience, the Impact Model for Insolvency Reforms used by the World Bank collectively tends to increase returns to creditors by an additional \$0.30 of recovery for four percent of stakeholders. Hence, assuming that a reform will improve recovery rates by \$0.30 (a recovery rate of \$0.82), this would bring an additional US\$2.1 billion (or 4.5 percent of GDP) in stakeholder-recovered funds from current NPLs, which if reinvested could generate around 80,000 new jobs. Assuming that the impact of the reform would extend beyond the existing NPLs (to approximately four percent of insolvent companies) would result in much larger benefits.

Tunisia's financial sector has also become hostage to a distorted collateral regime. The Tunisian credit institutions try to mitigate their lending activities, and the risks incurred by lending to cronies, by demanding a high level of coverage by collateral (mainly mortgage) ²³. There are

multiple reasons for this overreliance, notably: (a) most banks are unable to evaluate project risks, and smaller banks do not even have the necessary databanks; (b) collateral enforcement is known to be very slow and costly (see discussion above on the ineffective bankruptcy procedures) so lenders have no incentive to take security that would be more sensitive to time delays and costs (which is the case for movable, tangible and intangible assets, which can fluctuate rapidly); (c) the legal framework on security is complex and based on the principle that parties could not agree contractually beyond what is expressly allowed by law; and (d) there is no centralized collateral registry. As a result Tunisia is the MENA country with the highest collateral requirements. This strategy (of overcollateralization) has proven to be insufficient to protect banks against defaulting borrowers, however, and it also tends to exclude from access to finance firms and entrepreneurs without the required collateral ²⁴.

The lack of information on the repayment capacity of bank customers (and future customers especially) is also an important barrier to the development of the financial sector. In many countries there are private credit bureaus. These are companies that collect, store, and compile information, mainly on payment incidents and the debts accumulated by economic agents (companies, individual entrepreneurs, or consumers). In the absence of such systems, banks lend only to well-known customers (those who have had credit or are well connected in the business community), to the detriment of new entrepreneurs, young people, or economic actors in regions underserved by banks. Hence it is critical for Tunisia to allow the establishment of credit bureaus.

Limited Alternative Sources of Finance

Banks face only limited competition from other financiers (capital markets, foreign players). The largest Tunisian firms made only limited use of international markets (primarily loan syndications) and stopped when the global financial crisis broke out. Domestic financial markets play only a marginal role in financing Tunisian companies ²⁵. In 2010 the share of capital raised on the domestic market accounted for only two percent of GDP, and market capitalization stood at 24 percent of GDP in 2012.

The main reasons for the weakness of domestic capital markets have been identified in the FSAP report as weak domestic demand, lack of yield curve, and lax enforcement of prudential banking regulation. In this regard, the weak banking regulatory and supervision framework results in an underestimation of risk that allows Tunisian banks to provide companies financing conditions below those that would prevail in a healthy and competitive market where risk is properly assessed. In addition, Tunisia does not have effective financing windows or instruments for innovative (higher technology) investment projects and start-ups (box 6.4). The lack of a sovereign yield curve is a major impediment to the development of diversified capital markets because fixed-income instruments cannot be priced appropriately. Without a yield curve, monetary policy transmission is less efficient, asset prices are distorted, and investors are not properly protected. In several instances, the pricing of corporate bonds does not seem to reflect the risk or the rating of the issuer; shares of mutual funds are not marked to market but valued at historical cost which makes this product similar to a fixed-rate deposit. The lack of a yield curve (as well as the absence of a secondary market for treasury bills) make more difficult the differentiation of pricing between short- and long-term credit, thus also lowering the ability by financial institutions to finance longer-term projects.

There is a need to unleash the potential of venture capital in Tunisia. Venture capital (VC) helps firms meet their equity needs during various critical junctures of their life (startup, development, buyout). Since a significant number of Tunisian firms are run by aged owners who are ready to hand over, their buyout by other existing firms or individuals becomes an issue that needs to be

Box 6.4: Financing and Incentive Mechanisms for R&D and Innovation in Tunisia

According to official sources, Tunisia has invested about 1.25 percent of its GDP in R&D in 2009. In 2006, spending was 1.1 percent of GDP; and Tunisia was above Chile, Morocco, and Turkey but slightly under the MENA average.

Tunisia's financing of R&D and innovations is channeled through an elaborate system of support and incentives mechanisms, including sectoral technical centers, technoparks, and technopoles; numerous research centers (130 research laboratories and 600 research units); an agency for the promotion of research, innovation, and firm creation; an agency for industrial promotion (API); an agency for agricultural investment promotion (APIA); and the capital-risk companies (*Société d'Investissement à Capital Risque*, SICAR).

These institutions are complemented by a number of public programs, aimed at providing incentives for innovation, often among other objectives. These include the *mise à niveau* (upgrading) and industrial modernization programs that attempt to support investment in new technology and enhance organizational and managerial capacity of firms; the *Prime d'Investissement en Recherche et Développement* (research investment premium); the *Programme National de Recherche Intégrée* (a program that seek to link a research unit, a firm, and a technical center around a specific project); the *Programme de Valorisation des Résultats de la Recherche* (research development program); and the *Régime d'Incitation dans le Domaine des Technologies de l'Information* (a fund dedicated to innovative projects in the area of information technology).

Recent reviews of Tunisian innovation systems highlighted several inefficiencies in R&D and innovation financing and incentives, including the following:

1. R&D spending is scattered around a large number of themes and public institutions (World Bank 2010a). The criteria for distributing R&D spending are unclear, and no clear alignment with national priorities or any performance criteria is evident. They are not aligned with any apparent performance indicator either. As a result, budgets received by individual laboratories are limited, as is production. Furthermore, the incentive and reward framework for researchers is biased in favor of producing and publishing personal academic papers, not focusing on research topics directly utilizable by the private sector (Proceedings of the National Days of Scientific Research and Technological Innovation 2007).

2. The objectives of a large number of R&D programs overlap to the effect that some funds are underutilized, for example the research investment fund. This creates waste and inefficiencies (World Bank 2010a).

There is little collaboration between research centers and the private sector. In the ICTEQ 2010 enterprise survey, 40 percent of firms declared having invested in research but only 15 percent of those have collaborated with universities. Three factors play a key role in this poor outcome: (a) limited demand from the private sector due to its predominant specialization in low value-added sectors and sub-contracting; (b) a mismatch between the nature of public research and the needs of firms; and (c) complex bureaucratic procedures.

3. The contribution of capital-risk companies to financing innovation is limited. The existing mechanisms, especially the SICARs, predominantly finance firm creation and operate like classic banks by negotiating credit-like financing conditions (for example, most transactions take the form of a "portage" in which the SICAR gets back its funds at a specified time with a fixed interest rate). Risk taking is minimal in the SICAR system. The SICARs account for only 1.2 percent of total financing distributed by the financial sector. A small number of firms benefit, however, from international funds or lines of credit dedicated to supporting innovation (for example, European Investment Bank credit line).

Source: World Bank 2010a.

properly addressed. In 2011 Tunisian authorities established a sound institutional and regulatory framework in order to stimulate the development of private equity. The regulation appears to be comprehensive and clearly enabled the emergence of various types of funding vehicles, notably investment companies (SICAR), mutual funds dedicated to private equity activities (*Fonds Commun de Placement à Risque*, FCPR), and funds for startups (*Fonds d'Amorçage*). However, VC activity remains shallow in Tunisia due to a number of impediments that prevent investors from fully playing their role in the financing of the private sector. The government has not yet defined what measures it intends to adopt to facilitate the development of venture capital in Tunisia, but several possible measures are being explored²⁶.

The government has taken steps to promote SME financing, and additional measures are being discussed. Besides direct funding channels (such as VC), intermediated small and medium-sized enterprise (SME) financing remains a key element of the financial sector infrastructure in Tunisia to support job creations and spur innovation. As for venture capital, intermediated financing has a key role to play at all stages of firms' life: startup, development, restructuring, buyout. There is a need to improve the performance of the Tunisian Guarantee Society (*Société Tunisienne de Garantie*, SOTUGAR, a partial credit guaranty scheme aiming at providing collateral to entrepreneurs and SMEs applying for bank credits), and the SME Financing Bank (*Banque de Financement des Petites et Moyennes Entreprises*, BFPME), which is a financial institution specializing in financing startups and SMEs, by also allowing more actors to enter this market.

6.3 / A Reforms Agenda for the Financial Sector

The discussion above has highlighted the need to strengthen the regulation and supervision of the banking sector and adopt measures to enhance competition in the financial sector. A key aspect of this would be the restructure of the state-owned banks. In addition there is a need to review bankruptcy procedures and to take rapid action to address the high NPLs in the tourism sector. As mentioned at the onset, we do not discuss the financing of innovative or risky projects and/or microfinance, which also need to be addressed. Specific recommendations are discussed below.

Restructuring of the State-Owned Banks

It is critical to reconsider the role of the state in the banking sector and engage in the restructuring of public banks. Mindful of the ongoing problems in the public banks, the Minister of Finance, in agreement with the Central Bank, decided in June 2012 to launch full audits of the three largest state-owned banks. The audits will aim to provide a comprehensive picture of the strengths and vulnerabilities of the state-owned banks (including banking activities, branch network, internal control, organization, marketing, human resources, and IT system) as well as the actual needs for recapitalization²⁷. There is a wide range of restructuring options, spanning from privatization ("fix-and-sell" or direct sale) to the merger of the three state-owned banks into one major public entity. As a prerequisite to this decision, the government should revisit the rationale for being the ultimate owner of these three large public banks, which are essentially commercial, with limited activities formally conducted on behalf of the state. It should also stop using state-owned banks to support (even temporarily) state-owned enterprises and entities, and prefer direct and transparent support out of the budget and subject to parliamentary approval and oversight. It will be extremely difficult to engage the necessary modernization of these banks without this step, and as such restructuring could have a dramatic impact on the ability of state-owned enterprises and entities to operate.

As part of this process it will be important to improve the corporate governance of state-owned banks, which is at the root of the problem. The rationale and modes of intervention of the state in the economy need to be revised with a view to instill more transparency and accountability. As part of this decision the governance structure of state-owned commercial banks needs to be reconsidered. The main governance shortcomings include: (a) weak boards of directors with insufficient expertise; (b) a general lack of autonomy; (c) a heavy administrative control structure; and (d) the absence of an overall strategic framework or ownership policy. State-owned banks should be subject to the same rules and regulations as private banks²⁸. A first step therefore would be to exclude state-owned banks from the law on State Entities (Law 89-9) and to appoint a majority of seasoned board members from the private sector.

A related issue in Tunisia is the absence of institutions that can provide medium- and long-term capital for productive investment projects. In 2012 the authorities launched the *Caisse des Dépôts et Consignations* (CDC) precisely to increase investments for long-term growth²⁹. More recently the government has discussed the possibility of creating a new development bank tasked with making loans for specific national or regional projects to private or public bodies (possibly in conjunction with other financial institutions) to promote private investment opportunities. Before proceeding to establish a new development bank, however, Tunisia should take stock of the failed and costly experience with its own development banks in the 1980s and 1990s, and identify the lessons learnt from the few successful examples of development banks across the globe³⁰. The overarching lesson is that solid governance arrangements and adequate supervision are critical to the success of these projects.

Strengthen Regulation and Supervision over the Banking Sector

To improve the efficiency of the banking system, priority should be given to strictly enforcing bank regulation and to strengthening market contestability. To improve the efficiency of the Tunisian banking system, it is advisable to: (a) further strengthen regulation (in particular in loan classification and provisioning) and supervision for the Central Bank of Tunisia to effectively control all credit institutions and to impose stricter sanctions for violations of prudential rules³¹; (b) increase competition by removing the Law 99-64 that imposes limitations on the interest rates charged on loans, thereby artificially restricting access to credit; and, (c) strengthen market contestability by reviewing rules for entry (approvals) and exit of nonviable institutions. These measures are intended to promote the restructuring of the banking sector by facilitating the orderly exit of nonviable players and allowing the entry of new, more efficient, and better-managed players within a sound regulatory environment.

Measures to Enhance Competition in the Financial Sector

In addition to these measures, competition in the financial sector can also be enhanced by promoting the development of capital markets as alternative sources of finance to bank loans. Building a reliable yield curve is the first step to take, which will have a catalytic impact on all the other debt markets. In addition, there is a need to strengthen the rules and institutions on competition in the financial sector³². Notably measures to promote venture capital financing seem required. Also financing for SMEs remains especially difficult.

The Reform of Bankruptcy Procedures

The government is working on reforming and modernizing Tunisia's bankruptcy laws. The aim is to arrive at a single, streamlined new bankruptcy law that consolidates Chapter IV of the Commerce

Law and the Law N° 95-34 under one text in order to avoid duplication. The modernization of Tunisia's bankruptcy regime would improve debt recovery and thereby strengthen the credit environment and improve confidence between debtors and creditors. The new legal framework should improve efficiency and flexibility of the bankruptcy provisions, more effectively save viable enterprises (through restructuring), and enable fast and efficient exit from the market of non-viable enterprises (through liquidation).

In addition, parallel improvements in bank intermediation and modernization of infrastructures are also essential by having the Central Bank operate a credit registry (and other database, including on balance sheets) and allowing credit bureaus (as additional resources to develop information and tools and collection of information beyond credit institutions).

Addressing the High NPLs in the Tourism Sector

The government committed to establishing an asset management company (AMC) to resolve the NPLs accumulated in the tourism sector. After considering several options for reform, the government opted for the establishment of a centralized AMC to manage tourism restructuring. A dedicated law will provide the AMC with specific powers, aiming at expediting the restructuring of the problem loans in the tourism sector. The plan is for a significant share of the tourism sector NPLs to be transferred to an AMC and swapped against state-guaranteed AMC bonds. This represents between 150 and 300 hotel units. As a result, NPL ratios will decrease across the banking sector. To successfully restructure the bad loans, the AMC will have to buy the NPLs at a low price. If all these bad assets are transferred, the NPL ratio could decrease from the current 13.5 percent to 10.25 percent. Also, the possibility to repossess the AMC bonds would significantly improve the liquidity in the banking system, freeing up space for new loans to the public and private sectors. On the sector side, restructured hotels would be able to repay their loans. Those that cannot be restructured will be transformed into other projects (for example, offices, hospitals, residences, and so on) or closed down, such that they no longer undermine the operation of competitive hotels.

6.4 / Conclusions

This chapter has argued that the financial sector in Tunisia suffers from deep dysfunctions and has been unable to channel resources toward the most productive activities and projects, thereby entrenching the misallocation of resources and resulting in the weak economic performance and inadequate jobs creation. The Tunisian banking system is characterized by limited profitability, inefficiency, low credit intermediation, and significant vulnerabilities. In line with this, financial deepening has been limited over the past decade and remains well below potential, such that the provision of credit to the economy remains weak, especially when compared to banks in neighboring economies such as Morocco. The weak intermediation of credit to the economy is a brake to economic performance in Tunisia. Indeed 34 percent of Tunisian firms report that access to finance is a major constraint to them. Although ordinary businesses struggle to gain access to finance, however, cronies have had easy access. As a result, the performance of the loan portfolio is very weak and increasingly poses a risk to the stability of the financial system. Also, progress in product innovation and quality service has generally been low. The distorted operation of the financial sector has contributed to undermine competition across the economy (by favoring crony firms) and has resulted in the accumulation of large liabilities that will have to be repaid by taxing economic performance in Tunisia.

The disappointing performance of the financial sector is the result of a severe lack of competition, despite a large number of banks, in part due to poor regulation and corporate governance failures. Using a measure of the elasticity of bank revenue to changes in costs (Panzar-Ross approach), we show that the degree of competition in the Tunisian banking sector is lower than the regional average. Several other indicators also point to lack of competition in the sector—and reflect the fact that the performance of the sector has been stagnating. The low level of competition appears due to the existence of an environment characterized by weak regulatory practices and substantial failures in the corporate governance in particular of state-owned banks. Improving the performance of the sector therefore requires reforms to address these shortcomings.

In order to have banks increasingly finance the best projects, a series of profound reforms are needed in the financial sector. To improve the efficiency of the banking system, priority should be given to reexamining the role of the state in the banking sector, engaging the restructuring of state-owned banks, and strictly enforcing bank regulation with a view to level the playing field and increase competitive pressures in the banking sector. As part of this process it will be important to improve the corporate governance of state-owned banks, which is at the root of the problem. In addition to these measures, competition in the financial sector can also be enhanced by promoting the development of capital markets as alternative sources of finance to bank loans. Building a reliable yield curve is the first step to take, which will have a catalytic impact on all the other debt markets. The modernization of Tunisia's bankruptcy regime is needed to improve debt recovery and thereby strengthen the credit environment and improve confidence between debtors and creditors. There is also a need to take expeditious action to resolve the accumulated problem loans in the tourism sector, which impair both the stability of the financial sector and growth and jobs creation in the tourism sector.

Improving the performance of the financial sector can have significant implications for growth and jobs creation across the economy. By itself the reform of bankruptcy procedures could achieve additional investments of US\$2.1 billion, corresponding to approximately 80,000 new jobs. Further, deeper reforms of the sector that result in an increase in the share of credit to GDP from the current 70 percent to its potential level of 80-90 percent could generate in excess of US\$10 billion in additional credits that could be injected in the economy, over say the next 10 years, to finance private investment. Such an increase in investment corresponds roughly to an additional 380,000 jobs.

The next chapters will discuss a proactive agenda for economic growth by exploring what policies the government can put in place to support industry, services, and the agricultural sector. Our discussion so far has highlighted the need to improve the operation of markets in Tunisia, by increasing contestability and reducing distortive government interventions, and also to improve the investment policies, labor market policies, and the operation of the financial sector. In addition, there is a need to define a proactive strategic policy to enhance and guide the development of the economy to realize its full potential, and this is the focus of the next few chapters. Chapter Seven will focus on industrial policy and barriers to growth in specific high-potential export sectors. Chapter Eight will focus on fulfilling the potential of the services sectors. Chapter Nine will discuss the challenges of the agricultural sector. Finally, Chapter Ten will discuss what policies can help integrate lagging regions.

Notes

1 In addition the financial sector also enables firms and households to cope with economic uncertainties by hedging, pooling, sharing, and pricing risks. An efficient financial sector therefore reduces the cost and risk of producing and trading goods and services and thus makes an important contribution to raising the standard of living, which goes beyond the investment and efficient allocation of resources across the economy.

2 In this report we focus only on access to credit for firms; however, access to finance for the population is also very constrained. Only thirty-five percent of Tunisians have a bank or postal current account and 10 percent a bank loan. These are relatively good figures by regional standards but not by international standards.

3 Profitability has deteriorated since the revolution, weakening the banking sector as a whole.

4 Credit to GDP increased significantly in 2010 and 2011 largely as a result of the expansionary monetary policy of the Central Bank.

5 A recent IMF study examines the evolution of credit to the private sector versus the potential amount of credit provision in Morocco, Tunisia, and a sample of Central and Eastern Europe and the European Union and arrives at similar conclusions (Veyrunes 2011).

6 Tunisia's results are similar to Lebanon's, where 53 percent of the firms have a loan and 35 percent of firms perceive that access to finance is a major constraint.

7 Bank lending is also constrained by the low quality of credit applications. According to the 2012 Enterprise Survey, only 32 percent of firms had financial statements certified by an external auditor.

8 In fact the number of NPLs would be even higher if it were not for the Circular issued by the Central Bank in April 2011 that allowed banks not to classify and provision as NPLs loans restructured in 2011 and 2012 as a result of the economic difficulties. It is likely that NPLs may have deteriorated by approximately five percent since the revolution.

9 Source: Press statement by the Governor of the Central Bank of Tunisia in February 2011.

10 The baseline scenario included a moderate pick-up in growth in 2012, followed by strong medium-term performance. The adverse scenario simulated a further negative growth shock in 2012, followed by a gradual but lower medium-term recovery to a moderate growth level.

11 Further, as detailed in the FSAP report, banking sector vulnerabilities are likely to be higher than implied by officially reported balance sheet data (IMF and World Bank 2012).

12 The financial situation of the three public banks has prompted the Minister of Finance to launch full audits of the three largest state-owned banks and to decide to recapitalize the banks. Following an initial recapitalization of 0.3 percent of GDP in 2012, an additional amount is planned for 2014 (to be defined based on the results of the audits).

13 In fact these problems have been ongoing for a long time. Banking reforms undertaken since the early 2000s did not lead to the anticipated financial deepening. The reforms consisted of making all banks universal (including former

development banks in 2005), injecting significant resources to recapitalize the three large state-owned commercial banks, selling the small and poorly performing state-owned banks to foreign banks, and creating two new specialized state-owned institutions to support microcredit and small and medium enterprises (SMEs). Efforts made to restructure state-owned commercial banks produced disappointing outcomes. Notably, the situation of the STB bank (*Société Tunisienne de Banque*) sharply deteriorated after it absorbed two distressed former development banks in the early 2000s.

14 In fact, in most MENA countries the high level of concentration has led to poor outcomes in terms of access to credit for households and for SMEs, as poor performing large banks never exit the market.

15 The Ross-Panzar index measures the pricing power of firms in a market. This methodology computes an H-statistic that measures how much an increase in input prices is translated into output revenues. If H is equal to 1, it means that there is a perfect competition such that an increase in input prices is fully included into output prices. If H is lower than 0, it means that increase in input price is not translated into higher revenues but into lower output and we are in a situation of a monopoly. When H is comprised between 0 and 1, we are in a monopolistic competition. (Ross-Panzar 1987).

16 The Lerner index is a standard measure of market power used in the literature and is derived from the first order equilibrium condition of a profit-maximizing firm that chooses prices. It follows that $L_i = \alpha_i / \epsilon = ((P - MC)) / P$, where L_i is the Lerner index expressed as the equivalence of inverse demand elasticity ϵ weighted by α_i , the market share of firm i , and the Price Cost Margin (PCM), indicating the difference between price and marginal cost (MC) as proportion of the price. In the case of a monopolist, α is equal to 1 and the Lerner index can be derived from the monopoly equilibrium condition $MR = P(1 + 1/\epsilon) = MC$. Note that the Lerner index varies between 0 and 1, where 0 reflects $P = MC$ and hence perfect competition. Thus, the higher the PCM measure the higher is the average market power in the sector.

17 The lack of competition can explain both the limited improvements in bank efficiency and the lack of industry consolidation. In fact market competition is the usual key driver of industry consolidation across jurisdictions but has been unable to play this role in Tunisia.

18 The FSAP identified a number of breaches of solvency regulations (insufficient equity in most banks because of unrecognized risk); liquidity (average ratio for the whole less than 100 percent sector 2011); or high risk, which did not give rise to any sanction from the Central Bank of Tunisia.

19 While in line with international norms, provisions are calculated on a net-of-collateral basis; valuation rules for mortgage collateral can be considered lax by international comparison, which translates into lower provisioning efforts. This observation explains why provisioning ratios are lower in Tunisia than in many other countries (the international average is around 70 percent) and also why banks rarely accept other forms of collateral.

20 Law 99-64 (see <http://www.jurisitetunisie.com/tunisie/codes/teg/tie1000.htm>)

21 In addition, as banks started competing more aggressively on deposit interest rates in the aftermath of the revolution,

the Central Bank of Tunisia (CBT) cut this competition short by capping the maximum deposit rate. This measure enabled banks to preserve their margin, but it also triggered adverse effects: it increased banks' dependency on CBT funding, and it discouraged savings (as the difference between the inflation rate and deposit rates grew), thus maintaining liquidity pressure on banks. Deposit rates lower than inflation could also channel the savings toward real estate (the sector is booming) and foreign currency (putting more pressure on the CBT foreign currency reserves level). The CBT has recently removed the cap on deposit rates but not the cap on loans.

22 Tunisia currently has two laws dealing with restructuring and bankruptcy in Tunisia: Book IV of the *Code de Commerce* setting out the 1959 bankruptcy law, *Du concordat préventif et de la faillite*, and Law no. 95-34, (modified in 2003), setting out the provisions on business rescue, *Redressement des Entreprises en Difficultés Economiques*. Although these laws have helped strengthen Tunisia's bankruptcy regime to a certain extent, they have resulted in a fragmented bankruptcy regime with duplicate processes and overly lengthy processes for business rescue and business exit. Some of the primary problems include: obliging all businesses to go through *règlement judiciaire* proceedings, even if they are insolvent and the additional time will only drain money from the estate; providing that the *Commission de Suivi des Entreprises* (CSEE) play a role that includes a quasi-judicial role, which might not be suitable for such an entity; not providing for confidential *règlement amiable* proceedings, which makes debtor businesses reluctant to file for amicable settlement; including duplicate procedures in the two laws thereby extending delays; minimizing creditor's rights in the business rescue responding; and including heavy sanctions, even for non-criminal activities, increasing the stigma associated with bankruptcy.

23 In Tunisia, lenders use a very narrow range of security, limited to mortgage and personal guarantees.

24 The establishment eight years ago of the SOTUGAR (a partial credit guarantee scheme), and the BFPME (a public credit institution focused on start-ups), has offset this problem only to a very limited extent (see discussion below).

25 Since the revolution the Tunis Stock Exchange has been much more active and a number of new companies have been floated since 2012.

26 Investment in foreign countries financed by FCPRs could open new opportunities for Tunisia. As a first, immediate step, the government could authorize FCPRs to benefit from the common regime enabling Tunisian firms, under certain conditions, to invest abroad (FCPRs would be subject to the same rules, in particular the ceilings in terms of capital outflows) and, in some cases, to overcome this ceiling up to the total amount of their foreign liabilities (for the funds that collect foreign funds). These investments would primarily aim to support Tunisian firms in their effort to conquer markets overseas. Another useful measure would consist of giving FCPRs' managers the possibility to tap into technical assistance funds (TAF) to assist firms in their effort to grow their business. For instance, the TAF could finance the hiring of an expert in charge of assisting a firm in its efforts to register a trademark or to protect an innovation. It would be also very interesting to expand current experiment aiming at establishing public funds managed by private sector managers (such as SAGES Capital) selected through international procurement (the international

dimension of this selection process is critical to bring new skills).

27 The three large commercial banks (STB, BNA, and BH) have different business models that call for different restructuring approaches. However, a commonality is that there is great uncertainty about their financial strength due to major weaknesses in accounting, risk management, internal audit, external auditing, and supervision. Different evolutions can be contemplated to restructure and modernize these banks.

28 Specific laws applicable to public entities (on public markets and staff remuneration, for example) have made it more difficult for state-owned commercial banks to build up an effective governance structure and oversight mechanisms (that is, risk management, IT systems, and external auditors), resulting in less efficient operations and higher risks.

29 The government also considered establishing a sovereign investment fund (Inter-Generational Fund) managed as a private fund to leverage private resources to support equity finance in Tunisia (for details see IMF and World Bank 2012).

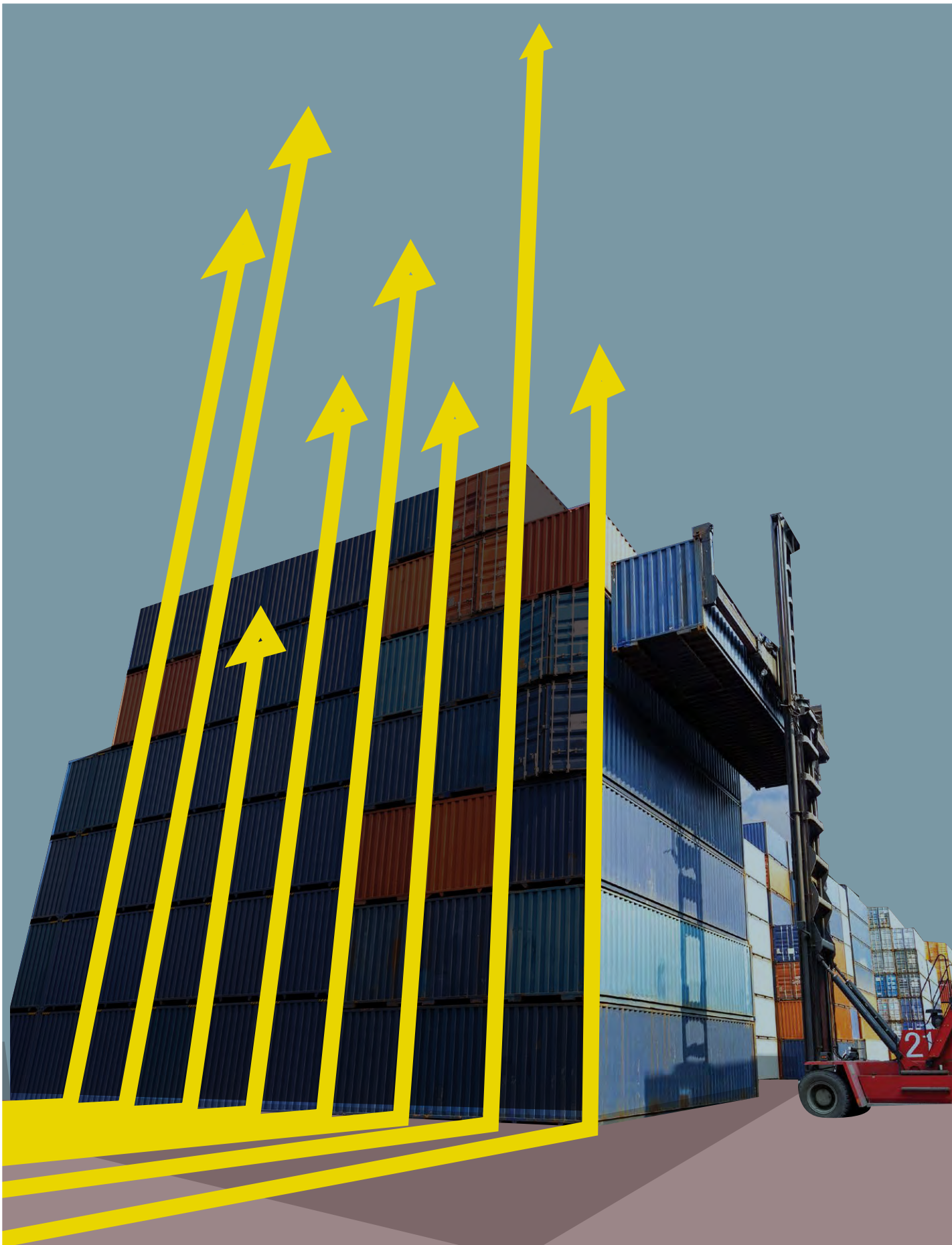
30 Development banks may be publicly or privately owned and operated, although governments frequently make substantial contributions to the capital of private banks. The form (share equity or loans) and cost of financing offered by development banks depend on their cost of obtaining capital and their need to show a profit and pay dividends. Development practices have provoked some controversy. Because development banks tend to be government run and are not accountable to the taxpayers who fund them, there are few checks and balances preventing the banks from making bad investments. Nevertheless, there are some examples of well-performing development banks, notably in Brazil and the Republic of Korea.

31 In June 2012, the Circular (91-24) of the Central Bank of Tunisia strengthened some aspects of its supervision over the banking sector.

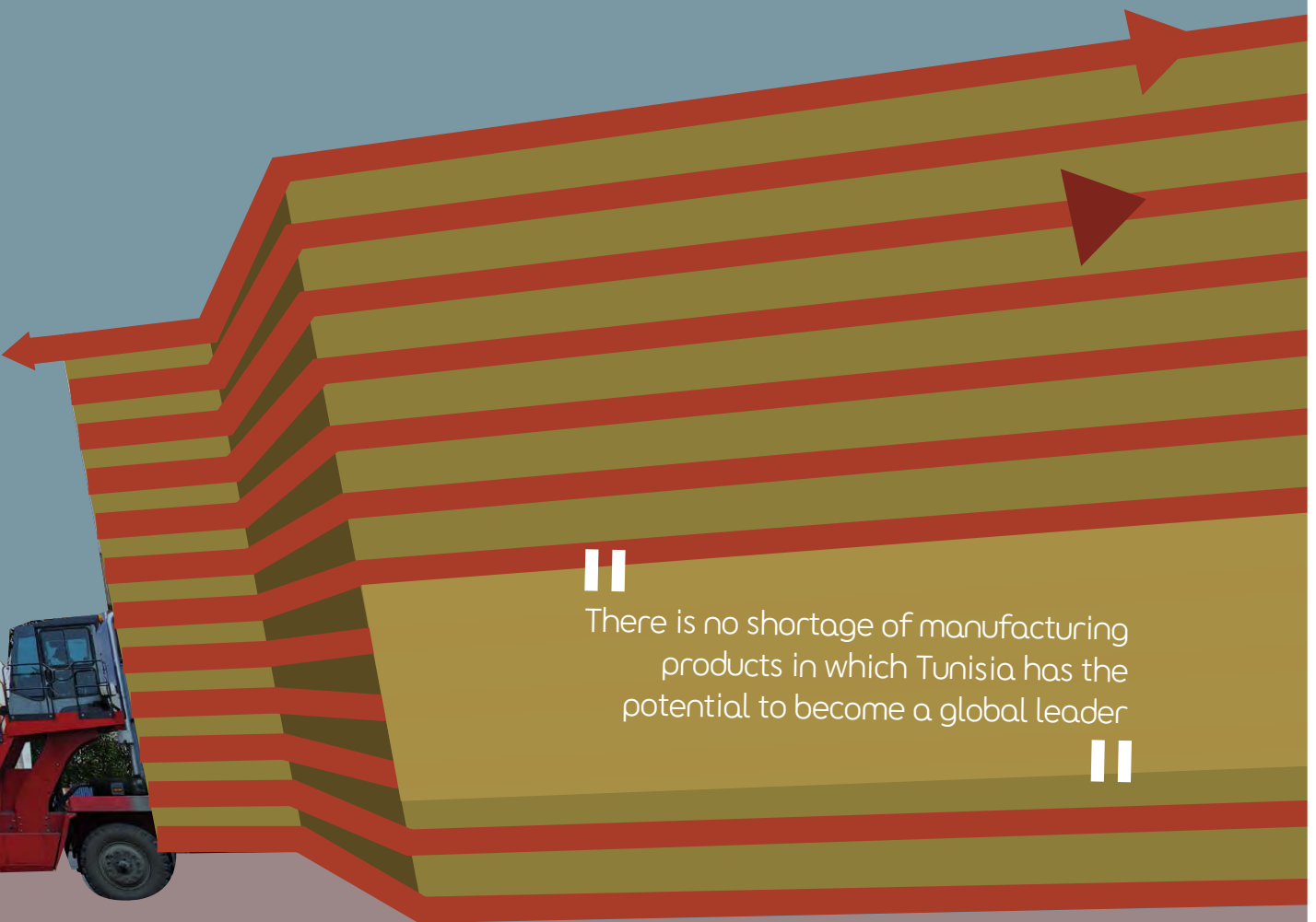
32 The rules must be clearly defined in the case of mergers, antitrust, and state aid in the financial sector and also to clarify the responsibilities of the Competition Council in this area.

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An Industrial Policy to Boost Value Added and Exports | 07



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There is no shortage of manufacturing products in which Tunisia has the potential to become a global leader

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An Industrial Policy to Boost Value Added and Exports

The previous chapters have highlighted that a key challenge for Tunisia is to transform its economic production structure to enable more value added forms of production. In fact, although low skill jobs have helped lift many Tunisians out of poverty, they are not adequate to employ the increasing number of graduates entering the labor market each year. Hence, there is a need to build on Tunisia's achievements so far by enabling (and not impeding) the structural transformation of the economy toward higher-skill activities and jobs creation. Our analysis identified key features of the competition and policy environment which have hindered the transformation, and which the government needs to address in order to foster a process of industrial upgrading. Assuming those fundamental issues are adequately addressed, there is a question as to any additional role that the government can play to accelerate growth. In this chapter we focus on policies to accompany the growth of industrial sectors. Services and agriculture face specific challenges and policies issues, and will be discussed in detail in the next two chapters.

This chapter explores the role the government could play in facilitating the process of structural transformation and economic development by supporting the growth of high-potential industries. There are a number of high-potential export sectors in which Tunisia is already doing well but which continue to remain underdeveloped largely as a result of the existing policy environment—fulfilling the potential of these existing export sectors should constitute a policy priority (World Bank 2008c). Similarly, there are sectors where Tunisia enjoys a strong revealed comparative advantage but which have not yet developed and which may have good potential if properly harnessed (El Kadhi 2012). These high-potential sectors could bolster the process of structural transformation and become a source of dynamic growth and jobs creation, notably for graduates. The barriers to unleashing growth in high-potential sectors have been discussed in previous chapters: barriers to competition, distortions resulting from the onshore-offshore duality, excessive red tape, and failures in labor markets and the financial sector. In addition, Tunisia's strategy and policies for industrial growth and services sectors also require rethinking—the current industrial policy places too much emphasis in providing (distortive) subsidies while too little attention is given to addressing coordination failures, strengthening logistics, and other “soft” aspects of the industrial environment.

7.1 / Untapped Potential: An Industrial Sector Ready to Climb Up the Value Added Ladder

A strategic approach to industrial policy entails focusing government action and attention on the most promising sectors. In this chapter we explore the industrial sectors in which Tunisia appears to hold the highest potential, and that the government could seek to nurture. We draw upon existing analytical frameworks, such as the Growth Identification and Facilitation Framework (Lin and Monga 2010) and the Product Space Analysis (Hausmann, Hwang, and Rodrik 2007; Hausmann and Klinger 2007), to identify high-potential industries and products to deepen and diversify exports (see also Mehchy, Nasser, and Shiffbauer 2012) ¹.

In line with the Growth Identification and Facilitation Framework (GIFF), we compare Tunisia to a set of regional and international benchmark countries. Benchmark countries include those that

are 100 to 300 percent richer than is Tunisia, have grown dynamically over the last twenty years, and have similar factor endowments. This approach is in line with the key selection criteria for benchmark countries proposed under the (first step of the) Growth Identification and Facilitation Framework (Lin and Monga 2010) ². The idea underpinning the GIFF is that richer countries will tend to have moderately higher prices and wages, such that they may be losing the competitive edge in some of the products they have been exporting—and these changes represent an opportunity for countries that have broadly similar characteristics but are catching up in terms of income levels (and wages).

We then use revealed comparative advantage (RCA) and products space (PS) analysis to help identify export sectors that appear to hold potential. Traditional trade theory argues that welfare is maximized when countries specialize in goods they can produce relatively cheaply—that is, goods in which they have a comparative advantage ³. The traditional measure for identifying comparative advantage is the Revealed Comparative Advantage index ⁴. More recently the Product Space Analysis has also been proposed to look at countries' export potential by mapping a country's current export performance against global patterns (Hausmann and Klinger 2007; see discussion below and box 7.2). In line with the GIFF, we next look at the changes in RCAs in Tunisia and the benchmark countries to identify sectors and products in which Tunisia may have potential to increase exports, both in terms of quantity and their value added content.

It is important to note up front, however, that these methodologies present shortcomings when used to identify high-potential products. These methodologies focus on exported products but ignore the role of imports (intermediates) in the production process. This is particularly important in the case of Tunisia since as discussed the domestic content of exported goods tends to be minimal—implying that the know-how involved in the products Tunisia exports is minimal. Also, these measures are based on an analysis of a country's current export structure, which is not necessarily the result of a true comparative advantage—rather it also reflects the policy distortions that have determined the current exports pattern. Again this is relevant in the case of Tunisia since, as discussed in previous chapters, the policy environment is characterized by distortions and barriers to the operation of markets, which hinder the development of the economy. Finally, these techniques look at export structure and do not take into account capabilities that have been developed through non-exporting manufacturing. It should be emphasized that these techniques are currently only applicable to traded goods (industrial and agricultural goods) but not to services.

Dynamics Analysis of Revealed Comparative Advantage in Tunisia and Benchmark Countries

Tunisia should hold a clear advantage to export wage-intensive goods for which benchmark countries are losing their competitive edge. Following the GIFF approach, we seek to identify export potential by assessing whether benchmark countries with similar endowments are becoming less competitive in the production of some of their exports. In recent decades, increased wages in higher-income countries, combined with a reduction in transportation costs, have shifted significant production from higher-income countries to lower-income countries. In fact Tunisia's wages have remained relatively low compared to its benchmark countries, which could provide an important advantage for Tunisia to produce and export more wage-intensive goods with a stable or increasing global demand, and where production costs in fast-growing benchmark countries have become relatively expensive.

An analysis of Tunisia's RCAs reveals that the sector with the largest number of products with high revealed comparative advantage is the textile sector, followed by the mechanical and electrical industry. Out of a total of 148 products for which Tunisia has an RCA above one, 39 products

belong to textiles and eight to the leather and footwear industry (annex 7.1). Tunisia has also 19 products in the mechanical and electrical industry with a revealed comparative advantage. Some agricultural products also have high RCA. Of Tunisia's 148 products with an RCA above one, global demand for 82 products has been declining between 2000 and 2010. Sectors with strong export growth and global demand growth are fertilizers and some mechanical products such as television receivers, electric motors, and insulated cables.

Our analysis highlights that benchmark countries have seen their RCAs decline in several industries and sectors in which Tunisia already enjoys a good RCA, such that it could take advantage of the expected shifts in production away from benchmark countries. In line with our expectation, an analysis of changes in RCAs in benchmark countries over the past decade confirms a significant decline in their RCAs in a few wage-intensive industries (annex 7.2). In several of these sectors and products, Tunisia has a good RCA; and in many of them it has seen its RCA increase over the past decade (in contrast with benchmark countries). Further, many of these products, though not all, have experienced an increase in global demand over the past decade. To refine the analysis, we distinguish these sectors and products in four groups (see table 7.1 for a summary at the 3-digit sector level and annex 7.3 for details at the 4-digit product level)⁵. We are particularly interested in Group 1, which highlights industries and sectors in which Tunisia holds high potential to increase its share of exports in the midst of increasing global demand. The results highlight that closely related industries and sectors at the 4-digit level may be in different groups, such that overall the analysis reveals potential in a number of sectors likely to move out of benchmark countries, notably: (a) textile and garment, (b) leather and footwear, (c) electrical and mechanical industry and transport equipment, (d) chemical products, (e) glass, iron, and metal materials for construction, and (f) home furniture and sanitary. Tunisia appears to hold potential in these sectors to a different degree, and the various individual products hold more or less promise depending on the evolution of global demand. It is also worth noting that several of these sectors are classified (according to United Nations Industrial Development Organization, UNIDO) as medium-skill and high-skill sectors, and as such they include segments that could provide jobs for graduates.

Based on these results, the GIFF proposes a policy approach to nurture the development of this potential without introducing distortions. The GIFF basically suggests how the authorities can facilitate the trial-and-error process that successful industrial development always involves (Lin and Monga 2010). For high potential industries and sectors in which some private domestic firms are already present, such as those identified in Group 1 or Group 2, the authorities should identify constraints to technological upgrading or further firm entry and take action to remove such constraints. Here we provide a brief discussion focusing on textiles and the electronic and electrical sectors (box 7.1), but it will be important to carry out in-depth sectoral studies to identify significant coordination failures or other sector-specific constraints. In industries where no domestic firms are present, such as those identified in Group 4, policymakers may try to attract foreign direct investment (FDI) from the benchmark countries or organize new firm incubation programs. The government could also compensate pioneer firms in the industries identified above with tax incentives for a limited period and/or co-financing the investments. That said, beyond the industries identified above, the government should also pay attention to spontaneous self-discovery by private enterprises and support the scaling up of successful private innovations in new industries. In this context, special economic zones or industrial parks may be helpful in overcoming barriers to firm entry and FDI and in encouraging the formation of industrial clusters.

Table 7.1: Synthesis of GIFF Analysis (First Step): Identifying Industries and Sectors in Which RCAs Decreased in Benchmark Countries, 2000-2010, and in Which Tunisia Has a High RCA

	TUNISIAN RCA IN 2010	TUNISIAN RCA'S EVOLUTION SINCE 2000	TUNISIAN MARKET SHARE EVOLUTION SINCE 2000	GLOBAL DEMAND'S EVOLUTION SINCE 2000	SKILLS
Group 1: Sectors with an increasing RCA while global demand is increasing					
Chemical products-wood based	13,28%	63,12%	98,74%	143,08%	High skill
Leather indutry (including footwear)	205%	240%	476%	43%	Low skill&resource based
Textile	143%	7080%	11003%	55%	Low skill&resource based
Miscellaneous- Textile	320%	814%	928%	19%	Low skill&resource based
Glass and Metal	92%	1120%	1277%	24%	Low skill&techno intensive
Machinery (for agriculture and mining)	43%	345%	530%	43%	Medium skill&techno intensive
Electric industry (wires and cables)	1282%	85%	94%	5%	Medium and high skill&techno intensive
Precise instruments (medical instruments)	91%	336%	467%	30%	High skill&techno intensive
Mechanical and transport material (cycles, ships, and boats)	228%	143%	255%	52%	Medium skill&techno intensive
Diverse manufacturing (jewellery and basketwork)	51%	2030%	3062%	35%	High and low skill&techno intensive
Group 2: Sectors with an increasing RCA while global demand is decreasing					
Textile and garment (synthetic fiber, yarn, cotton fabrics, carpets)	538%	702%	450%	-37%	Low skill&resource based
Leather (saddlery and harness)	253%	28%	13%	-11%	Low skill&resource based
Metal and Machinery	70%	20675%	17135%	-18%	Low & medium skill & techno intensive & resource based
Mechanical (motorcycles, other vehicles)	8%	402%	299%	-15%	Medium skill&techno intensive
Furniture and sanitary	236%	22%	6%	-14%	Medium skill&techno intensive
Diverse manufacturing	166%	504066%	354609%	-22%	Low & medium/high skill & techno intensive & resource based
Group 3: Sectors with a decreasing RCA while global demand is increasing					
Chemical products	37%	-43%	-27%	37%	High skill
Fertilizers	4674%	-62%	-28%	83%	High skill
Metal, tools and machinery (for washing and drying)	17%	-66%	-57%	23%	Low and medium skill&techno intensive
Mechanical industry	18%	-18%	-9%	11%	Medium skill&techno intensive
Furniture and sanitary	68%	-58%	-55%	8%	Low & medium skill&techno intensive
Electric industry (domestic items)	9%	-39%	-27%	20%	Low & medium skill & techno intensive & resource based
Textile and fur (dresses and apparels)	153%	-47%	-35%	23%	Low skill&resource based (medium skill in a lower extend)
Diverse manufacturing (umbrellas and other products)	51%	-80%	-71%	38%	Low skill&techno intensive
Group 4: Sectors not produced in Tunisia or with a very low RCA while global demand is increasing					
Metal and machinery	1,83%	-	-	43,51%	Low skill&techno intensive
Transport material (railway and tramway freight and tracks)	1,31%	-	-	29,89%	Low skill&techno intensive

Source: Authors' calculations

Box 7.1: Role of Government in the Further Development of Tunisia's Key High-Potential Exports

Garment, Textile, and Leather Products

The garments, textiles, and leather sector accounts for nearly one quarter of total Tunisian exports and nine percent of employment. About eight percent of low-skilled workers are employed in this sector (approximately 280,000 people)—in particular it is a very important sector for the employment of low-skilled women in Tunisia. Textile exports as a share of Tunisia's total exports have been declining with the phasing out of the multi-fiber agreement in the mid-2000s. More generally, the MENA region has been losing market share in textiles against the background of a dramatic increase in Chinese and Indian exports and strong performance by Bulgaria and Turkey. At the same time, global demand for many products in the sector has been declining steeply.

Nevertheless, Tunisia's RCA in several textile export goods has been increasing in recent years (notably for yarn of regenerated fibers, synthetic fabrics, and carpets). This reflects the fact that wages in the textile sector have increased in benchmark countries and other textile exporters—and this may open a window of opportunity for Tunisia.

The future of Tunisia's textile sector is likely to depend on whether it will be able to take advantage of its proximity to the European Union. Demand for garments (which offer prospects of higher value added) in the EU tends to be quite heterogeneous, with many smaller producers ordering small batches of customized garments relative to the United States. Responding quickly to changes in client demand, reducing time of production and increasing reliability of exports will be critical in order to meet expectations of EU clients. More standardized apparel articles, however, will probably face fierce competition from Asian countries.

Access to cheap inputs will be pivotal in terms of competitiveness because fabric costs tend to represent 60 percent of free-on-board prices. At present, inputs from many countries are subject to relatively high tariffs in Tunisia (World Bank 2010a). Also, the textile sector's competitiveness is very sensitive to wage increases. Although productivity in Tunisia's textile sector seems to be similar to regional benchmark countries, wages in the textile sector tend to be higher—not only compared to countries in the region but also to Turkey and some Asian countries. For comparison, Egyptian and Jordanian wages are lower than or comparable to those of most Asian exporters, giving these countries an advantage with respect to Tunisia (World Bank 2010a).

Contrary to that for textiles and garments, global demand for leather products on average has been steadily increasing. Although Tunisia produces only a few leather products, the Tunisian leather sector accounts for just over one percent of employment (approximately 31,000 persons in 280 companies, of which 212 are totally exporting firms employing about 29,000 persons). Today this sector is dominated by cutting and assembly. Tunisia does not produce its raw material, which it mainly imports from Morocco. While Tunisia's cost advantage in producing exports of leather goods seems to be mainly driven by low wages, RCAs of leather products have decreased in most benchmark countries with the exception of Turkey, Portugal, and the Slovak Republic, suggesting that this could be a high-potential sector.

Electronics and Electrical Equipment

This industry has slowly developed during the 1980s behind the curtains of import substitution policies, building on existing production capacities in machinery, tools, and welding. These

exports have experienced significant growth from 2000 to 2010—it has been one fastest growing export segments with an annual growth rate of nearly 20 percent between 2006 and 2010, and it has become Tunisia's largest export category as of 2010. It includes insulated electrical wire, cables, and radio broadcast receivers. About 93 percent of its total production was exported in 2010.

A large part of this sector is geared toward the production of automobile components—composed of three components (mechanical, electrical, and rubber), cabling represents 89 percent of exports and most of these exports are for the automobile industry. Since 1980, insulated electric wires and cables and electrical apparatus such as switches and relays have seen the largest increase of the nine electrical products whose export share is over one percent in the Tunisian portfolio. Unlike Tunisia, benchmark countries have increased their RCA in many different products of the electrical and electronics industry. Tunisia has also been outstripped by Morocco, which developed a better strategy to attract investors.

Tunisia has remained stuck in the low-skill segment mainly producing cables. In fact production of cabling beams in Tunisia largely consists of labor-intensive assembling tasks. Raw materials alone account for more than 70 percent of total product costs. This activity is also very sensitive to increase of wages for low-skilled workers. In addition, the industry is dependent on fiscal incentives (see Chapter Four). Similar to textiles, the sector benefits from Tunisia's proximity to Europe. The sector has synergies with the plastics or metal industries.

The main issues holding back a further development of the sector and related components are political and social stability. Both have been pinpointed as imperative for this sector's development given the large up-front investments involved. Other key constraints seem to be logistical costs, delays in production, and adherence to strict quality standards. Process innovation, logistical improvements, and an efficient banking sector are also likely to be important for strengthening this sector.

Tunisia's Product Space Analysis⁶

Recent research noted that changes in the revealed comparative advantage of nations are governed by the pattern of relatedness of products at the global level. The product space analysis closely complements the analysis of RCAs presented in the previous section. It provides a dynamic representation of the changes in Tunisia's RCAs, highlighting the potential for Tunisia to diversify into new products based on an analysis of global export patterns. As countries change their export mix, there is a stronger tendency to move toward related goods rather than to goods that are farther away (Hausmann and Klinger 2007; box 7.2). The product space analysis is based on the assumption that it is easier for a country to export a new product if its factors of production are already used in the production of other goods in this country (Hausmann and Klinger 2007). The product space analysis represents this idea graphically. The distance between two products is measured as the conditional probability that an exporter with a revealed comparative advantage (RCA) in the product X also has a RCA in product Y⁷. This approach builds on the empirical evidence that countries tend to diversify into products close to those they are already specialized in (exporting). Interestingly, it also follows that countries specialized in more “connected” products, whose production requires capabilities used for the production of other goods, are able to upgrade their exports basket more quickly.

Box 7.2: The Product Space Analysis

The product space analysis is based on the assumption that producing goods requires not only machines, raw material, and labor but also specific knowledge. Some of this knowledge can be readily accessed through manuals, the internet, or by asking experts, but the acquisition of some knowledge—for example, how to run a garment factory—is costly and time consuming, and this type of knowledge is hard to transfer. Hausmann, et al. (2011) refer to this knowledge as “capabilities.” The production of one good tends to require the interaction of individuals with different capabilities. As the complexity of goods increases so does the number of different capabilities required to produce a given good. Although the combination of capabilities is unique to a product, production of some goods may require more or less similar capabilities.

Moving into a new industry may be easier if the capabilities needed to produce this good already exist in the country. Firms that venture into new products may find it hard to secure all the requisite capabilities. Some capabilities, such as accounting or human resource management, may be readily available. But others, especially those that are specific to the production of this good, may be hard to find. Specific infrastructure needs such as cold storage transportation systems may not exist, specific regulatory services may be difficult to obtain, research and development capabilities related to that industry may not be there, and so on. Moving into a new product may therefore be easier if most of the capabilities required for producing this product are already available in the country.

The basic representation of the product space is identical for all countries because the measure of distance between products is computed based on the relative exports shares (and GDP) of all countries. The product space illustrates the existence of a densely connected core and several peripheral clusters. If a country has RCA in many products close to the core or one of these clusters, it has a better future diversification potential. Moreover, the products with high-productivity content are typically located in the core of the product space (for example, vehicles, machinery, or chemicals) and the electronics cluster. It follows that a country has a better potential to diversify into higher-value added products if it already hosts export successes in several products close to the densely connected core or electronics cluster. Hausmann and Klinger (2007) and Hidalgo et al. (2007) argue that a country’s capacity to diversify exports depends on where this country produces in the product space. If a country is producing goods in a dense part of the product space, the process of export diversification is much easier because the set of acquired capabilities can be easily redeployed to other nearby products. However, if a country is specialized in peripheral products, this redeployment is more challenging because the distance in capability space is more substantial.

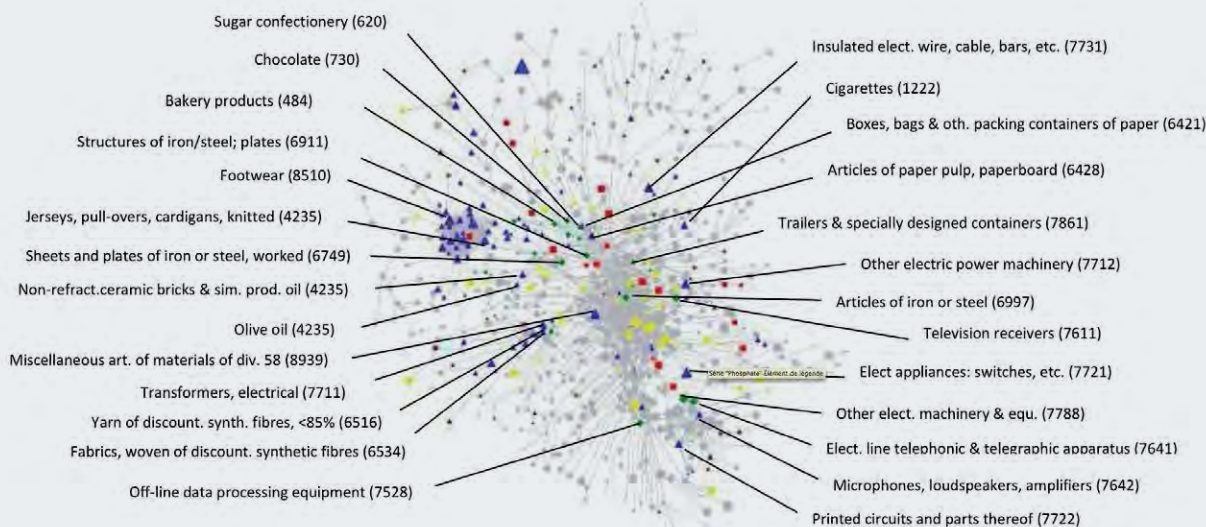
Source: Hausmann, et al. 2011; Hausmann and Klinger 2007; For more information visit: <http://atlas.media.mit.edu/>

Tunisia’s product space map is significantly less developed in the densely connected core compared to that of its benchmark countries. Tunisia’s appears to be significantly less developed in the densely connected core when compared to countries such as Croatia, Thailand, or even Indonesia (see Sahnoun and Schiffbauer 2012) ⁸. Compared to these peers, Tunisia has lower significant export shares in world markets in the industrial core of the product space which includes higher-value added industries such as electronics, chemicals, industrial machinery, and so on (figure 7.1). Given the potential wage cost advantage, Tunisian firms may have a comparative advantage in branching out in these markets.

When considering changes in Tunisia’s product space over time, we clearly see the emergence of new products in the electronics cluster. The dynamic illustration of the product space shows the changes in RCAs of Tunisian export products over the last decade in the context of the global exports product space (figure 7.1). The graph differentiates between four different categories of

Tunisian exports. First, the blue triangles refer to the classic products in which Tunisia had an RCA already in the period 2000–2002 and also in 2007–2009. Second, disappearing products are represented as red squares and reflect products in which Tunisia had an RCA in the period 2000–2002 but not 2007–2009. Third, emerging products are represented as green diamonds and show products in which Tunisia had an RCA in 2007–2009 but not in 2000–2002. Finally, marginal products reflect products where Tunisia has not yet acquired an RCA ($0.5 < \text{RCA} < 1$) but has experienced positive growth (of 10 percent or higher) since 2000–2002 and are represented as yellow pentagons.

Figure 7.1: Dynamic Representation of changes in Tunisia's Product Space, 2000–2002 to 2007–2009



Source: Sahnoun and Schiffbauer (2012); based on "World Trade Flows: 1962-2000" dataset, The Observatory of Economic Complexity website.

The dynamic illustration of the product space shows that Tunisia continues to have a number of classic products (blue triangles) with RCAs and has gained several RCAs in the closely connected core (green diamonds). Tunisia continues to have a number of classic products with RCAs in the textiles and garments area (blue triangles, figure 7.1) and has gained several RCAs in the electronics and closely connected cores (green diamonds). Tunisia has gained RCAs in 11 product categories close to the densely connected core or the electronics cluster over the last decade. These are mainly in manufactures of metals as well as iron and steel manufacturing (for example, articles of iron or steel, other sheets and plates of iron or steel, structures and parts of structures, iron), or construction materials. Likewise, Tunisia had an RCA in four classic products (blue triangles) in the electronics cluster and in electrical components close to the core in 2000–02 and gained five additional RCAs connected to that cluster in 2007–09 (for example, calculating machines and cash registers, electrical lines for telephone, other electrical machinery and equipment, television receivers, and off-line data processing equipment). These products are high-technology goods (with an average PRODY of US\$19,000) ⁹. Specifically, Tunisia had gained competitiveness in four high-PRODY goods prior to 2000–02 and managed to acquire RCA in six additional goods over the past decade. For example, it is now successfully exporting two types of television receivers. Moreover, Tunisia had an RCA in boxes and packaging containers in 2000–02 and gained RCAs in closely connected products by 2007–09, such as metal containers for storage and transport (casks, drums, boxes of iron or steel) and sugar confectionery and

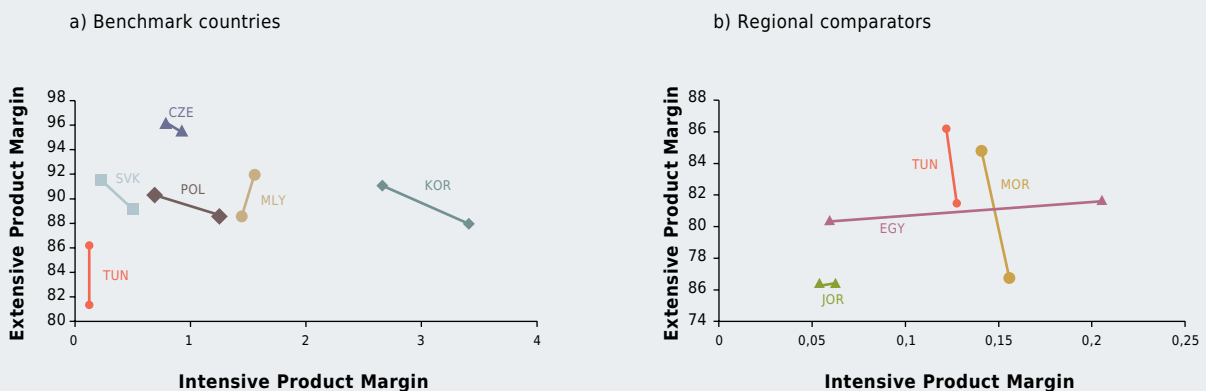
chocolate. The analysis also shows that Tunisia has a growing RCA in numerous additional products close to the closely connected core (yellow pentagons).

The product space analysis suggests Tunisia has the potential to expand its production and exports of goods it already produces, and also has growing opportunities to diversify into new products related to those it currently exports. As noted above, Tunisia has a high revealed comparative advantage in a wide range of goods it already exports, notably in several products in the textile and leather sector and in the mechanical and electrical industry. The product space analysis also highlights high-potential products in areas ranging from textile and fabrics, machinery and electronics, chemicals, and construction materials to food processing. As discussed above, for several of these products global demand has been consistently growing during the past decade. According to this analysis Tunisia has significant potential to expand in several of its existing subsectors/products; however it will be important to carry out in-depth sectoral studies to identify any significant coordination failures or other sector-specific constraints.

Looking at Intensive and Extensive Margins

One further way to analyze existing sectors with the potential to grow in the future is to analyze how different sectors in Tunisia perform relative to market trends. Exports can grow along two dimensions: a country can export more of the same goods (the intensive margin) or export new goods (the extensive margin)¹⁰. The product of the two margins is the share of the country's exports relative to the rest of the world.

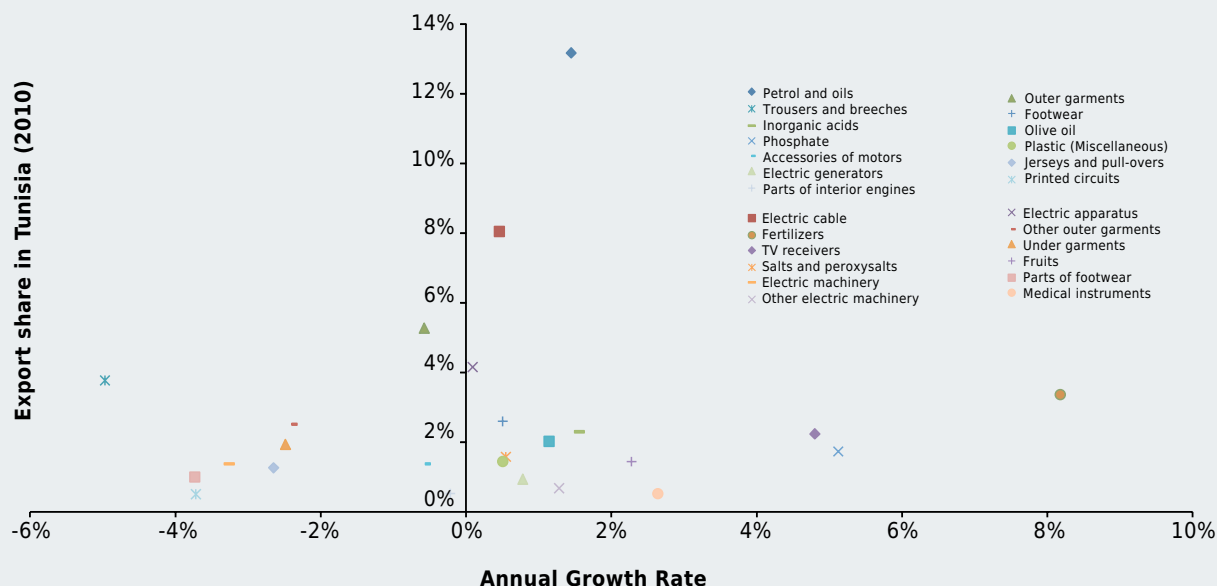
Figure 7.2: Evolution of Intensive and Extensive Product Margin, 2002-2011



Source: WITS Comtrade using H2 classification at 4-digit level; data for Egypt is available only for 2008-2012; authors' calculations
 Note: Czech Republic (CZE), Egypt (EGY), Jordan (JOR), Republic of Korea (KOR), Malaysia (MLY), Morocco (MOR), Poland (POL), Slovakia (SVK), Tunisia (TUN).

Tunisia's exports declined at the extensive margin over the past decade, reflecting the fact that its export basket is heavily dominated by goods that have experienced a slow growth in global trade. Similar to its benchmark and regional comparators, Tunisia's exports declined at the extensive margin over the past decade. In fact, Tunisia's decline in the extensive margin was steeper than in most benchmark countries and regional comparators (figure 7.2). In addition, unlike comparator countries, Tunisia did not expand its exports at the intensive margin. Most dynamically growing benchmark countries, with the exception of Malaysia, faced a decline in their extensive margin but were able to increase their export share by expanding at the intensive margin (figure 7.2)¹¹. The Arab Republic of Egypt's export growth was to a large extent the result of an increase of its export portfolio along the intensive product margin¹².

Figure 7.3: Tunisia's Main Exports and Evolution of World Trade, 2002-2011

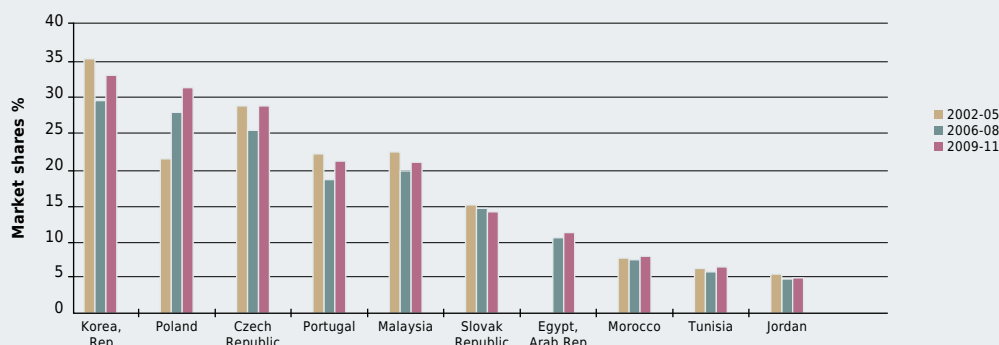


Source: WITS Comtrade; authors' calculations

This weak performance reflects the fact that Tunisia's export portfolio is concentrated in goods that have been losing importance in global trade. Global demand for many products related to traditional, non-synthetic textiles or leather products, the key pillar Tunisian exports, has been shrinking (figure 7.3). Demand for electrical cables has been growing slowly. Fertilizer (about five percent of Tunisia's exports), electrical equipment (mainly switches), television receivers, and medical instruments are Tunisia's only export products with an export share above one percent on annual growth rate of world demand above two percent.

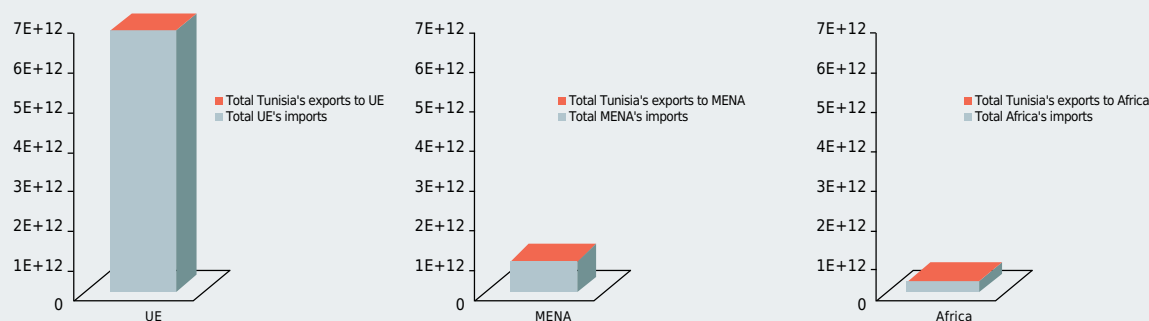
Tunisia's low export penetration suggests there may be significant scope to increase its exports by exporting more of the products it already sells. One potential way of expanding exports at the intensive margin is by exporting existing products to new markets. To measure the scope of increasing exports along this line, Brenton and Newfarmer (2009) developed the export penetration index. This index is defined as the share of potential destination markets that actually import the products that a given country exports¹³. Tunisia exports only to about seven percent of the countries that import its export goods, suggesting that there may be significant scope for Tunisia to export more of existing products (figure 7.4). It seems that Tunisia poorly exploits opportunities to sell its products abroad and in its own region. In fact, its index is far below that of comparator countries and particular weak for exports to its own region and to the United States.

Figure 7.4: Export Penetration Index, 2002-2011



Source: WITS Comtrade; authors' calculations.

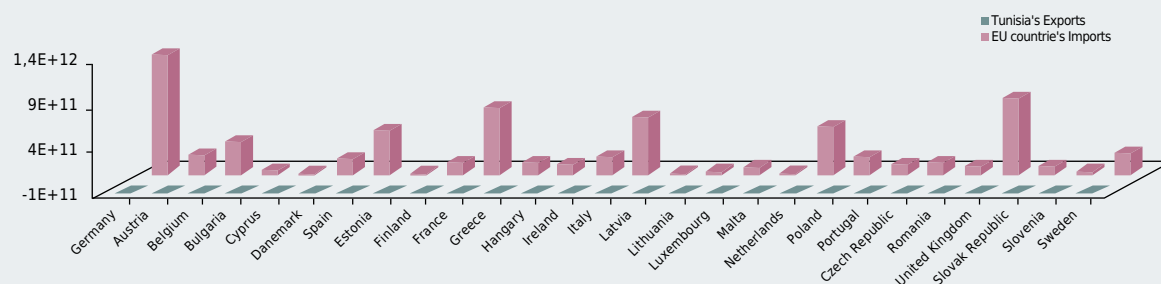
Figure 7.5: Tunisia's Exports and Regions' Imports in 2007 (current US\$)



Source: WITS Comtrade; authors' calculations
Note: Africa refers to Sub-Saharan Africa only

Just focusing on exports to the EU, it is clear that Tunisia has only started to scratch the surface of the potential for exports there. As discussed in Chapter One, the potential for Tunisia to expand its exports to the EU remains far larger than the potential in Africa or MENA (figure 7.5). The value of Tunisia's exports as a share of total EU imports (or GDP) remains insignificant, and indeed Tunisia hardly exports to most of the EU-28 countries (figure 7.6). Hence, while it is true that Tunisian exports are concentrated toward the EU and that the growth prospects for the EU are quite limited, these countries present a much greater purchasing power than MENA or Africa. Geographical diversification is of course a significant objective, but it is important to underline that the market potential offered by the EU-28 remains by far the greatest opportunity for Tunisia. Hence, in the short to medium term, in parallel with a push to foster greater trade integration across the Maghreb and with the broader MENA region and the Africa region (World Bank 2012a) ¹⁴, Tunisia should continue to seek deeper integration with the EU-28 (that is, beyond France and Italy) (World Bank 2014h).

Figure 7.6: Tunisia's Exports to EU and EU's Imports by Countries in 2007



Source: WITS Comtrade; authors' calculations.

In sum, Tunisia should focus on creating a level playing field as a prerequisite to increase the intensive margin of its exports and diversify its export portfolio toward products that have a growing global market share. As discussed in Chapter One, the low export penetration reflects the nature of Tunisia's economic model, which remains focused on assembly and other low-value added tasks for France and Italy. This is largely the result of the policy environment that has prevented companies from climbing up the value added chain. Indeed, as discussed above, Tunisia appears to have great potential to deepen value addition in several of its existing exports and to branch out into closely related products. We next turn to the policies that will be required to realize this potential.

7.2 / Moving Toward a More Effective Industrial Policy

In recent years, Tunisia has tried to move toward higher-value added production and a knowledge-intensive economy in an effort to absorb the increasing number of unemployed graduates. The design and objectives of Tunisia's industrial strategy are summarized in the National Industrial Strategy 2016 (*Stratégie industrielle nationale à horizon 2016*). The strategy targets a wide range of different groups such as exporters, foreign investors, small and medium-size enterprises, and specific high-value added sectors, using a wide range of different policy instruments. It identifies textiles; food processing; and the mechanical, electrical, and electronics industries as priority sectors. It also added two services sectors to this historical list: information and communication (ITC) and business process outsourcing (BPO). The strategy's objective is to double exports between 2008 and 2016 and move beyond traditional sectors to more sophisticated sectors to create jobs and raise value added.

Tunisia's industrial strategy remains centered on the Investment Incentives Code and preferential treatment for export sectors. The preferential offshore regime (which eventually was enshrined in the Investment Incentives Code in 1993) has been the central pillar of Tunisia's industrial policy since the early 1970s (annex 7.4). As discussed in Chapter One and Chapter Four, the dualistic model supported Tunisia's development until the 1990s; but in recent years it has increasingly hampered Tunisia's economic development and prevented Tunisia from progressing

to the next stage of development. In fact, as also discussed in Chapter One and Chapter Four, the segmentation and distortions associated with the onshore-offshore duality actually prevented Tunisia from moving into higher-value added production and better jobs for graduates. As mentioned in Chapter Four, the Investment Code is now in need of profound revision.

Box 7.3: Becoming Europe's Value Added Leader: The Strategy of the Slovak Republic

Independent since 1993, the Slovak Republic's value added has increased by 2.8 percent a year between 1995 and 2009, the largest increase in the EU28. Most of the increase in gross value added took place in the manufacturing sector, which increased its share in value added by 10 percent between 1995 and 2009. After independence the Slovak Republic's economy was dominated by heavy industry, an inheritance from the Socialist era. But it diversified quickly. Its strategy was based on three pillars. First, a reallocation of workers from farms to high-growth manufacturing and services boosted productivity growth. This reallocation was facilitated by a flexible labor market. Second, exporting enterprises in medium- and high-tech manufacturing industries were innovative: Slovak companies are among the highest producers of discoveries in chemicals, animal products, and raw materials in the region. At the same time, large capital investments in farms supported agricultural productivity growth. Third, FDI-attracted by a stable macroeconomic environment, targeted and streamlined tax incentives, a good business climate, a fairly skilled work force, and a relatively low number of strikes and lockouts—increased from negligible amounts in the late 1990s to 10 percent of GDP by 2010. A bulk of these investments went to the automobile sector. Today, cars account for a quarter of the Slovak Republic's manufacturing output. Between 2002 and 2010 the Republic of Korea was the second biggest investor in the Slovak Republic (12 percent of total FDI projects).

Source: Raiser and Gill (2012)

Although the focus of Tunisia's industrial strategy aims toward higher-value added sectors, in fact it has achieved the opposite results. Over the past decade, Tunisia has tried to move toward higher-value added production and a knowledge-intensive economy in the belief that this could address the increasing problem of graduate unemployment. However, as discussed in previous chapters, adopting a strategy designed to create a knowledge-intensive economy without addressing the underlying obstacles to private sector development (namely, the barriers to competitive pressures, the excessive regulatory burden, the pervasive cronyism, and the profound policy-induced distortions) has resulted in continued dependence on assembly and other low-value added production in Tunisia.

Beyond the problems with the underlying environment and the Investment Incentives Code, the design and implementation of instruments and programs needs rethinking. Tunisia's industrial policy spans a wide range of different objectives, sectors, and instruments, many of which have been in place for decades and do not appear to have been effective¹⁵. An arsenal of instruments has been mobilized to support firms, ranging from market-access restrictions to protect incumbents, tax incentives, and horizontal and sector-specific programs and support institutions (annex 7.5)¹⁶. In addition to abundant duplication and overlap, many support programs are distortionary because they largely extend support to selected firms rather than providing horizontal sector-wide support to sectors. As a result firms—even within preferred sectors—face a highly uneven playing field, which is likely to discourage firm entry (as well as exit of insiders) and depress productivity growth (see Chapter One and Chapter Two). Also, the focus on market-access restrictions, fiscal incentives, and firm-specific interventions opens the door to rent seeking (see Chapter Two and Chapter Three). Some private sector representatives have gone as far as arguing that Tunisia's industrial policy may actually impede innovation as

private firms are unlikely to invest unless their innovation falls in government priority sectors with access to public funds. Further, government support is not conditioned on success and has become entrenched over time.

Perhaps more important, the government's focus on promoting specific sectors has diverted attention away from cross-cutting reforms and addressing coordination failures. As discussed below, empirical evidence shows that reforms in the business climate, improving access to finance, or increasing the provision of public goods and addressing sector-specific coordination failures have the highest return in terms of boosting investment (see also box 7.3). These issues do not appear to be at the center of government policy focus in Tunisia, however. For instance, customs continue to pose a substantial barrier to import and export operations (see Chapter Three and Chapter Four), and more generally—as discussed in Chapter Three, Chapter Four, and Chapter Eight—the operations of the ports and airports remains inadequate. At the same time, the government does not seem to focus on identifying and removing sector-specific constraints, such that bureaucratic hurdles and coordination failures remain unaddressed. For instance, as discussed in Chapter Nine, the trucking sector (freight transportation) is hampered by the lack of logistical coordination, which is likely the main reason for high costs and the resulting high prices. Also, while the government has made an effort to foster industrial clusters with technopoles and incubators (*"pépinières"*), these efforts remain half-hearted and implementation has been marred by problems¹⁷.

What Role for the State in an Effective Industrial Policy?

From a theoretical point of view, industrial policy—that is policies designed to promote specific industries or groups of firms—can be welfare enhancing under certain conditions. Theory suggests that industrial policy can enhance welfare in the presence of externalities. These externalities can result from local ("Marshallian") externalities, inter-industry externalities, and specific types of coordination failures or information spillovers. Marshallian externalities refer to externalities affecting agents in the same geographical area—for example, through human capital spillovers within a specific area or infrastructure—which tend to disappear as the sector becomes large (see, for example, Fujita and Thisse 2002; Rosenthal and Strange 2004). Harrison and Rodriguez-Clare (2010) show that, in the presence of these externalities, protection of a sector may be welfare improving as long as protection is temporary and short-run costs not too high¹⁸. Protection of a specific industry can also be welfare enhancing if this protected industry generates positive externalities with the rest of the economy.

Empirical evidence suggests that designing effective industrial policy that distorts prices in support of specific sectors is difficult and likely to result in failure (box 7.4). Harrison and Rodriguez-Clare (2010) find little evidence that industrial policy intervention that distort prices, such as tariff protection or production subsidies, are beneficial¹⁹. Notably, abundant international experience has warned against 'seeking to pick winners' (i.e. seeking to identify new 'high potential' sectors). Industrial policies focused on identifying high-potential industries for import-substitution have failed in many countries in Latin America and Sub-Saharan Africa. This is because the discovering new export is a process of significant trial and errors, and government does not have the information to be able to make good choices. Easterly et al. (2009) show, the probability of a big hit decreases exponentially with its size, making 'picking winners' a lottery game²⁰. In addition, industrial policies providing advantages to specific sectors are prone to capture by cronies and rent-seeking, as the experience in Tunisia has demonstrated (see Chapter Three).

Box 7.4: The Ongoing Debate on the Effectiveness of Industrial Policy

Several eminent economists advocate that government should pursue active industrial policy. They argue that the market failures that industrial policies target—in markets for credit, labor, products, and knowledge—have long been at the core of what development economists study (Rodrik 2008, 2009; Lin and Monga 2010; Stiglitz, Lin, and Monga 2013). Further, these economists argue that historical evidence and economic theory suggest that, while markets are indispensable mechanisms for allocating resources to the most productive sectors and industries, government intervention—through the provision of information, coordination of hard and soft infrastructure improvement, and compensation for externalities—is equally indispensable for helping economies move from one stage of development to another. Some authors argue that industrial policy has been pivotal for some East Asian countries to advance manufacturing (Amsden 1989; Wade 1990). East Asian countries clearly pursued a wide range of policies to promote specific sectors, including through export subsidies. Most recently, renewed emphasis has been placed on the market failures and externalities surrounding learning and discovery as the rationale for government intervention.

There is, however, ample cross-country evidence of practical difficulties and costly failures with implementation of industrial policies. The East Asian Tigers provided successful examples of heterodox interventions and protectionist industrial policies; however, industrial policies such as import-substitution-industrialization have failed in many other regions like Latin America and Sub-Saharan Africa. The main criticism against industrial policy arises from the concept of government failure. Industrial policy is seen as harmful because governments lack the required information, capabilities, and incentives to successfully determine whether the benefits of promoting certain sectors above others exceed the costs and in turn implement the policies. Further, there is ample evidence that governments in making decisions with regard to electoral or personal incentives can be captured by vested interests—Tunisia being a strong case in point as discussed in Chapter Three—leading to industrial policy that only supports rent seeking by the political elite and distorting the efficient allocation of resources by market forces at the same time.

International empirical evidence also suggests that horizontal “soft” industrial policies tend to be beneficial. The same study concludes that soft industrial policies, such as sector-wide government-support training schemes or supporting critical services infrastructure, tend to be beneficial (Harrison and Rodriguez-Clare 2010). Hence, additional efforts may be required to address cross-cutting constraints to export production, whether by improving logistics, increasing access to information and advisory services, and providing private sector room for trial and error (see box 7.5). ²¹

Box 7.5: Singapore's Experience in Attracting Investment and Fostering High-Value Sectors Through Horizontal "Soft" Industrial Policies

Singapore is ranked first in the Doing Business Index and second in the Index of Economic Freedom. It transformed its economy from a closed, tightly controlled, inward-oriented economy based on import substitution to a market-oriented and export-led one. Trade and exchange rate liberalization and economic deregulation reforms (including large scale privatization and a shift from controlled and administered prices to market prices) were combined with foreign investment and export incentives. The safety of foreign investment was guaranteed by the constitution adopted in 1978. Singapore enjoys an efficient regulatory environment that encourages entrepreneurial activity, commercial operations are handled with transparency and speed, and corruption is perceived to be almost nonexistent. At the same time, a competitive tax regime and highly flexible labor market encourage investment. Foreign and domestic investors are treated equally, and Singapore's legal system is highly protective of private property. But, in addition to an excellent business environment, Singapore made several strategic choices. Most recently it decided to facilitate the development of its biomedical industry.

For a long time Singapore has invested in building a knowledge-intensive and innovation-driven economy. By the early 1990s, Singapore began to face greater competition in its traditional economic sectors. As a small country with a population of fewer than four million, Singapore promoted strong human capital.

In the late 1990s Singapore identified the biomedical sciences as a niche. For the period 2006 to 2010, the government doubled R&D spending compared to the 2000-to-2005 period. Of this spending, 25 percent was committed to the biomedical sector. Gross expenditure on R&D grew rapidly at a compound annual rate of more than 11 percent from 2000 to 2008, reaching 2.8 percent of GDP in 2008. At the same time, a coordinated R&D policy was implemented, facilitated by Singapore's small size. The lead public R&D agency (A*STAR) receives 40 percent of the total public R&D funds for activities with its partner agencies, including institutes, hospitals, and industries; and it closely coordinates synergies between fields, such as between biomedical and science and engineering. Overall coordination is helped by the physical proximity of hubs that also house corporate laboratories and private companies, fostering ties between the public and private sectors.

In addition, Singapore devised a comprehensive talent strategy to attract and develop world-class scientists. Internationally renowned scientists who moved to Singapore helped to jump-start the country's biomedical sciences efforts, providing leadership to the research institutes and mentoring young local scientists. In addition, various programs allowed the country to attract and produce researchers by providing funding for setup costs, research staff, and access to equipment and facilities. Singapore also attracted foreign students, with universities ranked among the top universities in the world.

The results of this effort have been outstanding. Singapore has succeeded in developing a high-value added, innovative biomedical industry. Singapore's R&D efforts significantly increased its private and public R&D investment ratio, from 1.7 in 2000 to 2.3 in 2008. More than 100 global biomedical sciences companies are based in Singapore, including cutting-edge research and manufacturing. Biomedical sciences' share of Singapore's total manufacturing output increased, from 3.9 percent in 2000 to 7.6 percent in 2008, with a compound annual growth rate of 10 percent. The number of jobs more than doubled between 2000 and 2008. Between 2002, when A*STAR was established, and 2008, its institutes published 1,927 papers in the biomedical sciences and filed 216 primary patents.

Source: Lim Chuan Poh (2007) "Singapore Betting on Biomedical Science"

A New Industrial Strategy for Tunisia

A key policy challenge for Tunisia is to reenergize the development of the industrial sector by exploiting the strengths of the country. Industrial development can be nudged in the direction of the evolving comparative advantages of the country and take advantage of productivity gains from a variety of channels (Rodrik 2009). In line with the discussion above, the “new structural economics” advocates the need for the government to play a “smart” role in industrial policy. The main idea from the new structural economics is that the government should work to harness the comparative advantage with soft industrial policies (Lin and Monga 2010). The government could facilitate the growth focus of those selected sectors by addressing coordination failures (Rodrik 2004; Rodriguez-Clare 2007) and removing key constraints to sectoral growth while ensuring a level playing field.

In Tunisia, there is a need for the government to focus first on creating a level playing field and then to nurture specific sectors via non-distortive policies. In line with the evidence on the challenges of industrial policy (including in Tunisia—see Chapter Three), the government should consider adopting a two-pronged strategy. First and foremost, the government needs to revise existing policies to ensure a flat environment that supports and rewards risk taking, thereby enabling the private sector to experiment and succeed in new products; and, second, because the government has limited capacity, it could prioritize its focus on interventions (via “soft” and non-distortive policies) aimed at enabling the growth of sectors in which Tunisia appears to have a strong comparative advantage. Soft policies cover capacity-building policies such as investments in infrastructure (transport, telecoms, and energy), fostering technical and scientific skills, and promoting research; they also include horizontal incentivizing measures such as macroeconomic policies (openness to trade, exchange rate policy, and fiscal and financial incentives), promoting human capital and research, supporting business development, harnessing foreign capital and knowledge, and labor market policies. The specific policy options are discussed in details in annex 7.6, which draws on the experience of East Asian countries (Yusuf 2013). There is no science to guide decision makers in the choice of policy instruments: policies must be designed with reference to the current state of industrial capability and evolving comparative advantage, and it will be critical to calibrate the effort in each category depending on planning and policy implementation capacity and also with reference to existing industrial capabilities.

Tunisia has already experimented with some soft policy tools unsuccessfully, which suggests the need to rethink their scope and design. In Tunisia the design of policies has been tainted by excessive administrative control in an autarkic economic and policy environment, which favors red tape, inefficiency, and capture by cronies. Again this underlines the importance of opening up the economy and removing dualism. It also highlights the importance of designing these programs by adopting international practice and standards, carefully monitoring their performance and outcomes, and working in partnership with the private sector. Experience has shown that the key to a successful industrial policy is to ensure that interventions support joint public-private efforts that lead to “discovery” by firms rather than the picking of winners by policy makers.

7.3 / Conclusions

Tunisia's industrial strategy and policies require rethinking. Beyond the distortions resulting from the onshore-offshore duality, industrial policy places too much emphasis on providing subsidies, with too little attention given to addressing coordination failures and other “soft” aspects of the industrial environment. International evidence suggests that the government can play an active role in accompanying the development of high-potential sectors through horizontal measures and addressing coordination failures.

There is no shortage of products in which Tunisia has the potential to become a global leader; notably Tunisia appears to have a strong competitive advantage to export wage-intensive goods for which benchmark countries are losing their competitive edge. The steep increases in wages in a set of relevant benchmark countries reflects a significant decline in their RCAs in a few wage-intensive industries, notably in (a) textile and garment; (b) leather and footwear; (c) electrical; (d) chemical; (e) glass, iron, metal materials for construction and mechanical; and (f) home furniture and sanitary. Tunisia already enjoys a good RCA in several of these industries and could take advantage of the expected shifts in production away from benchmark countries. Notably, Tunisia holds potential in several products in the textile and garments and leather and footwear sectors and to expand exports in the mechanical and electrical industries. For several of these products global demand has been consistently growing during the past decade. The challenge, however, is ensuring that firms in these sectors can climb up the value added ladder and increasingly become competitive in the higher-value added segments of the production chain.

However, this potential will never be realized unless the investment climate does not improve dramatically. In actual fact, the growth of these high potential sectors has remained stunted and largely limited to low-value added activities. By and large Tunisian firms have been unable to move past simple labor-intensive tasks to increase value addition in exported products. As discussed in earlier chapters, this is largely because the distortions and costs associated with current economic policies are too high. The duality in the economy, combined with the inefficiency in the onshore sector, has resulted in the lack of backward and forward links, preventing the development of firms into higher-value added activities. Adopting a strategy designed to create a knowledge-intensive economy without addressing the underlying obstacles to private sector development—namely the lack of competition, the excessive regulatory burden, the pervasive cronyism, and the profound policy-induced distortions—has not succeeded; and instead Tunisia has experienced continued dependence on assembly and other low-value added production. Therefore, the policy focus needs to shift to address horizontal constraints to domestic production that have impeded the realization of Tunisia's large industrial potential. As discussed in Chapter Four, the focus of reforms should be on expanding the positive traits of the offshore sector (and not destroying it by incorporating it in the onshore, which is inefficient and prone to rent seeking). In addition, the natural process of economic development suggests that average salaries are likely to increase soon in Tunisia, such that the country will no longer be competitive in low-wage jobs—which further highlights the importance of enabling a rapid transition toward higher-value added activities.

Beyond creating an environment conducive to private sector growth, the government should act to identify and address specific sectoral constraints. Some salient issues have been highlighted in this chapter, but it will be important to carry out in-depth sectoral studies to identify any significant coordination failures or other sector-specific constraints. This work should also identify specific industrial niche markets where Tunisian firms might be able to develop.

The next two chapters will examine the potential of the services sector and the agricultural sector, respectively. The analysis presented in this chapter has focused almost entirely on industrial goods. However, as will be discussed in the next two chapters, several studies have highlighted that Tunisia also holds large potential in the production and export of services and agricultural products.

Notes

1. This analysis will be complemented by in-depth strategic sectoral value chain studies to identify specific bottlenecks in high-potential sectors, which have been launched in collaboration with the government. The studies will entail an analysis of existing points of strength and weakness along the value chain, compared to international competitors, and will suggest appropriate ways to support the identified sectors.
2. These criteria apply to the Czech Republic, Malaysia, the Slovak Republic, Poland, and Turkey. The average growth rate of these countries was 4.3 percent, which is similar to Tunisia's growth rate but higher than the median growth of other countries with a similar income level. Countries with higher growth rates in this income category include, for example, Chile, Lebanon, and Panama, which have a very different economic structure than does Tunisia. Moreover, while Tunisia's real exports have grown by 3.7 percent on average, exports of these countries have grown nearly twice as fast. Benchmark countries also include the Republic of Korea, as a high performing country, and Portugal. Portugal's economic structure twenty years ago was very similar to Tunisia's current economic structure. Regional comparators are Egypt, Jordan, and Morocco.
3. Yet some authors argue that the production of some goods generates special economic benefits and that exporting these goods is particularly good for growth. Low costs of production may not be the only reason to export a good. Marshallian externalities or rents could potentially offset any losses arising from moving against comparative advantage. Hausmann, Hwang, and Rodrik (2007) argue that goods produced in richer countries yield spillovers that lead to faster growth.
4. The index was introduced by Balassa (1965 and 1989). The RCA is calculated as the ratio of product *k*'s share in country *i*'s exports to its share in world trade. $RCA = (\text{country } i \text{ exports of good } j / \text{total country } i \text{ exports}) / (\text{total world exports of good } j / \text{total world exports of all goods})$. A country is considered as having a revealed comparative advantage if this index is greater than one. In our analysis products are calculated using HS2 classification at the 4-digit level.
5. Group 1 highlights sectors and products in which Tunisia has seen an increasing RCA, and for which global demand is increasing; Group 2 highlights sectors and products in which Tunisia has seen an increasing RCA and for which global demand is decreasing; Group 3 highlights sectors and products in which Tunisia has seen a decreasing RCA and for which global demand is increasing; and Group 4 highlights sectors and products currently not produced in Tunisia, or with a very low RCA, and for which global demand is increasing.
6. This section draws on Sahnoun and Schiffbauer (2012).
7. It is important to note that distance across products is measured across all countries and is a technological feature of products, not of countries. There is therefore one product space in which countries move, rather than a product space for each country.
8. Tunisia's export structure resembles Portugal's 15 to 20 years ago. Portugal's export performance over the last 15 years contains valuable information for Tunisian firms. For instance, they might consider entering or expanding into new product categories for which Portugal has generated export successes close to the core of the product space over the last two decades (see Sahnoun and Schiffbauer 2012).
9. As explained in Chapter One, the PRODY of an exported good is calculated as the GDP per capita of each country exporting the good weighted by the export of each given country as a share of the sum of all export shares. Goods primarily exported by richer countries are presumed to be more sophisticated and receive higher PRODY.
10. The intensive margin can be calculated as the ratio of the dollar value of a country's exports to the dollar value of the world's exports of products that are in this country's export portfolio. The extensive margin is defined as the dollar value of the world's exports of products that are in this country's export portfolio over the dollar value of all traded goods (Hummels and Klenow 2005).
11. Activity at the extensive margin varies during the economic development process. Klinger and Lederman (2006) show that the number of new exports falls rapidly as countries develop, after peaking at lower-middle income level. The poorest countries that tend to have a narrow export base also have the strongest expansion at the extensive margin.
12. Since 2005, a Qualified Industrial Zones (QIZ) agreement allows Egypt to take advantage of the free trade agreements between the United States and Israel. Thus, goods produced in QIZ-notified areas can directly access U.S. markets without tariff or quota restrictions as long as they contain a small portion of Israeli inputs and the final good contains 35 percent of value added.
13. More precisely, the export penetration index is defined as the share of the actual number of export relationships (at the country product level) forged by Country A to the maximum possible number of export relationships it can form given the number of its exports. The denominator is calculated by summing the number of countries that import each product that Country A exports. If Country A were to export to all destination countries of its exports, the index would take on value 100.
14. Non-Tariff Measures (NTMs) and transport costs constitute severe constraints to intra-regional trade. NTMs are much more prevalent for intra-regional trade within the MENA region and represent a serious bottleneck to the implementation of the Pan Arab Free Trade Area (PAFTA). Intra-Maghreb trade costs are estimated to be at 95 percent for industrial goods, compared to trade costs between Maghreb and Western European countries of 75 percent. Transport-related infrastructure and real trade costs are ranked as the most significant constraint by the firms in the region. There is no coordination mechanism between the MENA countries on customs procedures and systems except for some limited initiatives that have started between Maghreb countries. There is no cross-border coordination between countries, and therefore multiple controls exist on each side of the borders (except the Tunisia-Libyan border at Raz Jair).
15. In fact, although some programs have been assessed in an ad hoc fashion, overall there exists no systematic, rigorous evaluation of the costs and benefits of the multitude of overlapping programs.
16. There is an array of horizontal and vertical programs introduced in the 1990s to assist firms in upgrading, innovating, and exporting; and a number of technical assistance centers were created. Industrial zones are supposed to play an important role in Tunisia's industrial policy, but as a result of their poor management their effectiveness remains

largely limited. To support innovation the government also promoted the creation of Technoparks (*Technopoles*) and business nurseries (*Pépinières d'entreprises*) at the university level to connect economic production, applied research, and higher education in supporting hi-tech start-ups and launched competitiveness hubs (*pôles de compétitivité*) to connect private firms in training, research, and production with the aim of supporting innovation, fostering international competitiveness, and promoting foreign investment. The government has also been trying to scale up the supply of high-quality graduates in science and technology.

17. An additional problem is that government responsibilities for the development and implementation of industrial policies are not clearly defined. Even though the Ministry of Industry is one of the main designers of industrial policy and is in charge of the Agency of Industrial Promotion (API) as well as the Industrial Property Agency (AFI), several ministries and agencies have overlapping responsibilities. For instance, the promotion of exports is supported by both the Ministry of Investment and International Cooperation through FIPA and the Ministry of Commerce and Handcraft through the CEPEX.

18. An example of this type of coordination failure is the case of flower exports from Ecuador, which only took off when the association of flower exporters, the government, and the national airline agreed to arrange a required number of cargo flights.

19. Reviewing single industry studies in advanced and developed countries, these authors find that infant industry protection may lead to higher growth by supporting the development of new industry but tends to result in net welfare losses as consumers have to pay higher prices (Harrison and Rodriguez-Clare 2010). Designing policies that increase overall welfare seems difficult.

20. For instance, few would have guessed that exports of “ceramic bathroom kitchen sanitary items not porcelain” would become one of Egypt’s most successful export products (see Cadot, et al. 2012, for in-depth discussion). Egypt derives 23 percent of its total manufacturing exports from this single product, mainly to Italy (94 percent of Italian imports of this product are from Egypt) (Lederman and Maloney, 2012).

21. Harrison and Rodriguez-Clare (2009) talk of the need to shift to “soft” industrial policy where government, industry, and clusters work together to increase productivity. “Thus, instead of tariffs, export subsidies, and tax-breaks for foreign corporations, we think of programs and grants to, for example, help particular clusters by increasing the supply of skilled workers, encouraging technology adoption, and improving regulation and infrastructure” (Harrison and Rodriguez-Clare 2009, 76).

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A man with grey hair and glasses, wearing a dark suit, is shown in profile, looking towards the right. He is seated at a desk, and a computer monitor is visible in the background. The background features stylized, abstract shapes in shades of pink and purple, suggesting a modern, professional setting. The overall composition is clean and professional, with a focus on the man and his work environment.

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Tunisia's high potential in services sectors could become a source of dynamic growth and jobs creation, notably for graduates

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From Rents to Competition:
Reaping Tunisia's Services Potential | 08



From Rents to Competition: Reaping Tunisia's Services Potential

Tunisia remains an underperformer in the services sectors compared to OECD and emerging economies. The services sector plays a vital role for the Tunisian economy: with a 50-percent value added ratio, services represent 59 percent of GDP (48 percent for tradable services) and 62 percent of formal employment (39 percent for tradable services); trade in services also contributes to reducing the deficit of the Tunisian balance of payments. Between 2000 and 2008, however, the services sector grew by 5.9 percent a year on average in Tunisia, compared to 6.2 percent in middle-income countries (MICs) and 9.1 percent in Asia. Over the same period, the nominal value of services exports grew by 10 percent a year on average, compared to 16 percent in middle-income countries and 17 percent in East Asia. In spite of Tunisia's important and diversified potential in services, tourism still represents over 70 percent of the country's services exports, with a growth rate close to zero in 2009 and 2010.

The Tunisian services sector remains characterized by privileges, with a frequent absence of competition that facilitates the capture of rents by services providers to the detriment of consumers and of the entire economy. As discussed in Chapter Two, all main areas of services remain closed to investors and protected by restrictive regulations. Such a rent system encourages corruption and either the capture of the rents by the political power itself (for example, if the ruler takes stocks in a business) or the distribution of rents in return for bribes (for example, if administrative authorizations are given in return for bribes or hiring of individuals close to power). In Tunisia, nepotism and corruption reached their apogee in the last few years of the old regime, as demonstrated by the fact that the number of administrative authorizations granted and reforms implemented to increase competition shrank significantly. These problems continue today—three years have passed since the revolution, but the system of privileges remains unchanged.

Tunisia's high potential in services sectors could bolster the process of structural transformation and become a source of dynamic growth and jobs creation, notably for university graduates. The analysis presented in the previous chapter focused on the potential for industrial goods. However, several studies have highlighted that Tunisia holds large potential in exports of services, and in today's globalized world services sectors increasingly play a pivotal role for economic development (Khanfir and Visentin 2004; World Bank 2008a; Roland Berger 2009; Diop and Dee 2010; McKinsey & Co. 2010; Ben Romdhane 2011). It is estimated that a comprehensive liberalization of the service sector could boost GDP growth and investment by one percentage point and would reduce the unemployment rate by 2.4 percent (approximately 90,000 jobs; ITCEQ 2010)¹. Tunisia should aim to accelerate trade integration in services sectors in which it has a comparative advantage, which implies a significant potential for exports, and adopt an "offensive" strategy. These sectors have been identified in previous studies: ICT and offshoring, professional services, transport and logistics, tourism, and health (Khanfir and Visentin 2004; World Bank 2008a; Roland Berger 2009; McKinsey & Company. 2010; ITCEQ 2010).

As discussed in this chapter, however, existing policies undermine the growth and export of services sectors². Hence Tunisia needs to rethink its approach to services sectors, to move from rents to competition. Enabling services to become competitive (and in particular transport, logistics, and telecommunications) is also a prerequisite to enabling manufacturing to move into higher-value added activities and thereby realize the gains from global trade integration (see Chapter Four and Chapter Seven). Therefore, Tunisia should unilaterally pursue the horizontal and vertical measures required to improve competition and performance in services sectors. Challenges affecting specific services

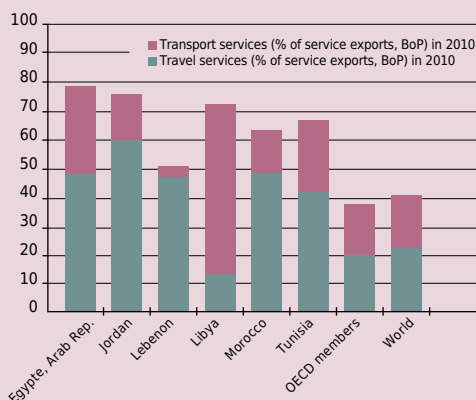
sectors have been mentioned in previous chapters and will not be repeated here, notably regarding the telecoms sector, the transport sector, and professional services (in Chapter Two), logistics (in Chapter Four), and the financial sector and tourism sector (in Chapter Six).

Yet as discussed in this chapter existing policies undermine the growth and export of services sectors². Hence Tunisia needs to rethink its approach to services sectors, to move from rents to competition. Enabling services to become competitive (and in particular transports, logistics and telecommunications) is also a pre-requisite to enable manufacturing to move into higher value added activities, and thereby realize the gains from global trade integration (see Chapter Four and Chapter Seven). Therefore, Tunisia should unilaterally pursue the horizontal and vertical measures required to improve competition and performance in services sectors. Challenges affecting specific services sectors have been mentioned in previous chapters and will not be repeated here, notably regarding the telecoms sector, the transport sector and professional services (in Chapter Two), logistics (in Chapter Four), and the financial sector and tourism sector (in Chapter Six).

8.1 / The Role of Services and Services Trade in Tunisia's Overall Economic Performance

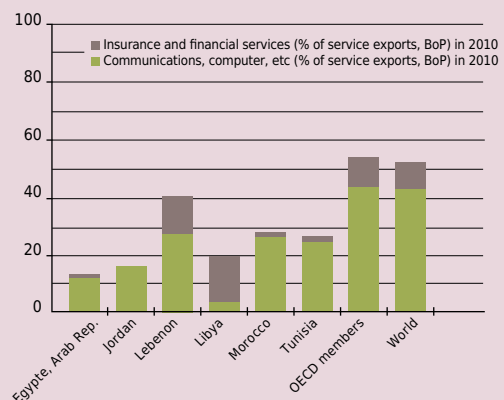
For over a decade, Tunisia has been underperforming in services trade. Prior to the revolution (2010), Tunisia ran a services trade surplus. In addition, the relatively high contribution of services trade to Tunisia's GDP (21 percent compared to 12 percent for OECD countries) would suggest both some openness and success on the trade front. However, a closer analysis of the country's services exports reveals a high dependence on transport and travel (tourism). Travel alone represents close to 50 percent of Tunisia's services exports, compared to 25 percent or less, on average, for the rest of the world and the OECD (figure 8.1 and figure 8.2). Cumulatively, travel and transport represent almost three quarters of Tunisia's services exports. As a result, the share in total exports of other types of services such as financial and insurance and communications and computer services remains well below the world average. This suggests a need for further diversification and a low capacity to innovate³.

Figure 8.1: A High Dependency on Travel and Transport Services



Source: World Development Indicators, World Bank 2011.
Note: BoP refers to "Balance of Payments"

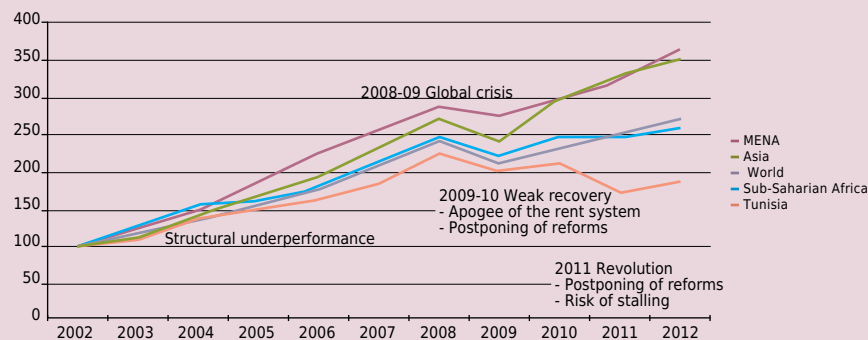
Figure 8.2: A Relatively Poor Performance in Other Services



Source: World Development Indicators, World Bank 2011.
Note: BoP refers to "Balance of Payments"

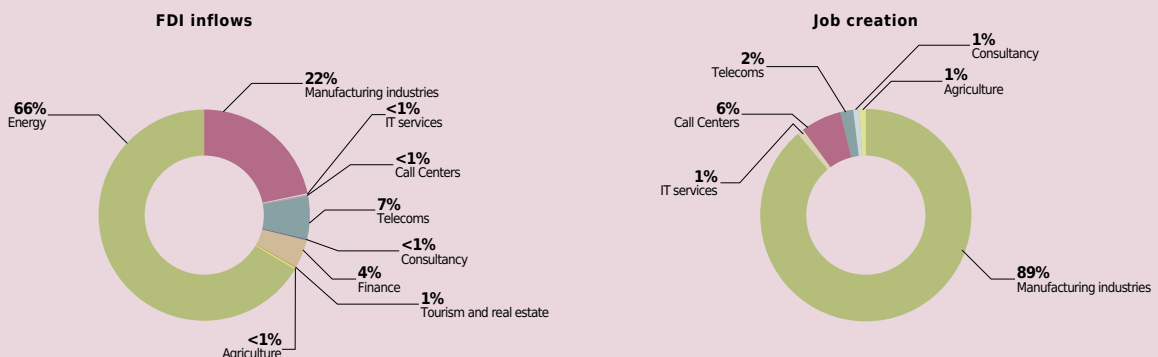
MENA countries have long been too dependent on the export of raw materials and low-value added industrial goods, stuck at the bottom of the productivity chain when emerging countries moved up the value chain (Müller-Jentsch 2005). Services trade, whether embedded in goods or standing alone, represents an important diversification, upgrading, and growth potential that has remained largely untapped. Over the last decade, Tunisian services exports have increased by 70 percent in value, which is significant but well under growth rates observed in the rest of the world (figure 8.3) As a result, Tunisia's services export growth was only 10 percent during 2000 to 2008, well below the 16 percent MIC average. As mentioned above, the share of services exports in Tunisia's GDP is relatively important (twice as large as the share observed on average in OECD countries) but is largely due to a high dependence on tourism (figures 8.1 and 8.2). In fact, only 11 percent of exporting firms operate in services activities, against 88 percent in the manufacturing industry. Thus, Tunisia needs to boost its services exports and diversify their content.

Figure 8.3: Performance of Commercial Services Exports, 2002-2012 (Index 2002 = 100)



Source: WTO online statistics (accessed in July 2013).

Figure 8.4: Distribution by sector of FDI inflows and job creations in Tunisia in 2012



Source: FIPA, 2012.

Note: Data from first quarter 2012; 100 percent corresponds to TND593 and 2,440 jobs, respectively.

Services trade is extremely relevant in terms of human capital and knowledge transfers usually associated with foreign direct investment (FDI), but the level of FDI in services in Tunisia continues to be small. The ratio of FDI to services trade is significantly higher than for merchandise trade: about 250 percent compared to 50 percent (Miroudot, et al. 2009). Although FDI inflows to the Middle East and North Africa (MENA) region increased significantly over the past decade ⁴, this has been primarily due to investments in the energy sector, with fuel-exporting countries receiving three-quarters of the FDI inflows. In Tunisia, the energy sector received over 60 percent of FDI inflows on average between 2006 and 2011 (see Chapter One, table 1.2). The services sector represented only 13.5 percent of total FDI inflows to Tunisia in 2012-generating 10 percent of the FDI-related jobs creation (figure 8.3) ⁵. This compares with services, accounting for approximately 90 percent of total FDI inflows in Morocco (see figure 1.2 in Chapter One).

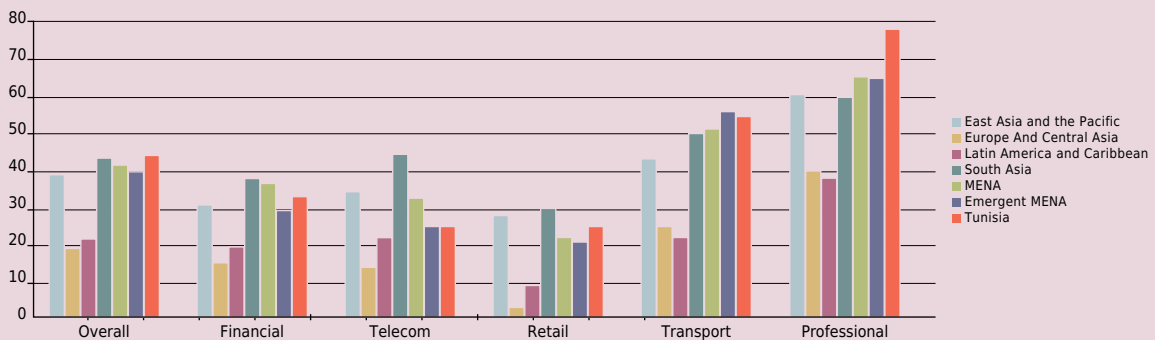
Tunisia's services sector is among the most restrictive in the world, and each of the services sectors is governed by several regulations. Restrictive regulations on all modes of services supply constitute a major obstacle to regional integration and to the participation of the region in the new division of labor allowed by the globalization of production networks and value chains. In 2010 the World Bank noted that while the Gulf Cooperation Council (GCC) is the most restrictive area of the world in terms of services trade, the MENA region at large is performing poorly on the openness front-the Services Trade Restrictiveness Index (STRI) measures the degree of openness of services sectors to foreign competition and highlights that all the countries in the Maghreb, with the exception of Morocco, appear relatively more restrictive than the world average, with the Arab Republic of Egypt and Tunisia being the most restrictive of the sample (Borchert, DeMartino, and Mattoo 2010). According to the STRI, Tunisia is the most restrictive MENA country for retail and professional services ⁶, and the second most restrictive country for transportation (figure 8.5). As a result, Tunisia has high telecommunications, Internet access, and transport costs (see Chapter Two), which affect the competitiveness of Tunisian firms as well as the attractiveness of the country to foreign investors.

There is an array of different types of restrictions that impair the growth of services sectors. Most of the investments in services activities are subject to approval when foreign equity holding exceeds 49 percent of capital (see Chapter Two and Chapter Four) ⁷. And, as discussed in Chapter Two, professional services are strictly protected, such that, while professional service represents 24 percent of global service exports (2008), it accounts for only six percent of Tunisian services exports. Restrictive employment policy for foreigners and protective corporate frameworks prevent foreign investment in professional services, despite its high export potentials. The Tunisian retail sector is also highly protected by complex red tape and narrow administrative regulations and authorizations. Although franchising was recognized in 2009, its application remains subject to case-by-case discretionary authorization by the concerned ministries. The financial sector has been liberalized since the 2009 law on non-resident financial institutions (offshore); however, in practice foreign exchange control limits the possibilities of trading these services. Due to the tight foreign exchange control, the Tunisian banking sector has only limited exposure to the international financial market, with less than 40 percent of Tunisian banks' capital belonging to foreigners, and offshore banks representing only seven percent of total assets.

Limited investment in services sectors in Tunisia, however, is likely due to more than just regulatory barriers. About 78 percent of total investments in the services sector (including tourism) originate in the MENA region. The EU represented less than a quarter of the foreign investment in services (tourism and other services) in 2012, which contrasts with 80 percent of the FDI in the manufacturing sector and 63 percent in the energy sector (with the United States and Canada representing another 23 percent). In other words, it seems that EU investors are interested only in the manufacturing and energy sectors, and the U.S. and Canadian investors essentially only in the energy sector. This

trend increased after the revolution. Since other Arab countries and Turkey already do invest in the services sector in Tunisia, it is unclear that the limited attractiveness of the country for EU and U.S. investors is simply the result of existing regulatory barriers. Most likely cultural proximity (including language) plays a major role in investment decisions in the services sector. On the other hand, EU and U.S. investors might also be more sensitive than their MENA counterparts to the security and predictability of the legal investment framework ⁸.

Figure 8.5: Service Trade Restriction Index (STRI) by Sector and Region



Source: Data from World Bank Service Trade Restriction Database
Note: STRI is calculated as simple country averages.
Emergent MENA economies exclude Iran and Yemen

The efficiency of services inputs is a key determinant of Tunisia's competitiveness and growth. Services are inputs into any kind of economic activity and production, representing generally between 10 and 20 percent of industrial production costs (Hodge 2002). In Tunisia it has been calculated that the cost of logistics services accounts for 18 percent of electrical and electronic industry exports and approximately 24 percent of olive oil exports (Khanfir and Visentin 2004). Services trade liberalization, if implemented in a proper regulatory and competition framework, could remedy supply-side constraints and increase competition on the domestic market, resulting in a more diversified and competitive local supply of services. Gains expected from trade also include knowledge spillovers and FDI inflows. Beneficiaries are the local consumers of services, including firms that use services in their production. In turn, productivity gains allow growth and job creations in all sectors. A recent study by Arnold, et al. (2012) found that banking, telecommunications, insurance, and transport reforms in India all had significant, positive effects on the productivity of manufacturing firms: a one-standard-deviation increase in the aggregate index of services liberalization resulted in a productivity increase of 11.7 percent for domestic firms and 13.2 percent for foreign enterprises.

Improving the efficiency of services is important to any trade integration (or export-led growth) strategy and is necessary to compete with cost-efficient emerging countries. Due to the "servicification" of the economy and the increase in the services content of traded goods, ease of access to quality, efficient, and moderately priced services all along the production chain (including abroad) has become a key determinant of competitiveness and participation in global production networks in traditional sectors such as agriculture and industry. About 75 percent of services trade is in intermediate services, suggesting that services trade primarily takes place in global value chains (Miroudot, et al. 2009). A recent study by the Swedish National Board of Trade (2010) revealed that 40 different services tasks are involved when a manufacturing firm internationalizes its production. Participation in global production networks will depend on the country's ability to efficiently supply

those services (either onshore or offshore): in relation to the EU, Tunisia's geographical proximity and just-in-time production are a major comparative advantage that relies on sophisticated supply chain management.

Despite recent improvements, trade in intermediate goods remained relatively modest in the MENA region, suggesting that the region is not part of the main global production networks. This could be explained in part by a high level of protection in the services sector, including in key sectors like telecommunications and transport and logistics. Major obstacles to trade in services and poor services efficiency could contribute to leave the region outside of major global value chains. For example, barriers to establishment (such as the equity limits imposed in many sectors in Tunisia—see Chapter Two and Chapter Four) and movement of persons (such as Tunisian nationality requirements for work in professional services) could constrain production relocation decisions (FDI) in some industries; barriers to trade in retailing and distribution (such as the discrimination against foreign franchises that require, unlike Tunisian franchises, administrative authorizations) could be an impediment to backward links in the industry and agriculture sectors (when the lead firm is a global retailer—see for instance the problems met by big retailers trying to establish in Tunisia); and absence of adequate protection of data could be an obstacle to services off-shoring (McKinsey and Company. 2010).

8.2 / Reforming the Services Sector: The Role of Unilateral Reforms and Regional Trade Integration

Tunisia will not become a major exporter of services unless it opens its market to imports. Services have become increasingly complex, and intra-firm trade and trade in intermediate services have surged—country specialization (and trade) can be at the task level, although recent trends toward global value chain consolidation suggest that countries able to supply a bundle of tasks will be more attractive to leading multinational firms. Tunisia cannot become a major services exporter unless it is open to services imports. As noted above, services trade is 75 percent trade in intermediate services: this includes trade in services inputs to agriculture, manufacturing, and services. With regard to the last, two phenomena are noticeable: first, services exports include about 15 percent of imported services inputs (Miroudot, Lanz and Ragoussis 2009); and, second, about a quarter of cross-border services trade is intra-firm (Lanz and Miroudot 2011). Thus, a country not open to trade in services automatically excludes itself from a meaningful part of world services trade, significantly increasing its trade costs to the detriment of its competitiveness, and being left outside of major global value chains and intra-firm trade. This is the case, for example, in professional services where the “big four” in accounting and auditing or large U.S. or United Kingdom law firms capture a large share of top multinational firms: if such firms cannot establish in Tunisia, Tunisian accounts will be treated from abroad, with no spillover effects on the local economy.

Tunisia should have holistic services trade and reform strategies, or it will never be able to move up the value chain and become part of the main global production networks. Trade in intermediate services and tasks has created new prospects for international division of labor and productivity growth. A country can specialize in different tasks and progressively move up the value chain—for instance from business process outsourcing (BPO) to knowledge process outsourcing (KPO) (Gereffi and Fernandez-Starck 2010). Starting with call centers, Tunisia could move to exporting knowledge if market access were granted by key trading partners. Recent studies suggest, however, that not all tasks can be performed independently or offshore (Lanz, Miroudot, and Nordas 2011), and that only countries able to offer a “bundle of tasks” to lead firms will remain part of the main global value chains that have consolidated their activities after the crisis (Cattaneo, Gereffi, and Staritz 2010). Thus, it is not enough to liberalize the performance of one specific task when it is bundled to other tasks.

Reforms should be made in Tunisia's best interest and most of them unilaterally. Nonetheless, regional trade integration could provide an impetus and help build consensus for the reforms as part of the convergence process ⁹. The driver of the regional trade integration negotiations between Tunisia (and its neighbors) with the EU could be the creation of a production platform with intermediate goods and services traded within the zone and a competitive services/industrial/agricultural offer in relation to the rest of the world. It is not about competing with China and other emerging countries but is about offering a bundle of tasks with high-value added content at key points of global value chains. This will require more freedom of trade in services and an increased efficiency of services links to allow a new division of labor, as well as important technology and knowledge transfers for Tunisia and its neighbors to move up the value chain.

The liberalization of the services sector, therefore, has two dimensions: one domestic (increasing competition among domestic providers) and one international (increasing the openness of the economy). A number of regulations apply in the services sectors that serve legitimate objectives, such as the protection of consumers against malpractice or universal access to essential services. These equally affect domestic and foreign competition. Some other regulations, however, discriminate against foreigners (market access and/or national treatment) and aim to protect domestic providers against foreign competition (under one or more modes of services supply: cross-border, consumption abroad, foreign establishment, and temporary movement of services providers).

The international dimension: The Tunisian government has retained a considerable degree of regulatory discretion in the implementation of its policies. Thus, *de jure* openness did not always translate into *de facto* openness, and a key reform issue will be to reconcile regulatory discretion—to the extent it serves legitimate domestic policy objectives—with the need for foreign and domestic service providers to have clear and predictable rules (Borchert, Gootiiz and Mattoo 2010). A number of companies that attempted to enter the Tunisian market in the last years of the old regime faced problems with corruption and nepotism and were refused administrative authorizations to establish or even open franchises in strategic sectors (for example, retail, real estate, and hospitality). The restoration of the country's attractiveness will therefore depend not only on a *de jure* but also *de facto* opening (that is, greater transparency, predictability, and security of the rules and their implementation).

Trade negotiations deal with both sectoral and horizontal barriers to trade. The rent system developed by the old regime has relied heavily on horizontal barriers that added to the complexity of the regulatory framework and the lack of transparency of the system ¹⁰. The government should focus on restoring legal security and predictability and should take the opportunity of the regional trade negotiations to remove unnecessary horizontal barriers to trade, such as limits on foreign equity or employment of foreign nationals.

The domestic dimension is also important: It is not enough to focus on liberalization and market access—Tunisian services providers should be competitive enough to enjoy the benefits to be expected from further integration. A number of services sectors have suffered from excessive administrative burdens and controls. In the last years of the old regime, nepotism prevailed and distorted competition on the markets; tax audits were also used to capture rents. Foreign companies that benefited from offshore status could avoid some of these issues faced by their Tunisian counterparts. The main objective of the reforms should be to restore transparency, security, and predictability ¹¹. Moving from rents to competition is not an easy task due to adjustment costs and the likely resistance of incumbent actors. In some sectors where entry and operational costs are high, the introduction of competition might also challenge the profitability of existing firms. In a post-revolutionary context, those problems become even more acute. Companies that benefited from the rent system will need to be restructured to survive the opening of markets to competition—more generally, all Tunisian services companies would benefit from upgrading.

The improvement of business and investment environments is a large and long-term need, and most of the priority reforms have been raised in previous chapters. Key measures that would help the development and efficiency of services include:

- *Simplifying the Regime of Administrative Authorizations:* As already discussed in Chapter Four, the scope and ambition of the ongoing “guillotine” regulatory reform of administrative procedures should be maximized. It is also important to switch to systems of tacit authorization in case of absence of response from the administration.
- *Removing Discriminatory Barriers to Entry Based on Nationality:* As already discussed in Chapter Two, these restrictions primarily affect professional services and should be replaced, in such case by objective qualification criteria. They also constitute a major barrier in key sectors of the economy that still benefit from rents: for example, in the distribution and retail sector, the *carte de commerçant* remains an obstacle to certain types of establishment by foreigners; and the acquisition of certain lands also remains forbidden for foreigners, affecting investment prospects in hospitality among other industries.
- *Removing the 49-Percent Limit on Foreign Equity in Strategic Sectors in Need of Foreign Investment:* As already discussed in Chapter Two and Chapter Four, these limits ought to be removed for all but the strategic sectors. The objective would be to authorize a foreign investor to hold a majority of the shares, even if limits on equity are maintained. A number of multinational companies would like to invest in the country but have trouble identifying the right partner (for example, in the cosmetics industry).
- *Ending Discrimination between Tunisian and Foreign Franchises:* Franchises are a predominant business model in a number of services sectors. The Tunisian law submits foreign franchises to burdensome administrative authorizations, which, in the recent past, had been attributed only in counterpart for rents. Franchises represent an important source of investment, jobs, and knowledge transfers.
- *Reforming the Legal Framework Regarding Competitiveness:* As discussed in Chapter Two, it is important that efficient competition laws and enforcement mechanisms are in place so that the opening of the Tunisian market does not result in new rents being captured by foreign companies.
- *Reinforcing Intellectual Property and Personal Data Protection:* Moving up the value chain in the services sector requires the improvement of the protection of high-value added activities. For instance, better personal data protection is necessary to allow the movement from BPO to KPO.
- *Revising Government Procurement Rules:* The revision of these rules would benefit a number of services sectors, including engineering and construction. As discussed in Chapter Two, these reforms should aim at increasing the efficiency, transparency, and accountability of procurement.
- *Removing Employment Limits for Foreigners:* As discussed in Chapter Four, the limits on employment of foreigners do not result in more jobs for Tunisians—rather they discourage foreign investment and reduce the number of jobs available to Tunisians. Skills required for performing certain tasks or providing certain types of services have become increasingly specialized. Temporary movement of key personnel should be allowed at critical stages of a firm’s life—it could be accompanied by obligations of training local staff if the objective of the government is to build local capacities. In an economy where global value chains prevail, key personnel should be able to move up and down the value chain to ensure the good functioning of the global network.

8.3 / Conclusions

Several studies have highlighted that Tunisia holds large potential in exports of services, and in today's globalized world services sectors increasingly play a pivotal role for economic development. Previous studies have estimated that opening up competition in the services sectors could generate over 90,000 jobs. The sectors with the greatest potential have been identified in previous studies and include ICT and offshoring, professional services, transport and logistics, tourism, and health. Further, competitive “backbone” services to firms, such as transport, logistics, and telecommunications, are necessary to improve the competitiveness of manufacturing and the shift toward higher-value added activities.

The revolution provides Tunisia a unique opportunity to implement long-overdue reforms and realize this potential. While social tensions are still vivid, with resurgent protests and strikes, it is important to send strong signals to investors and restore faith in good governance. Reforms need to be taken at a time when the costs of adjustment (for instance potential short-term job losses, even with prospects of longer-term jobs creation) come with a high political cost. However, delaying reforms any longer just threatens to increase the risk of stalling for the country. In a highly integrated world, the absence of action means not only stagnation but also the loss of ground with respect to competitors ¹².

To unleash the potential of services sectors, market access (“liberalization”) alone is not enough and needs to be preceded by reforms of the business environment and competition at large (discussed in previous chapters). In fact, the sequencing of reforms is key. Accompanying regulatory reforms, sometimes non-trade related, will determine the impact of services liberalization. Trade liberalization should be preceded by reforms of the business environment and competition at large. Opening a services sector to domestic (through privatization or suppression of a public monopoly) and/or foreign competition without paying attention to the domestic regulatory and competition environment could have negative effects—allowing, for example, anticompetitive behaviors and price increases. The government needs to ensure that regulatory reforms are effective to guarantee greater competition and remedy market failures. It is particularly important in a country in democratic transition like Tunisia—where part of the economic assets could have been captured by a few—to make sure that trade services liberalization and economic growth benefit the population at large and not just a few domestic or foreign investors.

Most of the reforms entail opening up the services sectors to competition and should be taken unilaterally in Tunisia's best interest, without waiting for reciprocal trade negotiations. Nonetheless, regional trade negotiations, notably with the EU, could provide an impetus and help build consensus for reforms as part of the convergence process but should not become an excuse to delay the unilateral opening of the services sectors, which is in Tunisia's best interest. Regional integration could be conceived as tool for the promotion of good governance, and its main benefits would reside in the convergence process that would help restore a transparent, secure, and predictable regulatory environment as well as send a strong signal to potential investors.

Trade negotiations should deal with both horizontal and sectoral barriers to trade. Just as important are the cross-sectoral and horizontal barriers that continue to hamper competitiveness. The rent system developed by the old regime has relied heavily on such horizontal barriers that added to the complexity of the regulatory framework and the lack of transparency of the system. The government should focus on restoring legal security and predictability, and take

the opportunity of the regional trade negotiations to remove unnecessary horizontal barriers to trade. The "Advancing Tunisia Global Integration" report (World Bank 2014h) presents a detailed discussion of the most urgent reforms needed in key services sectors.

In addition to significant potential in industrial goods and services, Tunisia also holds large unexploited potential in export of agricultural products. Following the discussion of the potential of the industrial sector in the previous chapter and the discussion of services potential in this chapter, the next chapter discusses how to realize the full potential of Tunisia's agricultural sector.

Notes

1 Other studies have estimated that the benefits from liberalization could be even greater. For instance, Ben Romdhane (2011) estimates that opening up the services sectors (which would result in the removal of the monopoly-rent distortions and inefficiency) could increase welfare by over four percent of GDP, mostly as a result of allowing foreign direct investment. Similarly, Konan and Maskus (2006) estimate that the benefits could reach approximately 4 percent of GDP.

2 This chapter draws on the report “Advancing Tunisia’s Global Integration” (World Bank 2014h).

3 While these trade patterns seem to be common to most countries in the region, the example of Lebanon suggests that a specialization in more innovative services (such as finance or communications and computer services) could be successful and reduce the dependence on tourism receipts.

4 At the beginning of the 2000s, the World Bank and the European Commission pointed at the failure of the MENA region to use trade and FDI as an engine for growth (Müller-Jentsch 2005); starting with a low baseline, between 2000 and 2008, MENA has multiplied its FDI inflows 17-fold, compared to a mere increase of 86 percent in Latin America and the Caribbean (LAC) or 68 percent in China; the 2009 crisis has resulted in a brief drop in FDI (-19 percent) that was recovered in 2010 (+12 percent) (O’Sullivan et al. 2010).

5 In 2012, two major operations in the financial and telecoms sectors boosted Tunisian FDI inflows and masked an otherwise flat growth of FDI.

6 After correction of the index regarding the openness of legal services.

7 Sectors concerned by this restriction include transport, communications, tourism, education, culture, entertainment and activities for youth and children, construction, real estate, computer services, and others.

8 The example of the U.S.-Morocco FTA shows that such agreement could give a significant impetus to investment decisions: between the conclusion of the negotiations (2004) and the entry into force of the agreement (2006), FDI inflows to Morocco multiplied threefold and jumped from US\$800 million to US\$2.4 billion—the signal sent to investors by the conclusion of the agreement should not be underestimated.

9 Linking reforms with regional trade integration and convergence could also help Tunisia benefit from technical assistance and capacity-building programs that are likely to reduce adjustment costs.

10 For example, the Tunisian investment code contains twenty times more pages than regular investment codes. For years, the revision of the code has been planned but postponed due to the complexity of the task. Tunisia has also been a leader in terms of competition law, but the adaptation of the system to new requirements is taking time. Laws regulating the professions date back several decades. The multiplication of administrative authorizations and other arbitrary restrictions on entry contributed to the deterioration of the business and investment climates in Tunisia.

11 For instance, as discussed in Chapter Four, while according to international indicators Tunisia is perceived to have fairly good logistics services, in fact this is not the experience of the private sector in Tunisia. According to the World Bank LPI rankings, Tunisia is now a fairly good performer (third best performing country in the region), but in fact the LPI likely underestimates the problems confronting the Tunisian logistics sectors (see box 4.6 in Chapter Four). In the context of a “dual economy” and in an environment where political connections are so crucial, the results depend on who is interviewed. In other words, in Tunisia there are differences in treatment between onshore and offshore firms and there is also a significant gap between *de jure* regulations and *de facto* regulations reflecting the discretion exercised by the administration, notably by customs. For instance, when compared to other countries, including in the sub-region, cargo dwell time in Tunisia is, on average, the worst after Algeria (close to 10 days), much worse than Morocco (below 5 days) and not better than Lebanon or Egypt (see figure 4.11 in Chapter Four). Discretion and unpredictability play an important role. For instance, the ratio between the longest dwell times with the average for all the companies surveyed should be rather close to one since most of the time importers have rather similar cargo to import. However, once again this ratio is worst in Tunisia (see figure 4.3 in Chapter Four). This means that it is possible for an importer to face a much longer dwell time than the average and, while this could capture many factors, in general it is a proxy for some bargaining processes to reduce fees, bribes, and duties.

12 For example, if Morocco concludes its Deep and Comprehensive Free-Trade Agreement (DCTFA) with the EU before Tunisia, the risk is that—within the most-favored nation (MFN) clauses—Tunisia will just have to abide the rules set by its neighbor. The opening of the negotiations, in July 2013, of the U.S.-EU FTA also changed the rules of the game at several levels. Specifically: (a) the transatlantic agreement will capture many of the EU Commission’s negotiation resources; (b) it will set a new level of concessions that are likely to be asked from trading partners, the EU and U.S. FTAs with the Republic of Korea serving as a basis for the negotiations; and (c) it will provide simultaneous access to the U.S. and EU markets for those countries having concluded with either of the parties a separate FTA with an MFN clause. In that respect, Jordan, Morocco, and other countries that already have an FTA with the U.S. are more advanced, and it is even more important to conclude an agreement between Tunisia and the EU before the U.S.-EU FTA is negotiated.

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Unleashing the Potential of Agriculture to Boost Growth in Interior Regions | 09



Tunisia does not have an agricultural policy; rather it has a food security policy, which goes against the potential of its agricultural sector



Unleashing the Potential of Agriculture to Boost Growth in Interior Regions

The agricultural sector plays a key role in the Tunisian economy, especially in the poor rural areas of the interior. In 2010 the agricultural sector accounted for nearly eight percent of GDP, contributed nearly one-tenth of total exports, and accounted for nearly 20 percent of employment (directly in agriculture and indirectly in the food industries). In fact nearly 34 percent of the population lives in rural areas and depends on the agricultural sector, whether directly or indirectly, as the sector remains the main source of employment in rural areas, accounting for about 44 percent of rural employment. Moreover, agriculture provides employment to almost all women in the countryside. Hence, agriculture is a very important sector for growth and poverty reduction, especially in lagging regions (annex 9.1).

This chapter suggests that Tunisia does not really have an agricultural policy but has instead a food security policy that in fact hinders the development of its agricultural sector¹. The current system of state intervention has repressed the agricultural sector, distorting production away from Mediterranean products in which Tunisia has a natural comparative advantage toward continental products in which Tunisia is not very competitive but which are key to food security. This policy has helped increase self-sufficiency in staple foods by “inflating” the growth of continental agricultural products, but in the process it has led to distortions and inequitable redistribution of wealth, keeping agricultural production at a sub-optimal level and unable to realize its full potential. Further, this chapter highlights that current agricultural policies in Tunisia, while well intended, are in fact both inefficient and inequitable and, paradoxically, contribute to increasing unemployment and regional disparities.

Food security is an essential priority that cannot be compromised, but food security is not synonymous with food self-sufficiency. The relevance of food security concerns has been reemphasized by the severe international food prices spike in 2007 to 2008². Nevertheless in light of the problems with agricultural policies discussed in this chapter, Tunisians should carefully consider possible alternative ways to ensure food security, ways that do not undermine the development of their agricultural sector.

9.1 / The Agricultural Sector Performs Below Its Potential and Appears Distorted Toward the Production of Goods in Which It Is Not Competitive

Countries have a comparative advantage at making products that are intensive in the use of the factors with which they are relatively well endowed—Tunisia is relatively well endowed in labor but has a relatively scarce supply of arable land and water resources. Hence we expect Tunisia’s comparative advantage to be in the production of goods that are least intensive in arable land and water. In order to assess Tunisia’s comparative advantage in agricultural production, we calculated the domestic resource cost (DRC) of production for various products using price data for the years 2000, 2004, and 2008 (World Bank 2009d). This indicator measures the ratio of the social cost of production (production valued at social prices) to the cost of production at domestic factors prices, thereby giving an indication of Tunisia’s competitiveness of Tunisia in the production of each given agricultural good (box 9.1). International agricultural commodity prices are currently between the 2004 and 2008 prices (figure 9.1), such that the results of the analysis for those two years can provide a valid approximation of the current competitiveness of Tunisian agriculture.

Tunisia has a comparative advantage in crops with greater labor intensity and a disadvantage in crops with high land intensity. The results of the calculation of DRCs suggest that Tunisia does

Box 9.1: Methodology for the Analysis of the Competitiveness of Agricultural Products in Tunisia, 2000-2009

An analysis of the competitiveness of agricultural products in Tunisia was performed calculating the Policy Analysis Matrix (PAM) based on data from 2000, 2004, and 2008 (World Bank, 2009d). This analysis allows a measure of the discrepancy between economic or real costs of production and international reference prices (the prices prevailing in a situation of perfect competition without market failure or distortion). Specifically, the PAM is composed of two types of budgets: one valued at market prices (financial budget) and the other valued at the social opportunity cost or economic prices (economic budget). Market prices are those farmers pay (or receive) while economic prices reflect the cost to the economy or society. We can thus calculate the difference between the financial budget and the economic budget. In developing the budget, all inputs and outputs are classified as tradable or non-tradable. Tradable products are those that can be imported or exported, and theoretically valued at world market prices, while non-tradable goods and domestic factors are those that are not normally traded in the international market. PAM is used to calculate private profit (or financial profit), which measures the competitiveness of the production system, and a social profit (or economic profit) that measures the comparative advantage.

The products reviewed are soft wheat, durum wheat, barley, tomatoes, potatoes, olive oil, peaches, oranges, milk, ovine meat, and bovine meat. In addition the analysis differentiates the productivity across four different classes of farm size (< 5 hectares, from 5 to 10 hectares, from 10 to 50 hectares, and > 50 hectares) and three different agro-climatic and agro-ecological zones (humid and sub-humid, semi-arid superior, and semi-arid inferior).

An indicator of competitiveness, the domestic resource cost (DRC), has been calculated for each product. This indicator measures the ratio of the social cost of production (production valued at social prices) to the cost of production at domestic factors prices. In practice, the DRC is calculated as the ratio of the value of domestic resources and non-tradable inputs (land, labor, certain types of capital, and water) to value added (defined as the value of output less the cost of tradable inputs). The ratio indicates whether the use of domestic production factors is socially profitable ($DRC < 1$) or not ($DRC > 1$). So if $DRC < 1$ for a given good, it would be cheaper in domestic resources to produce the good locally rather than to import it (that is, less than one dinar of domestic resources is needed to produce a dinar of value added) and vice versa.

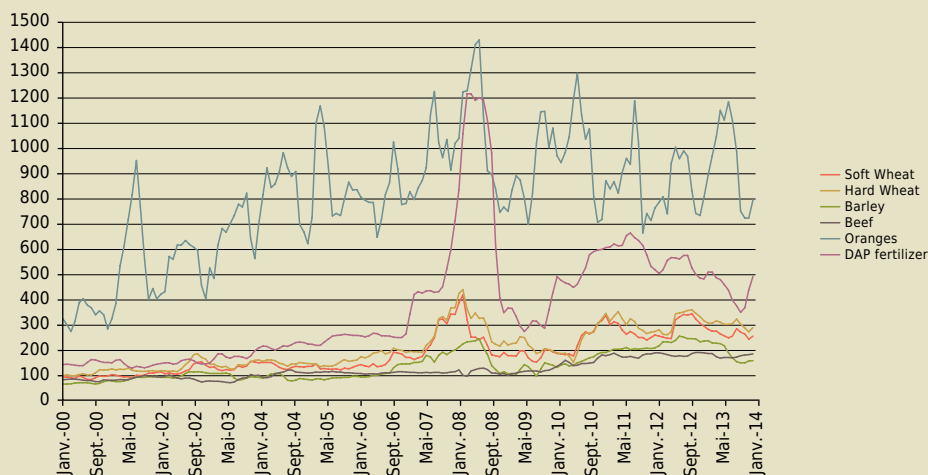
Table B9.1.1 Cost of Production in Domestic Resources

Products	2000	2004	2008
Soft wheat	1.86	3.13	0.9
Soft wheat, irrigated	0.97	n.d.	0.65
Hard wheat	1.2	0.96	0.56
Hard wheat, irrigated	0.61	n.d.	0.39
Barley	3.14	4.02	1.69
Potatoes	0.56	0.5	1.39
Tomatoes	0.6	0.45	0.66
Oranges	0.83	0.31	1.29
Peaches	0.49	0.49	1.39
Olive oil	0.91	0.82	0.36
Bovine integrated local breed	0.79	2.22	3.65
Bovine, non-integrated local breed	1.85	2.6	4.57
Bovine, integrated pure breed	1.32	1.75	<0
Bovine, non-integrated pure breed	1.46	2.03	<0
Integrated milk	0.82	1.23	1.15
Non-integrated milk	1.06	2.1	1.91
Ovine	0.44	0.65	0.5

Source: World Bank 2009d (the results for 2000 and 2004 are based on a report by IDEACONSULT in 2005).

not have a strong comparative advantage in cereals, which are intensive in land and are socially less profitable than arboriculture, fruits, and vegetables (box 9.1). Tunisia is very competitive in production of olive oil and tomatoes (as shown by the $DRC < 1$) in each of the three years for which the analysis has been carried out (2000, 2004, and 2008). It is also competitive in production of oranges and potatoes, except in 2008 when the price of fertilizer was extremely high. Tunisia is also competitive in durum wheat (rain-fed and irrigated) and was also competitive in irrigated soft wheat when the international prices spiked in 2008, such that temporarily it became profitable to produce soft wheat in Tunisia. The competitiveness in soft wheat is limited to the irrigated areas and areas in the north and northwest regions where the rainfall is more favorable (not shown). In terms of farm size, unsurprisingly, the larger the farm the more competitive the wheat production (not shown). Tunisia is not at all competitive in production of barley. In terms of meat, Tunisia is very uncompetitive in production of beef and milk ($DRC > 1$), but it is very competitive in ovine meat.

Figure 9.1: International Price of Selected Agricultural Commodities and Fertilizer, 2000-2014



Source: World Development Indicators (WDI).

Note: Soft Wheat (U.S.), no. 2, soft red winter, export price delivered at the U.S. Gulf port for prompt or 30-days shipment, U.S. Dollars per metric ton; Hard Wheat, No.1 Hard Red Winter, ordinary protein, Free On Board (FOB) U.S. Gulf port, U.S. Dollars per metric ton; Barley, Canadian no.1 Western Barley, spot price, U.S. Dollars per metric ton; Beef, Australian and New Zealand 85% lean fore, Cost and Insurance Freight (CIF) U.S. import price, U.S. cents per pound; Oranges, miscellaneous oranges, CIF French import price, U.S. Dollars per metric ton; DAP (diammonium phosphate), standard size, bulk, spot, FOB. U.S. Gulf port, U.S. Dollars per metric ton.

These results highlight that Tunisia's agricultural sector is not realizing its growth potential because it concentrates on products in which it is not competitive. Conversely, in areas where Tunisia is competitive, it does not capitalize on its advantage. The most competitive products, namely durum wheat, arboriculture (including fruit and olive oil), vegetables, and fisheries—which represent 58 percent of production over the last 20 years—contribute to the growth of the sector only up to about 46 percent, while non-competitive products (cereals, excluding durum wheat, beef, milk)—which concern 39 percent of production—contributed up to about 52 percent (table 9.1).

A quick review of Tunisian exports to the European Union also signals that the comparative potential in the arboriculture and fruits and vegetables segments is not fully exploited. In fact, in 1998 Tunisia used only approximately 55 percent of its citrus export quota (CNEA 2005b), and this amount was still only approximately 60 percent in 2010 and 2011 (table 9.2 and figure 9.2);

Table 9.1: Contribution of Individual Products to the Growth of the Agricultural Sector

	Share in overall production (1990-2010)	Contribution to the growth of the sector (1990-2010)
Competitive		
Durum wheat	10.0	8.0
Arboriculture	27.0	23.5
Horticulture	15.2	15.2
Fisheries	5.8	-0.7
Total	58.0	46.0
Non competitive		
Cereals (excluding durum wheat)	4.2	5.0
Livestock	35.2	46.7
Total	39.4	51.7
Other products	2.6	2.3

Source: Author's calculations.

exports of tangerines and clementines are virtually non-existent because farms can supply only the local market. Exports of apricots have increased from a mere 15 percent of the available EU quota in 1998 to approximately 70 to 100 percent of quota in 2010-2011. Similarly, Tunisia used only 25 percent of its tomato quota in 1998 and still used only 50 to 70 percent of its quota in 2010 and 2011, respectively. Even for olive oil, Tunisia still manages to export only about 20 percent of its quota. In sum, Tunisia is not taking advantage of the existing opportunities to export agricultural products to the EU. This largely reflects the weakness

of Tunisia's production systems, which is partly the result of lack of government action to support these Mediterranean crops, notably for olive oil and citrus (box 9.2). For other products, such as tomatoes, the shortfalls in taking advantage of these export opportunities is also due to the fact that the EU import quotas are subject to specific calendars which further restrict their use.

More generally, the potential to increase the quantity and value of olive oil exports worldwide remains unexploited. Tunisia is the second largest olive oil exporter in terms of volume worldwide, and olive oil constitutes about 5.5 percent of Tunisia's total exports in 2010. Despite a clear comparative advantage in olive oil production given its high quality and low costs of production, however, Tunisia's production has stagnated over the last 12 years even though world demand has steadily been increasing (box 9.2).

Figure 9.2: Exports to the EU of Selected Products as a Percentage of Quota, in 2010 and 2011

Source: Tunisia Ministry of Agriculture

Box 9.2: High Unexploited Potential for Export of Olive Oil and Citrus

Olive oil prices depend on quality. Virgin olive oil is the highest olive oil quality and represents over 70 percent of the international market. Tunisian oil exports, however, consist mainly of the lowest grade of such virgin olive oil. This low quality rate is the result of various factors such as (a) inappropriate harvest, storage, and transport methods; (b) a long harvest and storage cycle; and (c) obsolete extraction equipment. The vast majority (above 90 percent) of Tunisian olive oil is still traded unbranded and in bulk. Several factors constrain productive investments in Tunisia's olive oil sector: variability in terms of production is high and returns are low in Tunisia mainly due to antiquated production techniques—it has been estimated that mechanization could increase returns by 20 percent (World Bank 2008a). There is also a lack of local norms and clear quality standards, which does not help the process of creating a quality brand and targeting high-end markets. While many origin trademarks exist in Greece, Italy, and Spain, Tunisian olive oil producers are only now developing origin trademark and quality labels. Moreover, the Vegetable Oils Marketing Board (*Office National des Huiles*, ONH) undermines Tunisian exporters because it sets prices, controls access to the EU quotas (allocating some of the quota to private operators through procedures that are not made public), and at the same time monopolizes the control of quality. In the past it also occasionally banned exports at times of lower supply and higher international prices—at a great loss to private investors. In addition, many olive producers have difficulties in accessing finance in part because olive oil production is a long-term investment (as it takes several years before the olive trees start producing olives). Private-sector exporters believe there is significant scope for increasing olive oil exports by targeting emerging markets, such as China, India, or the Russian Federation; improving packaging and marketing (for instance using a label of origin and quality); creating an organic agricultural label; and perhaps promoting cooperatives. Still, although the olive oil sector would also provide an opportunity to increase labor demand in Tunisia's inner provinces, necessary reforms to boost the performance of the sector seem to have been stalled for decades.

Citrus production has stagnated for more than a decade, and growing domestic demand absorbs more than 90 percent of local production. Current citrus exports to the EU amount to 24,000 tons and represent only 60 percent of the country's preferential quota. To take advantage of this opportunity, Tunisia needs to increase the quantity and quality of production. Tunisian citrus fruits are graded as being of "average" quality. Many citrus orchards are old and unproductive. The conversion of old orchards into younger and more productive farms is slow. Yields are low, and fruit are too small to get good prices. Negligence at harvest is damaging fruit. Fruits that are tree-harvested and those collected on the ground are often mixed together. More efforts should therefore be made in applied research and extension service to develop appropriate harvest and post-harvest techniques that ensure high fruit quality for exports. These techniques must be developed for all stages of the supply chain and be easy to implement by citrus growers, fruit processing centers, and traders. Despite price liberalization, retail margins are still regulated by a 1988 decree that retail margins be set based on official purchase prices. Fruits growers and collectors are required to sell their produce to the official wholesale market, and fruit retailers must purchase their goods at the same market. The permitted retail margin is low, encouraging retailers to avoid the formal wholesale market and directly purchase fruit from local producers or collectors. This trend is coupled with quality-damaging practices where fruits of all quality levels and sizes are mixed and sold as a whole regardless of size and quality differentiation.

Table 9.2: Exports to the EU for Selected Products under Quota, 2010 and 2011

	Tons			Percentage of EU quota	
	2010	2011	UE Quota	2010	2011
Citrus fruit	24580	23610	39355	62	60
Apricots	1522	2337	2240	68	104
Almonds	1384	1330	1120	124	119
Tomatoes	9820	13384	18816	52	71
Olive oil (conditioned)	10877	12035	56000	19	21

Source: Tunisia Ministry of Agriculture

9.2 / A Distortive, Expensive, and Inequitable Agricultural Policy

The focus of farmers on products in which Tunisia is not competitive is the direct result of existing agricultural policies. In fact much of the growth in agriculture has been driven by subsidies and the trade protection of products in which Tunisia is not competitive. Agricultural production increased by 67 percent (in value) over the period 1990-2010, but almost one-third (17 percent of the value) originates in bovine beef and milk, in which Tunisia is not competitive. In other words, much of the growth in agriculture has been caused by support provided to the agricultural sector (input subsidies, market price support, and trade protection) that has artificially inflated the growth of the sector, but at a net loss for the country (see below). This support policy provides agriculture with a transfer of resources that are borne by taxpayers, consumers, and the rest of the economy. Further the amount paid by taxpayers, consumers, and the other sectors of the economy is greater than the benefits received by the agricultural sector, which implies a net loss for the country.

Tunisian agricultural policy aims to ensure food security, protect farmers' incomes, and support economic activity in interior regions through provision of input subsidies, guaranteed prices, trade protection, and other ad hoc interventions. We briefly review the main features of each of these instruments below (table 9.3).

- *Market price support is significant, accounting for over 30 percent of total budgetary transfers to agriculture in recent years:* The amount of price support for each product varies from year to year depending on movements in international prices. Market price support is carried out mostly through the implementation of a guaranteed minimum price for producers of cereals and intervention purchases carried out by the state marketing boards for milk, sugar beet, and tobacco³. The level of guaranteed prices is determined annually by the relevant marketing boards, taking into account international prices, production costs, and the situation of the domestic market. Market price support is particularly important in the milk sector, which accounts for over 50 percent of expenditure on market price support in recent years. Cereals (soft wheat, durum wheat, and barley) account for a further third of the expenditure on market price support.
- *Tunisian agricultural trade policies entail customs duties and quotas on imports of agricultural products:* Overall the impact of the international push to liberalize agricultural trade (and notably the 1994 Uruguay Round of trade negotiations) has had a limited impact on the level of protection and trade in Tunisia. Agricultural products continue to be subject to much higher customs duties compared to international standards, and import penetration into the domestic food products markets is much

lower than in the industrial sector. In general, tariff protection for agricultural products far exceeds that of other products. The simple average of the “most favored nation” (MFN) rates applied to agri-food products is 24.6 percent (compared to 16.5 percent for all products), with a maximum rate of 36 percent. “Record prices” (those above 15 percent, according to the World Trade Organization [WTO] definition) account for about 60.5 percent of agricultural tariff lines, compared to 32.5 percent for non-agricultural products. Among the categories of agricultural products, the highest overall tariffs (around 32 percent) are for animal products, milk products, and fruits and vegetables. In addition to ad valorem duties, Tunisia also applies tariff quotas (a combination of quotas and customs duties where these duties increase when imports exceed a specified amount).

- *Input subsidies (such as improved seeds, forage seeds, energy, irrigation water, and so on) also play an important role and account for approximately 20 to 25 percent of total budgetary transfers in recent years:* In 2008-2009, the largest share was allocated to fuel subsidies (approximately 40 percent of total input subsidies), milk collection premia (approximately 40 percent), and irrigation subsidies (approximately 18 percent). Fertilizer subsidies were discontinued in 1991.
- *In addition to marketing boards, trade protection, and input subsidies, the state intervenes extensively in the agricultural sector by directing the activities of farmers and private traders:* For instance, the state controls the margins of retail sales of several products, puts pressure on wholesalers to keep their prices low, imports when prices are rising (including for products like vegetables for which there is no guaranteed price), pays inadequate quality bonuses for cereals, and caps the prices of processed foods. Although the intention is to stabilize markets and support farmers’ incomes, in fact all these interventions create distortions to marketing systems and reduce the efficiency of resource allocation, thereby undermining the performance of the agricultural sector.

The overall cost of agricultural support in Tunisia is high. In addition to budgetary costs, which are borne by taxpayers, there are also direct costs to consumers who have to pay higher prices for food products⁴. Moreover, the distribution of these benefits (that is, the transfers to support agricultural production) is regressive both geographically and in terms of household wealth of the beneficiaries. Price interventions also distort production and trade, generating efficiency losses borne by the rest of the economy. Finally, the bureaucratic machinery required to administer this array of interventions also poses a challenge to the farmers. We review each of these items in turn below.

Budget Transfers: Support measures to agriculture (pricing and input subsidies) are expensive. The budgetary direct costs of policies reached approximately 0.8 percent of GDP in 2010 (or TND 350 million), which represents a significant burden for taxpayers. These budgetary transfers grew substantially during the 2000s, primarily due to expenses incurred by market price support and input subsidies. Hence, although Tunisia committed (in the framework of the 1994 Uruguay Round of trade negotiations) to reduce the overall mass of domestic support (from 76 million to 66 million dollars), in fact the budget expenditure for agricultural support has been steadily increasing (table 9.3 and figure 9.3). Further, the composition of budget transfers to the agricultural sector shows a shift in the type of support away from horizontal measures toward more distortionary measures. Between 2000 and 2009 the share of market price support and input subsidies increased from 31 to 53 percent while those of investment aid (budgetary funds to support small farmers and investment subsidies granted under the investment code and intended for integrated projects) and those intended for general services actually decreased (support to research and extension, preservation of the natural environment by soil and forestation work, and the fight against certain diseases by vaccination and treatment campaigns) (table 9.3 and figure 9.1). This trend runs counter to the commitments made by Tunisia with regard to the WTO to move away from disruptive measures. These observations about the total cost and form of budget support to the agricultural sector highlight the need to phase out administered prices (guaranteed prices and input subsidies) and replace them with direct income

payments (which do not vary with international prices). This type of reform would be in line with the changes to the EU Common Agricultural Policy since the mid-1990s.

Table 9.3: Composition of Budget Transfers to the Agricultural Sector (in TND Million)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Price support and market regulation	20	10.4	27.3	25.2	20.7	19.5	26.4	49.8	79.9	116.7
Subsidies for the purchase of inputs	44.9	49.9	50.9	55.6	57.7	61.9	57.3	57.3	59.2	73.4
investment aid	77	96.1	101	94.6	97.8	99	97	100	103	105
General services	62.6	52.1	50.5	47.1	50.9	52.2	50.9	52	53.3	55.5
Total support	204.5	208.5	229.7	222.5	227.1	232.6	231.6	259.1	295.4	350.6

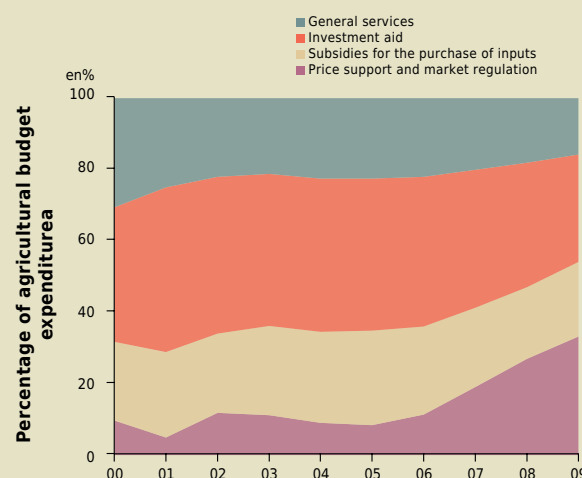
Source: WTO (Domestic support) and Ministry of Agriculture and Water Resources.

Consumer Costs: In addition to the budgetary costs, consumers also bear a significant financial cost as a result of the current agricultural policies. In fact, border protection raises farm gate prices and reduces consumer welfare. Consumers are forced to pay much higher prices compared to world market prices. These extra amounts particularly affect low-income people, who tend to spend a larger share of their income on food purchases. Using an economy-wide computable general equilibrium (CGE) model, the World Bank estimates that the net effect of trade protection of agricultural goods is equivalent to a loss of approximately four percent of consumer spending if the consumer purchases remain constant, and approximately 5.6 percent if consumers readjust their spending in response to changes in relative prices (table 9.4) (for a full discussion of the model and these results see World Bank 2006)⁵.

Cost of Food Subsidies: In addition to direct transfers to the agricultural sector, the state also supports agriculture by providing consumption subsidies for key food products. In 2009 the budgetary cost of food subsidies was approximately 1.5 percent of GDP, and this amount increased to over three percent of GDP in 2012 (table 9.3). This cost should be compared with the weight of agriculture in economic activity, which is relatively small at eight percent of GDP.

Efficiency Losses Borne by the Rest of the Economy: Using the CGE model of the Tunisian economy, the World Bank has estimated that the elimination of tariff barriers on agricultural products would increase GDP by approximately 0.8 percent (agriculture would shrink by 1.4 percent of GDP, but the rest of the economy would grow by 2.2 percent of GDP) and produce a total gain of approximately TND 7.1 billion over 25 years (table 9.4; World Bank 2006)⁶. However, the elimination of tariff barriers on agricultural goods would also cause a loss of approximately 87,000 jobs from agriculture that would have to be absorbed by other sectors. Half of the

Figure 9.3: Composition of Budget Transfers to the Agricultural Sector in Tunisia, 2000-2009



Source: WTO (Domestic support) and Ministry of Agriculture and Water Resources.

benefits estimated by the simulations would be induced by the liberalization of arable crops, mainly cereals—which has a limited impact in terms of employment (nearly 9,000 jobs) since arable crops use little labor. In this respect, it is estimated that the annual cost of protecting employment in the cereals sector is four times the national per capita income. Therefore, the overall economic costs of protecting the agricultural sector are self-evident. The protection of agriculture encourages producers to keep more resources in agriculture and prevent them from being allocated to other sectors (industry and services), even though they could be used more productively in those other sectors⁷. While providing support to the agricultural sector could be the result of a legitimate choice of Tunisian society (for example, to ensure food security, protect farmers' incomes, and support economic activity in interior regions), it appears that these policies are not achieving their objectives.

Table 9.4: Effects on the Entire Economy of Opening Up Trade in Agricultural Goods

Variables and parameters	Baseline scenario	Full liberalization scenario	
		With EU agricultural subsidies	Without EU agricultural subsidies
Economic growth (% per year, in the years following liberalization)	5.7	6.5	6.2
Agricultural labor force (% of employed population)	20.2	17.4	18.3
Labor force transferred to other sectors (in thousand jobs)	-	87	67
Adjustment costs (million TND through 2025)	-	984	874
Gains of adjustment (million TND through 2025)	-	7107	4441

Source: CGE model simulations, World Bank (2006)

Efficiency Losses Borne by the Agricultural Sector, Mainly in the Interior Regions: The bias introduced by protection of selected agricultural products results in a reallocation of capital and labor toward those overprotected products at the expense of alternative products in which Tunisia's exports have a comparative advantage, thus introducing an anti-export bias. Agricultural liberalization can lead to significant gains in production for some farmers. Using a linear programming model (which takes into account farming methods and profitability by type of farm), the World Bank estimates that nearly 70 percent of farms would gain from the removal of price distortions in the agricultural sector (table 9.5). Further, the results of the linear programming model highlight that "winning" farms would be distributed in the driest central and southern zones, producing sheep, olives, fruit, and vegetables. The winning subsectors (mainly breeding, arboriculture, and horticulture), which are particularly tradable sectors, represent together about 60 percent of the agricultural labor force and are geographically dispersed—thus benefiting the interior regions of the country. The farms that would lose from liberalization are generally those that produce cereals in the better-watered north and northwest parts of the country.

Table 9.5: Winners and Losers from a Reform of Agricultural Policies in Tunisia

Farm	Change in gross margin	% of total farms	% of the arable area	Type of farm
Farms benefiting from the liberalization	Gain from 55 to 294%	41	30	Olive oil, Off season Horticulture (Gabes) Citrus (Nabeul)
Farms the profitability of which would be more or less the same	Gain of 47%	42	41	Arboriculture and sheep rearing (Central and South) Irrigated farms
Farms loosing from liberalization	Loss from 1 to 79%	16	30	Cereal farms (North and North West)

Source: Linear Programming modelling results, World Bank (2006)

Regressive Impact of the Interventions: Finally, contrary to popular belief, the agricultural policy does not promote small family farms but mostly benefits a few large land owners (producing wheat, milk, and beef), who are often the most prosperous. This is because most support is provided based on output and farm size. Hence, the distribution of the benefits from existing agricultural subsidies is highly inequitable. As such, contrary to commonly held beliefs in Tunisia, current agricultural policies also fail to fulfill a positive social role.

Finally, perhaps the greatest cost of current agricultural policies is that they distort attention away from the products in which Tunisia can be competitive. Existing policies are strongly targeted toward supporting continental products (that is, they are largely focused on supporting cereals, milk, and beef), implicitly discriminating against Mediterranean products. In addition, the current set of policies is focused on price-support mechanisms, marketing boards, and trade barriers, and as a result insufficient attention is given to addressing cross-cutting problems, especially those affecting Mediterranean crops in which Tunisia can be competitive. Agricultural producers who operate in *filieres* (sectors) that hold great promise (for example, dried fruit, olive oil, fruit, and vegetables), prevalently in interior regions, often receive little or no support from agricultural policies and have great difficulty in accessing financing, inputs, information, or advice on agronomic matters and in marketing and exporting their output (box 9.3). A better approach would be to focus government intervention toward horizontal policies that do not privilege one crop at the expense of another but that support farmers by improving access to financing and risk management, access to quality inputs, extension services, and the marketing of their products.

Box 9.3: Know-How, But No Support—Tunisian Farmers Struggle to Move Up the Value Chain

SOUK ESSEBT, Jendouba—Hassen Abidi crumbles a sickly-looking ear of wheat in his hand. He doesn't need an agronomist to tell him it's infected with a fungal blight known to local farmers as *septoria*. "I know more about growing things than any doctor knows about medicine. But I'm at my wit's end with all this," he says. "I sometimes wonder why I carry on planting." This year he and his associates had no cash for pesticides for the wheat, nor to repair the broken pump that is part of an ageing irrigation system. For their melons and tomatoes, they will have to bring water by truck from a cistern some distance away.

It is two years now since they rented these 37 acres (15 hectares) from other locals, under simple verbal agreements. At 1,000 dinars per hectare, they need to find 15,000 dinars (about 6,750 euros) annually for rent.

Their low-volume business is on the brink of failure. This year, tomato seedlings have been supplied on credit by a company producing tomato paste, which also lent planting machinery and will provide pesticides on credit for the tomatoes. But producers' margins leave little cash for other expenditures, says Abidi. Even the plastic to cover the melons has been a major expense.

Agricultural economists estimate that farmers like Abidi could gain from moving into higher-end products such as sun-dried tomatoes or certified organic vegetables, which have a high markup on European tables. For this, however, Abidi would need advice about the shifting tastes of European consumers. "We know about growing things. We're ready to work day and night. What we don't have is the support," he says.

Down in central Tunisia, 40 miles (65 km) inland from the port city of Sfax, Mohamed Messaoudi knows that the olives, seedless table grapes, and early peach varieties he produces are of a high quality. Part of his crop has already been certified as organic.

The olive oil he produces at his Italian-made press is sold in bulk either to the official Vegetable Oils Marketing Board (*Office National des Huiles*, ONH) or to an exporter in Sfax—whose range includes extra-virgin infused with lemon, basil, and garlic.

Messaoudi wants to add more of that value himself, out here in the fields. And he knows that, despite the recognized quality of its olive oil, Tunisia is still using only 20 percent of its quota of exports to the European Union. For more than a year he has been seeking a lender for the 600,000 dinars (270,000 euros) needed to set up a bottling and marketing operation that would allow him to export directly. Bank lending at affordable rates has not been forthcoming.

He also plans to invest in packaging his fruit and vegetables. "I have plenty of contacts, in Libya and Algeria. They are ready to take my produce but they need it properly packaged," he says. In the meantime, he spends evenings running his business from the Publinet public Internet café in Regueb. Even just a few kilometers out of town, Internet connections are too slow and sporadic to allow for effective work.

Source: Interviews with Hassen Abidi, near Souk Essebt (Jendouba region, northwest Tunisia), and with Mohamed Messaoudi, near Regueb (central Tunisia), April 2014.

9.3 / Distinguishing Between Food Security and Food Self-Sufficiency⁸

The distortions, costs, and inequality of the agricultural policies in Tunisia are often justified because of the need for Tunisia to ensure its food security. Food security is indeed an essential priority, which cannot be compromised. The 2007-2008 food price crisis has made governments across the world consider the food security of their countries and their vulnerability to the movements in grain markets.

However, food security does not require achieving food self-sufficiency. There exists an array of options to ensure the food security of Tunisians at a time of possible crisis (World Bank 2008d, World Bank, FAO and IFAD 2009; Syroka and Nucifora 2010; Wright and Cafiero 2011)⁹. Recognizing the unreliability of imports, vulnerable countries face various options: (i) pursuing self-sufficiency by growing domestic grain supplies; (ii) acquiring foreign land to ensure supplies for domestic consumption; (iii) reducing the trade-related risk through closer regional coordination and integration; and/or, (iv) investing in strategic reserves (physical and virtual). In deciding the best policies to adopt, each country must carefully consider the tradeoffs from different policy options¹⁰.

Traditionally MENA countries have put food self-sufficiency at the center of their food security strategy. Looking ahead, Arab countries can take steps to further increase food production at home, even with the constraints imposed by the limited availability of water and land (World Bank, FAO and IFAD 2009). This approach would require improving agricultural productivity through investments in research and development. Improved technology would boost cereal yields, which are currently only half of the average yields worldwide. Better water management will also be critical in raising agricultural productivity.

Most MENA countries, however, have no comparative advantage in expanding cereals production, given restricted water supplies. Given the adverse agro-climatic conditions, however, ensuring food self-sufficiency may prove very expensive. Saudi Arabia has recognized the folly of producing grain at a cost five times the prevailing world price while depleting its scarce supply of fossil water and spreading salinity. Tunisia and other MENA countries around the Mediterranean have better agricultural potential. However, as discussed above, Tunisia's agricultural comparative advantage lies in Mediterranean products and not in the production of soft wheat. At the margin, it would be better to turn to larger stockpiles rather than to the expansion of grain production to ensure food security.

In practice, Tunisia (and other Arab countries) will continue to need to import much of their cereal consumption, even in cases when they produce some domestically. There is a complex balance of advantages and sacrifices involved in either importing less cereal, or having more agricultural export earnings with which to import¹¹. The tradeoffs between these options need to be carefully evaluated when considering water policy that shapes production choice. This tradeoff is unique in each country, depending on its food needs and agricultural potential. So long as the necessary time series data on planted areas and yield is available, an optimization model can be used to evaluate the tradeoff (World Bank, 2007b).

The possibility of purchasing lands abroad to cultivate grains for domestic consumption entails inherent risks at a time of crisis. Investment in foreign land for grain production is unlikely to solve the problem of unreliability of access to imports in emergencies, manifest in the actions of many exporters to ban food exports during the recent food price spike. Acquisition of foreign lands leaves food supplies exposed to sovereign risk and other supply chain problems beyond importers' control.

Improving trade integration, particularly at the regional level, should be part of the overall strategy. A food security policy does not have to be developed at the national level. The food security policy

could be defined in a regional context in which strong trade partnerships are established which entail commitments to protect food security (FAO 2003). The Food and Agriculture Organization (FAO) study on North African food security recommends the joint management of the volatility of grain prices to improve supply to domestic markets and ensure stable and affordable prices. Key aspects of the project would entail: (a) the creation of a Maghreb observatory for cereals to ensure the smooth supply of markets; (b) piloting the establishment of a Maghreb strategic cereals reserve to better manage the volatility of international prices; and (c) the expansion of the trade in food commodities among Maghreb countries. (FAO Maghreb Program on management of volatility in international cereals market volatility). A similar approach could also be developed with the European Union.

Increasing grain reserves has figured prominently in international discussions as a security mechanism. Accumulation of stocks to be used in case of tight global markets may be a more efficient and much cheaper strategy than attempting grain self-sufficiency by expanding domestic grain production¹². A national (or regional) food reserve is thus likely an essential element of a prudent national security policy for many MENA countries. The key question, then, is the size of the reserve. The answer must depend on such facts as the diversity of food supplies, dependability of traditional suppliers, and the cost of the program. Such stocks tie up capital for the substantial intervals between releases and can be expensive to maintain (stocks are “rolled over” with no net release, as required to maintain quality). Their efficient management also uses scarce human capital, and temptations for corruption can easily arise.

A “virtual grain reserve” also entails some risks, as it relies on the actions of the country which hosts the physical commodity and on the reliability of supply routes. Since Arab countries are likely to remain net cereal importers even with the successful implementation of these measures, financial instruments such as options and futures provide an attractive means for reducing exposure to market volatility by hedging risk. A virtual grain reserve refers to the possibility of having access to call on a stock of grain through the purchase of commodity futures and options trading. Futures contracts eliminate counterparty risk with respect to performance of the futures contract, including delivery at the designated delivery point. Most countries, however, do not view international futures markets as reliable substitutes for the local accumulation of stocks. This is easy to understand for landlocked countries that rely on the transport infrastructure of neighboring countries and are subject to foreclosure of crucial trade routes when they are most needed. More generally, governments have a perhaps unfounded concern that a futures market might be shut down or exports banned by the host country in a time of severe crisis, and a futures market therefore does not provide a secure alternative to having food already available in country. In practice, therefore, a virtual reserve is more likely to be useful as a complement to a physical reserve.

In sum, food security is not synonymous with self-sufficiency. There exists an array of options to ensure the food security of Tunisians at a time of possible crisis (World Bank 2008d, World Bank, FAO and IFAD 2009; Syroka and Nucifora 2010; Wright and Cafiero 2011)¹³. In light of the problems with agricultural policies discussed in this chapter, Tunisians should carefully consider possible alternative ways to ensure food security that are more cost-effective and do not undermine the development of their agricultural sector.

9.4 / Reforms Agenda: Unleashing the Potential of the Agricultural Sector

Tunisia holds great potential in the production of several Mediterranean agricultural products, notably durum wheat, olive oil, fruit, vegetables, and fisheries; but its agricultural policies are not conducive to realizing this potential. Current agricultural policies are focused on assuring food security, by pursuing

self-sufficiency in food production. This objective, however, comes at the expense of supporting the performance of the agricultural sector because it has focused production toward continental products that are core for food security (wheat, milk, and beef) but in which Tunisia is not competitive.

To unleash the potential of agriculture and enhance its competitiveness, a major reform of agricultural policies must be implemented. As discussed in the previous section, a prerequisite is to decide on a food security policy that does not undermine the agricultural sector. Once food security policy has been separated, the reform of the agricultural policy should follow five main parallel priorities: (a) progressively phase out price support and input subsidies and replace them with a system of direct support to incomes that creates less distortions; (b) gradually end direct state intervention in the marketing of agricultural products; (c) implement targeted social assistance programs to help the poor and vulnerable citizens directly (and not through agricultural support); (d) significantly invest in and improve the soft and hard infrastructure and services for the agricultural sector, notably by strengthening research and extensions, irrigation, land registry, financing, and transport infrastructure, which are essential to the growth of agriculture; and (e) simplify the procedures and improve the effectiveness of the public administration. We discuss each briefly below:

(a) Progressively shift away from price support and orient agricultural policy toward direct income support: The reform of the pricing policy involves reducing customs tariffs and government controls as well as the gradual elimination of the commercial role of state marketing boards. It is important to highlight that distortions cannot be corrected quickly in the agricultural sector. Unlike in the industrial sector for example where it is possible to change from one activity to another relatively quickly in response to international market data, in the agricultural sector the response time is longer and may require years to change activities. The first step would be to convert all quantitative restrictions into tariff equivalents and then to gradually reduce all customs duties (soft landing). Reducing guaranteed production prices (for cereals, sugar, and tobacco) and removing input subsidies would produce budgetary savings that could be reallocated to investment in rural infrastructure, thereby boosting private investment in rural areas. This reform should be accompanied by measures to help farmers adjust their production to the new systems of relative prices and compensate them against potential income losses due to price liberalization. The progressive phasing out of price support and input subsidies should be accompanied by a system of direct support for incomes based on a uniform area payment (which creates less distortion). The experience of other emerging countries (such as Mexico and Turkey) shows that this type of reform is feasible. In Tunisia, the establishment of such a mechanism of direct area-based support would first require strengthening of the institutional framework for property and land registration. As discussed above, this reform would bring economic gains to Tunisia that far outweigh the job losses. In fact, the agricultural sector is competitive in labor-intensive industries (notably, arboriculture, fruit and vegetables, and ovine).

(b) Gradually end direct state intervention in the marketing of agricultural products: To unleash the potential of agriculture, the state needs to play a different role in agricultural markets. The state should allow markets to freely establish prices and should refrain from direct intervention in the market, focusing instead on providing a regulatory framework and public goods to support the development of the sector. The experience of other countries suggests three main roles for the state: (a) design and implement a legal framework to ensure the efficient functioning of markets for goods, services, and factors of production (finance, land, labor); (b) protect people's health, natural resources, and the environment; and (c) provide essential public goods to encourage high-quality production through research, extension, pest control, and regulation of food safety. It would also be necessary to develop a strategic cereals reserve for food security purposes (with a combination of physical stocks and financial derivatives, to cover approximately three months of imports).

(c) Introduce social programs to alleviate the cost of adjustment: Move to separate agricultural policy from social policy, while ensuring that social policy is effective to protect all the poor and vulnerable (including, but not limited to, poor and vulnerable farmers). As discussed above,

current agricultural policies do not help small family farms and instead mainly benefit large farms (which are often the most prosperous). Nevertheless, it is estimated that the transition from a protected and distorted agriculture to a more competitive agriculture may entail the loss of 87,000 jobs from agriculture. While the reforms in non-agricultural sectors are expected to generate additional employment (in industry and service—see Chapter Seven and Chapter Eight), it may not be these same workers who find the new jobs. Social tensions may occur, and the less skilled workers and those who are not capable of coping with the adjustment will be the most affected. To make the transition successful, therefore, agricultural sector reform should proceed hand in hand with the introduction of stronger social protection programs to mitigate the cost of economic adjustment, and more generally to support the poor and vulnerable.

(d) Shift the support to strongly invest in and improve soft and hard infrastructure and horizontal services for agriculture: In order to boost agricultural growth there is a need to substantially improve the legal and institutional framework of inputs and outputs. Only a brief discussion is provided in this study because an in-depth discussion has been provided in previous World Bank reports (2006; 2009; 2012b). Similarly issues related to land markets and the land registry are discussed in detail in a recent report (World Bank 2014g). It is important to emphasize, however, that these government interventions need to be seriously strengthened and scaled up in order to enable the agricultural sector to fulfill its potential. The main aspects of soft infrastructure include:

- Redefining the role of professional agricultural associations (agricultural service cooperatives, collective interest groupings (GIC), agriculture development groupings, and so on) (World Bank 2006; 2009d);
- Focusing the work of the Ministry of Agriculture by revising programs and objectives toward the provision of public goods essential to encourage high-quality output (through research, extension, pest control, and regulation of food safety) (World Bank 2006; 2009d);
- Putting much more emphasis on research, extension, and training, which are the keys of agricultural development; as part of this effort there is a need to reform the management of research and extension by institutionalizing the involvement of farmers in directing research and the management of extension services as well as implementing budgeting by objectives (World Bank 2006; 2009d);
- Implementing an integrated water management system that can determine the least expensive means to better achieve the objectives of increasing water volume and water supply stability (for example, infrastructure investment vs. soil conservation, extension services, protection against water pollution, and so on) (World Bank 2006; 2009d);
- Facilitating the consolidation of land plots by simplifying the legal and regulatory framework, creating local one-stop shops for land transactions, and fostering the development of the land market (see Chapter Four; World Bank 2006);
- Simplifying and improving access to land (notably land which is held in public domain) and land registration process and cadaster. There is also a need to allow for longer-term land leases to facilitate large investments in agriculture (World Bank 2014g);
- Taking action to improve access to finance for the agricultural sector¹⁴. Access to finance is especially challenging for investments in arboriculture (olive oil and fruit), which entail several years between the initial investment and the start of the production phase. Specific reforms required to improve access to credit for farmers (such as completing the reform of the legal and institutional frameworks for microfinance) are discussed in detail in a

dedicated report on financing services for agriculture in Tunisia (World Bank 2012b);

- Establishing a framework to facilitate risk management in agriculture. For instance, promoting the development of weather-based insurance instruments can help farmers cope with the impact of drought in areas where there is no access to irrigation (World Bank 2006; 2009c; 2009d).

(e) Simplify the bureaucratic procedures and improve the performance of the public administration: The extensive system of intervention is supported by complex bureaucratic machinery. Farmers complain about the bureaucracy and lack of accountability of the public administration (box 9.4). There is a need to significantly reduce bureaucratic requirements in agriculture and to improve the efficiency, accountability, and transparency of the public administration. There are ongoing efforts to revitalize public administration in the agriculture sector. The Ministry of Agriculture is aware of the difficulties with the administrative machinery and is carrying out a reorganization of administration services. It has also taken seriously its part in the ongoing regulatory simplification reform launched by the government in 2012: out of 212 procedures identified, the ministry has proposed eliminating 61 (24 percent), and simplifying 109 (43 percent), and maintaining untouched only 42 (17 percent).

Box 9.4: A View from the Farm on the Problems with the Agricultural Sector and Priorities for State Intervention

"There are so many problems with agriculture in Tunisia. To start with, the state should distribute the state lands to those who can use them efficiently, and there should be much more transparency regarding the award process of these lands. These processes are very slow, often taking about two years, which seems wholly unnecessary.

More generally the lethargy of the administration frustrates farmers and constitutes a real barrier to agricultural investment, notably in matters related to water resources. And I don't even want to talk about the widespread corruption in the administration.

Then there is a strong need for research labs to develop local seeds and seedlings, as the imported ones are very expensive. In addition, imported seedlings often are not well adaptable to our climate. Today many farmers have local (Tunisian) seed varieties of excellent quality, but the Ministry of Agriculture does not grant the authorization to produce them. The *Coopérative Centrale de Semences et de Plantes* (CCSP) and the Office of State Lands have a monopoly on seeds and seedling production. The only seeds locally produced are for wheat and some other cereals.

There is also a need to encourage firms to invest in production of fertilizer compounds. We are one of the largest world producers and exporters of phosphates, and we import fertilizers! The Ministry of Industry should try to understand why this is happening. And also why are there no firms to produce phytosanitary products? The imported products are very expensive....

To boost the profitability of agricultural products, they should encourage basic transformation (for example, drying) or local packaging (local sorting, packaging, storage). This will help to control the flow of products to the market and avoid the sale on the spot to intermediaries or to the wholesale market at rock-bottom prices. The wholesale operators do not know how to differentiate between the various high-quality varieties and impose a price cap on the best quality—but later they sell them at a much higher price to the fruit and vegetable retailers. My impression is that wholesale markets represent the biggest rip off for the farmer—there is no transparency!

Then there are the problems of the labor force and the mechanization, etc., etc. We could go on for a long time...."

Source: Interview with Tunisian agricultural investor, February 2014.

9.5 / Conclusions

Current agricultural policies pursue self-sufficiency in cereals production in order to ensure food security. Clearly food security cannot be put at risk: nevertheless, ensuring food security should not be synonymous with pursuing self-sufficiency in grains production. A prerequisite to agricultural policy reform is to put in place a food security policy that does not undermine the agricultural sector. In light of the problems with agricultural policies discussed in this chapter, it is reasonable to ask whether there are better ways to ensure food security, ways that do not undermine the development of the agricultural sector in Tunisia. Several options have been proposed that can help constitute a different food security policy that would not run against the development of the agricultural sector in Tunisia.

Current agricultural policies undermine growth and employment and exacerbate regional disparities. This chapter has shown that, while well intended, agricultural policies in Tunisia have repressed the agricultural sector by distorting production away from labor-intensive Mediterranean products in which Tunisia is competitive and toward continental products such as cereals, beef, and milk in which Tunisia is not competitive. While such a policy may make sense through the lens of a self-sufficiency drive to ensure food security, it runs counter to the development of the agricultural sector because it keeps agricultural production at a sub-optimal level and unable to realize its full potential.

Tunisia is not taking advantage of the existing opportunities to export agricultural products, notably to the EU. The EU does not subsidize its fruit and vegetable production as much as it does continental products. Although Tunisia has a comparative advantage in Mediterranean products, however, for most of these products Tunisia uses only a small fraction of its available export quotas to the EU. Instead of taking advantage of this export opportunity, Tunisia subsidizes products in which it does not have an advantage and which continue to be protected under the EU Common Agricultural Policy. Beyond the EU the potential to increase agricultural exports (in quantity and value), most notably of olive oil, remains unexploited.

Current agricultural policies are expensive and inequitable. In addition to budgetary costs borne by taxpayers, which amount to approximately one percent of GDP, there are also direct costs paid by consumers who have to pay higher prices for food products, estimated at four percent of consumption. Moreover, beyond budgetary and consumer costs, the agricultural interventions also distort production and trade, generating efficiency losses that are borne by the entire economy and that are estimated at approximately 0.8 percent of GDP. The result has been a net loss of welfare for the country, as well as the redistribution from consumers and taxpayers toward farmers in coastal areas. Further, contrary to commonly held beliefs in Tunisia, the distribution of the benefits from existing agricultural production subsidies is highly inequitable. In fact, benefits accrue mostly to a few large landowners (producing wheat, milk and beef) and do not benefit smallholders. As such, current agricultural policies also fail to fulfill a positive social role, which goes against commonly held beliefs in Tunisia.

Further, although well intended, current agricultural policies in Tunisia are inefficient and paradoxically contribute to increased unemployment and regional disparities. While Mediterranean products are labor intensive and better suited to interior regions of the country, continental products are land intensive and water intensive and are produced only along the coastal northern regions. Hence, paradoxically, agricultural policies contribute to shifting production away from labor-intensive products in which interior regions of Tunisia are competitive, thus increasing unemployment and regional disparities. The result of current policies has been a net loss of

welfare for the country, as well as the redistribution away from interior regions and toward coastal areas.

A major reform of agricultural policies away from distortive price support policies and toward strengthening horizontal interventions would help unleash the potential of agriculture and reduce regional disparities. It would be in Tunisia's interest to shift the support toward labor-intensive products and to help investment in arboriculture (fruit and olive oil) and in greenhouses. The state should gradually withdraw from intervention in the marketing of agricultural products. At the same time, agricultural policy reform should progressively phase out price support and input subsidies and replace them with horizontal measures that create less distortion. This would entail the adoption of strong measures to improve the soft and hard infrastructure and services for the agricultural sector, notably by strengthening research and extensions, irrigation, land registry, financing, and transport infrastructure, which are essential to the growth of agriculture. Tunisia also needs to simplify bureaucratic procedures and improve the performance of the public administration.

A move away from distortive agricultural policy, and to support agriculture instead with horizontal policies, would result in gains for almost 70 percent of farmers and benefit mainly the interior regions of the country. In fact, farmers benefiting from price liberalization are particularly those located in the driest central and southern zones producing sheep, olives, fruit, and vegetables. The "winning" subsectors (mainly ovine breeding, arboriculture, and horticulture) are tradable sectors, in which Tunisia could boost its exports without any subsidies; represent together about 60 percent of the agricultural labor force; and are geographically dispersed.

A system of direct income transfers could be introduced to mitigate the impact of the reform on existing beneficiaries. Beyond compensation transfers to current beneficiaries, there is a need to ensure well-functioning social protection programs targeted to the poor and vulnerable citizens directly (separate from agricultural support).

Notes

1. This chapter draws on previous World Bank reports on the Tunisian agricultural sector (World Bank 2006; 2009d). The chapter does not discuss issues related to management of water and natural resources use, even though these are clearly central to sustainable agriculture, because these have been discussed in separate World Bank studies (World Bank 2006; 2013c).

2. In 2007–2008 aggregate stocks of major grains declined to minimal feasible levels due to high global income growth and biofuel mandates. Given these minimal stocks, prices were very sensitive to shocks, such as the Australian drought, and biofuel demand boosts due to the oil price spike. The effects of these shocks were magnified by a sequence of trade restrictions by key exporters to protect vulnerable consumers. Beginning in the thin global rice market in the fall of 2007, these turned market anxiety into panic, which sent agricultural commodity prices skyrocketing during late 2007 to summer 2008. Prices have since dropped back by more than 50 percent but remain well above the average during the decade prior to the 2008 crisis (figure 9.1).

3. For example, the Cereals Marketing Board (the *Office des Céréales*) is responsible for controlling wheat purchases from producers and supply to mills. In addition to its domestic intervention, it has a monopoly on duty-free cereal imports (of durum wheat, soft wheat, barley, corn, and soybean meal). The *Office* sets the wheat purchase price paid to producers as well as the selling price to millers. The purchase price is usually higher than the selling price. The *Office* is able to fulfill this function because it receives the necessary subsidies to maintain the selling price below the purchase and import prices. This mechanism reduces the average price charged to processors. Hence, the intervention mechanism provides support both to producers (as the purchase price is higher than the import price) and to processors and thereby to consumers, because in fact all the margins along the value chain from the miller to the consumer are regulated by law. Generally, the administrative centralization of grain marketing is harmful in many ways: (a) it is expensive for the budget; (b) it does not target the poor because large farms benefit most from it; (c) it discourages the restructuring of the private sector; (d) it artificially promotes growing of non-competitive cereals at the expense of other crops; (e) it prevents the development of competitive markets; and (f) it often has a detrimental impact on the environment because it leads to an inefficient use of scarce water resources. In the milk sector, the producer price is fixed by agreement between the professions involved in the industry, under the auspices of the Organization of Milk Professionals (*Groupement Interprofessionnelle du Lait*).

4. Alternatively, when food consumer prices are subsidized, such as is the case for wheat, this will result in additional costs to the budget.

5. A CGE model is one of the most rigorous, cutting-edge quantitative methods to evaluate the impact of economic and policy shocks—particularly policy reforms—in the economy as a whole. CGE modeling reproduces—in the most possible realistic manner—the structure of the whole economy and therefore the nature of all existing economic transactions among diverse economic agents (productive sectors, households, and the government, among others). Therefore, CGE analysis, in comparison with other available techniques, captures a wider set of economic impacts derived from a shock or the implementation of a specific policy reform. Thus, it is possible

to evaluate the implementation of a policy reform as well as the distributive effects within the economy at different levels of disaggregation. CGE analysis, on the other hand, presents several caveats. The first one relates to its significant data and time requirements. Collecting updated, high-quality, multiregional data; building Social Accounting Matrixes; and programming and calibrating a CGE model are very time-consuming processes and often require making assumptions and data imputation to accommodate gaps in the available data. A second caution should be made about the interpretation of results. Because of its complexity (ironically, in its complexity is also its strength), interpretation of results should be focused more on magnitudes, directions, and distributive patterns than on numeric outcomes themselves. In that sense, results from CGE models should be used as “road maps” for policy implementation, which should be complemented by additional analytical work using alternative quantitative methods. Third, while assumptions can be introduced to account for inertia and price-stickiness, most CGE models generally assume the perfect operation of markets. In practice, however, price transmission may be less than perfect across the various stages of the value chain, which will then impact the results in terms of growth, employment, and welfare effects.

6. GDP growth would increase by only 0.5 percent if the EU agricultural subsidies are lifted simultaneously with Tunisian liberalization. In fact, lifting subsidies on European products would increase the prices in international markets by about 10 percent, which will accordingly raise the food bills of Tunisian consumers.

7. It should be noted that the evaluation of welfare effects of agricultural trade liberalization in Tunisia does not take into account barriers to the level of market integration, which would result in imperfect vertical and horizontal price transmission. In other words the magnitude and speed with which price movements are transmitted along the various stages of the agro-food chain (from farm to processing and retail levels or vice versa) depend on the level of market integration, which may be weak especially in remote areas (see Chapter 10). This may hinder the realization of the full impacts, especially in remote areas, as price transmission assumptions along the supply chain play an important role in determining the size and distribution of welfare effects of trade policy reform.

8. This section draws on World Bank, FAO and IFAD (2009) and on Wright and Cafiero (2011).

9. The Food and Agriculture Organization (FAO) study on North African food security recommends the joint management of the volatility of grain prices to improve supply to domestic markets and ensure stable and affordable prices. Key aspects are: (a) the creation of a Maghreb observatory for cereals to ensure the smooth supply of markets; (b) piloting the establishment of a Maghreb strategic cereals reserve to better manage the volatility of international prices; and (c) the expansion of the trade in food commodities among Maghreb countries. (FAO Maghreb Program on management of volatility in international cereals market volatility)

10. In addition, Tunisia should seriously consider whether a policy that substantially subsidizes grain consumption, even for wealthy citizens, and discourages control of waste and diversification of calorie sources is worth its price in terms of budget expense and does not paradoxically increase Tunisia's vulnerability and dependence on foreign supplies.

11. Encouraging farmers to replace cereals with high-value crops has mixed implications for food security. The World Bank's 2008 World Development Report (2007b) argues that the top agricultural priority for the majority of Arab countries is to diversify production out of staples and into high-value crops (like fruits and vegetables) for export. High-value crop production gives landowners more entrepreneurial opportunities, creates more employment for women and landless workers, and raises agricultural wages. In countries that have a mix of rain-fed and irrigated agriculture, such as the Maghreb countries, the Mashreq, and Sudan, water pricing could create a natural split; cereal would be grown primarily under rain-fed conditions, and high-value crops under irrigation. This would increase dependence on imported cereals, but it would also generate more foreign exchange from high-value crop exports that would cover the cost of additional cereal imports. This would also be more profitable for farmers and leave them disposable income with which to buy staples. This is not to say that countries that depend entirely on irrigation should stop growing cereal where it is economically viable and sustainable (such as for instance in the Nile Basin of Egypt). In Gulf countries, where irrigation water is more limited, cereal production might be eliminated completely in favor of more efficient high-value crops.

12. Saudi Arabia has recognized that storing one or two years' supply in its dry desert climate, though incurring a substantial capital cost, might be a sustainable and far more economical use of its resources than its former production regime.

13. The Food and Agriculture Organization (FAO) study on North African food security recommends the joint management of the volatility of grain prices to improve supply to domestic markets and ensure stable and affordable prices. Key aspects are: (a) the creation of a Maghreb observatory for cereals to ensure the smooth supply of markets; (b) piloting the establishment of a Maghreb strategic cereals reserve to better manage the volatility of international prices; and (c) the expansion of the trade in food commodities among Maghreb countries. (FAO Maghreb Program on management of volatility in international cereals market volatility)

14. As of 2010, the portion of farmers benefitting from bank loans did not exceed seven percent, and bank financing accounted for just 11 percent of total agricultural investment. The share of investment funded by credit halved in the second half of the 2000s, and seasonal credit covers only one-fourteenth of agricultural input use. The share of farmers reporting that their credit demand was satisfied fell from 54 percent in 1990-94 to 36 percent in 2000-04. The share of farmers investing fell from 36 percent to 26 percent over the same period, limiting the ability of the sector to modernize and grow.

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The solution is not the provision of fiscal and financial incentives; rather it is essential to improve the quality of life, access to basic services, and connectivity of interior regions



Regional disparities are of concern to policy makers around the world, and Tunisia is no exception. Approximately 56 percent of the population and 92 percent of all industrial firms in Tunisia are located within an hour's drive of Tunisia's three largest cities, Tunis (the capital), Sfax, and Sousse. These three coastal cities are the centers of economic activity, accounting for 85 percent of the country's GDP (figure 10.1 and figure 10.2)². Similarly, in spite of generous fiscal and financial incentives, foreign firms established in the poorer "regional development zones" account for less than 13 percent of the total foreign firms in Tunisia and for 16 percent of jobs created by them. As a result, policy makers in Tunisia are concerned about the lack of economic opportunities in lagging areas (Ministry of Regional Development of Tunisia 2011)³.

Concentration of economic activity and population is not unique to Tunisia, however. Half the world's production occurs on 1.5 percent of its land. In Japan, Tokyo has four percent of the country's land area but generates 40 percent of its output. In France, Paris has only two percent of the land but accounts for 30 percent of the country's output (Kochendorfer-Lucius and Pleskovic 2009). Despite concentration of economic activity, however, these countries have seen convergence in access to basic services: unbalanced growth has been accompanied by inclusive development. When development is inclusive and living standards converge, the benefits from growth are shared beyond regional boundaries (World Bank 2014g). This is not the case in Tunisia where income disparities remain significant across regions. As discussed in this chapter, the benefits of economic growth have not spilled over to the hinterlands and inner regions and did not lead to improved opportunities in disadvantaged areas. The challenge for Tunisia, therefore, is to ensure that living standards can converge.

Figure 10.1: Density of Population per Square Kilometer in Tunisia, 2012

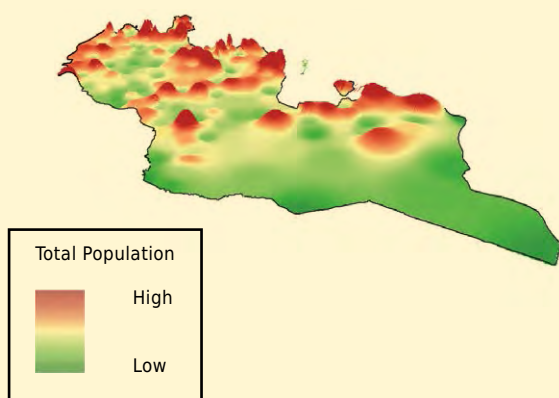
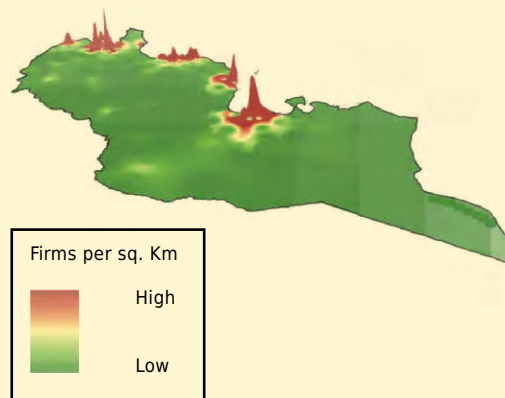
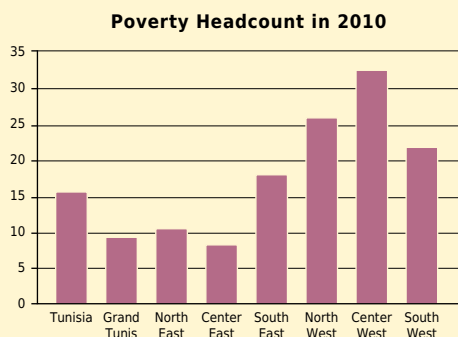


Figure 10.2: Firm Density per Square Kilometer in Tunisia, 2012



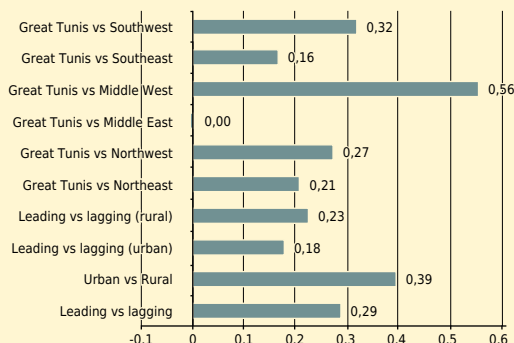
Source: Tunisia Urbanization Review, World Bank 2014g (based on INS population data for 2011 and industrial firm data for 2011 compiled from the Commissariat Général au Développement Régional, Office de Développement du Nord-Ouest, Office de Développement du Centre Ouest, and Office de Développement du Sud).

Figure 10.3: Poverty Rate by Region in 2010
(Percent of Population below the Poverty Line)



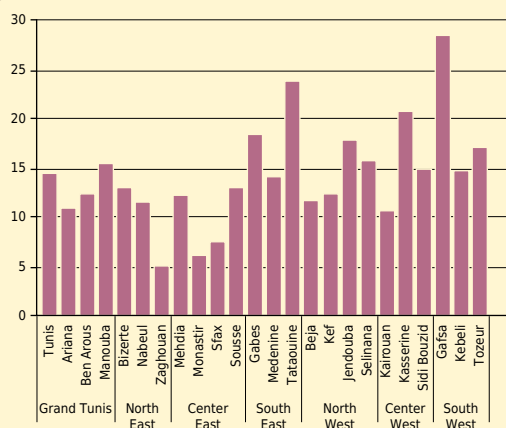
Source: INS, AfDB and World Bank (2012).

Figure 10.4: Welfare Gap between Regions in 2005
(Consumption Gap as a Percent)



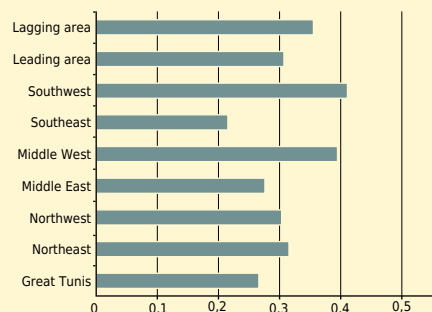
Source: Calculations based on INS 2005 household survey

Figure 10.5: Unemployment Rates by Province and Region in 2010
(Percent)



Source: Calculations based on INS 2013 Labor Force Survey.

Figure 10.6: Welfare Gap within Regions in 2005
(Urban vs. Rural Areas)



Source: Calculations based on INS 2005 household survey

As discussed in previous chapters, regional disparities in Tunisia have paradoxically been exacerbated by economic policies. Industrial policy, and specifically the Investment Incentives Code, labor market regulations, and agricultural policy have all contributed to deepen, rather than mitigate, regional imbalances⁴. Removing those distortions and rigidities is a prerequisite to achieve a more balanced economic development. It is these nationwide policy changes that will have the greatest impact in terms of reducing regional disparities.

In addition, this chapter explores the scope for additional policy actions available to the authorities for attacking regional disparities. It highlights the tradeoff between equity and efficiency, and the inefficacy of seeking to reduce regional disparities via providing fiscal and financial incentives. It argues instead for a policy that focuses on improving living conditions across the country to ensure quality of basic services (such as health, education, and transport), access to good infrastructure (such as transport and telecommunications), and more generally quality

of life (including cultural events and recreational amenities). It also highlights that improving connectivity, to enable people to move to jobs as well as to lower costs for investors, is critical and goes well beyond investments in infrastructure—in fact market failures call for an active role of the government.

10.1 / Regional Disparities in Tunisia

Despite success on many fronts, Tunisia still faces persistent regional disparities in living standards between rural and urban areas and between leading and lagging regions. Glaring regional disparities persist, with poverty estimates in 2010 ranging from a low rate of eight to nine percent in the Center East region and Greater Tunis to a high of 26 and 32 percent in the North West and Center West regions respectively (figure 10.3)⁵. Such wide variations in poverty rates reflect very large average consumptions differentials, across regions and within regions as well (figure 10.4 and figure 10.5; see also Ayadi and Amara 2008). In 2005 the consumption gap between urban areas and rural areas within each region was at least 20 percent, and reached approximately 40 percent in the Center West and South West. Across regions the urban-rural consumption gap was 39 percent on average. Similarly, the average consumption gap between leading areas (mainly along the coast) and lagging areas (mainly in the interior) was approximately 29 percent on average, but reached 56 percent between the center west and the Greater Tunis and Center East regions (Figure 10.4).

Similarly, unemployment rates show considerable disparities across regions, and are especially high in the interior rural regions. Unemployment is concentrated geographically in the North West (at 20.3 percent as of mid-2013), the Center West (at 15.6 percent), and the interior South of the country (at 23.5 percent). Levels of unemployment are lower along the northeast coastal areas (at 12.5 percent). The highest unemployment rates (20 to 22 percent) are in interior areas (the governorates of Le Kef, Jendouba, Kasserine, and Gafsa), compared with seven to 11 percent in the coastal areas (the governorates of Nabeul, Sousse, Mounastir, and Sfax) (figure 10.5). A recent survey of Tunisian households living in peri-urban areas (World Bank 2013b) suggests employment outcomes in urban areas also vary considerably across regions. While coastal areas have an unemployment rate of 12 percent, unemployment reaches 16 percent in the interior urban areas⁶. In recent years the increase in unemployment has affected predominantly regions with already high levels of unemployment. In fact, unemployment has actually grown faster in interior governorates while decreasing in coastal ones.

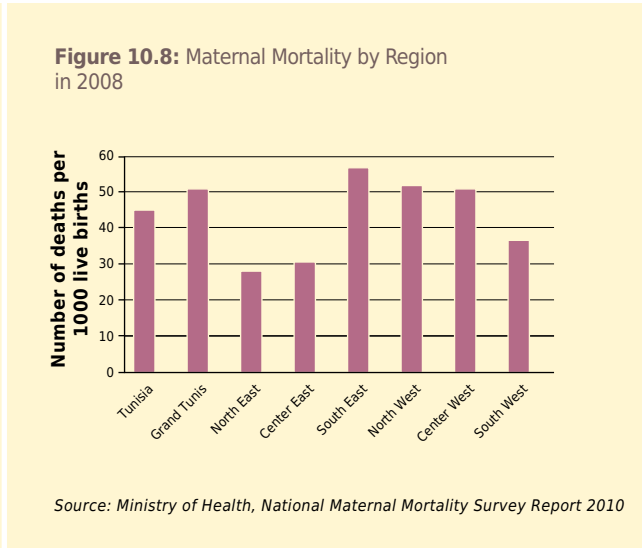
10.2 / What Explains Such Large Intraregional and Interregional Variations in Income and Employment Levels?

Differences in Access to Basic Services and Human Capital

Access to basic services has improved significantly, but differences between leading and lagging areas persist, especially in rural areas. Access to electricity in urban and rural areas has converged, with near universal coverage throughout Tunisia. For other basic services, however, a significant gap remains in lagging regions and rural areas. Urban areas have close to universal coverage of basic services in all regions, but rural areas still lag behind. Access to the water network has also improved substantially over the past 25 years. While 97 percent of households in Greater Tunis in 2005 had piped water in their dwelling as their main water source, only 61 percent of households in the North West and Center West did, and only 40 percent of

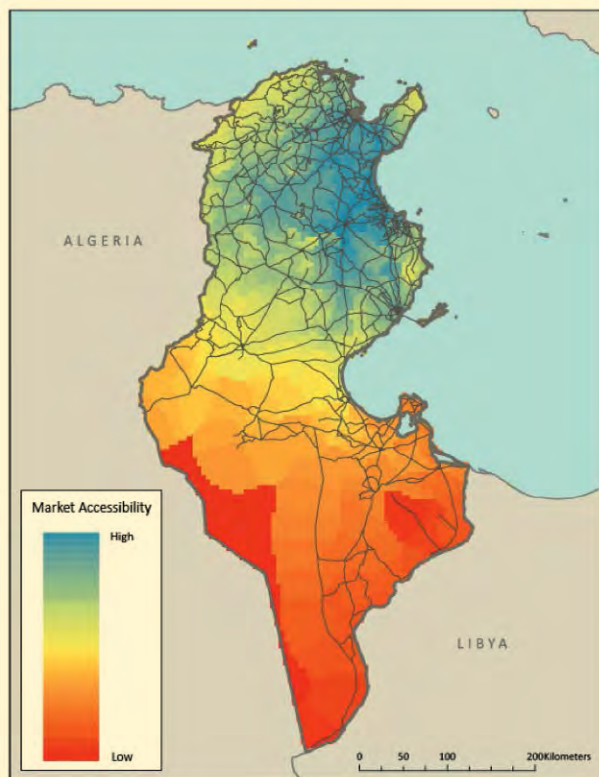
rural households in the North West, did. Similarly, more than 90 percent of households had a toilet in their dwelling in Greater Tunis and the South West, but only 66 percent of households in the Center West did. And, while by 2004 almost 93 percent of homes in Tunis were connected to a public sanitation network, only 12 percent enjoyed the same in Sidi Bouzid (in the Center West). Overall, nearly 25 percent of Tunisian households lack connections to a public sanitation network.

Despite the large progress for both men and women, regional disparities persist in access to education in rural areas, with the North West and Center West lagging behind other regions. Close to 80 percent of household heads in Greater Tunis and the Center East have some form of education, compared to less than half in the North West. This gap has been almost eliminated for the younger generations, reflecting the success of government efforts to reduce disparities in education. The 2004 census showed that enrollment in primary education is largely consistent with the distribution of children ages 6–14. This improvement in educational attainment likely stems from expanded physical access to schools across Tunisia. As expected, spatial inequalities persist in the distribution of the population ages 19–24 enrolled in higher education, with people living in localities (*délégations*) within one hour of a major city accounting for 74 percent of enrollment in higher education (despite accounting for only 62 percent of the population) (figure 10.7).



Access to health care is also concentrated near large cities. Access to health services is now uniformly good in urban areas, but significant barriers to access exist in remote lagging areas (as shown by maternal mortality rates in figure 10.8). Some 77 percent of the country’s public basic health care centers are in localities (*délégations*) within an hour of a large city; less than one percent are in localities that are more than two hours from a large city, even though such localities account for nearly 20 percent of the country’s population. The perception of the quality of services is also lagging behind in interior regions. Youth (aged 15 to 29) perception of the quality of health services available in the neighborhood where they reside is more negative in the interior than in the coast, especially in the South West and the Center West (World Bank, 2013b). In line with these differences, although aggregate health indicators improved across most of the country, progress has been limited in remote rural regions. In 2010 children in rural areas are more than twice as likely to be stunted (10 percent in rural areas versus four percent in urban); fewer women get prenatal services or treatment for high-risk pregnancies; and maternal mortality rates are three times higher (70 versus 20 deaths per 100,000 live births).

Figure 10.9: Market Accessibility across Tunisia



Source: World Bank 2014g

Overall, differences in access to basic services and human capital endowments persist, notably between leading and lagging areas, and could be a key driver of spatial disparities in labor market outcomes. Physical access to education and health facilities and access to basic amenities and services appear to be fairly uniform across urban areas of the country, but significant gaps persist in lagging rural areas. Observed variations in labor market outcomes across Tunisia could potentially be due to the differences in human capital; however, it seems likely these differences may explain only part of the variation in incomes in remote rural areas, since as discussed below these areas are also hampered by lower connectivity and access to markets.

Differences in Transport Infrastructure and Access to Markets

Market accessibility appears to be good for most of the northern and center parts of the country and quickly decreases for the southern areas⁷. Tunisia is a small country, such that half of Tunisian localities are within one hour's travel time of a city with more than 100,000 inhabitants—these localities are home to 62 percent of the country's total population and 71 percent of the urban population. We calculated a “heat map” that accounts for both the actual extent of the road network and the location of population to provide a measure of market accessibility (World Bank 2008e; World Bank 2014g)⁸. Market

accessibility is a more informative measure than simple distance using straight lines as it considers not only the time traveled between different points in the country through the transport network but also the population living in the different areas. Using data on population at the level of localities for 2010 and on Tunisia's road network, we calculated an accessibility measure for every point in Tunisia (figure 10.9; for details of the methodology, see World Bank 2014g).

As expected, the south, and in particular the South West, seem to be the most “remote” areas of the country. Most of the country seems to be relatively well connected in terms of travel time through the road network to Tunis, Sfax, and Sousse⁹. The South West region, however, is relatively disconnected from the rest of the country¹⁰. Remoteness is a relative concept in this analysis; and, with being Tunisia's being a small country, physical connectivity does not appear to be a binding constraint for overall connectivity. Figure 10.8 suggests that the longest trip from Tunis, Sfax, or Sousse would still only be less than 10 hours.¹¹

Why are Firms and Employment Opportunities Clustered Along the Coast?

Private sector activity is heavily concentrated along the coast, reflecting the natural geographic advantages and the need to connect to international markets, which have been reinforced by the impact of distortive economic policies. As mentioned, firms and jobs are concentrated at the coast (see also

Amara and Ayadi 2011). In particular almost all industrial firms are located close to the three coastal cities of Tunis, Sfax, and Sousse; and 56 percent of the population lives in the same area (figure 10.2; World Bank 2014g). Firm size is also larger in the coastal regions than in the interior regions. To a large extent such concentration of economic activity and people along coastal areas and in urban centers is natural given the many benefits to trade, access to markets, and availability of a set of essential services. Indeed we observe similar patterns all over the world (World Bank 2008e). As discussed in Chapter Four, however, these natural patterns of spatial location have been exacerbated by the focus of industrial policy (notably through the Investment Incentives Code) on export promotion—which has further incentivized firms to establish close to the export infrastructure, along the coast. In addition, as also discussed in Chapter Four, firms perceive the business environment as being better in Tunis than in the rest of the country (World Bank 2014e).

This spatial clustering of firms implies that the availability of jobs is also regionally skewed. Because firms tend to mass around large population centers at the coast, dense population pockets in the interior do not have a significant private sector presence (figure 10.2). Private firms tend to be very small in Tunisia, and the few large firms tend to be offshore firms located in the coastal regions (Chapter One). In the Center West, 94 percent of private firms are one-person firms (that is, self-employed) while this proportion is down to 83 percent in the Center East. The resulting widespread lack of job opportunities, especially in the interior, is confirmed by perception survey data: 83 percent of respondents, against 73 percent in the coast (World Bank 2013b).

What Explains Such Large Intraregional and Interregional Variations in Income and Employment Levels?

The main driver of the consumption gap between rural and urban areas within the same region is differences in household characteristics. Differences in consumption within and across regions can be decomposed using the Oaxaca-Blinder decomposition approach, which is useful in examining whether the differences stem primarily from differences in household characteristics or differences in the returns to those characteristics (box 10.1). The results from this approach have major implications for deciding how to invest to reduce the welfare gap. For rural-urban differences within the same region in all cases (except the South West—discussed below), the consumption gap is driven by differences in household characteristics (that is, endowments; figure 10.10). These results are important in light of the disparities highlighted above—they suggest that rural-urban differences are driven by those disparities.

Box 10.1: The Oaxaca-Blinder Decomposition: Endowments or Markets?

The Oaxaca-Blinder decomposition can be used to estimate welfare differences across regions and understand their main components. As a first step we estimate the log of the welfare ratios as a function of household characteristics (education, access to basic services, and the like):

$$y_j = X_j \beta_j + \varepsilon_j$$

where j are regions, X is a vector of household characteristics, and β are the relevant parameters.

Then, we use the O-B decomposition to estimate welfare gap and obtain its components, by carrying out a decomposition of the welfare identifies characteristics versus the returns effects:

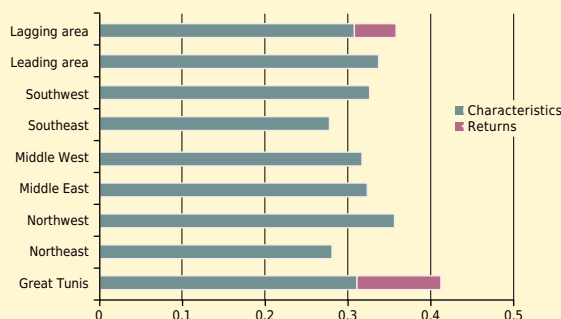
$$y_A - y_B = X_A \beta_A - X_B \beta_B$$

$$y_A - y_B = (X_A - X_B) \beta_A + (\beta_A - \beta_B) X_A$$

The results allow us to separate the differences in welfare associated with differences in characteristics, from the unexplained amounts we can attribute to differences in returns, due to differences in the operation of markets at the local level (for example, due to limited connectivity and/or other market failures).

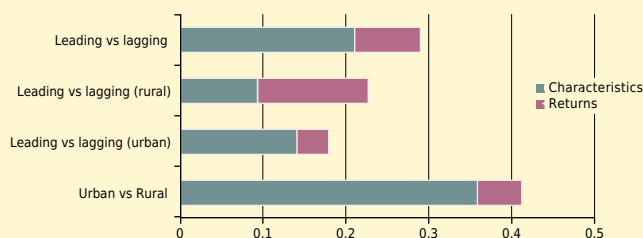
Source: Blinder (1973); Oaxaca (1973).

Figure 10.10: Oaxaca-Blinder Decomposition between Rural and Urban Areas within Each Region



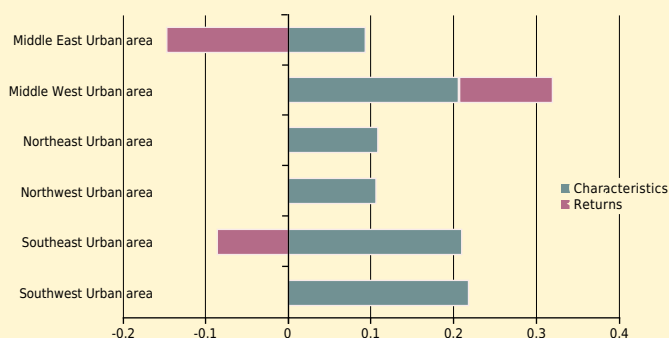
Source: Calculations based on INS 2005 household survey

Figure 10.11: Oaxaca-Blinder Decomposition between Leading and Lagging Areas (and Rural vs Urban Areas)



Source: Calculations based on INS 2005 household survey

Figure 10.12: Oaxaca-Blinder Decomposition across Urban Areas (Compared to Greater Tunis)



Source: Calculations based on INS 2005 household survey

For the South West differences in characteristics still dominate, but the difference in returns to characteristics is also important. The analysis suggests that, if households in rural areas in the southwest had characteristics (education, access to services, and the like) similar to those in households in urban areas, the consumption gap between rural and urban areas would decrease by almost three quarters. There are also issues with mobility, as indicated by the difference in returns—which resonates with the observation above that the South West is particularly worse off in terms of connectivity (figure 10.9). Returns to household characteristics are lower in rural areas in the South West, accounting for almost 25 percent of the total gap between rural and urban areas in that region.

Over 80 percent of the consumption gap between urban areas in lagging and leading regions appears due to differences in household characteristics; however, differences in returns are most important when looking at differences between rural areas in lagging and leading regions, accounting for almost 60 percent of the gap. The total gap is considerably larger between rural areas (22 percent) compared to the gap between urban areas (18 percent).

The composition of the gaps is also very different: for urban areas, the dominant effect is the characteristics effect while differences in returns dominate between rural areas (Figure 10.11). For differences between urban areas in leading and lagging regions the main component of the consumption gap is the differences in household characteristics for all regions except the Center East, where returns to characteristics are higher than in Greater Tunis (Figure 10.12). If urban household characteristics in the Center West urban areas were similar to those in Greater Tunis, the consumption gap would decrease by almost two thirds, from a welfare gap of 32 percent to a gap of around 11 percent.

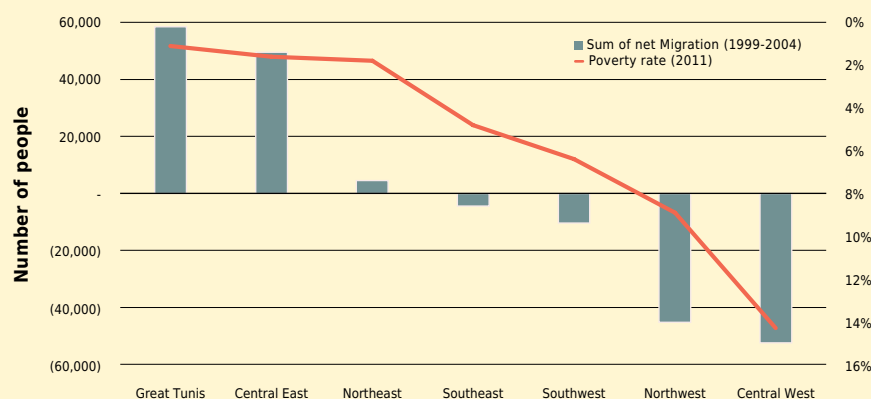
10.3 / Boosting Endowments and Enabling Returns in Lagging Areas: A Clear Role for the Government

These results appear to reflect the existence of disparities in the demand for labor, physical access to jobs, and access to information and networks. Spatial disparities in employment outcomes in Tunisia appear to be mainly due to the lack of private sector job opportunities. As discussed in Chapter One, the record of the Tunisian private sector as a creator of jobs has not been satisfactory; and private sector does not exhibit signs of dynamism and creative destruction (Chapter One). The policy levers to bridge these spatial disparities can be either through taking jobs to people or through bringing people closer to jobs. In the first case, as discussed above, there are significant economic and strategic advantages in the coastal areas of Tunisia that have led to a concentration of labor demand in these areas. From the efficiency perspective, the current pattern of firm location is in line with exploiting these advantages and reaping agglomeration economies. Over and above boosting the employment generation capacity of Tunisia's coastal private sector, the policy challenge is to better connect people with jobs. The two primary levers for the latter are improved transportation and migration (box 10.2).

Box 10.2: The Search for Jobs: Internal Migration in Tunisia

Internal migration flows indicate that people are moving from high-poverty to low-poverty regions in search of opportunity. Proximity to centers of job creation can, however, be bridged either by improving connectivity through transportation and communication or by facilitating the movement of people toward jobs. In contrast to the relatively uniform access to education and health services, access to public transportation is much lower in the interior regions. Thus, the higher unemployment rates in the interior regions may be because job seekers find it more difficult to bridge the physical gap between home and work. While 87 percent of urban households in Tunis live within a 15-minute walk to the nearest bus station, in the North West and Center West respectively, this proportion falls to 54 and 65 percent respectively. Taking the interior as a whole, two-thirds of households have access based on this measure whereas four-fifths of households in the coast are close to bus services (World Bank 2013b).

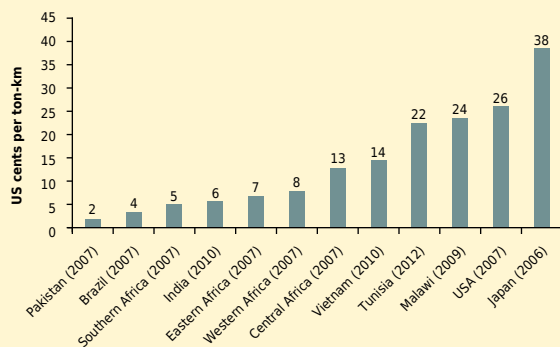
Figure B10.2.1: Tunisia's Net Internal Migration, 1994-2004



Source: Tunisia Urbanization Review, World Bank 2014g

An efficiently functioning transportation system can support and further enhance the benefits of agglomeration economies. It is also a key determinant of a country's economic geography. The design, functioning, and development of a transportation system can determine where economic activity will grow and thrive. Transport connectivity is an important tool at the hands of planners and policy makers for accelerating growth. But the decisions of where to invest will have implications for both efficiency and equity and therefore have to be analyzed with care. Identifying where the key bottlenecks lie is essential to identifying the key options for improving connectivity and understanding the tradeoffs that such improvement may bring.

Figure 10.13: International Truck-Freight prices, in US cents per ton-km



Source: World Bank 2014g.

In Tunisia, while physical distances are small, economic distances appear to be large (World Bank 2014g). While Tunisia has a good transport infrastructure network such that travel times are relatively small, nevertheless “economic distances” (internal transportation costs) are very high. Average truck freight prices in Tunisia are US\$0.22 per ton km, only two cents lower than the average prices in the United States, a country with more than 10 times the GDP per capita of Tunisia (figure 10.13)¹². The average price of truck freight in Tunisia is much higher than in other developing countries such as India (US\$0.06) and Vietnam (US\$0.14). It is also substantially higher compared to average freight prices in Sub-Saharan Africa (US\$0.05 to US\$0.13) (Teravaninthorn and Raballand 2009)¹³.

Tunisia's national average price-cost gap of truck freight is large at 44 percent and persists despite a very fragmented industry. There is a large variation in the estimated price-cost gap across city and movement types. The price-cost gaps for cities not connected to highways and national routes are high and above 48 percent, irrespective of the distance travelled. Today large price-cost gaps exist for medium—and long-distance freight trucking trips as well as for short trips from cities that are not connected to the national highway system. Variations in the price-cost gap across city types suggest that the level of competition varies across routes, with narrower price-cost gaps for short trips around large (–1 percent) and connected cities (10 percent) and wider gaps for longer trips (above 55 percent for all routes) and even short trips for non-connected cities (48 percent). A key question is whether these price-cost differences are, at least in part, a result of a monopolistic or cartelized market structure as is the case for several countries in Sub-Saharan Africa (Teravaninthorn and Raballand 2009)¹⁴. This does not appear to be generally the case in Tunisia, since following deregulation in the 1990s the domestic trucking industry is highly fragmented with many small truck operators (World Bank 2007a; 2011; 2012a). The survey confirms the high incidence of small operators and domestic ownership¹⁵. The argument of high fragmentation appears true for routes in large and connected cities. However, the relatively higher price-cost gap for unconnected cities is indicative of the possibility that fewer truckers operate in these markets allowing them to extract higher rents. Still, the competitive forces in Tunisia's trucking industry do not appear to drive down prices sharply.

Accompanying market fragmentation, there appears to be a clear lack of coordination of freight activity in the industry. The truckers report no role of unions or transport associations in the market. More than 50 percent of truckers report conducting business by direct contacts with shippers or by waiting at lorry parks. The survey reveals that in 50 to 75 percent of the cases, prices are set by direct negotiations with the client. Additionally, a majority of the 116 respondents report that there exists no system of load

consolidation; and, for the 13 percent that report some load consolidation, it occurs within the company itself. This lack of coordination is a likely cause of the higher costs as trucks often return empty on the return legs (approximately 72 percent of empty backhauls), which is much higher than for European transport companies (empty return represents 60 percent for small trucks and 46 percent for other types of vehicles)¹⁶. There is also no evidence of cartels bidding up transport prices as in the case in Sub-Saharan Africa. The analysis seems to highlight a lack of logistical coordination and poor operational efficiency as the main reasons for high costs and the resulting high prices.

There also remain barriers to entry for larger trucking companies that would bring stronger financial and technical capabilities. The regulations for entry into the road transport sector were revised in 2008 to impose higher capacity restrictions on new companies. The revision introduced higher investment obligations for any new operator wanting to enter the market compared to the existing operators—hence, the regulation does not encourage larger operators even if that was likely its original intended purpose. In addition, the original 1994 Decree restricts access by foreign operators, as they are obliged to enter into a partnership with Tunisian nationals to provide road transport services¹⁷. With regard to freight forwarding, however, the Ministry of Transport carried out a study, “*Etude du Plan National des Transports*,” which concluded that for international road transport the development of an equitable partnership with foreign companies having an international expertise and financial strength and credibility is difficult to conceive. Removing barriers to entry into the road transport sector for both domestic and foreign operators could also help drive costs down. In particular, foreign operators would probably be most interested in operating larger businesses/logistics chains rather than small ones.

10.4 / Attacking Regional Disparities: Balancing Spatial Equity with Economic Efficiency

As Tunisia’s policymakers try to economically integrate lagging and leading regions, they face a dual challenge of balancing spatial outcomes with economic efficiency. On the one hand, efficiency suggests that infrastructure investments are likely to yield the highest returns in the vicinity of Tunisia’s largest urban agglomerations in leading areas, where firms, people, and business are already locating. If markets are fluid and infrastructure appropriate, the density in these places will allow firms and people to further exploit agglomeration economies and economies of scale, leading to innovation, job creation, and growth. On the other hand, equity concerns would suggest that investments in lagging regions should be a priority. However, since market forces are not driving firms and people to these areas, some resources may be wasted. Other investments, such as those in social infrastructure, will have large benefits in lagging regions and throughout the national territory and can lead to increases both in efficiency and equity. Hence, public policy should focus on improving living conditions across the country to ensure quality of basic services (such as health, education, and transport), access to good infrastructure (such as transport and telecommunications), and more generally quality of life (including cultural events and recreational amenities). Differentiated policies for different regions are more likely to achieve the desired balance, in particular when the overall focus of public policy is to enhance welfare everywhere. In order to address regional disparities, there are four main lines of intervention open to policy makers:

Ensure that economic policies are “spatially blind”

As discussed in previous chapters, current economic policies exacerbate regional disparities. There is a need to revise the Investment Incentives Code, labor market rules and regulations, and agricultural policy to ensure that they do not inadvertently favor one region over another as is currently the case. The Investment Incentives Code favors the coastal region by providing large incentives to exporters. The labor market sector-wide collective wage agreements impose country-wide wage floors, to the disadvantage of poorer interior regions. Agricultural subsidies favor crops in which the interior regions do not have a comparative advantage,

to the advantage of northern regions. It is important to revise these policies to remove these distortions and ensure a level playing field across the entire country.

Extending basic services: thinking beyond investments in infrastructure

The analysis above suggests that efforts to equalize characteristics across regions should remain a key focus of future policy. Factor mobility does not appear the main impediment in Tunisia's urban areas, as the differences in returns across and within regions are relatively small. Rather, differences in characteristics drive the differences in consumption both across and within regions¹⁸. This result is important because it underlines the existence of disparities in several household characteristics across regions, as discussed above, and confirms that these disparities are associated with lower income levels—therefore extending access to basic services in lagging areas with the overall objective of achieving universal access and high quality of basic services and improving living conditions across the country should remain key objectives of government policy.

Extending basic services and access to quality health and education services can contribute to reducing regional disparities in Tunisia. Policy makers in Tunisia need to think beyond infrastructure provision to tariff design and cost recovery, which will extend access while improving service quality. In particular in basic services, moving toward cost recovery is essential. Other countries have seen positive impacts from these reforms. Algeria, Egypt, and Morocco have all decentralized administration and reformed tariff programs to increase cost recovery and encourage water conservation. In Algeria new legislation in 2005 allowed consumers to choose between an elevated fixed fee and a metered fee. The elevated fixed fee has encouraged consumers to pay progressive, metered tariffs, which encourages sustainability by decreasing demand and increasing cost recovery. And, by decentralizing water management, tariffs have also been set by location to match the real cost of provision and capital improvements (Pérard 2008). That many other countries have expanded service provision highlights the need for prices that can cover operating and non-operating costs while guaranteeing affordability¹⁹.

Leveraging private sector capital, either through operating or infrastructure partnerships, can expand networks and improve quality of service. Public-private partnerships can structure incentives for private participation to places where private investors alone would not go. In the Middle East and North Africa, Egypt, Jordan, and Morocco have developed their regulatory context to support private water supply providers, with contracts ranging from five to 25 years (Pérard 2008).

Linking lagging areas to markets and addressing market failures

Improving connectivity of lagging areas will also be key to providing equal opportunities across the country. Improving connectivity and mobility for firms and people in lagging areas can stimulate trade and allow people and firms to move to areas where they are most productive. By connecting poor populations to large cities and leading areas and reducing transport costs, countries create a win-win situation by promoting inclusive development. Connecting lagging areas to large markets and other leading areas will increase spatial concentration of economic activity in leading areas (increases in efficiency) but will also increase overall growth, although nominal income inequalities may increase on the whole. To enhance connectivity between lagging areas and the rest of Tunisia, lowering transport prices is important. Investments in infrastructure that facilitate the flow of goods, people, and information between leading and lagging areas can foster economic concentration in leading areas and promote convergence of living standards (World Bank 2008e). That said, as discussed above, in most of Tunisia the key bottleneck does not appear to be a lack of infrastructure.

Improving connectivity in Tunisia also requires government action to ensure that markets are functioning by removing coordination failures and improving the efficiency and competitiveness of the trucking sector. There appears to be a strong need to develop a system of third-party logistics for the coordination

of trucking operations, following the example of the Indian trucking industry. These recommendations echo previous World Bank work that points at a need to develop and implement innovative solutions like (a) third-party logistic services, (b) specialized infrastructure like logistic zones, and (c) regulatory support for implementation of new practices (World Bank 2007a; 2012a). The Tunisian government is currently developing logistic zones in the port of Rades and Djebel Oust and plans to develop them in several other cities, such as Jendouba, Gafsa, Zarzis, Sousse, and Sfax (Study of Regional Trade Facilitation and Infrastructure for Maghreb Countries, World Bank 2012a). These logistic zones, along with improved third-party logistics services, will go a long way toward improving the economic efficiency of trucking operations and lowering the costs and prices of road transport in Tunisia.

There is also a role for government to ensure equity in connectivity. Efficiency grounds would call for opening all routes to market forces and focusing only on enhancing competition. Equity advocates indicate, however, that low traffic in some areas (such as those in sparsely populated small cities) would make certain routes unattractive for private investors or operators, leaving those areas disconnected. For lagging areas, where demand is low, government intervention may be necessary to ensure that these places are still connected to the rest of the country. If left alone, the small volumes from lagging areas will discourage transport providers (Arvis et al. 2007). Sacrificing some efficiency may be necessary to achieve equity, but investments should be prioritized so that no efficiency is sacrificed unless equity is improved. In other cases, where markets are thin and attracting transport operators is difficult, encouraging intermediate modes of transport may be a good alternative. Bicycles, handcarts, motorcycles, power tillers and trailers, and community participation become essential to enhance mobility in rural areas (Lall and Astrup 2009).

In addition, efforts to address market failures (and improve access to markets) play a key role in reducing welfare gaps, especially between leading and lagging rural areas. Market failures appear to be a key constraint in rural lagging areas even when endowments are similar to those in leading areas. This is important because these are the areas where we find the greatest income disparities and largest poverty rates. It also confirms the existence of labor market frictions and segmentation that keep lagging rural areas isolated from economic opportunities.

Providing incentives for firms and people to move to lagging areas in the hope of promoting an increase in economic activity and job creation.

The provision of fiscal and financial incentives for regional development is unlikely to achieve meaningful results. In tackling the dual challenge of balancing spatial equity and economic efficiency, history suggests that policies that facilitate convergence of living standards across regions as well as concentration of economic activity in and around urban areas may help Tunisia transition from a middle-income to a high-income economy (World Bank 2008e). Coordinated policies under the first and second points described above can enhance efficiency of cities while also leading to improvements in equity. This third option-of providing incentives for firms and people to move, however, has proven to be an unsuccessful choice in trying to reduce regional disparities in different countries around the world.

The Tunisian experience also shows that incentives are not the solution to reducing regional disparities in economic activity. Since 1993, Tunisian legislation has enabled the government to provide incentives for private investment in lagging areas or priority zones, promulgated in the Investment Code revised in 2011 (*Code d'Incitations aux Investissements*). These incentives include tax exemptions on profits and a 50-percent reduction on taxable ceilings. Other countries have also attempted to reduce disparities between leading and lagging areas by de-concentrating economic activity or people—and most have failed. Indonesia's transmigration program tried to relocate people from Java to less populated areas such as Kalimantan, Papua, Sulawesi, and Sumatra. The objective was to promote more balanced development by providing land and new economic opportunities to poor settlers in Java. But the high-cost program

had no impact on Java's density or on poverty rates among migrants (World Bank 2008e). Egypt tried a different approach to de-concentrate its population away from the traditional centers of growth by planning 20 new towns over the past 20 years to reduce population growth in Cairo and the Nile Valley. Built for five million people, they have attracted barely 800,000 (World Bank 2014g).

Interregional transfers can be used to achieve convergence in living standards, however. While national transfers are likely to be important for lagging areas, policymakers should keep in mind that international experience suggests that interregional transfers are best used to achieve convergence in living standards. Resources are wasted when they are instead distributed with the objective of shaping economic activity (see box 10.3).

Box 10.3 Interregional Transfers Can Drive Convergence in Living Standards but Typically Fail to Shape Economic Activity

International experiences suggest that interregional transfers can drive convergence in living standards but typically fail to shape economic activity. For example, equitable funding for public services is associated with reduced inequalities in opportunity for households. In Japan major investments in basic services and infrastructure through transfers beginning in the 1970s are widely credited with evening living standards and the subsequent convergence in incomes between leading and lagging areas (World Bank 2008e).

International experience also suggests that, to maximize impact, transfers should prioritize low-income or fast-growing areas, reward areas with higher return to investment with more allocations, and ensure equitable distribution based on need (World Bank 2008e).

In the European Union transfers have not achieved convergence in economic activity but have led to convergence of living standards. Supranational regional equity transfers in the European Union, the structural and cohesion funds, have accounted for over 30 percent of total EU spending for many years, around €347 billion in 2011. Despite their large size, there is no evidence that the transfers have led to convergence in incomes; however, positive impacts on human development indicators have been documented (Checherita, et al. 2009). In lagging regions in Portugal, for example, convergence in income has not occurred, but some regional equity indicators have improved (Arcalean, et al. 2012). Improvements have not come uniformly, however, to all regions; convergence was more likely in areas with institution-building components and regional and private cofunding. More flexible funding has also been correlated with improved outcomes. In Argentina interregional transfers were strongly associated with increased human development when allocated unconditionally (Habibi, et al. 2003).

In 1970 Japan initiated the "New Economic and Social Development Plan" with the main objective of addressing disparities in living standards that widened as a result of accelerated growth in the largest industrial areas. The plan provided public investment in basic services and social institutions everywhere in the country, with additional investments directed to less developed areas. The main objective was for these areas to achieve a minimum standard in access to basic services. The central government provided both earmarked and non-earmarked transfers. The earmarked transfers were allocated mostly to investments in basic services (including rural roads) and social institutions (such as public utilities, medical facilities, and schools) and used cost-sharing agreements with local governments.

Conversely, transfers that attempt to achieve convergence of incomes or economic activity often fail. As in Tunisia, firms rarely locate in regions with poor connectivity and few agglomeration economies, despite incentives, resulting in lost public investment (Deichmann, et al. 2008; Schultze 1983; Glaeser and Gottlieb 2008). In fact, these types of transfers have been linked to worsening regional equity; a recent study of the Organization for Economic Co-operation and Development countries found a correlation between higher interregional transfers and slower convergence (Kessler and Lessmann 2010).

Source: World Bank 2014g.

10.5 / Conclusions

The persistence of regional disparities has been made worse by current economic policies. Economic growth and public investments in human development contributed to impressive improvements since 1990 in health and education. Tunisia remains characterized, however, by significant regional disparities—and the resulting social tensions are widely regarded to have been one of the triggers of the 2011 revolution. Paradoxically, to a large extent these disparities have been entrenched, if not exacerbated, by the current set of economic policies. The industrial policy, through the Investment Incentives Code, strongly favors exports that are naturally located along the coastal regions (Chapter Four). Competition policy has restricted access to most of the onshore domestic economy, enabling a web of regulation and cronyism to hinder the development of the domestic onshore economy (Chapter Two and Chapter Three). Labor market policies introduce rigidities by forcing common national wages, discouraging employment in interior regions where productivity of labor is lower (Chapter Five). Even agricultural policies favor water-intensive arable crops located in northern and coastal areas to the detriment of arboriculture, horticulture, and sheep and goat breeding, which are labor-intensive activities mainly located in interior regions (Chapter Nine). These policies have exacerbated the already higher production costs in interior regions due to weaker infrastructure and lower connectivity.

The solution is not the provision of fiscal and financial incentives; rather it is essential to improve the quality of life, access to basic services, and connectivity of interior regions. In addition to removing the distortions introduced by existing policies, international experience shows that government should focus on improving services and connectivity. This is confirmed in the case of Tunisia. The analysis presented in this chapter highlights that most of the consumption gap between urban areas in lagging and leading regions appears due to differences in household characteristics (that is, education, access to basic services, and the like) while differences in returns to household endowments (for example, due to limited connectivity and/or other market failures) are most important when looking at differences between rural areas in lagging and leading regions. This suggests that the government should: (a) focus its interventions to extend access to basic services in lagging areas with the overall objective of achieving universal access and high quality of basic services (such as health, education, and transport) and more broadly quality of life across the country (including cultural events and recreational amenities) and (b) improve the links of lagging areas to markets through improvements in connective infrastructure (such as transport and telecommunications) and through improving the operation of markets (to ensure that the existing infrastructure is used efficiently). International experience shows, and indeed the Tunisian experience confirms, that financial and fiscal incentives to investors are not an alternative for these policies.

There is a role for the government in ensuring that competitive markets are well functioning. The case of the Tunisia trucking industry provides a useful example that liberalizing a market does not ensure its good operation. The trucking industry in Tunisia was liberalized in the 1990s; and, although it displays a high level of fragmentation with many small operators, it does not appear to deliver low freight prices. The data seem to indicate a lack of logistic coordination and poor operational efficiency as the main reasons for high costs and the resulting high prices. This calls for a strong role of the government in helping to overcome these coordination failures by supporting the development of a system of third-party logistics for the coordination of trucking operations. In addition, removing barriers to entry for domestic and foreign operators may foster a consolidation toward larger groups and drive prices down—which would improve connectivity and contribute to fostering development in interior regions.

Notes

1. This chapter draws on the Tunisia Urbanization Review (World Bank 2014g). This chapter does not discuss issues related to local government and decentralization as these are treated in detail in the Tunisia Urbanization Review.

2. Tunisia is organized in 24 governorates that can be aggregated into seven administrative regions, each comprising several contiguous governorates: Greater Tunis (Tunis, Ariana, Ben Arous, La Manouba); North East (Bizerte, Nabeul, Zaghouan); North West (Beja, El Kef, Jendouba, Siliana); Center East (Mahdia, Monastir, Sfax, Sousse); Center West (Kairouan, Kasserine, Sidi Bouzid); South East (Gabes, Medenine, Tataouine); South West (Gafsa, Kebili, Tozeur). Greater Tunis, North East, and Center East are considered leading areas while the North West, Center West, South East, and South West are considered lagging areas.

3. See the recent *Livre Blanc Tunisie : nouvelle vision du développement régional*, Ministère tunisien du développement régional, November 2011.

4. Senior staffs in the Tunisian administration have pointed out that, even though reducing regional disparities was often mentioned, in fact it was not a priority objective under former president Ben Ali.

5. It should be acknowledged that even the wealthier cities of Tunis, Sfax, and Sousse have pockets of poverty.

6. The same survey brings evidence that the coast has a larger percentage (25 percent versus seven percent in the interior) of unemployed who turn down jobs because of a perceived incompatibility between their educational qualifications and the available job opportunities.

7. Tunisia's modal mix of domestic freight transportation is highly skewed toward road transport, with more than 80 percent of all domestic movements being carried by trucks. While 4 percent of domestic goods are transported by sea, railways account for only about 14 percent of all land-based transport of goods (Study on Freight Transportation: Diagnosis of the Current Situation, A Synthesis Report 2001, see World Bank 2007a). Given the importance of road and freight transport for Tunisia's economy, we focus on measuring physical road connectivity and economic costs of road freight transport in the country.

8. Mere straight-line distances fail to capture the nuances of economic distance that, especially in the case of freight movements, consists of time and money costs (World Bank 2008e; World Bank 2012a, among others). Several factors affect actual travel conditions—the existence of a road network, the terrain on which the network is built, the quality of the network like number of lanes, the roughness of the road, and the pavement ratio—and as a result determine travel time and travel costs.

9. The relatively good physical connectivity observed in Tunisia reflects the recent efforts by the government of Tunisia to modernize its road network, focusing on the development of highways as a key instrument to strengthening competitiveness. The efforts started as early as 1998 where the Tunisian government defined a highway development plan promoting the development of highways going out of Tunis.

10. It is also interesting to note that the port of Gabes is not well integrated to the rest of the country and that there are also some coastal areas in the north that have lower market access.

11. While connectivity appears to be good, the indicators shown in this section are not able to identify issues about capacity or

detailed quality of the roads. This is an important issue and should be explored in future work. For details on the assumptions used for these calculations see World Bank 2014g.

12. A survey of Tunisia's trucking industry was conducted by the World Bank in 2012 to better understand the nature of intercity and interregional freight transportation. A random sample is drawn from a total population of 125 trucking companies and 480 individual truck owner-operators from a pool of registered and non-registered. It includes detailed information on prices charged by truckers, the costs of operation, key characteristics of trucking services (like mileage, payload utilization), and significant obstacles faced by service providers. The information was collected from 84 individual truckers and 49 trucking companies with a median employment size of 20 full-time permanent employees. Following domestic deregulation, the industry has no state ownership and less than 10-percent foreign ownership, reflecting a domestic industry run by small operators and medium-sized firms. The analysis provides insights into the market structure of the industry, the economic efficiency of operation, and the challenges faced in freight connectivity like infrastructural bottlenecks and the regulatory environment.

13. The results of the survey suggest that possible causes underlying high prices are high operational costs, especially fuel and maintenance associated with less modern truck fleet, and operational inefficiencies (poor road quality and congestion).

14. The national average estimated price-cost gap is 44 percent, which while large is still considerably lower than the profit margins estimated for international routes in African countries like Chad (163 percent), Ghana (80 percent), Kenya (66 percent), and Uganda (86 percent) (Teravaninthorn and Raballand, 2009).

15. There are 1,600 registered trucking operators (including individual truckers), and the number of non-registered operators is estimated at 40,000 (trucks with gross weight load less than 12 tons are not required to obtain a permit). Of 133 respondents, 65 percent are individual truck owners who own fewer than two trucks; and 90 percent of the sample is domestically owned companies or local truck operators. As part of subjective responses, more than three quarters of the respondents report facing tough competition from more than five competitors and almost all report at least two to five competitors. More than 50 percent of respondents report facing competition from individual truckers and another 30 percent from local small- and medium-sized trucking companies.

16. <http://www.euromedtransport.org/En>

17. Decree 94/1994; and also see 2008 Agreement on Concessions of Road Transport (*Agreement de concessionnaire en matériels de transport routier*) available at: <http://www.commerce.gov.tn/>

18. This is in contrast to what has been found in countries in Latin America, and even in Egypt, where factor mobility is a concern within regions but not across regions (World Bank 2014g).

19. In Colombia policies that loosened caps on fee increases permitted private water utilities to recover costs and expand operations. Similarly, for electricity, Colombia loosened regulations to permit more companies to join the market and recently became a net power exporter (World Bank 2013d).

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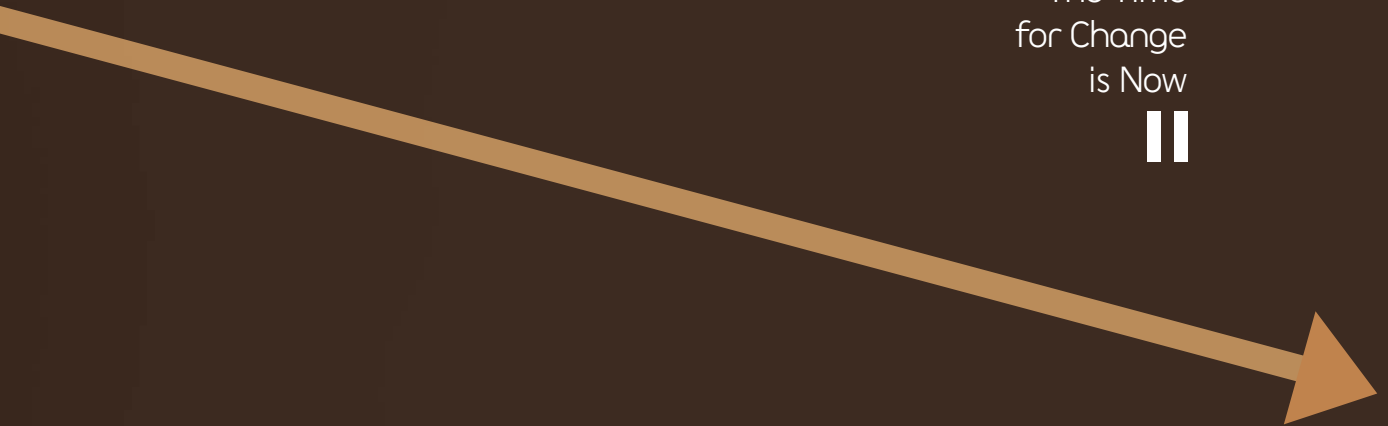
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Synthesis and Policy Recommendations | 11



The Time
for Change
is Now



Tunisia holds enormous potential. A skilled workforce, including a relatively large number of foreign-educated graduates. A good public administration building on a tradition established since the time of President Bourguiba in the 1960s. Good road infrastructure across the country, such that most of the country (but not all) is well connected to urban centers. A good number of ports and airports. Good access to electricity, safe drinking water, and telecommunications. Its strategic geographic location gives it privileged access to the huge European market. And last but not least, the country has an established tripartite dialogue process on economic policies between government, trade union and employers' federation. Tunisia has everything it needs to become the "Tiger of the Mediterranean".

Although this economic potential has long been recognized, the reality is that it has not materialized. Over the past decade, the economy has remained stuck in low performance, with high unemployment, and has been unable to take off—there is broad agreement that the inadequate economic performance is at the root of the 2011 revolution. This report seeks to understand the reasons for this impasse, and to outline an agenda to realize Tunisia's full potential.

11.1 / Tunisia's Economic Paradox: From Good Performance to the Impasse of the Economic Model¹

Tunisia's good economic performance over the past few decades enabled the country to experience increased prosperity and rapid poverty reduction. In the 1970s Tunisia adopted a public sector-led development model that saw the state play an active role in strategic sectors and in imposing barriers to entry in large segments of the economy. Tunisia developed well during the 1970s as limited steps were taken to open up the economy, notably with the inception of the "offshore" regime, coupled with pro-active government industrialization policies². By the 1980s, however, the limits of the state-led economic model started to emerge as Tunisia was impacted by a severe economic crisis. Parts of the economy were liberalized in the late 1980s and 1990s with the consolidation of the offshore sector and as part of a process of greater integration with the EU. Nevertheless, the core thrust of the economic model remained fundamentally unchanged, as the state retained close control of most of the domestic economy. As discussed below, today over 50 percent of the Tunisian economy is still either closed or subject to entry restrictions.

This state-led dualistic development model served Tunisia well in the initial stages of its economic development, as Tunisians experienced a rapid increase in income per capita. Even over the past decade Tunisia enjoyed fairly rapid growth in GDP, placing the country among the leading performers in the MENA region. Growth was fairly inclusive, with poverty decreasing from 32 to 16 percent between 2000 and 2010 using the national poverty line, and income per capita of the lower 40 percent of the population improving significantly over the period (by one-third in per capita terms). Public investments in human development contributed to bring impressive improvements to reduce infant and maternal mortality and child malnutrition at the national level, and education levels increased dramatically. A strong road infrastructure was built throughout the country, as well as ports and airports and infrastructure for information and communications technology.

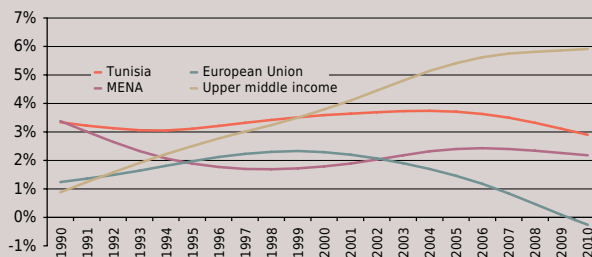
By the late 1990s, however, the economy increasingly struggled to advance, and economic performance remained insufficient. Although Tunisia's real GDP per capita growth since the 1990s was the second strongest in the MENA region, it has remained far below the growth rates observed in other upper-middle-income countries over the same period—and unlike many of its peers Tunisia did not experience a take-off during the past two decades (figure 11.1).

Further, Tunisia was plagued by high unemployment because the rate of jobs creation was insufficient and the quality of the jobs created remained low. Unemployment has remained persistently above 13 percent since the early 1990s, increasingly affecting youth (figure 11.2)⁴. Most of the jobs created by the economy were actually in low-value added activities and mostly in the informal sector, offering low wages and no job security, which did not meet the aspirations of the increasingly large number of university graduates⁵.

Hence, as Tunisia expanded tertiary education in preparation for moving up the value chain, the economy was unable to advance beyond low-skill, low-wage activities. As a result, in recent years the inflow into unemployment has mostly fallen on young and educated individuals, reflecting a structural mismatch between the demand for labor, tilted toward the unskilled, and a growing supply of skilled labor (World Bank 2010a). The public sector increasingly became the only source of employment for graduates, and over 30 percent of graduates remained unemployed as of end-2010. These high rates of unemployment, along with the low quality of available jobs, underpin the great social discontent expressed by Tunisia's youth.

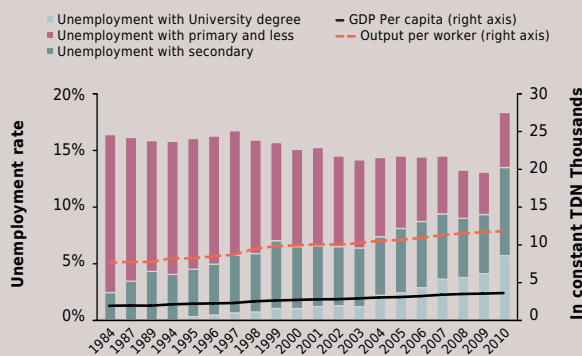
The failure to adapt the economic policies meant that Tunisia never moved beyond creating low-wage jobs. As mentioned, the state-led model was characterized by limited competition and active state intervention. This model worked fairly well for Tunisia initially but, as will be discussed below, increasingly resulted in inefficiency, distortions, and rent seeking, which hindered economic activity. It is not the “liberalization” of the economy that brought unemployment and low-wage jobs to Tunisia—Tunisia always had unemployment and low wage jobs. In fact the opening of the export-oriented offshore sector and the process of gradual liberalization since the late 1980s helped create more jobs, which by and in itself was a positive development. However, while low wage jobs may have been satisfactory in the 1980s and 1990s when education and living standards were lower, they became increasingly insufficient as the country passed certain development stages (in education, income, and industrialization). Tunisia was unable to advance

Figure 11.1: Real Per Capita Growth Rate 1990-2010



Source: World Development Indicators (WDI); authors' calculations.
Note: MENA refers to non-oil-rich MENA countries. Growth rates in graph have been smoothed with HP filter.

Figure 11.2: Evolution of Unemployment by Level of Education



Source: INS; authors' calculations
Note: A change in the definition of unemployment was introduced in 2008 to align Tunisia to the ILO definition and resulted in a reduction of approximately 1.5 percentage points in the level of unemployment.

beyond the low-skill, low-wage economy because it did not in fact open up its economy (to domestic investors, as well as internationally) and did not change the underlying state-controlled economic model. It was this lack of change, in the face of the demographic time bomb of educated youth, which rendered the economic model increasingly inadequate.

To make things worse, the extensive web of regulations associated with pervasive state intervention facilitated the growth of corruption and cronyism, such that opportunities were not the same for all. Cronyism and corruption increasingly became rampant, and those in power recurrently bent the rules to serve their interests (World Bank 2009a). Laws meant to encourage competition and investment were circumvented, and ultimately rents extraction by the few closest to the political power undermined the economy's ability to take off and bring prosperity and good jobs to all. Inequality and unequal access to opportunities gave rise to resentment among the population (box 11.1).

Box 11.1 How the World Bank is Learning from Tunisia

Until 2010 Tunisia appeared to be doing well and was heralded as a role model for other developing countries by the World Bank and the IMF, and the World Economic Forum repeatedly ranked Tunisia as the most competitive economy in Africa. In fact, beyond the shiny façade often presented by the former regime, Tunisia's economic environment was (and remains) deeply deficient. Even more important, not only has the policy infrastructure put in place during the Ben Ali period resulted in inadequate economic outcomes but it also supports a system based on privileges, which invites corruption and results in social exclusion of those lacking significant political connections.

The shortcomings of Tunisia's economic model were largely visible already during the presidency of Ben Ali. In fact, the revolution was, arguably, one of the outpourings of popular discontent against the system that the Ben Ali clan created because, even if Tunisians weren't allowed to talk about it, everyone knew what was going on behind the scenes.

While previous World Bank reports regularly detailed the regulatory failures, the barriers to entry, and the privileges of the old system, these were often masked in bureaucratic language that did not get to the heart of what was clearly a system asphyxiated by its own corruption. In retrospect, the Bank has learned that, in its effort to remain engaged and help the poor, it can far too easily overlook the fact that its engagement might perpetuate the kinds of economic systems that keep poor people poor. Learning from this lesson will require the World Bank to unreservedly emphasize, for itself and its partners, the critical importance of the right to access to information, transparency, and accountability as part of a pro-poor development agenda, in Tunisia and everywhere else.

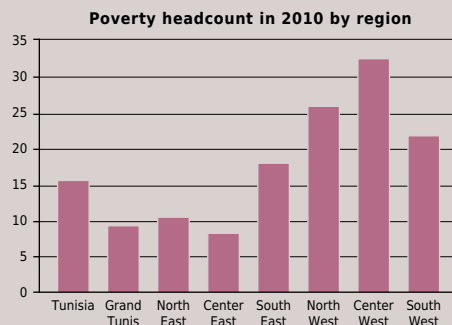
In fact this economic model may have reached an impasse earlier had it not been for the growth of the offshore sector. The relatively open and investment-friendly offshore environment was a magnet for private investment and kept the economy moving and creating some jobs. Nevertheless, the offshore regime in Tunisia (and similarly the "free zones" established in several MENA countries) was created to attract foreign direct investment (FDI) in a confined environment, leaving the rest of the economy ruled by heavy regulations and anti-competitive practices. Hence, while the offshore economy thrived along the coast, the dearth of economic opportunities in the interior parts of the country fuelled even more frustration.

Economic conditions improved for most Tunisians, but significant disparities persisted between the coast and the interior regions. Average poverty rates remained four times as high in the interior of the country, compared to the richer coastal areas (figure 11.3). The economic policies contributed to maintain these disparities because most private investment was attracted in the

export-oriented offshore sector and therefore largely located along the coastline, close to the export infrastructure. Similarly, agricultural policies favored crops that are not produced in the interior. Public investment was also skewed the coast such that the quality of public services and infrastructure in interior regions remained weaker.

Ultimately, Tunisia's economic policies became inadequate to tackle the new development challenges: lack of competition and cronyism, dualism and overregulation increasingly suffocated economic initiative and prevented the transformation of the country. Economic performance was positive, but insufficient and unfairly shared. The persistence of inequality and unequal opportunity coupled with lack of transparency and rampant abuse by cronies, fuelled frustration amongst the population and set the stage for the January 2011 revolution.

Figure 11.3: Large Regional Disparities Persist in Tunisia



Source: INS and World Bank (2012).

11.2 What is Wrong with Tunisia's Past Economic Policies?

This report argues that Tunisia's disappointing economic performance and feeble jobs creation are the result of multiple barriers to the operation of markets and deep distortions introduced by well-intended, but misguided, economic policies. Many policies and regulations initially introduced to direct and accompany the economic development of the country by attracting investment, boosting economic growth and employment, and reducing regional disparities, increasingly became distortive of market development and generated unintended barriers to competition. In doing so, they hampered the process of "creative destruction" and hindered the reallocation of resources toward greater productivity and jobs creation. Further, industrial policy and labor market rules and institutions inadvertently introduced a bias toward low-value added activities and in favor of the coastal areas. Similarly, agricultural policy hindered, rather than supported, the development of interior regions. The interventionist policies also fostered cronyism and corrupt practices, which further discouraged entrepreneurship and private sector investment. Hence, although they may have been introduced with the best intentions, many of the interventionist policies in fact ended up resulting in inequities and the exclusion of those lacking significant political connections. These pitfalls are discussed below.

In this report we focus on the salient features of Tunisia's economic policies, those that led to the current impasse but could also play a pivotal role in unleashing Tunisia's potential. We assess the regulatory framework for competition and investment, which is the foundation of markets. We discuss the workings of key factor markets, notably labor markets and the financial sector. We then review Tunisia's industrial policy, agricultural policy, policies for services sectors, and policies for regional development, which are at the core of Tunisia's economic challenges and opportunities. We begin in the next few paragraphs by providing the highlights of the assessment of Tunisia's economic policies.

A Protected Regulatory Environment: Lack of Competition and Large Bureaucratic Burden

Rather than nurturing it, the current economic model has restricted competition. Widespread restrictions to the number of firms allowed to operate in the market have been coupled with many legal (public) monopolies and undue regulatory constraints, severely limiting competition. In fact, sectors in which investment faces restrictions account for over 50 percent of the Tunisian economy, whether through the Investment Incentives Code (IIC), the Competition Law, or specific sectoral legislation (see Chapter Two). Many of these sectors at present remain de facto closed to competition. The number of competitors is explicitly restricted by law or regulation in some markets (for example, water, electricity, telecoms, road transport, air transport, railways, tobacco, fisheries, tourism, advertising, health, education, vocational and professional training, real estate, agricultural extension services, retail and distribution, and so on)⁶. Furthermore, state-owned enterprises (SOEs) hold between 50 percent and 100 percent of the markets of gas, electricity, railroad transport, air transport, and fixed-line telecommunication services; and many SOEs act as monopolists in the production, import, and/or distribution of various goods (for example, olive oil, meat, and sugar). Even segments of markets in gas, transport, and telecoms where private sector participation is feasible are closed compared to OECD and comparator countries (see Chapter Two).

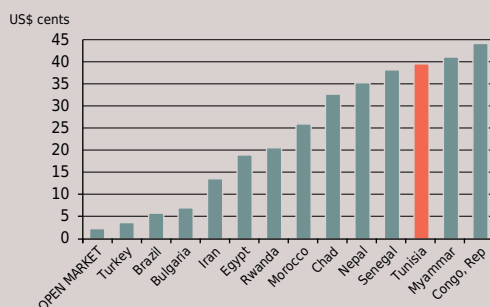
Although this has become the status quo to Tunisians, the widespread lack of competition has far-reaching implications for the performance of the economy. Firms in sectors with restricted entry benefit from rents that arise because the firms face limited competition. These firms remain profitable largely thanks to the protection they enjoy in the domestic market—at the expense of the consumers who

are forced to buy more expensive and lower quality goods produced by these uncompetitive firms—further reducing investment and jobs creation. For example, the cost of international telephone calls to and from Tunisia is one of the most expensive in the world, over 10 times international market prices, and on par only with countries such as the Republic of the Union of Myanmar and the Democratic Republic of Congo (see Chapter Two). This high price paid by consumers and firms translates into oligopolistic profits for *Tunisie Telecom* and Ooredoo Tunisie (formerly Tunisiana), and to a lesser extent Orange, and reduces the competitiveness of Tunisian firms (for instance, the high cost of international telecommunications undermines Tunisia’s potential as an offshoring hub for marketing, financial, accounting, and legal services for EU firms, which could bring significant jobs creation). The rationale

for such restrictions was often to enable the development of a local production capacity, and to include the provision of basic services and utilities. In practice, as discussed below, these restrictions have outlived their development goals; and over time they have increasingly hampered competition, fuelled inefficiencies and cronyism, and undermined private initiative.

The banking sector provides an example of the effects of limited competition—but the same problem affects many other sectors of the economy. The Tunisian banking system is characterized by limited profitability, inefficiency, low credit intermediation, and significant vulnerabilities (see Chapter Six). Financial deepening has been limited over the past decade and remains well below potential. Further,

Figure 11.4: Cost of International Calls from Skype



Source : Skype, Cost of call from US to countries.

the performance of the loan portfolio is very weak and increasingly poses a risk to the stability of the financial system. Also, progress in product innovation and quality of services has generally been low. Paradoxically, despite the large number of banks, we find that the degree of competition in the Tunisian banking sector is lower than the regional average. In no small part this is the result of the inefficiency and governance failures affecting the three large state-owned banks (SOBs), which together account for almost 40 percent of the sector⁷. The result is that ordinary businesses struggle to gain access to finance and are therefore unable to invest and grow—it was regarded as a major constraint by 34 percent of Tunisian firms and by 39 percent of medium size firms in the World Bank 2014 Investment Climate Assessment (see Chapter Six; World Bank 2014e).

In addition to widespread barriers to entry, the pervasive role of the state in the economy has translated into a thick layer of bureaucracy that stifles entrepreneurship efforts by Tunisians and reduces firms' competitiveness. The heavy cost of bureaucracy represents a burden especially for the small entrepreneurs that do not have the means to outsource the handling of administrative requirements, and induces small companies to remain informal. The results of the World Bank 2014 Investment Climate Assessment highlight that overall the bureaucratic burden imposes a huge "tax" on firms' competitiveness, reducing investment and jobs creation—it is estimated that close to 13 percent of firm annual sales are spent dealing with regulations, which results from the cumulative cost of interaction with the administration (direct and indirect costs, including compliance time; see Chapter Four). In fact this burden is even higher for firms producing for the onshore sector.

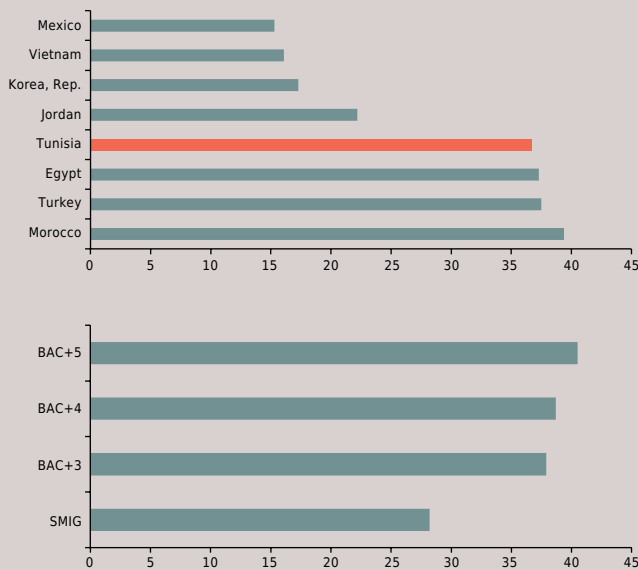
A further area of bureaucratic quagmire extends to land markets, which poses a problem for investors, agriculture, and urban planning. Regulations governing property registration and transactions also make it difficult for poor people to own land and property. For example, it costs 6.1 percent of the property's price to register the property, in addition to TND30 in government fees and TND30-300 in lawyer fees. In the OECD countries the registration cost is lower at 4.5 percent of a property's price. And in Georgia—a country that has reduced transaction costs and red tape across the board—the registration involves a single procedure to register the title with a public registry and on average takes only two days and costs 0.1 percent of a property's price (see Chapter Four).

Labor Rules Promote Exploitation and Job Insecurity

Paradoxically labor markets rules and institutions have exacerbated the bias toward low-value added activities in Tunisia, while failing to protect either workers or jobs. Tunisia does not have a strong social security system and notably lacks an effective loss of employment insurance. In order to protect workers from sudden job loss, Tunisian labor regulations compensated with rigid firing rules for open-ended contracts. In turn, these rules induced firms to look for greater flexibility in adapting staffing to economic conditions. This was addressed in the early-2000s with the introduction of fixed-term contracts that allow the possibility of hiring workers on very flexible short-term contracts for up to four years. The rigid firing rules for open-ended contracts contrast sharply with the "savage flexibility" of fixed-term contracts (see Chapter Five). This dichotomy between fixed-term and open-ended contracts indirectly promotes informality and job insecurity as firms avoid giving workers open-ended contracts to maintain flexibility—the abuse of this practice has given rise to exploitative labor practices, referred to in Tunisia as the phenomenon of *sous-traitance*.

By making it very expensive to terminate open-ended contracts (and thereby favoring informality and fixed-term contracts, which are more suited for low skilled jobs), labor regulations have inadvertently contributed to direct private investment toward low-value added activities and low-skill jobs. Further, Tunisia's social insurance system entails a very high level of tax wedge, which is contributing to the high level of informality, and discourages creation of high-skills jobs⁸. Evidence across countries shows that as the tax wedge increases, formal employment declines. In Tunisia payroll taxes (paid

Figure 11.5: Tax Wedge in Selected Countries and By Education Level in Tunisia



Source: Processed from World Bank (2013a) (top) and Belghazi (2012) (bottom).

by employers) and social security contributions (paid by employees) approach 29 percent of wages. In fact, social security contributions are often perceived as a tax because the revenues are not directly linked to the benefits perceived by the worker. Depending on how much workers value the bundle of social insurance benefits, the average tax-wedge in Tunisia could be as high as 38 percent, and is certainly acting as a barrier to the creation of more formal employment, particularly among medium and small firms (see Chapter Five). The result has been an even higher level of informality—and therefore lower protection of workers. Due to the progressivity of the income tax, the tax-wedge is higher for skilled than unskilled workers (figure 11.5).

Further, industry-wide collective agreements may exacerbate regional disparities. In Tunisia, a collective agreement (CA) is binding on all workers in occupations within its scope. The CAs may establish a salary grid or scale that may exceed productivity levels if employers do not object. While minimum wages are unlikely to be binding in Tunisia, there is evidence that CAs may be constraining, as the floor level of wages

in CAs is often set at a relatively high level compared to average productivity (see Chapter Five). These industry-wide agreements therefore may hamper the competitiveness of interior regions because the same pay scales apply country wide, thus undermining the possibility for interior regions to attract investors by offering lower labor costs. If the challenges and costs of setting up a business in interior regions are higher compared to the coastal regions, and if wages are the same, investors will choose not to set up their firm in the interior—hence, paradoxically, the CAs may end up exacerbating regional disparities.

Industrial Policy and Agricultural Policy Introduce Distortions and Deepen Regional Disparities

The investment policy, which is centered on the separate treatment of companies producing for the domestic market (onshore) and companies producing for exports (offshore), is at the root of the development challenges facing Tunisia today. The onshore-offshore dichotomy was initially helpful in the 1970s but is now contributing to keep both sides of the economy trapped in low productivity (see Chapter Four). On the one hand, as discussed further below, the highly protected onshore sector is characterized by low-productivity firms that survive largely thanks to privileges and rents extraction (arising from the barriers to entry facing competitors). On the other hand, the firms that operate in the 50 percent of the economy that is open to competition (the so-called offshore sector) are harmed by the fact that the services and intermediate goods produced in the onshore sector have low quality and/or are not competitively priced.

This segmentation, which limits links between firms in the two regimes, has resulted in greater imports of intermediate products and fewer products made in Tunisia (that is, less value added in Tunisia) and therefore fewer jobs. In theory the offshore firms could buy tax free from the onshore

and could also sell a share of their production in the domestic market. However, very few offshore firms take up these options. In order to be competitive and be able to sell their products in the global market, these firms cannot use these low-quality and expensive parts in their manufacturing processes and instead import most of the inputs they need. In addition, trading with the onshore would expose them to a heavy administrative burden (see Chapter Four). Hence, offshore firms prefer to buy good-quality tax-free intermediate inputs from abroad. This implies that the value added content of Tunisian exports remains limited, as most of the content of exported products is in fact produced abroad—and only the assembly and lower value added tasks are performed in Tunisia. Hence, although more than half of Tunisia's exports are finished products, including many high-technology goods like sewing machines, television sets, and precision medical instruments, in practice Tunisia does not produce much of these products—mostly it assembles parts produced abroad. As a result, not only are there fewer jobs but there is also no demand to hire the many skilled graduates. And, because the value added by Tunisians workers to the exported products is small, the salary these jobs can pay is also low.

The Investment Incentives Code therefore has had limited results in terms of attracting additional investment and jobs creation, and has exacerbated regional disparities. The direct cost of the incentives is very high compared to their limited impact. The analysis of the costs and benefits of the Code has shown that the total cost of incentives is approximately 2.2 percent of GDP (in 2009; or approximately US\$1 billion) and that 79 percent of this amount is wasted in that it benefits companies that would have invested even in the absence of incentives (see Chapter Four). In addition, fewer than 2,500 firms receive most of the incentives, and these firms are concentrated in sectors that are not labor intensive and do not require the incentives, notably mining, energy, and banking. As a result, each additional job created thanks to the investment incentives costs as much as US\$20,000 per year, which is extremely high for Tunisia. In addition, as discussed further below, the Code has attracted mainly “footloose” investment focused on assembly and other low-value added activities—thus distorting production against high-value added activities that are sorely needed to employ graduates. Further, over 85 percent of projects and jobs benefiting from the incentives were created in the coastal regions (where exporting firms are naturally located), thereby also exacerbating the disparities with the interior regions.

Agricultural policy has failed to boost agriculture and contributes to shifting production away from labor-intensive crops produced in interior regions, thus paradoxically increasing unemployment and regional disparities. Tunisia does not really have an agricultural policy; rather it has a food security policy that in fact hinders the development of its agricultural sector. Agricultural policies were intended to protect farmers' revenues and boost food security in cereals, beef, and milk. In fact these policies have repressed the agricultural sector by distorting production away from labor-intensive products in which interior regions of Tunisia are competitive and toward products such as cereals, beef, and milk, in which Tunisia is not competitive and which are mainly grown in coastal northern regions. The overall cost of agricultural support in Tunisia is high. In addition to budgetary costs borne by taxpayers (which amount to just less than one percent of GDP), there are also direct costs paid by consumers who have to pay higher prices for food products, estimated at four percent of consumption (see Chapter Nine). Agricultural interventions also distort production and trade, generating efficiency losses, which are borne by the entire economy, estimated at approximately 0.8 percent of GDP. The result has been a net loss of welfare for the country, as well as the redistribution away from interior regions and toward coastal areas. Further, contrary to commonly held beliefs in Tunisia, the distribution of the benefits from existing agricultural subsidies is highly inequitable because they mostly benefit a few large landowners (producing wheat, milk, and sugar), and mainly those in coastal areas, and do not significantly benefit smallholders.

11.3 / Tunisia's Economic Impasse is the Result of These Policies

An in-depth analysis of the performance of Tunisia's economy reveals severe dysfunctions resulting from the current set of economic policies discussed above. We find that economic resources appear to be stuck in relatively low-productivity sectors, suggesting the existence of barriers and distortions that have prevented a reallocation of resources toward more productive activities. This is important because higher productivity is a means to faster and better quality jobs creation. Reflecting the limited pace of change in the economy, however, firms appear to be stagnating in terms of productivity and jobs creation—a sort of private sector paralysis. Similarly, in terms of exports and trade integration, Tunisia's economy appears unable to move beyond assembly and other low-value added tasks for France and Italy (which entails low quality jobs). These problems reflect an environment where cronyism and rents extraction (rather than competition and performance) drive economic success. We elaborate on our main findings below.

Structural Stagnation: Persistently Inefficient Allocation of Resources

The Tunisian economy appears unable to efficiently reallocate resources across sectors and continues to operate below potential. One of the key insights of development economics is that growth is driven in part by a structural shift from agriculture to the industrial sector. This is because agriculture is typically the sector with the lowest labor productivity (that is, the lowest creation of value added per worker), such that as labor moves from agriculture to the industrial sector, overall productivity rises and incomes expand. In fact dynamic economies tend to be characterized by rapid structural transformation as resources are reallocated from low-productivity activities toward more productive uses. This process is also accompanied by greater and better quality jobs creation. Instead the contribution of “structural change” to growth has been weak in Tunisia—structural change, the reallocation of labor from low-productivity to high-productivity sectors, contributed only eight percent to the change in real GDP per capita between 2000 and 2010, which is low compared to other countries (see Chapter One).

Worse, when labor does move from one sector to the other, it does not necessarily become much more productive. In Tunisia average productivity of the manufacturing sector remains very low and not much greater than that of the agricultural sector. In fact, our analysis shows that the productivity gap between manufacturing and agriculture is very low at 1.7 in Tunisia—even lower than the 2.3 gap in Sub-Saharan Africa and much below the 2.8 in Latin America and 3.9 in Asia (McMillan and Rodrik, 2011; see Chapter One). This reflects the fact that with some notable exceptions, manufacturing in Tunisia consists mainly of textiles and the assembly of final goods and other low-value added activities. Further, the textiles sector in Tunisia is less productive than agriculture.

The Tunisian economy in general has very low productivity, and this is at the root of the insufficient and low quality jobs creation. The fact that resources are stuck in low-productivity activities is at the root of the feeble economic performance. Reflecting this reality, today 77 percent of Tunisian workers and 75 of its human-capital-adjusted labor are employed in sectors with below average levels of productivity (figure 11.6). This share of workers in low-productivity sectors is high when compared to other countries (see Chapter One). A decomposition of the sources of economic growth in Tunisia confirms that growth over the past two decades was largely driven by “input accumulation”—that is, increases in the amounts of capital and labor and in the quality of human capital. There was, however, only limited improvement in the productivity of these inputs. Specifically, the contribution of capital, labor, and improvements in human capital to economic growth in Tunisia over the last two decades was 36 percent,

35 percent and 22 percent, respectively, while total factor productivity (TFP) accounts only for the balance of 5 percent, which is low (see Chapter One). Low TFP growth usually reflects the presence of frictions in the economy that prevent the reallocation of resources across economic sectors toward more productive activities and higher-paying jobs.

Private Sector Paralysis: Small Firms, Low Productivity, and Limited Jobs Creation

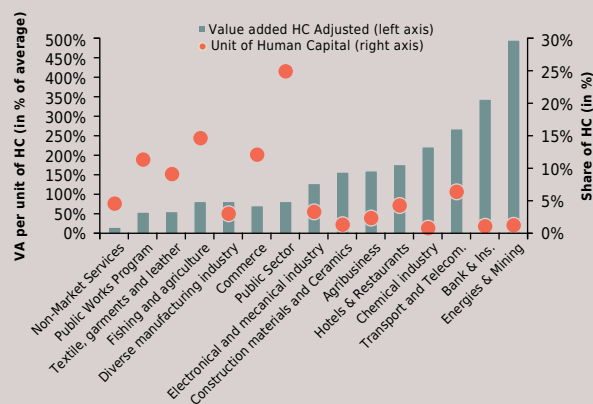
These macroeconomic observations reflect the lack of dynamic growth at the firm level. As discussed below, our analysis shows that private sector firms are stunted: they are characterized by stagnant productivity, weak job creation, and feeble export performance. Very few private sector firms enter the marketplace, and those that do rarely exit, a reflection of both barriers to entry and limited competition in the marketplace (see Chapter One). Job creation is hampered not only by limited entry but also by a lack of (upward) mobility; very few firms grow both in the short and the long run. Aggregate net job creation rates show that post-entry job creation is low on average (figure 11.7). Most firms do not grow, even in the long run. For example, only two percent of all firms employing between 10 and 50 people in 1996 employed more than 100 workers by 2010. Such weak firm performance demonstrates the existence of limitations in Tunisia's current economic environment.

Additionally, firms' mobility, that is, their ability to enter new markets (through growth or innovation) is extremely limited and only weakly correlated with productivity. Whereas one would expect that highly productive firms are the most profitable or successful, instead in Tunisia we find that is not the case—innovation and productivity are not rewarded in Tunisia. This is important because productive firms cannot grow and create more and better paying jobs.

As a result, growth and jobs creation has been very low; and allocative inefficiency—that is, the inability of firms to move toward more productive uses of resources—has persisted over time. In terms of jobs creation, very few firms grow, such that aggregate net job creation has been disappointing (in spite of low exit rates) (figure 11.7). In fact there is no strong correlation between jobs creation and firms' performance (as proxied by productivity and profitability; see Chapter One), which again suggests that the most productive firms are unable to attract resources and grow, pointing to severe weaknesses in the business environment. As mentioned, this results in lower average productivity, and therefore less investment and jobs creation.

The Tunisian private sector is dominated by small and relatively unproductive firms, likely reflecting the numerous barriers and distorted incentives facing firms. The data show that Tunisian firms are small on average and very large firms are few and far between, scarce both in absolute and in relative terms (see Chapter One), which is indicative of the presence of significant distortions constraining private sector development. This is unfortunate because large firms consistently outperform small firms in terms of productivity, export performance, and net job creation and offer more stable and better paying jobs. At present, however, there is a shortage

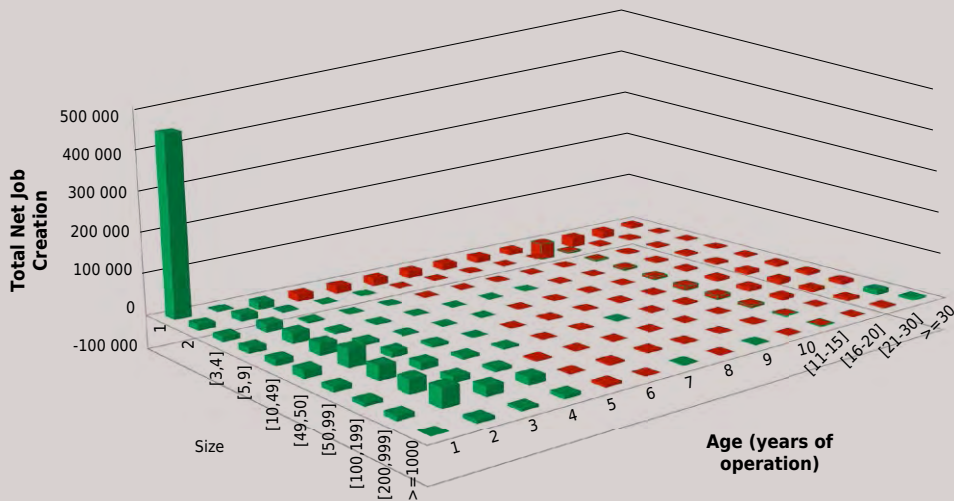
Figure 11.6: Sectoral labor Productivity and Employment (in 2009)
Shows Severe Misallocation of Resources



Source: Authors' calculations based on 2009 data from the INS.

of large firms in Tunisia, which is suggestive of a distorted economic environment forcing firms to remain suboptimally small (figure 11.7).

Figure 11.7: An Economic Desert: Net Job Creation in Tunisia by Firm Size and Age, 1997-2010 (Green=positive, Red=negative)



Source: Authors' calculations using RNE.

One plausible explanation for these paradoxical findings is that firms used to try and stay “below the radar screen” to minimize the risk of predation from the Ben Ali and Trabelsi clan. More generally these findings reflect the numerous barriers and distorted incentives facing the private sector. Indeed a qualitative survey commissioned for this report highlights a significant fear of Tunisian entrepreneurs that success would attract unwanted and expropriatory attention from government officials (and notably by the family of former president Ben Ali), especially in the onshore sector in which regulations are rife (see Chapter Three). One reaction to these fears—predicted by theory and confirmed in interviews—is to stay small, commit less capital, and maintain a short horizon (see Chapter Three). These reactions to threats of predation suppress competition, hamper productivity growth, and limit jobs creation.

Our results also highlight strong differences in performance between onshore firms and offshore firms, reflecting the segmentation of the economy. The analysis provides evidence for significant duality between firms producing for the domestic market (the so-called “onshore” sector) and firms producing for export (the so-called “offshore” sector), manifested among other things in differences in firm size distribution, average productivity, and export performance (see Chapter One). The offshore sector has performed better than the onshore sector as an engine of jobs creation and exports growth, stemming to a large extent from its ability to attract FDI.

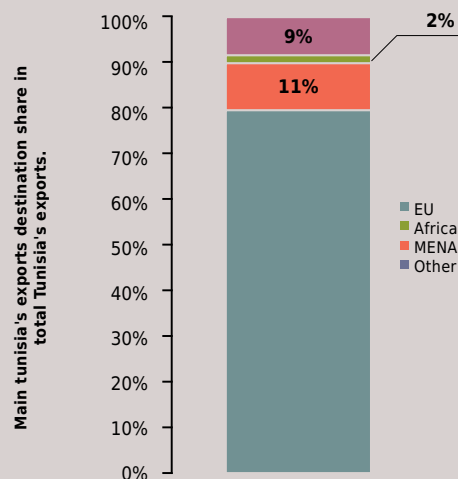
This duality reflects deep distortions that segment the economy and limit the interaction between firms in the two regimes. Hence, whereas one would expect that the products of local (onshore) industries would be used as intermediate inputs in export-oriented (offshore) industries, in fact, as discussed above, in Tunisia this does not usually happen. The segmentation therefore results in greater imports of intermediates from abroad, and less value added (products) made in Tunisia (see Chapter One and Chapter Four). As a result, not only are there fewer jobs but there

is also no demand to hire the many skilled graduates. And, because the value added by Tunisians workers to the exported products is small, the salary these jobs can pay is also low. Further, the segmentation reduces competition, thereby attenuating the process of “creative destruction” and preventing the emergence of a class of large firms that in other countries drive job creation, growth, and innovation.

Deceptive Integration: Assembling Products for France and Italy

In a sense, Tunisia does not “produce” its manufacturing exports—it assembles products from and for France and Italy. Despite significant efforts to diversify exports, geographic diversification of exports has actually been very limited, with the EU absorbing nearly 80 percent of Tunisia’s exports and, within the EU, France and Italy accounting for more than 55 percent of total exports (figure 11.8). This highly skewed trade pattern reflects the nature of the Tunisian economy. It is important to highlight that the fact that Tunisia’s exports are very concentrated on the European Union is just a symptom of a deeper problem—the real problem is that Tunisia does not produce much of its exports and that its trade patterns are largely limited to the assembly of products from and to France and Italy (see Chapter One). Companies in these countries have outsourced the assembly tasks and other low-value added tasks to Tunisia, taking advantage of the very favorable offshore tax regime, the availability of cheap low-skilled human resources, and the subsidized energy. This is not a problem in itself; on the contrary many Tunisians have benefited from the (low-wage, low-skill) jobs created as a result. However, the challenge is that Tunisia’s economy has been unable to move beyond the assembly and low-value added processes, meaning that demand is limited to low-skill labor and low-paying jobs. As discussed above, this production and trade structure is no accident—it is largely the result of the current set of economic policies, most notably the duality between the onshore and offshore sectors.

Figure 11.8: Tunisia’s Exports Concentration by Country, 2007



Source: WITS Comtrade; authors’ calculations

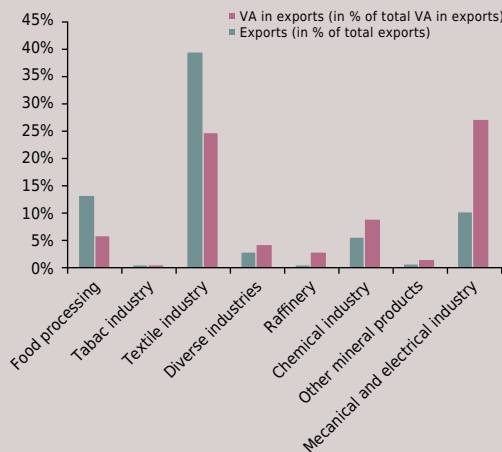
Beyond appearances, therefore, Tunisia’s integration with the global economy remains superficial, both in quantities and sophistication of exports. As a small economy of just over 10 million people, greater integration in the global economy remains critical to Tunisia’s economic success. However, although the perception in Tunisia is that economic growth has been characterized by trade integration and strong export performance, in actual fact trade integration remains highly limited and export performance has been deteriorating (Chapter One). Tunisian export growth during 2000 to 2010 was positive (3.3 percent) but slower than export growth in many other countries and also slower than Tunisian GDP growth. In fact, Tunisia’s share of goods exports in world trade has been declining over the past decade.

Export performance has been less spectacular than gross export growth numbers suggest because, as discussed above, firms rely heavily on imported inputs. As a result, the value added of Tunisian manufacturing exports remains extremely low. Reflecting this pattern, Tunisia’s export sophistication remains low compared to benchmark countries and has increased only

slightly over the past decade. Even this slight improvement in the sophistication (and technology intensity) of exported products is misleading since it largely reflects the assembly of higher-technology products (that is, the finished products exported are more sophisticated, but their technological content is not made in Tunisia) (Chapter One). For instance, although Aerolia, a branch of Airbus, opened a plant in Tunisia in 2009 that exports components of the aeronautic industry for the production of the Airbus 320, in fact only the low-skill tasks were decentralized

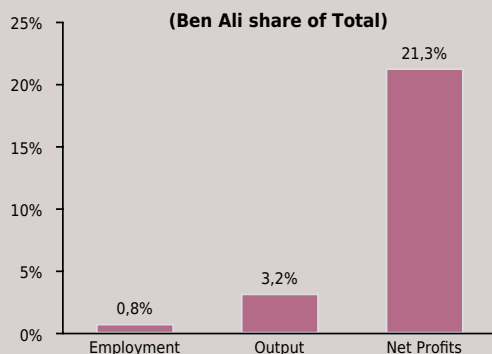
to Tunisia while the high-value added tasks (notably the cabin parts) are produced in France. Similarly, while Tunisia exports television receivers and medical precision instruments, in fact all the components are imported into Tunisia and only the final product is assembled, or “Made in Tunisia.” Indeed the value added of export sectors with a high share of high technology goods tends to be low in Tunisia (figure 11.9). Therefore, while Tunisia’s exports appear to be increasingly sophisticated, in fact they have remained largely confined to low-value added tasks and jobs. This is relevant because low-value added production activities largely offer low-paying and less stable jobs.

Figure 11.9: Value Added in Tunisia by Export Sector



Source: WITS Comtrade; authors’ calculations

Figure 11.10: Economic Significance of Connected Firms



Source: Authors’ calculations

Market Regulation Has Become a Smokescreen for Rents Extraction by a Small Elite

The heavily regulated market access has created opportunities for rents extraction by cronies who receive privileged access to certain lucrative activities. Our results show that Tunisia’s investment policy (and notably the Investment Incentives Code) not only produced subpar results—it also created an environment that was increasingly used as a vehicle for rent creation for the former president and his cronies. Our analysis shows that firms owned by Ben Ali’s clan were on average significantly larger than their competitors and record spectacularly higher levels of output, profits, and growth (see Chapter Three). We find that the scale of state capture in Tunisia under Ben Ali was extraordinary—by the end of 2010 some 220 firms connected to Ben Ali and his extended family were capturing an astounding 21 percent of all private sector profits annually in Tunisia (or US\$233 million, corresponding to over 0.5 percent of GDP). That such a small group of 114 people could appropriate such a large share of Tunisia’s wealth creation illustrates how corruption has been synonymous with social exclusion.

The results suggest that the superior performance of Ben Ali-owned firms stems to a large extent from regulatory capture. The sectors in which Ben Ali firms

were active (such as telecoms, air and maritime transport, commerce and distribution, financial sector, real estate, and hotels and restaurants) are disproportionately subject to restrictions on entry (prior government authorization) and foreign investment. Moreover, the performance of

firms connected to Ben Ali's family is significantly stronger when they operate in these highly regulated sectors—which likely reflects the fact that these areas are subject to administrative discretion and thus cronies can more easily capture rents (see Chapter Three). Put simply, constrained competition allowed more rents to accrue to Ben Ali firms. In the absence of these regulations, performance differences between Ben Ali firms and others were much smaller, absent altogether, or even negative.

Further, the proliferation of regulation may be in itself a consequence of corruption. The Tunisian experience shows that well-intended interventionist industrial policy was captured by the cronies of the former president. In fact, the evidence suggests that the state allowed a significant part of the private sector to be appropriated for the regime's own rent seeking by ring fencing family-connected companies from regulations or giving special advantages to those firms. More perniciously, we also found evidence that the regulations themselves were in fact being adjusted in response to personal interests and corruption (see Chapter Three).

The problem of crony capitalism is not just about Ben Ali and his clan—on the contrary it remains one of the key development challenges facing Tunisia today. Due to data limitations the analysis presented in this chapter has focused only on the firms confiscated from former president Ben Ali and his family, as opposed to all firms with cultivated connections. Hence, our estimates are probably best interpreted as a lower bound on the importance of political connections. In fact, the Ben Ali clan owned only a fraction of the firms operating in markets protected by barriers to entry, such that other firms operating under these regulations continue to benefit from these privileges. At the same time, most Tunisian businesses and unconnected firms continue to suffer because they face barriers to market entry and their efforts are stymied by the unfair advantages enjoyed by privileged firms.

The consequences of this use of regulations to extract rents (that is, to appropriate wealth) are much worse than just the cost of the corruption. Consumers pay monopoly prices. Firms have no incentive to improve product quality. And the productivity gains and innovation that would come from new firms are halted. In other words, it undermines the competitiveness of the economy, hampering investment and the creation of jobs.

Further, these regulations also perpetuate social exclusion, as unconnected Tunisians face very limited economic opportunity. A few people who have access to those in power and in the administration can capture these benefits, while those who do not have those contacts are excluded from the economic system. Hence, this system generates deep social injustice and is at the root of the frustration of most Tunisians who felt and feel excluded from economic opportunity.

The weak performance of the financial sector in part also reflects the misuse of public assets and institutions by cronies. Tunisia's financial sector has been unable to perform its role as catalyst and has failed to allocate resources toward the most productive activities and projects in the economy, often to the advantage of cronies. The governance failures affecting the large state-owned banks effectively undermine competition in the banking system and result in weak performance and inefficiency in the channeling of funds from lenders to businesses. Tunisian banks funded businesses linked to the family of former president Ben Ali to the tune of 2.5 percent of GDP (that is, the equivalent of five percent of all financing by the Tunisian banking sector). Further, nearly 30 percent of the cash was provided with no guarantees of repayment¹⁰. Such governance failures are at the root of the large percentage of non-performing loans (NPLs) on banks' balance sheets and contrasts with the fact that Tunisian firms report substantial difficulties in accessing credit from banks—as mentioned above, it is regarded as a major

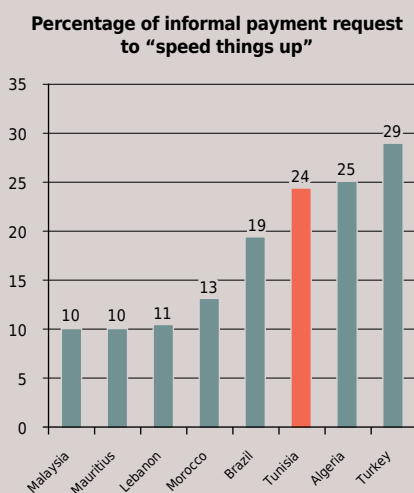
constraint by 34 percent of firms. In fact, while cronies have had unrestricted access to credit (at convenient rates and low collateral or guarantees), ordinary businesses struggle to gain access to finance. The outcome is a significant cost to the country both directly in terms of accumulated losses in public banks (estimated at between three to five percent of GDP as of the end of 2012; see Chapter Five) and indirectly by reinforcing the anticompetitive environment for the private sector (see Chapter Six). Inadequate bankruptcy procedures exacerbate these problems because they enable inefficient firms to survive (instead of having to restructure or exit), thereby slowing down the success of productive firms and the rechanneling of resources toward more productive uses—thus contributing to the structural stagnation discussed above (see Chapter Six).

The large debt problem of the tourism sector is emblematic of these financial sector failures in Tunisia. Tourism accounts for over 25 percent of total NPLs. The detrimental role of public banks tended to both mask the problems in the tourism sector and contribute to them by channeling credit to less productive entrepreneurs and by freezing liquidity that would otherwise have circulated in the sector (see Chapter Six). The heavy weight of debt on many hotel borrowers has led them to give short shrift to renovation and to operational necessities, further continuing the downward spiral in quality and prices that has hurt the whole sector—such that revenues and employment in the tourism sector have been stagnating, if not decreasing. In addition, an increasing percentage of hotels have stopped repaying their debts. This enables them to unfairly cut prices and undermines the profitability of better performing hotels, accelerating the downward price and investment spiral and exacerbating the problems of the sector. More recently, political instability and security concerns have pushed the sector into a severe recession with tourism revenues falling by about 40 percent in 2011. Indeed, out of the 850 hotels, it is reported that one-third went into severe financial distress in 2011. As a result tourism NPLs increased even further since the revolution.

The room for discretion in administering the web of regulations further encourages corruption, which undermines economic initiative and good performance. The prevalence of corruption “to speed things up” in Tunisia is among the highest in the world by international standards. More than a quarter of all firms in the World Bank 2014 Investment Climate Assessment declared they have to provide some form of informal payment to accelerate some form of interaction with the administration (figure 11.11). The prevalence of corruption associated with the regulatory burden points to the importance of discretion and arbitrary application of the rules (see Chapter Four). Hence, in addition to the direct costs, the excessive regulatory environment also stifles competition by allowing inefficient firms to gain unfair advantages via privileges and corruption. These practices have a cost that goes beyond the corruption itself—they prevent the success of the best-performing firms and thereby lower the performance of the entire economy.

Tariffs and tax evasion also give a strong unfair advantage to the (larger and) better-connected firms. This problem appears to be most prevalent in the customs and tax administrations, suggesting these

Figure 11.11: Percentage of Informal Payment Requests to “Speed Things Up”



Source: World Bank (2014e).

services require significant regulatory simplification and reform (aiming to reduce the room for discretion). We find strong evidence of discretionary implementation of customs regulations and tariff evasion. According to our estimates, such tariff evasion results in an annual revenue loss of at least US\$100 million (approximately 0.22 percent of GDP; see Chapter Three). Moreover, we estimate that import-monopolists (that is, firms that are the only ones importing particular products) on average under-report in the magnitude of 131 percent relative to firms that do not. Corruption in customs is well known to be one of the key mechanisms by which cronies were able to reap rents. As shown in the report, however, there is strong evidence that these problems may even have gotten worse since the revolution (see Chapter Three)¹¹.

11.4 / Tunisia is Now at a Crossroads

The January 2011 revolution largely reflects the failures of Tunisia's past economic policies. The discussion above has highlighted that Tunisia's economy appears to be stuck in low-productivity activities, largely assembling exports for France and Italy; and it lacks a dynamic environment where productive firms can thrive and grow and create jobs. This situation is largely the result of well-intended, but misguided, economic policies that have failed to achieve the goals for which they were introduced. Indeed some aspects of these policies actually exacerbate the problems because they encourage economic activity along the coast and make it challenging for Tunisian firms to move beyond assembly tasks and other low-value added activities. Further, the current policy architecture is largely the result of cronyism—it supports a system based on privileges at the expense (and exclusion) of those lacking significant political connections.

Tunisia does not have to follow this model. In fact, a door is open for Tunisia to turn to a new page. There is a need for a different approach to achieve the objectives. It is clear that Tunisia's development issues go beyond the gradual reform proposals so often put forward under the previous regime. Marginal changes to the economic policies will not be sufficient to address the deep dysfunctions of the economic model discussed above. In fact, the frustration expressed in the revolution reflects a demand by Tunisians for radical changes to the socioeconomic system. The post-revolution transition represents a unique opportunity for Tunisians to revisit their economic system and agree on bold changes to open up economic opportunity to all Tunisians, accelerate shared growth, create quality jobs, and promote regional development.

Tunisia is at a crossroads of values, norms, and beliefs—it needs to debate and choose a vision for society that will then largely determine the economic policies in the next decades. Tunisians can choose to continue with the same state-led, rent-prone economic model, or they can choose to take the path of other upper-middle Income-countries (which have performed much better than Tunisia over the past two decades) in favor of real integration into the global economy. This requires a national social dialogue to discuss how to create a healthier economic environment that can promote investment and enable firms to increase their productivity, be competitive, and thereby accelerate creation of good quality jobs. In contrast with the past, the new model should eliminate privileges, open up economic opportunity to all Tunisians, and increase prosperity across the country. At the same time, Tunisians need to decide what level of redistribution may be appropriate to share fairly the benefits of economic growth and to ensure that no one is left behind. It is clear therefore that the choice facing Tunisia is not merely an issue of economic policies. It is first and foremost a societal one.

This report is intended as a contribution to this dialogue. It provides an assessment of Tunisia's development policies and articulates a vision for a different development mode—to move Tunisia from a system based on privileges to one based on competition, one which can bring good quality

jobs and prosperity to all Tunisians¹². Several other books and studies have been published in the past few years that also provide a rich contribution to this debate (see, among others, Achy 2011; Meddeb 2011; AfDB/MCC/MDCI 2013; and Jouini 2014).

A new economic model will require an active and crucial role for the state. It is important to clarify that this debate is not about reducing the role of the state—the role of state, however, needs to be different in order to support, rather than impede, the private sector. In Tunisia, the policies pursued by the state have failed to reduce unemployment and foster the creation of good quality jobs, they have undermined the ability of competitive firms to grow and climb up the value added ladder, and they have not reduced regional disparities. The ample literature on market failures shows that the state has a critical role to play in enabling the operation of markets and fostering a competitive private sector, as well as being responsible for an effective social protection policy for the poor and vulnerable. The challenge therefore is to move from a paternalistic state, which breeds inefficiency and has given rise to cronyism and privileges for the elite, to a system where the state is focused on leveling the playing field, enabling private initiative (across the country, not just along the coast), and effectively supporting the poor and vulnerable.

Changing the development model will not be easy, however, as it requires pushing against entrenched interests and inherent resistance to change. In every country there is resistance to implement significant change. First, the privileges and rents associated with the current system are deeply entrenched and those lobbies will argue strongly against any changes that remove their privileges. Second, the Tunisian administration has not changed with the revolution and remains deeply averse to change, both because of fear of the unknown and because of the natural difficulty for human beings to change their beliefs, even in the face of the evidence of failure (in fact the impasse of the current economic model is at the root of the revolution). These forces will push Tunisia toward only incremental changes. This is not sufficient, however, to meet the expectations of the Tunisians. Without deep economic reforms Tunisia runs the risk of settling back to the moderate level of growth experienced over the past two decades under Ben Ali and never realizing its full potential.

In fact, the gradualism of economic reforms, so much cherished by Tunisia's policy makers and administration prior to the revolution, poses a risk to Tunisia's future. Tunisia's inability to profoundly reform its economic system was at the root of the revolution in January 2011. There is now a real risk for Tunisia to settle back to the prerevolution economic status quo, with just marginal modifications to its development model. As shown by the experience of the past decade, incomplete reforms, or marginal changes in the economic model, will not be sufficient—tackling the challenges of graduate unemployment and fostering development in lagging regions will require Tunisia to transform its economic environment. In January 2011 Tunisians surprised the world with the audacity of the revolution that removed Ben Ali from power. Similar audacity is required in the economic reforms.

It is critical that reforms be undertaken quickly, as they will take time to take effect and bring results. Three years after the revolution, however, the economic system that existed under Ben Ali has not changed significantly—and the demands of Tunisians for access to economic opportunity are far from being realized. Profound changes in the economic environment are difficult to implement in practice, and therefore there will necessarily be a lag from the adoption of new policies to their effective implementation on the ground. It is urgent to accelerate this process because these reforms will take time to take effect and accelerate jobs creation and inclusive growth.

The policy infrastructure inherited from the Ben Ali era perpetuates social exclusion and invites

corruption. With the revolution Tunisians have freed themselves of former president Ben Ali and the worst of corruption, but the economic policies remain largely intact and prone to abuse. Cronyism in Tunisia is a widespread phenomenon that predates Ben Ali's presidency and permeates private sector environment—and arguably a large share of the private sector has benefited from the system to different degrees. Hence, it would be a mistake to assume that, following the departure of former president Ben Ali and his family, cronyism and rent seeking have disappeared in Tunisia. In view of the legacy of corrupted state-business relationships, it is essential to rapidly remove barriers to market entry and reduce the room for regulatory discretion. Most of the needed reforms are politically sensitive and therefore can be politically motivated or manipulated. Time increases the risks that vested interests will capture existing opportunities for rent seeking and be in a stronger position to prevent change.

11.5 / The Future: A Policy Reform Agenda to Realize Tunisia's Full Potential

This report argues that, to become the “Tiger of the Mediterranean,” Tunisia needs to create an economic environment that facilitates a structural transformation of the economy by removing distortions and promoting competition. By documenting the symptoms of stagnation, this report underscores the importance of reforming the policy environment to remove distortions and barriers to market access that undermine productivity growth and ultimately jobs creation. To unleash private sector growth, the focus needs to be on promoting competition and removing barriers to “creative destruction.” It is critical to promote entry of new firms, especially of large firms, and remove constraints to firms' growth to enable small firms to grow large.

This report outlines a vision for a new economic model in which firms' productivity is the basis of their competitiveness and a level playing field enables the most productive firms to be successful and create good jobs. As discussed above, Tunisia's competitiveness in the past has been based on its cheap labor. However, salaries have increased substantially since the revolution and are likely to continue to do so reflecting the natural process of economic development. This further underscores the need for Tunisia to move from a model in which competitiveness was based on low wages to a new economic system that enables firms to be competitive based on their productivity while ensuring an equitable sharing of the benefits of growth.

To achieve this goal it is essential to create a level playing field by opening up the economy and removing Tunisia's three dualisms, namely the onshore-offshore division, the dichotomy between the coast and the interior, and the segmentation of the labor market. In addition, trade policy, industrial policy, agricultural policy, and the policies regulating the services sectors should support a favorable environment for growth, by avoiding distortions and enabling competition. A strong social policy is also necessary, of course, and should be designed in such a way as not to interfere and undermine the operation of private sector. In sum, a series of deep economic policy reforms is required to transform the Tunisian economy and enable it to take off. In addition to preserving macroeconomic stability (which requires reforms to control public expenditures and increase public investment, not discussed in this study), changing the dynamics of the economy will require a package of ambitious economic reforms. A reforms agenda in line with this vision is outlined below as a contribution to foster a national debate in Tunisia.

A first series of economic reforms should focus on removing barriers to market entry and competition, and reforming the financial sector. Adopting policies to better protect the poor and vulnerable are also part of the priorities:

Opening up to competition, leveling the playing field, and removing the onshore-offshore duality

Removing the barriers to entry and competition would substantially improve the performance of the Tunisian economy and boost the ability of the most productive firms to grow and create good quality jobs. The removal of barriers to market competition should be gradual, starting with backbone services sectors and sectors with high potential for jobs creation, notably commerce, telecommunications, transport, health, and education, to considerably open up investment in these sectors (see Chapter Two and Chapter Eight). These reforms should aim at favoring a competitive level playing field that encompasses unrestricted firm entry and competition and is a necessary condition for achieving and sustaining increases in productivity, innovation, employment, and welfare. The gains from higher competition in Tunisia would be considerable and result in faster jobs creation. There is ample empirical evidence internationally on the substantial benefits of allowing greater competition. Our empirical analysis in Tunisia found that a five-percentage point decrease in firms' profit margins (driven by greater competition) would translate into additional GDP growth of around 4.5 percent per year and approximately 50,000 new jobs per year (see Chapter Two). Increasing competition to reduce firms' market power therefore would give a significant boost to reduce Tunisia's unemployment. Further, the sectors that would benefit the most are the backbone services (such as telecoms, transport services or professional services), which are particularly important for the overall competitiveness of the economy (as they are intensely used as inputs in value chains) and in which Tunisia has great export potential (see below).

There is also a need to reform the competition law and the public procurement system, which are pivotal for increasing the competitiveness of the domestic (onshore) sector. The Competition Law and regulations should be revised to lessen the scope for inefficient state intervention in markets, which are currently undertaken through price administration, legal monopolies, and discretionary granting of exemptions and provision of state aids, notably for public enterprises (see Chapter Two). In addition, the revisions should move toward a single, independent, and effective authority capable of enforcing the law as well as coordinating with other government entities and sector regulators to achieve certainty regarding the effects of competition policy in the market. Improvements to the antitrust framework should complement measures to reduce restrictive product market regulation. A more effective competition policy framework should also guarantee competitive neutrality between private and public companies and among private firms. Such reforms would foster a more predictable and transparent business environment leading to greater investment and jobs creation (see Chapter Two). Also, public procurement is considered as a leverage of the national economy to the extent that it represents more than 18 percent of the gross domestic product. It's also an essential instrument of implementing the fiscal policy given that almost 50 percent of the country budget is dedicated for procurement. A reform of the public procurement system was approved in early 2014. Following the initial year of implementation, it will be important to assess whether the public procurement system still suffers from complex procedures and lack of transparency, and whether any technical gaps prevent the new procedures from functioning effectively (for example, lack of databases, archiving and statistic compilation system, lack of integration of new technologies in the procurement process, and so on).

The government should also revise the Investment Incentives Code to progressively eliminate the onshore-offshore dichotomy and level the playing field to boost investment and jobs creation. The duality introduced by the IIC is at the heart of many of the failed development outcomes that Tunisia is experiencing today. It is important to substantially open up market access to investors, and to align the procedures to those used for sectors and activities that do not require authorization—in other words there is a need to make the onshore more like the offshore, and not vice versa. In

addition, reform should remove the onshore-offshore dichotomy. Reducing the generosity of the incentives is also justified, as the incentives are very expensive compared to their limited impact (see above and Chapter Four)—and of course there appears to be ample scope to drastically simplify the system by removing incentives of little or no use (which, however, are expensive in terms of readability and administration). The ongoing reform of the Code has made some progress, but the fundamental problems have not been addressed. An ambitious overhaul of the Code to create an open and investor-friendly economic environment with a competitive tax rate and simple and transparent procedures would go a long way toward increasing investment and jobs creation in Tunisia. The experience of Asian countries in adapting their investment incentive policies can be of relevance to Tunisia (see Chapter Four).

The reform of the Investment Incentives Code needs to proceed hand in hand with the reform of the corporate tax policy because the duality is largely caused by the dichotomy in fiscal regimes between onshore and offshore firms. The reform of the tax system should focus on broadening the tax base and reducing the corporate tax rate for all firms to eliminate distortions in the economy, improve tax fairness, and improve compliance. A convergence to a single corporate tax for both onshore and offshore regimes, which could be set around 15 to 20 percent, would ensure that Tunisia remains competitive while reducing distortions and removing the dualistic economic structure, and maintaining revenue neutrality (see Chapter Four). Existing incentives already granted should be grandfathered. Hence, there would be no immediate revenue gains from the elimination of incentives from the offshore firms. The sharp reduction in corporate tax rates will lead to an immediate drop in tax revenue from the onshore firms that the government cannot afford; therefore, to neutralize the erosion of the tax base, it would be necessary to introduce dividend taxes. Convergence to a single corporate tax rate of around 20 percent would allow, in parallel, reduced social security contributions (as discussed below), thereby incentivizing employment creation. The entire Tunisian economy would remain more competitive than regional peers. Such a reform of the corporate tax system would reduce the existing distortions, significantly improve the investment rate of return (IRR), thereby triggering private investment, eliminating or reducing the bias against equity, and stimulating the demand for labor, which in turn would have significant multiplier effects on the economy as a whole. It should be noted that part of the attraction of the offshore regime is linked to the light regulatory burden. Hence, a key part of removing the duality needs to be to simplify the regulatory burden with a view to making the onshore sector become more like the offshore (by aligning the investment procedures to those used for sectors and activities that do not require authorization, drastically reducing the bureaucratic burden and lowering the tax rate across the economy).

It is important to consider the reform the tax system in its entirety. A comprehensive assessment of the tax system has been prepared by the IMF in 2012 (IMF 2012). There are significant aspects of the Personal Income Tax and VAT that are also in need of urgent reform. Most notably, the Regime forfaitaire, which is supposed to provide a small flat tax for micro firms, appears to be severely abused with 98 percent of tax payers hiding behind this flat rate scheme (for individuals with turnover below TND100,000). The reform of the Regime forfaitaire to reduce the room for its abuse would increase tax compliance and reduce the regulatory bias toward small-scale production (See Chapter Four; and IMF 2012).

Finally, there is a need for a drastic simplification and reduction in the number of regulations to free up economic initiative and reduce costs to firms. As discussed the heavy regulatory burdens cost the private sector approximately the equivalent of 13 percent of revenues, and the room for discretion in their implementation opens the door to corruption and cronyism. Notably, it is urgent to improve the operation of the customs and the tax administration, and also the administration of the land offices and the land registry. Hence, this is an area where substantial gains can be made to improve the business environment and make firms more competitive. A drastic simplification

of the pool of regulations hindering private sector activity with a view to reducing the room for discretion in their implementation is critical to improving the private sector environment in Tunisia and increasing investment. This is not, however, an easy task; international experience has shown it requires ruthless determination. The experience of several OECD countries, for instance The Republic of Korea and Mexico, provides an example of how this can be achieved successfully—notably, these experiences show that in order to maximize the success of the regulatory simplification efforts it is essential to empower the private sector to play an active role in highlighting all the procedures that are costly and unnecessary (see Chapter Four).

Reforming the financial sector

Reforming the banking sector will enable resources to be channeled to the most productive projects and increase the quantity of financing available to the private sector for investments. Better performance in the banking sector could increase the level of credit to the private sector by at least 10 percent of GDP, which could generate in excess of US\$10 billion in additional investments to be injected in the economy over the next 10 years, corresponding roughly to an additional 38,000 additional jobs per year (Chapter Six). To improve the efficiency of the banking system, priority should be given to strictly enforcing bank regulation, revising the procedures to deal with banks in financial difficulty, and restructuring of state-owned banks (SOBs). Notably there is a need to strengthen regulation (in particular in loan classification and provisioning) and supervision for the Central Bank of Tunisia (CBT) to effectively control all credit institutions and to impose stricter sanctions for violations of prudential rules. In addition, competition could be strengthened by removing the limitations on the interest rates charged on loans, which currently artificially restrict access to credit. More important, it is essential to reconsider the role of the state in the banking sector, which long served as a tool for rents extraction and crony capitalism, and to engage in the restructuring of public banks. There is a wide range of restructuring options, spanning from privatization to the merger of the three SOBs into one major public entity. As part of this decision it will be important to consider the governance structure of SOBs, such that they are subject to the same rules and regulations as private banks. Reforming SOBs would avoid the rebuilding of new NPLs and losses (Chapter Six; IMF and World Bank, 2012).

There is also a need to help develop alternative sources of finance and effective financing windows and instruments for innovative projects and start-ups. Domestic financial markets only a marginal role in financing Tunisian companies. In 2010 the share of capital raised on the domestic market accounted for only two percent of GDP and market capitalization stood at 24 percent of GDP in 2012¹³. The main reasons for the weakness of domestic capital markets have been identified in the Financial Sector Assessment Program report (FSAP) as weak domestic demand, lack of yield curve, and lax enforcement of prudential banking regulation (IMF and World Bank, 2012). In this regard, the weak banking regulatory and supervision framework results in an underestimation of risk that allows Tunisian banks to provide companies financing conditions below those that would prevail in a healthy and competitive market where risk is properly assessed. In addition, there is a need to develop effective financing instruments for start-ups and risk projects, in order both to facilitate entry of new firms and to facilitate development of higher technology investment projects (see Chapter Six).

In addition, a reform of the bankruptcy framework (to more effectively save viable enterprises and enable nonviable businesses to exit the market) could lead to significant benefits for Tunisia. In order to improve debt recovery and thereby strengthen the credit environment and improve confidence between debtors and creditors, the government is also working to modernize Tunisia's bankruptcy regime to more effectively save viable enterprises and enable nonviable businesses to exit the market. This reform should result in a single, streamlined law that addresses business restructuring of viable businesses and fast and efficient liquidation of non-viable enterprises. A more predictable, transparent, and efficient bankruptcy regime will help to better price risk for creditors, maximize stakeholder returns, and retain employment

in viable businesses. It will further encourage information production and sharing that allows financial institutions to price risk more accurately. Moreover, the insolvency regime should facilitate exit and re-entry of entrepreneurs, allowing loans to be repaid to financial institutions in an efficient manner and lent afresh to new market participants. Reforming this regime is expected to strengthen the country's overall credit environment, leading to significant financial gains for the economy. Estimates using the Impact Model (developed by the World Bank to simulate the effects of insolvency reforms) suggest that the reform of Tunisia's bankruptcy regime would result in an additional US\$2.1 billion (or 4.5 percent of GDP) in funds from current NPLs, which if reinvested could generate around 80,000 new jobs (see Chapter Six).

In parallel, resolving the problem of the excessive debt of the tourism sector would help consolidate the banking sector and boost the performance of the whole tourism sector and create more jobs. After considering various options the government is working to establish an Asset Management Company (AMC), which would be granted specific powers to expedite the restructuring of the problem loans in the tourism sector. A significant share of the tourism sector NPLs should be transferred to the AMC and swapped against state-guaranteed AMC bonds. This represents between 150 and 300 hotel units (out of a total of approximately 850 hotels). As a result, NPL ratios will decrease across the banking sector. To successfully restructure the bad loans, the AMC will have to buy the NPLs at a low price. If all these bad assets are transferred, the NPL ratio could decrease from the current 13.5 percent to 10.3 percent. On the sector side, restructured hotels would be able to repay their loans. Those that cannot be restructured will be transformed into other projects (schools, offices, hospitals, residences, and so on) or closed down, such that they no longer undermine the operation of competitive hotels. International experience with AMCs in other countries (Malaysia, the United Kingdom, and so on) has shown that they are difficult to establish and success depends critically on ensuring their complete independence from the government (see Chapter Six).

Protecting the poor and vulnerable

Arguably a prerequisite to all the reforms discussed above is the reform of Tunisia's social protection system, which needs strengthening in order to effectively protect the poor and vulnerable and to improve its equity and efficiency. The social security system in Tunisia currently fails to protect the poorest and paradoxically largely benefits the better off, thus exacerbating inequality and social tension.¹⁴ The current model relies mostly on untargeted food and fuel subsidies, which are expensive and inequitable—because the largely benefit the rich.¹⁵ Also, in tandem with international food and fuel prices, the fiscal cost has increased rapidly in recent years, reaching seven percent of GDP in 2012.¹⁶ Combined with the fiscal losses of the social security funds (pensions and health insurance), as discussed above, this has highlighted the need for an urgent comprehensive reform of the social security system in Tunisia. The experience of social protection programs in Brazil and Mexico, and several other countries all over the world, has shown that well-designed social protection programs can foster inclusive economic development. The reform of the social protection system (including the fuel and food subsidies) is not discussed in this report, as it is the subject of a recent dedicated study *Towards Better Equity in Tunisia* (World Bank 2014f).

A reform of the subsidies system would require prior adoption of a system of social protection to shield the vulnerable households from the effects of the reform. Subsidy reform generally should proceed hand in hand with a package of mitigating social measures to protect the poor and vulnerable, and also possibly targeting subsidies or transfers to certain sectors, tax credits or preferential energy prices, or wage and employment support to vulnerable workers. Based on the experience of Brazil, Chile, the Dominican Republic, and Chile, the social measures will reduce the impact of reforms on households, especially new temporary assistance programs or cash transfers targeted to vulnerable households through the banking system or money orders. In the case of Tunisia, the compensation money transfer is considered by many stakeholders as the best option for reasons of efficiency

in terms of administration and transparency. Tunisia already has in place a national cash transfer system (Programme National d'Aide aux Familles Nécessiteuses (PNAFN); and, while this program suffers from large errors of inclusion (of non-poor) and exclusion (of poor) (see World Bank 2014f), it is possible to improve its targeting, building on extensive international experience and modern technologies. Strengthening the PNAFN program can be readily done, with a view to ensuring transparency and good governance of any new targeting method.

In fact the reform of the subsidies system should be used to introduce a strong and well-targeted social protection system that can ensure that no one is left behind. The savings realized from a subsidy reform can be reallocated to cover the necessary budget transfers to protect vulnerable households and support critical economic measures (see World Bank 2014f). The cost of a program to support vulnerable households, including workers, will depend on the number of targeted households and the amounts of transfers. Clearly, the larger the number of households that receive social assistance or industries that are supported during the transition, the smaller the availability of resources for public investment (or tax measures) will be to strengthen long-term growth. The Ministry of Social Affairs (and specifically the Centre de Recherche et d'Etudes Sociales, CRES) is leading an assessment of social protection programs, including social assistance and social security, and preparing an integration strategy for social protection systems that should form the basis for an overall reform of the system.

A second series of economic reforms should focus on eliminating the dichotomy in the labor market and strengthening the social security system, reforming the education system to improve quality, revising the industrial policy to support productivity and innovation, unleashing the potential of the services sectors and of the agricultural sector, and adopting policies to mitigate regional disparities:

Eliminating the dichotomy in the labor market and strengthening the social security system to protect all workers

A comprehensive labor market reform could be the outcome of the national social dialogue launched in 2012-2013. Building on the process started by Tunisia with the tripartite social dialogue and the signing of the new Social Pact in January 2013¹⁷, it should be possible to agree on a comprehensive package of reforms of labor market rules and institutions that would better protect all workers while giving firms the flexibility required to be competitive and adjust to the changing global markets. Such a system would facilitate firms' competitiveness, and, therefore, greater investment and jobs creation. There is a need to boost labor demand by lowering the tax wedge on labor, while reforming the pensions system to ensure its sustainability. There is also a need to converge the firing rules of open-ended and fixed-term contracts to remove the existing dichotomy, and to remove the existing barriers to investing in higher value added activities by giving firms the required flexibility to be competitive. In parallel, reforms should strengthen workers' protection by providing social insurance against the loss of the job. It is also important to have policies that can actively promote women's participation in the labor force.

A key principle of the reforms should be to link contributions by each worker to the benefits perceived by that worker, and financing explicit subsidies (redistribution) through general revenues. One of the options to reduce the tax-wedge to create more formal wage employment (while addressing problems of financial sustainability—as discussed in Chapter Five) is to link social security contributions to benefits while financing redistribution and transfers to ad hoc programs through general revenues. Alternative options can then be considered to create the necessary fiscal space. As discussed above, the reform of corporate tax could provide fiscal space to finance some of these costs. Essentially, the social insurance system could focus on covering essential risks: sickness, disability, death, old age, and unemployment. As shown in Chapter Five, the total contribution rate to the various programs could be capped at 25 percent (see Chapter Five).

The pensions system should be reformed to ensure fairness, transparency and financial sustainability. In the case of pensions, for instance, the first step would be to define a target for the replacement rate at the statutory retirement age (without a ceiling on the salary used to calculate pensions) and then set the contribution rate that is needed. In the case of a pay-as-you-go system such as the Tunisian, a contribution rate of 15 percent could finance a replacement rate of 50 percent after 40 years of contributions. The second decision is to decide whether to subsidize benefits for those workers who are not able to contribute enough to accumulate a decent pension (to be defined), and to decide how to subsidize these transfers (via general revenues; see Chapter Five).

The introduction of a “loss of employment” insurance and the reform of the severance pay rules would improve workers’ protection and facilitate labor mobility. It is possible to conceive a reform that achieves a lower rate of social contribution and still is able to finance a loss of employment insurance scheme (see Chapter Five). If the payroll taxes to finance other transfers (for instance, training and housing) are removed, and financed through general revenues, there would be room to both increase the contribution rate for pensions and set up a larger loss of employment benefit system. The current unemployment benefit system and severance pay could be replaced by a scheme that offers a higher replacement rate and wider coverage and that reduces distortions in labor markets. As in the case of pensions, the first decision would be in terms of the level of benefits: a replacement rate could range between 50 to 70 percent with duration of three to 12 months. The contribution rate would be set accordingly, taking into account the unemployment rate of the population of beneficiaries. The second decision is about how to subsidize benefits for those workers who are not able to contribute enough.

It is also important to gradually integrate, or at least harmonize, the various social insurance programs while expanding coverage in such a way as to ensure a minimum level of protection for all Tunisian residents. The guiding principle would be that all Tunisian residents, regardless of where they work, would have access to the same system under the same rules. Self-employed workers or wage employees in the agricultural sector, for instance, would also join the current system for private sector workers. Like them, they would benefit from the basic pension and be allowed to make additional contributions. In the case of civil servants, it would be disruptive to integrate them into the scheme for private sector workers and dramatically change their entitlements. An alternative approach would be to set a date when new civil servants would enroll in the schemes for private sector workers. Jordan, for instance, achieved this in 2000 (World Bank 2005).

In parallel, labor regulations need improving to increase protection for fixed-term workers and provide greater flexibility to firms that use open-ended contracts. The basic goals would be to align both entitlements and dismissal rules with international standards. The main recommendations when it comes to the reform of the labor code are to align maternity and annual leave entitlements (with explicit financing by employers and employees) with international standards, while introducing more flexibility in dismissal procedures, extending the benefits that come with fixed-term contracts, and modernizing minimum wage policy. It is important to allow employers to dismiss workers for economic or technical reasons without requiring third party authorization, but while reinforcing controls and penalties for wrongful dismissals. This can be done, if an adequate loss of employment insurance program is put in place, as discussed above. The main condition regulating dismissal would be to provide an adequate advance notice (for example, at least 3 months), a period during which the workers continue to receive their salaries but are allowed to engage in job search activities. In addition, workers should be allowed to present complaints in cases of wrongful dismissal, for instance, those linked to discrimination. Efficient mechanisms should be in place to expedite the processing of these complaints while enforcing penalties on employers found at fault. In parallel, the benefits in terms of social insurance should be extended to fixed-term contracts. The goal, eventually, should be to blur the line between fixed-term and open-ended contracts (see Chapter Five).

Allowing greater flexibility in the setting of industry-wide collective agreements could help investment and jobs creation in interior regions. Wage floors should be negotiated taking into account information about costs of living but also the financial situation of the firms. It may also be appropriate for the agreements to specify regional variations in wages based on the results of the negotiations. Also, in a rapidly changing economic environment, it would be advisable for the CAs to be revisited every two years (compared to the current five years), with the possibility of extension by consent of the parties to the agreement. CAs should apply to employers that are members of employers' association(s), signatories of the collective agreement, but not to those firms who are not signatories of the collective agreement. Notably, there are many small firms that may be unable to afford these entitlements. In fact, it would also be appropriate to consider raising the requirement's threshold to companies with at least 10 employees in which the standard redundancy arrangements, such as a severance pay, apply—thereby lessening the burden on small businesses (see Chapter Five). This approach has been applied in many countries like Germany, Greece, and others.

Reform the education system at all levels to improve the quality of human capital

Improve the quality, efficiency, and integrity of primary and secondary education institutions. The quality of learning outcomes in Tunisia is low by international comparison. Evidence on learning outcomes—as measured by Trends in International Mathematics and Science Studies (TIMSS) among eighth graders and by the Program for International Student Assessment (PISA) among 15 year olds—points to a relatively low quality of education (see Chapter Five). There may be a need for an in-depth independent analysis of reasons for the low effectiveness of classroom learning. Nevertheless, several reports have already flagged the need to introduce a criteria-based assessment of quality assurance in pre-university education. In addition, it is important to adopt mechanisms to strengthen the accountability of teachers and schools vis-à-vis the education authorities and stakeholders, for instance through the adoption of a code of professional conduct, an active school inspection system, and the use of scorecards and community accountability instruments.

Encourage higher education institutions to seek international certification and to pursue partnerships with the private sector. In line with the 2008 law on higher education, there is a need to allow more autonomy in higher education institutions and to favor the partnership with the private sector. In addition, these institutions must improve the selection process to better detect student ability and academic aptitude. Also, it is critical to operationalize the national evaluation and accreditation agency established in 2013, enhance its independence from the Ministry, and more generally promote the adoption of international certification standards. Closer partnership with the private sector is also needed in order to ensure that the curricula correspond to the demand in the jobs market.

Improve the relevance and the quality of the Vocational and Educational Training (VET) system. There is a need to decentralize training centers and also to allow the provision of vocational training by private providers. In parallel, the vocational training should refocus toward a dynamic, knowledge-based economy (rolling out the pilot reforms engaged in the mid-2000s).

Adopt an industrial policy to boost value added and exports

Tunisia's industrial strategy and policies require rethinking. The focus on market access restrictions, fiscal incentives and firm-specific interventions opens the door to rent seeking. The government's focus on promoting specific sectors has diverted attention away from cross-cutting reforms and addressing coordination failures. Beyond the distortions resulting from the onshore-offshore duality, the industrial policy needs to become smarter and place less emphasis on providing blunt subsidies and tax breaks, and more on addressing infrastructure and other regulatory bottlenecks, coordination failures, and other "soft" aspects of the industrial environment (see Chapter Seven). International evidence suggests that the government can play an active role in accompanying the development of high potential sectors through horizontal measures and addressing coordination failures (see Chapter Seven).

Tunisia appears to have a strong competitive advantage to export wage-intensive goods in which comparator countries are losing their competitive edge. The steep increase in wages in a set of relevant benchmark countries reflects a significant decline in their Revealed Comparative Advantage (RCA) in a few wage-intensive industries (that is, intensive in human capital). In addition to services sectors, discussed below, our analysis suggests that Tunisia has an opportunity to successfully develop high-value added segments in several manufacturing sectors (which mostly already exist, but mainly remain confined to low value added), and notably in (a) textile and garment, (b) leather and footwear, (c) electrical industry, (d) chemical industry, (e) glass, iron, metal materials for construction and mechanical industry, and (f) home furniture and sanitary (see Chapter Seven). Tunisia already enjoys a good RCA in several of these industries and could take advantage of the expected shifts in production away from benchmark countries. Notably, Tunisia holds potential in several higher-value added products in the textile and garments and leather and footwear sectors and to expand exports in the mechanic and electric industry. For several of these products, global demand has been consistently growing during the past decade.

In sum, there is no shortage of products for which Tunisia has the potential to become a global leader; however, this potential will never be realized unless the investment climate improves dramatically. The growth of these high potential sectors has, in fact, remained stunted and largely limited to low-value added activities. By and large Tunisian firms have been unable to move past simple labor-intensive tasks to increase value addition in exported products. As discussed in earlier chapters, this is largely because the distortions and costs associated with current economic policies are too high. As discussed above, the duality in the economy, combined with the inefficiency in the onshore sector, has resulted in the lack of backward and forward links and has prevented the development of firms into higher-value added activities. Adopting of a strategy designed to create a knowledge-intensive economy without addressing the underlying obstacles to private sector development—namely the lack of competition, the excessive regulatory burden, the pervasive cronyism, and the profound policy-induced distortions—has resulted in continued dependence on assembly and other low-value added production in Tunisia. Therefore, bold changes are required to remove constraints to domestic production that have impeded the realization of this large potential. Tunisia's successes in the offshore sector show how such opportunities can be seized. That positive experience can now be expanded to the entire economy.

Beyond creating an environment conducive to private sector growth, the government should act to identify and address specific sectoral constraints. Some salient issues have been highlighted in the main report, but it will be important to carry out in-depth sectoral studies to identify any significant coordination failures or other sector specific constraints.

Reaping Tunisia's potential for export of services

Tunisia's high potential in services sectors could bolster the process of structural transformation and become a source of dynamic growth and jobs creation, notably for graduates. Several studies have highlighted that Tunisia holds large potential in export of services, and in today's globalized world services sectors increasingly play a pivotal role for economic development (Khanfir and Visentin 2004; World Bank 2008a; McKinsey & Company 2010; ITCEQ 2010) (Chapter Eight). It is estimated that a comprehensive liberalization of the service sector could boost the growth and investment by one percentage point and would reduce the unemployment rate by 2.4 percent (approximately 90,000 jobs; ITCEQ, 2010). Tunisia should aim to accelerate trade integration and adopt an "offensive" strategy in services sectors in which it has a strong comparative advantage, which implies a significant potential for exports. Several high potential sectors have been identified by previous studies: ICT and offshoring, professional services, transport and logistics, tourism, health services, and higher education.

To reap the potential of services sectors, market access ("liberalization") alone is not enough and needs to be preceded by the reforms of the business environment and competition at large (which have been discussed

above). The sequencing of reforms is key. Accompanying regulatory reforms, sometimes non-trade related, will determine the impact of services liberalization. Trade liberalization should be preceded by the reforms of the business environment and competition at large (discussed above). Opening a services sector to domestic (for example, through privatization or suppression of a public monopoly) and/or foreign competition without paying attention to the domestic regulatory and competition environment could have negative effects—allowing, for example, anticompetitive behaviors and price increases. The government needs to ensure that regulatory reforms are effective to guarantee greater competition and remedy market failures (see Chapter Eight).

Most of the reforms entail opening up the services sectors to competition and should be taken unilaterally in Tunisia's best interest, without waiting for reciprocal trade negotiations. Cross-sectoral and horizontal barriers continue to hamper competitiveness of services sectors in Tunisia. The rent system developed by the old regime has relied heavily on such horizontal barriers that added to the complexity of the regulatory framework and the lack of transparency in the system. The government should focus on restoring legal security and predictability, and take the opportunity of the regional trade negotiations to remove unnecessary horizontal barriers to trade (see Chapter Eight). Regional trade negotiations, notably with the EU, could provide an impetus and help build consensus for the reforms as part of the convergence process but should not become an excuse to delay the unilateral opening of the services sectors, which is in Tunisia's best interest and would lead to greater investment and jobs creation. Regional integration could be conceived as a tool to promote good governance, and its main benefits would reside in the convergence process that would help restore a transparent, secure, and predictable regulatory environment as well as sending a strong signal to potential investors. The Advancing Tunisia Global Integration Study (World Bank 2014h) presents a detailed discussion of the most urgent horizontal and sectoral policies reforms needed in key services sectors.

Unleashing the potential of agriculture

The current system of state intervention has repressed the agricultural sector, distorting production away from Mediterranean products in which Tunisia has a natural comparative advantage toward continental products in which Tunisia is not very competitive but which are key to food security. Current agricultural policies pursue self-sufficiency in cereals production in order to ensure food security. Clearly food security cannot be put at risk: nevertheless, ensuring food security should not be synonymous with pursuing self-sufficiency in grains production. A prerequisite to agricultural policy reform is to put in place a food security policy that does not undermine the development of the agricultural sector in Tunisia. Several options exist to put in place a food security policy that does not run against the development of the agricultural sector in Tunisia (see Chapter Nine).

Tunisia could take advantage of the existing opportunities to export agricultural products to the EU. Tunisia uses only a small fraction of its available export quotas for fruit and vegetables to the EU. Instead of taking advantage of this export opportunity, Tunisia subsidizes or protects products in which it does not have an advantage and which continue to be heavily protected under the Common Agricultural Policy of the European Union, notably cereals, milk, and beef. This largely reflects the weakness of Tunisia's production systems, partly the result of lack of government action to support these Mediterranean crops, notably for olive oil and citrus (see Chapter Nine). For other products, such as tomatoes, the shortfalls in taking advantage of these export opportunities are also due to the fact that the EU import quotas are subject to specific calendars that further restrict their use.

The reform of agricultural policies could unleash the potential of agriculture in interior regions. To enhance the competitiveness of agriculture, a major reform of agricultural policies must be implemented gradually. Once food security policy has been separated, the reform of the agricultural

policy should follow five main parallel priorities: (a) progressively phase out price support and input subsidies and replace them with a system of direct support to incomes that creates fewer distortions; (b) gradually end direct state intervention in the marketing of agricultural products; (c) implement targeted social assistance programs to help the poor and vulnerable citizens directly (and not through agricultural support); (d) significantly invest in and improve the soft and hard infrastructure and services for the agricultural sector, notably by strengthening research and extensions, irrigation, land registry, financing and insurance, and transport infrastructure, which are essential to the growth of agriculture; and (e) simplify the procedures and improve the effectiveness of the public administration (see Chapter Nine). It is important to note that the aim of this reform should not be to reduce the funding allocated to the agricultural sector but rather to ensure that these resources are reallocated toward the most effective instruments for supporting agricultural production—without introducing distortions and without undermining comparative advantage. In turn this would bring higher investment and employment in agriculture.

In fact, removing distortions in markets for agricultural products would result in gains for almost 70 percent of farmers benefitting mainly the interior regions of the country. A previous World Bank study has estimated that farmers benefiting from price liberalization are particularly those located in the driest Central and Southern zones producing sheep and goats, olives, fruit, and vegetables (World Bank, 2009). The “winning” subsectors (mainly breeding, arboriculture, and horticulture) are tradable sectors in which Tunisia could boost its exports without any subsidies, represent together about 60 percent of the agricultural labor force, and are geographically dispersed (see Chapter Nine). Further, as mentioned, the funds saved could be rechanneled to infrastructure (for example, irrigation) and other horizontal measures to boost productivity and support the sector (such as extension services and certification services). These policies are not discussed in detail in this study and should be the object of additional in-depth study (notably including the potential for significant public investments in irrigation).

Reducing regional disparities while enhancing economic growth

The first step to reducing regional disparities should be to level the playing field and adopt economic policies that mitigate, rather than enhance, regional disparities. While regional disparities cannot be eliminated, minimizing them requires a rethinking of Tunisia’s regional development policies. As discussed above, the current set of economic policies (notably the competition policy, the industrial policy with the Investment Incentives Code, the agricultural policy, and labor market policies) have all exacerbated the already higher costs of investing in interior regions and contributed to entrench regional disparities. Adopting “spatially blind” economic policies is a prerequisite for any attempt to mitigate regional disparities. In addition to removing the distortions introduced by existing policies, international experience shows that government should focus on improving the quality of life, access to basic services, and connectivity of interior regions. A brief discussion of key policies is presented below (and in Chapter Ten), but a more in-depth discussion of the challenges related to urbanization and regional disparities is presented in the report Tunisia Urbanization Review (World Bank 2014g).

Government should improve the quality of life and access to basic services in lagging areas. Our analysis shows that factor mobility is not the main impediment in Tunisia’s urban areas, as the differences in returns across and within regions are relatively small (see Chapter Ten). Rather, differences in characteristics drive the differences in consumption both across and within regions. Therefore, extending access to basic services (notably to provide access to quality health and education services) in lagging areas should remain a key objective of government policy. International experience shows that improving the overall quality of life (through the availability of basic social amenities, and public services and infrastructure) is essential to improving services and private sector investments in interior regions. Further, policymakers need to think beyond infrastructure

provision to also consider tariff design and cost recovery, which will extend access while improving service quality. Other countries have seen positive impacts from these reforms. Algeria, the Arab Republic of Egypt, and Morocco have all decentralized administration and reformed tariff programs to increase cost recovery, notably in water provision. Many countries have expanded service provision by charging prices that can cover operating and non-operating costs while guaranteeing affordability (see Chapter Ten).

In addition, the government could better link lagging areas to markets through improvements in connective infrastructure. Investments in infrastructure that facilitate the flow of goods, people, and information between leading and lagging areas can foster economic concentration in leading areas and promote convergence of living standards (World Bank 2008e). This also requires improving the design, execution, and monitoring of public investment projects. That said, in most of Tunisia the key bottleneck does not appear to be a lack of infrastructure. Instead there appears to be a strong need to develop a system of third-party logistics for the co-ordination of trucking operations (following the example of the Indian trucking industry). Improving connectivity in Tunisia requires government action to remove coordination failures and improve the efficiency and competitiveness of the trucking sector (see Chapter ten). These recommendations echo previous World Bank work that points at a need to develop and implement innovative solutions like (a) third-party logistic services (b) specialized infrastructure like logistic zones and (c) regulatory support for implementation of new practices (World Bank 2008; 2012).

It is also important to be aware that fiscal and financial incentives for regional development are not likely to achieve the objectives. International experience shows, and indeed the Tunisian experience confirms, that financial and fiscal incentives to investors are not an alternative for the policies discussed above. The Tunisian experience also shows that incentives are not the solution to reduce regional disparities in economic activity. Since 1993, Tunisian legislation has enabled the government to provide incentives for private investment in lagging areas or priority zones, promulgated in the Investment Incentives Code. These incentives include tax exemptions on profits and a 50-percent reduction on taxable ceilings. Other countries have also attempted to reduce disparities between leading and lagging areas by de-concentrating economic activity or people—and most have failed. Interregional transfers can be used to achieve convergence in living standards; however, resources are wasted when they are instead distributed with the objective of shaping economic activity.

Deepening trade integration

Tunisia has a unique opportunity: it is situated next to the massive market offered by the EU-28 and it has so far only started to scratch the surface of the potential for exports into the EU. As discussed, Tunisia's trade integration has been largely limited to assembling and re-exporting products for France and Italy. The reason for this superficial integration is the nature of the economic policies that have prevented Tunisian firms from climbing up the value added ladder. Most of the reforms to remove existing bottlenecks to greater global integration are domestic ones and should be undertaken from a unilateral basis since they would increase investment and jobs in Tunisia. International and regional trade integration could support this process by locking in necessary reforms. Given the high potential for services exports and the role they play as a backbone for the economy as a whole, there would be large benefits from opening up competition in the services sectors. Improving the competitiveness of services is critical to enabling the manufacturing sector to climb up the value added chain and exploit the opportunities for export to the EU. The reform of the competition framework and of the public procurement system are pivotal to increasing the competitiveness of the domestic (onshore) sector, and thereby enabling exporting companies to rely on local intermediate products and increase value added of Tunisian exports. In terms of strategic orientation, the potential for Tunisia to expand its exports to the EU remains far larger than the

potential in MENA or Africa (see Chapter Seven). Hence, in parallel with a push to foster greater trade integration across the Maghreb, Tunisia should continue to seek deeper integration with the EU-28. Tunisia would also achieve significant gains from a stronger economic integration with Libya, on the condition that key reforms are implemented in anticipation of the progress toward deeper integration between the two countries. However, the magnitude of the impacts remains small compared with other initiatives taken by Tunisia such as its integration with the EU. An agenda for deepening trade integration is discussed in detail in the study *Advancing Tunisia Global Integration Study* (World Bank 2014h).

11.6 / Conclusion

Tunisia is at a crossroads and has a unique opportunity to make radical changes to its economic policies. There is a need for a new vision for the economic development of the country that can be shared by a majority of Tunisians—and that can then drive the nature of the required reforms to the current system. This will require strong leadership to drive a national dialogue on how to create a healthier economic environment—an environment that can promote investment, enable firms to increase their productivity, enable them to be highly competitive in the international arena, and thereby accelerate jobs creation. At the same time this new environment must include a system for sharing fairly the benefits of this growth and ensuring that no one is left behind. This report is intended as a contribution to this dialogue.

Notes

1. Throughout this report we use the terms “development model” or “economic model” interchangeably to refer to the set of socioeconomic policies which regulate the creation and distribution of wealth in a given country.
2. Starting in 1972, Tunisia granted 10 years of corporate tax holiday and tax-free imports of intermediate inputs for firms producing for export, the so-called “offshore” sector. These firms are also largely spared from the suffocating layers of red-tape and bureaucracy that afflict (mainly) the firms producing for the domestic market, the so-called “onshore” sector.
3. Similarly, the percentage of the population below the international US\$2 per day (PPP) poverty line dropped from 12.8 percent in 2000 to 4.3 percent in 2010.
4. Unemployment rose to 18.9 percent in 2011 following the revolution and declined to 15.3 percent as of December 2013.
5. In fact, jobs have increasingly been informal or in fixed-term contracts, which provide no job security, and have translated into an overly high level of turnover.
6. The operation of markets in Tunisia is also constrained by regulatory limitations on the number of competitors in network industries and other business activities and services, which restrict free entry. Network sectors such as gas and electricity, water collection, purification and distribution, and rail transport (infrastructure operation, passenger and freight transport) as well as other sectors such as the tobacco supply chain are legal or state monopolies. In addition, regulatory barriers to international telecommunications and air transport entail de facto monopolies or oligopolies also in those sectors.
7. The weak performance may also in part be a consequence of the structure of the Tunisian banking market. Apart from the large public banks, the rest of the sector is relatively fragmented, which does not allow the economies of scale necessary for the development of highly competitive and innovative banking institutions.
8. The tax wedge is defined as the difference between the total cost of labor, take home pay, and the valuation of social insurance benefits.
9. Economic growth can be thought of as the combination of two dimensions: first, the increase in the quantities of inputs used (or “factor accumulation”), and notably capital, labor and the quality of the labor (which we refer to as “human capital”)—and, second, the efficiency with which these inputs are combined (or their “total factor productivity”).
10. Source: Press statement by the Governor of the Central Bank of Tunisia in February 2011.
11. In addition, since the revolution there has also been an explosion in informal trade with Libya and Algeria, which poses a critical problem of its own. A recent World Bank study estimates that the magnitude of informal trade with Libya and Algeria accounts for seven percent of total imports, which is in excess of TND2 billion (Ayadi, Benjamin, Bensassi, and Raballand 2013). Moreover, this type of trade represents an important part of the bilateral trade with Libya and Algeria, accounting for more than half of the official trade with Libya and for more than total official trade with Algeria. While it is harder to estimate the level of informal trade with Algeria because it is more widespread and clandestine, it is possible to estimate that roughly 20 percent of the fuel consumed in Tunisia is in the form of informal imports from its neighbor. While this makes petroleum more affordable for Tunisian households, total informal trade also leads to a shortfall in revenue for the Tunisian authorities equivalent to a quarter of total customs revenues.
12. The report does not pretend to be exhaustive; there are several important aspects of Tunisia’s development model not discussed in this study (see Introduction).
13. Since the revolution the Tunis Stock Exchange has been much more active and a number of new companies have been floated in 2012 and 2013.
14. The reform of the system of taxation (personal income tax, corporate taxes, consumption taxes, payroll taxes, and trade taxes) also affects the process of redistribution of wealth across people and should therefore be seen as complementary to the social protection system.
15. Fuel subsidies are particularly inequitable, with 70 percent of the benefits accruing to the wealthiest 20 percent of the population (World Bank 2014f)—in fact only seven percent of the benefits from gasoline and diesel subsidies reach the bottom 50 percent of the population. While food subsidies in Tunisia are significantly less inequitable, they still also benefit mostly the rich.
16. Expenditures on food and fuel subsidies increased from approximately one percent of GDP in 2000-2004 to reach approximately five percent of GDP in 2012. Further, as discussed below, a system of hidden cross-subsidies to SOEs (STIR and STEG) masks the full extent of the expenditure on energy subsidies. The cost of these hidden subsidies in 2012 was estimated at approximately 2.2 percent of GDP. Hence, the total cost of subsidies to Tunisia is some 30 percent higher than appears in the budget, reaching over seven percent of GDP (World Bank 2014f).
17. In May 2012, the Government launched a social dialogue process that reached a significant milestone in January 2013 with the signing of a new Social Pact. The Social Pact sets in place principles for launching dialogue on key areas of reform involving social protection, regional development, employment and skills, and governance of social dialogue, namely among the government, the labor unions (as represented by Union Generale des Travailleurs Tunisiens, UGTT), and the private sector (as represented by Union Tunisienne de l’Industrie, du Commerce et de l’Artisanat, UTICA). The dialogue process has been facilitated by the International Labor Organization (ILO).

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Until 2010 Tunisia appeared to be doing well and was heralded by the World Bank and the IMF as a role model for other developing countries, and the World Economic Forum repeatedly ranked Tunisia as the most competitive economy in Africa. Yet, the Tunisian model had serious flaws. Inadequate creation of jobs, notably for university graduates, and deep regional disparities were a source of increasing frustration across the country in the run up to the January 2011 Revolution.

The Unfinished Revolution shows that, in contrast to the façade often presented by the former regime, Tunisia's economic environment was and remains deeply deficient. Extensive barriers to entry and market restrictions coupled with a heavy business regulations and a poorly functioning financial system, have resulted in economic stagnation. Economic policies have exacerbated cronyism and rent-seeking, allowing under-performing firms to survive, regardless of their productivity. As a result, Tunisia's private sector is stuck in low productivity activities and it lacks a dynamic environment where productive firms can thrive and grow.

In the three years since the revolution, Tunisia has achieved significant progress on the political front, culminating in the consensual adoption of a new Constitution. However, the economic system which existed under Ben Ali has not changed significantly—and the demands of Tunisians for access to economic opportunity have not yet been realized.

This book documents how Tunisia could capitalize on a strong competitive advantage to export wage-intensive goods, expand its export of services, and unleash the potential of agriculture, to the benefit of small businesses, young graduates, and farmers in Tunisia's long-neglected interior regions. Realizing these benefits will require improving the investment climate, rationalizing regulations, and developing more equitable development policies that benefit all of Tunisia's regions.

The Unfinished Revolution is a challenge for policymakers to rethink Tunisia's economic development model, to question existing assumptions, and to dare to think big about policy reforms which can accelerate growth and shared prosperity, create quality jobs and promote regional development.