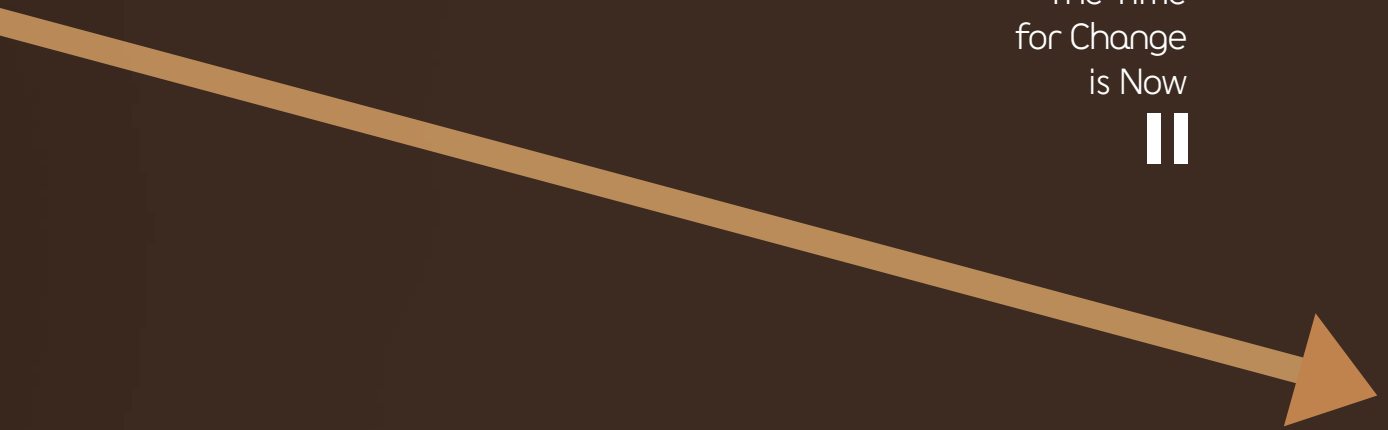




Synthesis and
Policy Recommendations | 11



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.

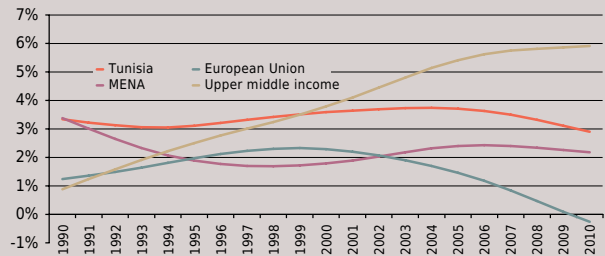
By the late 1990s, however, the economy increasingly struggled to advance, and economic performance remained insufficient. Although Tunisia's real GDP per capita growth since the 1990s was the second strongest in the MENA region, it has remained far below the growth rates observed in other upper-middle-income 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.

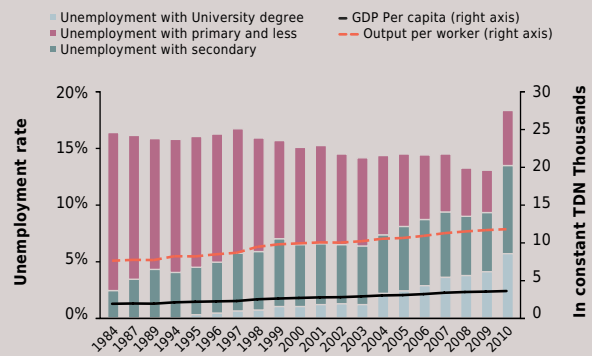
The failure to adapt the economic policies meant that Tunisia never moved beyond creating low-wage jobs. As mentioned, the state-led model was characterized by limited competition and active state intervention. This model worked fairly well for Tunisia initially but, as will be discussed below, increasingly 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.

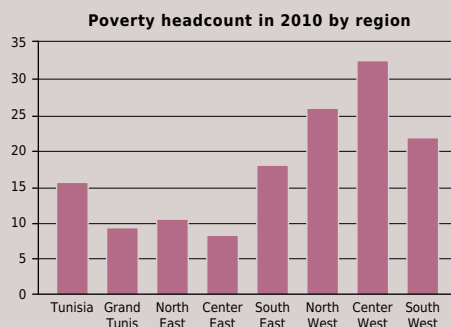
In fact this economic model may have reached an impasse earlier had it not been for the growth of the offshore sector. The relatively open and investment-friendly offshore environment was a magnet for private investment and kept the economy moving and creating some jobs. Nevertheless, the offshore regime 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).

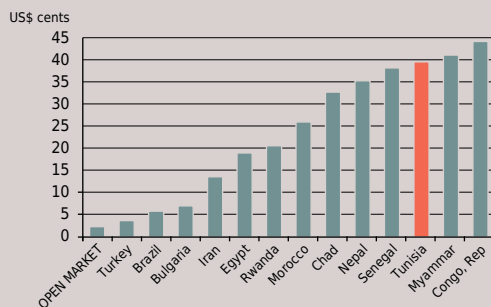
Although this has become the status quo to Tunisians, the widespread lack of competition has far-reaching implications for the performance of the economy. Firms in sectors with restricted entry benefit from rents that arise because the firms face limited competition. These firms remain profitable largely 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.

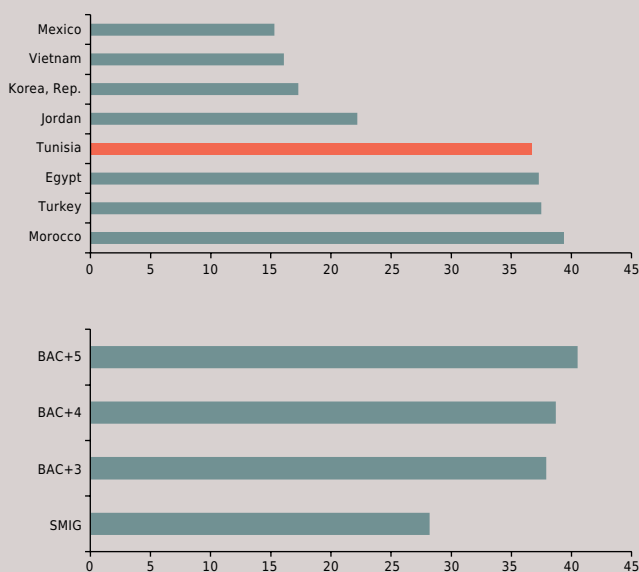
A further area of bureaucratic quagmire extends to land markets, which poses a problem for investors, agriculture, and urban planning. Regulations governing property registration and transactions also make it difficult for poor people to own land and property. For example, it costs 6.1 percent of the 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.

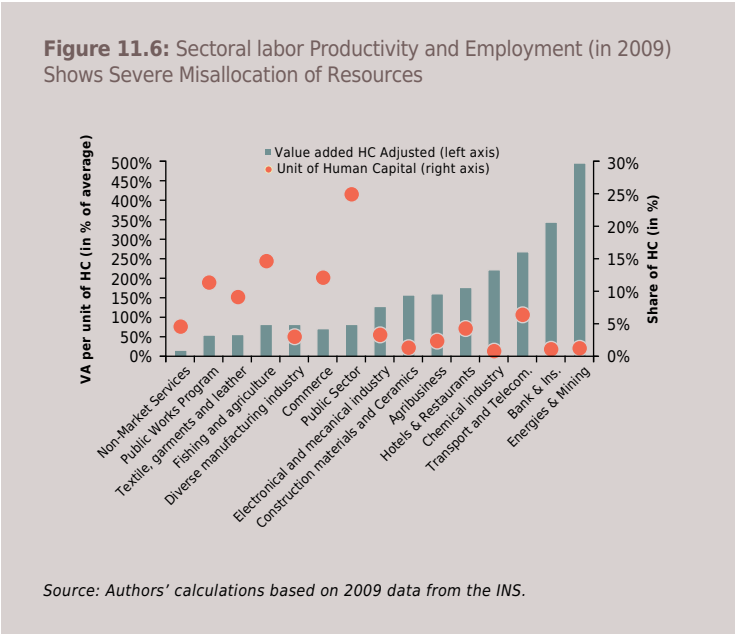
Private Sector Paralysis: Small Firms, Low Productivity, and Limited Jobs Creation

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.

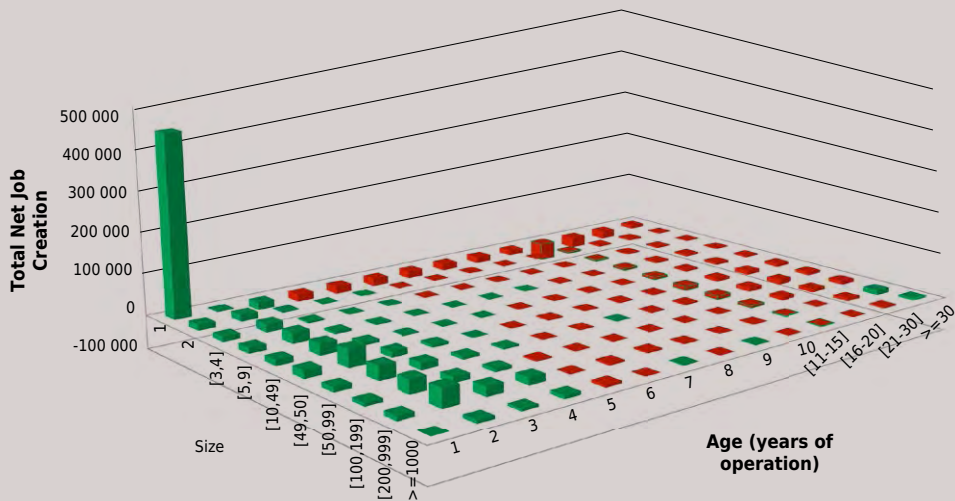
As a result, growth and jobs creation has been very low; and allocative inefficiency—that is, the inability of firms to move toward more productive uses of resources—has persisted over time. In terms of jobs creation, very few firms grow, such that aggregate net job creation has been disappointing (in 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



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.

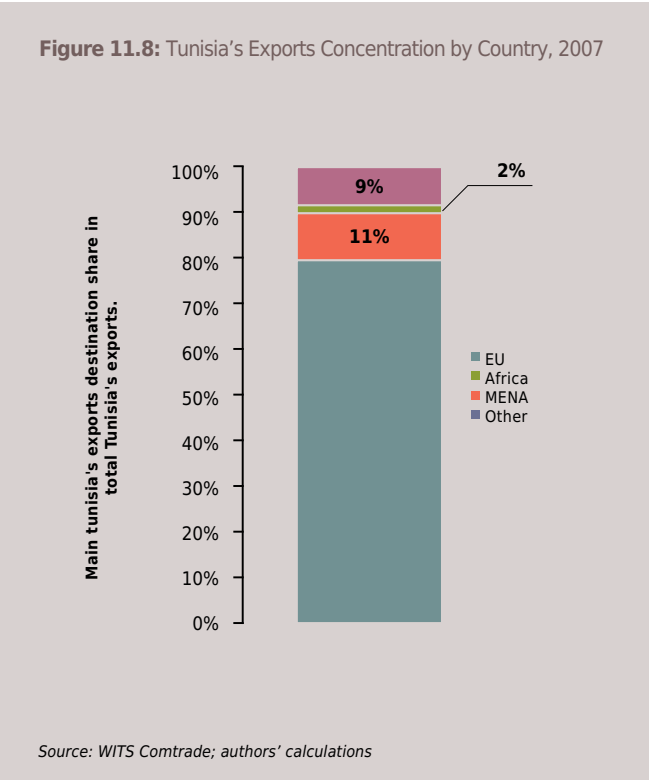
Our results also highlight strong differences in performance between onshore firms and offshore firms, reflecting the segmentation of the economy. The analysis provides evidence for significant duality between firms producing for the domestic market (the so-called “onshore” sector) and firms producing 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.

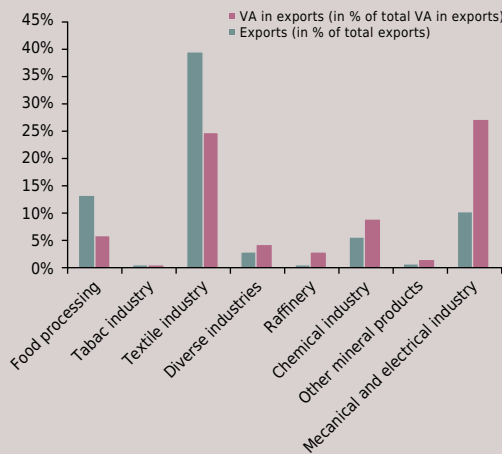


Beyond appearances, therefore, Tunisia’s integration with the global economy remains superficial, both in quantities and sophistication of exports. As a small economy of just over 10 million people, greater integration in the global economy remains critical to Tunisia’s economic success. However, although 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

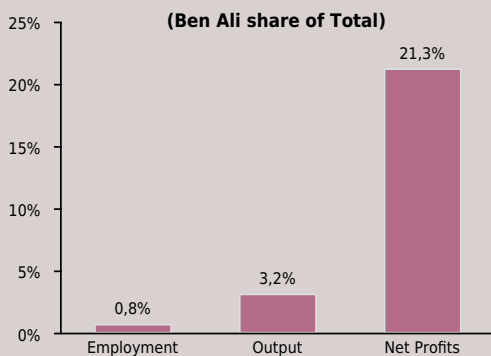
slightly over the past decade. Even this slight improvement in the sophistication (and technology intensity) of exported products is misleading since it largely reflects the assembly of higher-technology products (that is, the finished products exported are more sophisticated, but their technological 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.

Market Regulation Has Become a Smokescreen for Rents Extraction by a Small Elite

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

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

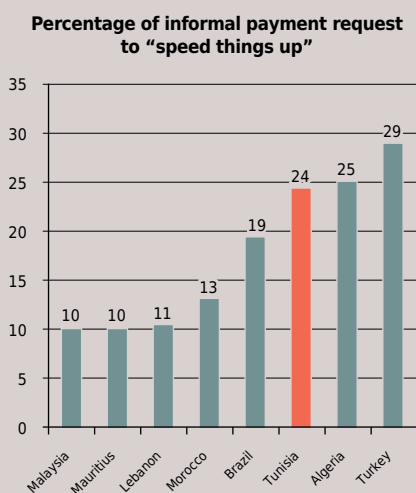
constraint by 34 percent of firms. In fact, while cronies have had unrestricted access to credit (at convenient rates and low collateral or guarantees), ordinary businesses struggle to gain access to finance. The outcome is a significant cost to the country both directly in terms of accumulated losses 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 benefitting 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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