



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



The Regulatory Environment | 04
for Private Sector Investment



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

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

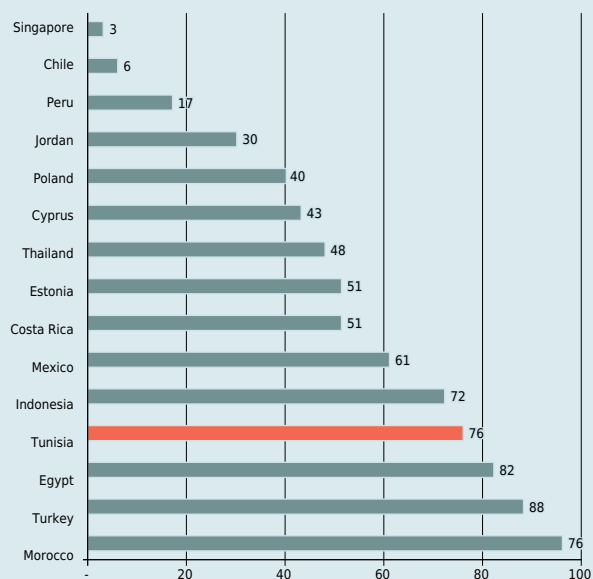
4.1 / Tunisia's Policy Framework for Investment

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

Box 4.1: Chile's Investment Attractiveness

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

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



Source: UNCTAD (2012)

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

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

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

The Investment Incentives Code

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

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

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

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

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

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

Box 4.2: Barriers to Trade between Onshore and Offshore Firms

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

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

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

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

Source: Interviews with UTICA private sector representatives.

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

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

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

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

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

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

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

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

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

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

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

Source : Interview with La Pratique Electronique, April 2014.

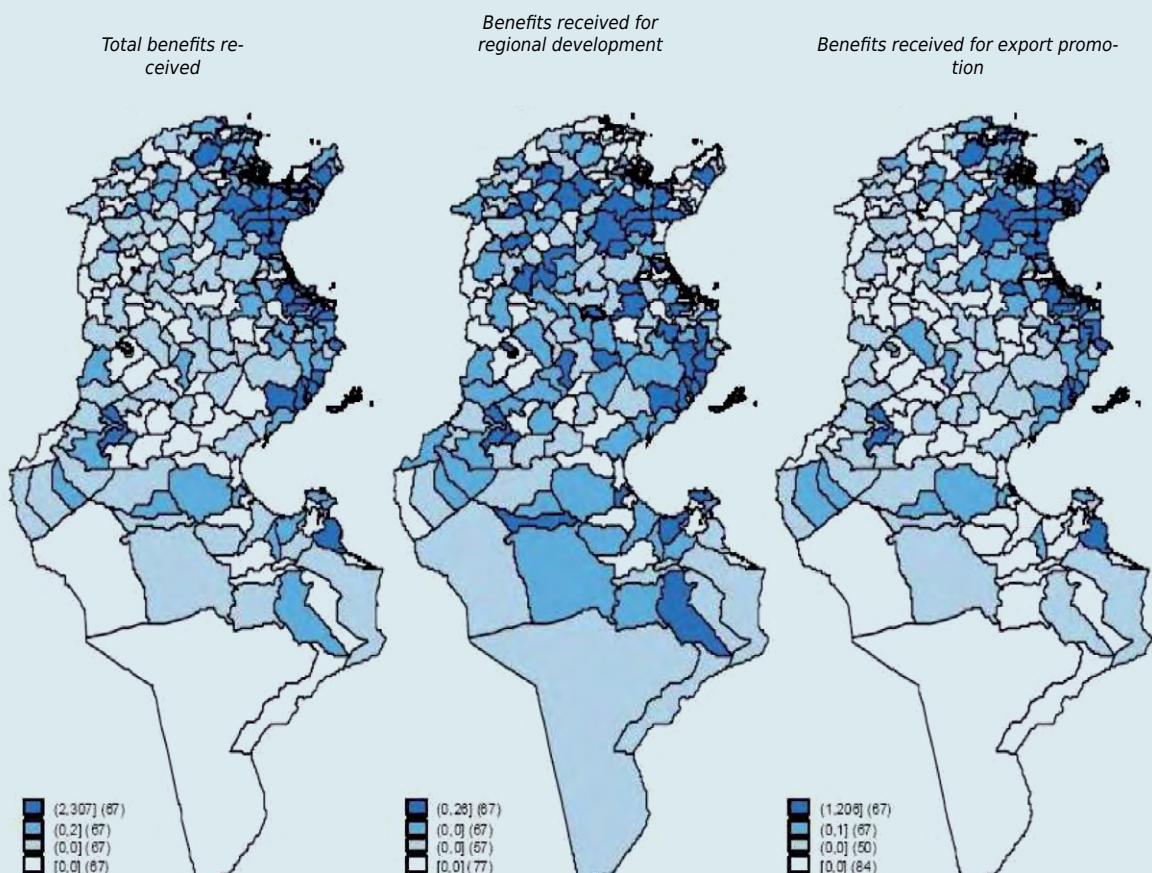
The dual economy model has kept most of Tunisian domestic economy (the onshore sector) highly protected and closed to foreign investors, with resulting loss of growth and jobs creation. Studies of the Tunisian investment climate and regulatory framework highlight that, although most comparable countries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

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

In addition, the generous tax regime for offshore companies has attracted mostly footloose assembly-factory investments that have generated mainly low-skill insecure jobs. As discussed in Chapter One, the inefficiency in the onshore sector also undermined the competitiveness of the offshore sector, thereby discouraging investments in higher value added activities⁶. In fact, as also shown in Chapter One, the FDI to Tunisia has been focused mainly on energy projects (which are capital intensive) and low value added manufacturing (notably in textiles and electrical cabling). As a result, Tunisia's economy continues to perform weakly, exports have low value added content, and what jobs have been created are mainly of low quality.

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

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



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

Inefficient Use of Public Resources: High Redundancy of the Incentives

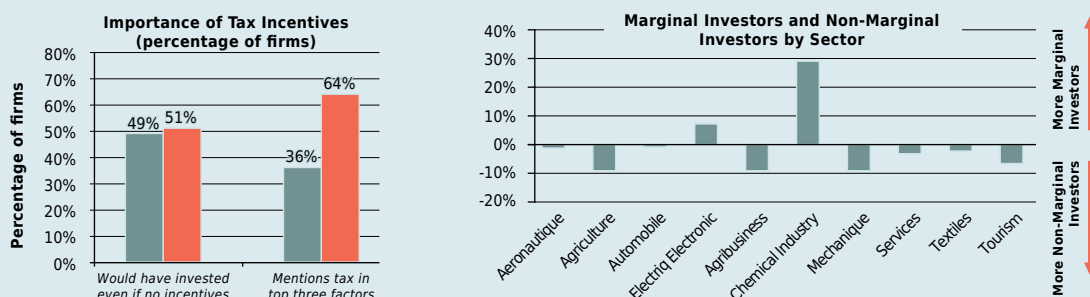
Tunisia attracts mainly low quality investment projects because it relies on fiscal incentives and cheap labor as its main selling points. The results of the Investors Motivation Survey carried out by the World Bank Group in 2012 in collaboration with the government explored the motivations of investors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

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

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

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

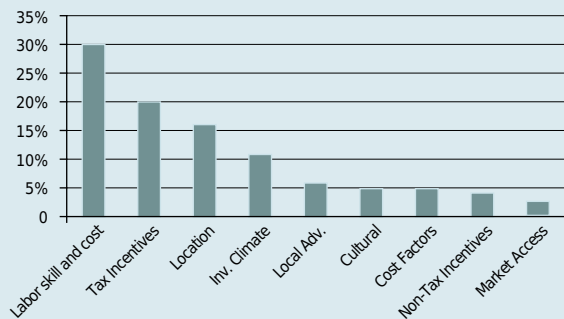
Figure 4.3: Importance of Tax Incentives in the Decision to Invest in Tunisia and Distribution of Marginal Investors by Sector



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

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

Figure 4.2: Importance of Different Factors for Investors in Tunisia



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

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

Box 4.4: International Evidence on the Impact of Investment Incentives

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

Source: IFC (2009)

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

High Fiscal Costs of Incentives, With Limited Benefits⁸

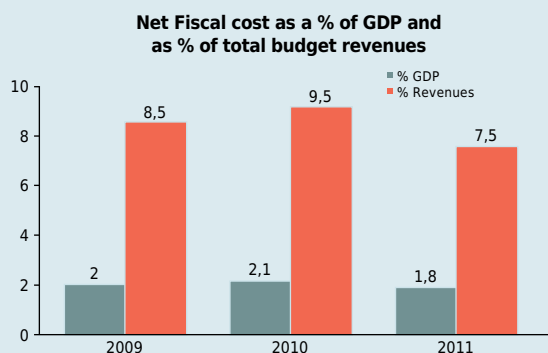
An assessment of the direct costs and benefits of the Investment Incentives Code suggests that the investment incentive scheme is highly costly and brings little benefit to Tunisia. A study by IFC and ECOPA (2012) measured the direct costs of the incentives system provided by the IIC in terms of direct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

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

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

Source: IFC and ECOPA (2012)

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



Source: IFC and ECOPA (2012)

The direct cost of the incentives is high at approximately 2.2 percent of GDP⁹. The total cost of tax and financial incentives is estimated at 2.2 percent of GDP (or TND 1296 million; approx. US\$850 million) in 2009 or 8.5 percent of total revenues, which is a large amount (table 4.2 and figure 4.4)¹⁰. The loss of revenues from fiscal incentives accounts for the largest share of the costs, with fiscal benefits accounting for 92 percent of total costs in 2009. Among these tax incentives, the benefits granted to exporting companies (offshore) are the most expensive, accounting for 67 percent of the total cost of tax and financial incentives (table 4.3)¹¹. Interestingly, firms use only very few types of benefits—the first four types of incentives (out of 68 different types) account for nearly 85 percent of incentives (table 4.3). In fact, many incentives schemes are redundant as they duplicate support for similar objectives and remain unused.

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

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

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

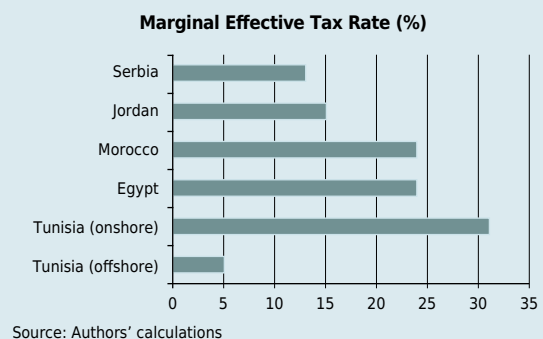
Source: IFC and ECOPA (2012)

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

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

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

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



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

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

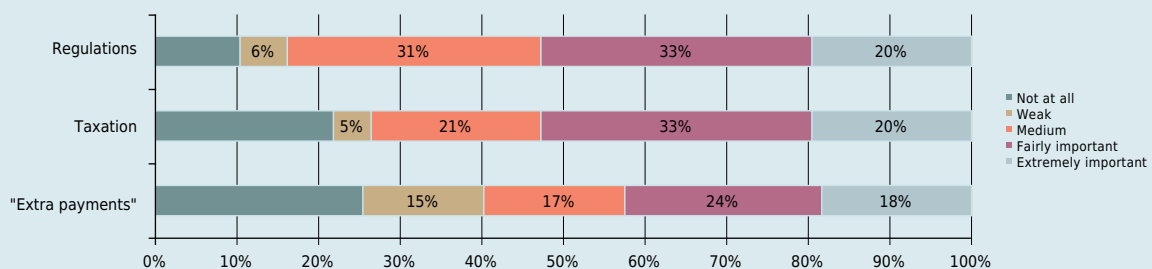
Creating investment projects in sectors and activities not subject to pre-authorization is fairly simple in Tunisia; however, when a project is subject to pre-authorization, the length of time is generally many months and could reach 1-2 years. In recent years, the establishment of a one-stop shop has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

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

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

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

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



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

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

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

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

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

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

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

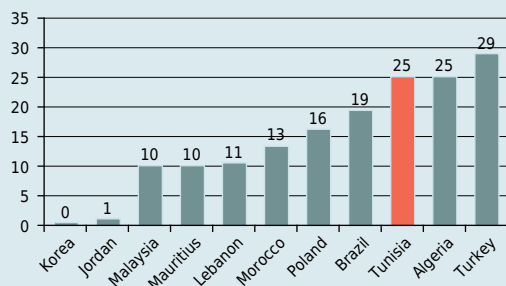
Before the revolution, annual sales peaked at 3 million dinars (about 1.35 million euros). By 2012 they had fallen to 700,000-800,000 dinars, as Rugby's workforce struck for more pay.

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

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

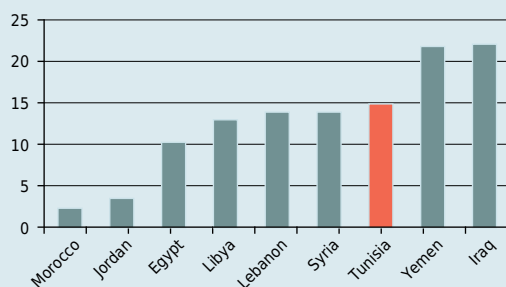
Source: Interview with Samir Mallek, Rugby's managing director, April 2014.

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



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

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



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

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

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

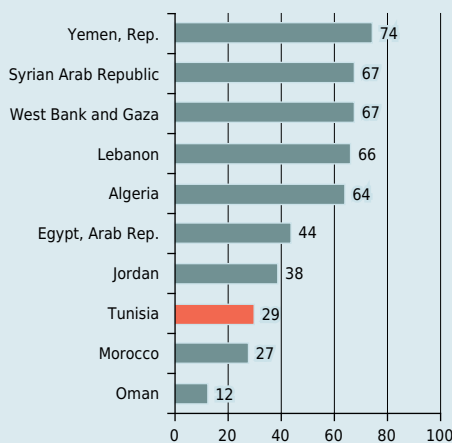
The high cost of compliance with the regulatory burden reflects in part the significant discretion in the application of the rules, which allows for corruption and cronyism. The high losses arising from weaknesses in the investment climate combined with the large share of senior management time is indicative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

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

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

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

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



Percentage of informal payment request to “speed things up”



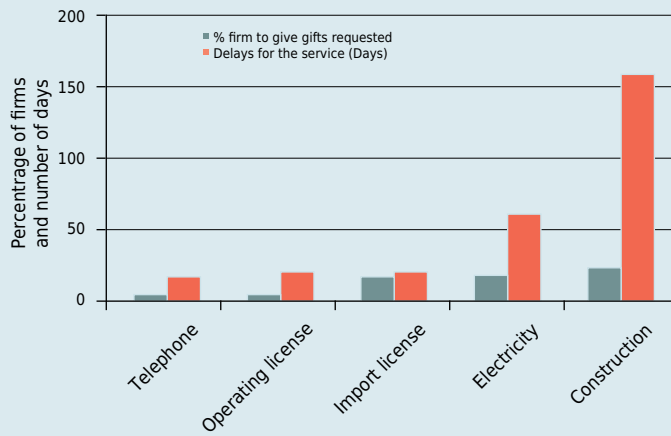
Source: World Bank (2014e), based on the World Bank’s 2012 Enterprise Survey in Tunisia.

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

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

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

Figure 4.10: Prevalence of Petty Corruption and Delays for Services

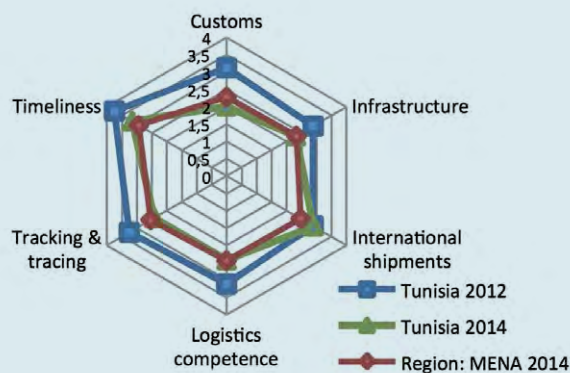


Source: World Bank (2014e), based on the World Bank's Enterprise Survey 2012

Box 4.6: Logistics is a Bottleneck in Tunisia

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

Figure B4.6.1 Tunisia Logistic Performance Index 2012 and 2014



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

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

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

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

Notes:

ⁱ For more details on the LPI, see:

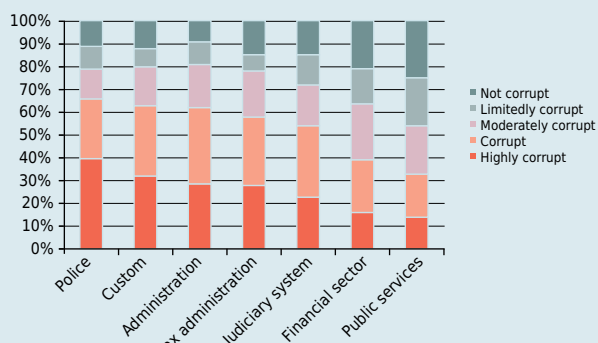
<http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTTRANSPORT/EXTTLF/0,,contentMDK:21514122~menuPK:3875957~-pagePK:210058~piPK:210062~theSitePK:515434,00.html>.

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

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

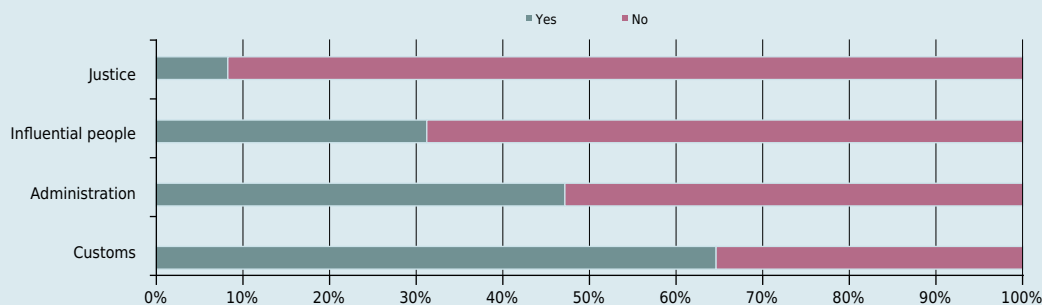
The perception of investors is that customs and the tax administration are the main institutions affected by corruption. The majority of the firms in the ITCEQ Investment Climate Survey 2012 perceive the public administrations as corrupt (figure 4.11). The results suggest the problem is most acute when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

Figure 4.11: Corruption Perception among Tunisian Firms, 2010



Source: ITCEQ, Investment Climate Survey 2012

Figure 4.12: Identifying the Nature of Corruption



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

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

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

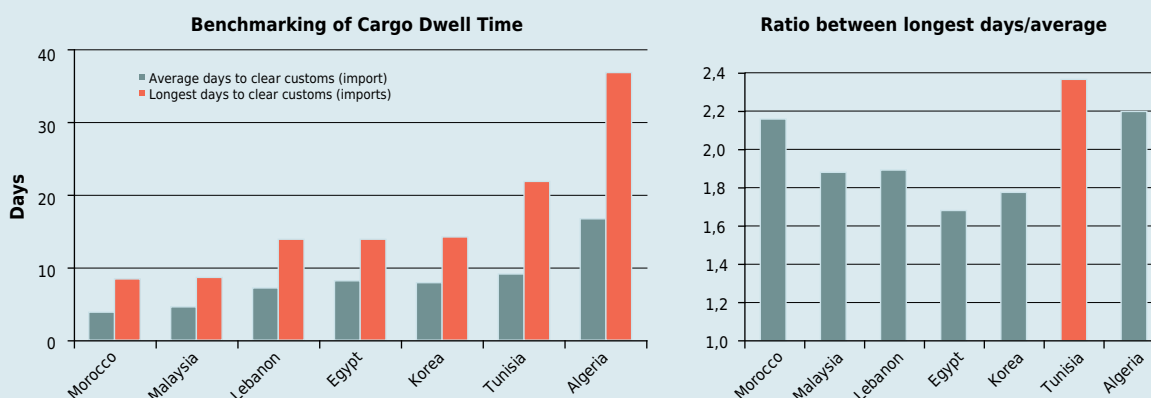
	All firms	Foreign-owned	Non-exporter
Fiscal evasion	49	34	50
Customs duties evasion and trade-related regulations	37	17	35

Source: World Bank, Enterprise Survey 2012

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

Another example of discretion and uneven enforcement of regulations is illustrated with the cargo dwell time, that is, the time for cargo to exit the main port of the country (figure 4.13). When compared to countries, including in the sub-region, cargo dwell time in Tunisia is, on average, the worst after Algeria (close to 10 days), much worse than Morocco (below five days) and no better than Lebanon and Egypt. Discretion and unpredictability seems also to play a role. The ratio between the longest dwell times with the average for all the companies surveyed should be rather close to one since most of the time importers have rather similar cargo to import. However, once again this ratio is the worst for Tunisia (figure 4.13). This means that it is possible for an importer to face a much longer dwell time than the average—and, while this could capture many factors, in general it is a proxy for some bargaining processes to reduce fees, bribes, and duties. It is important to note that the existence of discretion often hides a gap between de jure regulations and de facto performance in the business environment, which is not easily picked up by standard indicators (box 4.6). Tunisia also performed better than the regional benchmark countries in the ranking of the Doing Business indicator—trading across border ranking²¹. According to this ranking, Tunisia is ranked at the 40th rank far before Turkey (67th rank), Morocco (72nd rank) and Algeria (122nd rank). Hence, the legal business environment (de jure regulations), measured by the World Bank Doing Business indicators, can at best only partly explain Tunisia's lackluster performance.

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



Source: World Bank, Various Enterprise Surveys

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.3 / Reforms Agenda to Improve the Investment Environment

The Reform of the Investment Incentives Code

In mid-2012 the government announced its intention to revise the Investment Incentives Code²². The new Code should set the scene for an enabling environment that drives economic growth and addresses the shortcomings identified in the past. As discussed in this chapter, the onshore-offshore dualism, while useful in the initial stages of Tunisia's development, has now become a barrier to faster economic development (see box 4.8). In fact, as will be discussed in Chapter Seven and Chapter Eight, the performance of several high potential sectors has been suppressed by the heavy regulation and barriers in the onshore sector—and in turn this has also suffocated the growth of the offshore firms themselves.

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

The new Investment Code also needs to address Tunisia's specific development challenges, notably by (a) fostering development in lagging regions, (b) promoting investments into higher value added activities, and (c) facilitating employment of graduates²³. Based on the above discussion, it is suggested that the new Code should address four main aspects: (i) increase market access, (ii) simplify and reduce fiscal and financial incentives to investors, (iii) consolidate investor guarantees, and (iv) streamline the institutional framework governing investment. The key elements are discussed below (see details in annex 4.5):

i. Improve market access and allow investment freely. The Code should affirm the principle of freedom of investment and removing entry barriers for both local and international investors. It should remove barriers to investment into almost all sectors, including to foreigners, to foster competition, innovation, and quality enhancement. There is a need to reduce the number of activities requiring pre-authorizations for local and international investors (currently 15 sectors and 20 activities) to not more than a few activities of strategic importance related to arms fabrication, alcohol, and tobacco²⁴. To simplify access, the Code should move from authorization

to declaration when possible, clearly stating the role of the state and limiting its discretionary powers (including the role of the *Commission Supérieure d'Investissement*). Additional restrictions pertain to foreigners only. Yet no more than a few activities ought to be restricted to foreigners, since it makes no sense to prevent investment and local job creation²⁵. It is also recommended to review and reduce the current list of 49 restricted sectors to ensure that all activities with economic spillover effects are open to all investors (notably transport, telecommunications, education, advertising, legal, and audit services). Activities that can be reasonably restricted to foreign investors are those with limited spillover effects or with cultural and heritage elements (museums, libraries, theatre, and so on). In the case of Tunisia, notably services (such as banking and insurance, transport, telecommunications, tourism-related activities, and so on) should be opened to all private investors²⁶. A number of multinational companies would like to invest in the country but have trouble identifying the right partner, for example in cosmetics. Hence the policy should be to authorize a foreign investor to hold a majority of the shares, even if limits on equity are maintained. In this context, it is also important to reduce the scope of application of Decree 14/1961, which reduces market access significantly for service—and commerce-related activities, limiting the ability of the Investment Code to affect large segments of the economy critical for Tunisia's economic development.

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

Restrictions on access to land for foreigners unnecessarily discourage investors, with no benefit in terms of sovereignty for Tunisia. In several countries, land ownership is restricted to investors as it is considered a matter of national sovereignty, and in some countries the state can be the only owner of the land. In order not to discourage foreign investors, it is suggested that at the very least Tunisia should provide foreign investors with land leases of 50 years, renewable for a further 50 without cumbersome procedures²⁸.

ii. Simplify and reduce fiscal and financial incentives to investors. It is important to drastically reduce and simplify the provision of financial incentives to arrive at a simple and transparent framework for investors, and avoid the bureaucratic quagmire of the past. The new tax regime should be simple and transparent with no discretionary power in the hands of government authorities. Moreover, it should address the problem of dichotomy between onshore and offshore regimes, creating a level playing field that can boost investment and foster good quality jobs creation and facilitate the integration of the Tunisian economy. Addressing the dichotomy in corporate tax rates is discussed separately below. All incentives could be eliminated with the exception of incentives that create positive externalities such as specific incentives to encourage R&D, and the hiring of qualified staff²⁹. In order to avoid regulatory capture, incentives could be maintained at minimal levels for so-called high value added goods but apply across the board in offshore and onshore locations, and be automatically approved so that no regulatory capture is possible. While political expediency may demand the inclusion of regional incentives, in actual

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

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

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

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

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

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

The incentives introduced to promote increased sophistication in production are:

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

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

Specific incentives to strengthen research and marketing

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

Specific incentives to promote ICT

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

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

The Reform of the (Corporate) Tax System

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

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

The current system implicitly represses the demand for labor by raising the cost of labor relative to other inputs. The burden of personal income tax (PIT) along with payroll taxes is relatively high, thereby undermining the competitiveness of Tunisian labor. Further, material inputs imported from abroad are not taxed if used to produce exports, while labor is taxed. This represses the demand for labor³¹. It is feasible to increase the demand for labor without reducing investment and output by redressing this distortion in the relative cost of labor, which would entail reducing labor taxes and social security contributions and reducing implicit subsidies on material inputs such as fuel. Because most labor is provided by Tunisians, this could have significant multiplier effects on the domestic economy as increased labor demand would raise domestic demand.

A reduction in corporate taxes can also be expected to boost investment. The decision to invest is determined by the net present value of equity investment (NPV). The adverse impact of a high fiscal deficit on NPV flows from two sources: a higher discount rate and a reduced net benefit due to higher interest payout. The discount rate for determining the NPV of equity is dependent on the Marginal Effective Tax Rate (METR) on equity³², post-tax return on debt, and risk premium for equity investment. It increases with increase in the METR on equity and post-tax return on debt (that is, interest net of tax). Similarly, METR increases with increase in the corporate tax rate. However, any reduction in corporate tax rate will improve Net Present Value (NPV) and Internal Rate of Return (IRR) of equity investment thereby triggering private investment. Further, under the existing tax law in Tunisia, interest is deductible in determining profit while dividend payout is not. As a result, the METR on equity financing is relatively higher than the METR on debt, and there is an inherent bias against equity. A reduction in corporate tax rate will reduce this bias. In the last couple of years, corporate tax rates have registered a general decline; the corporate tax rate in most countries has gravitated to under 25 percent. The corporate tax rate in some East European Countries is below 20 percent. Tunisia must move to a competitive corporate rate to become a favorable investment destination.

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

is, no retroactive removal of incentives), such that in practice very few of the existing offshore exporters will start paying taxes in the near future³⁵. Moving gradually toward simplification and unification of regulations and taxes across the offshore and onshore sectors is in line with best practice and has been followed by a number of countries, including most recently China, which eliminated tax holidays for foreign investors to level the playing field. A detailed note on the proposed corporate tax reform in Tunisia is presented in annex 4.6.

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

The Simplification of Regulatory Procedures

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

A mammoth effort to further simplify lower-level licenses and permits at sector level will be required to effectively remove barriers to entry in Tunisia. For over a decade, Tunisia has implemented a significant number of reforms to simplify administrative burdens, with limited results³⁶. The process by which such reforms were designed also limited their impact and credibility in the eyes of investors and citizens: weak participation by users, lack of a systemic and coordinated approach, as well as insufficient communication and transparency in measuring outcomes and the quality of service. Moreover, attention was often focused on simplifying procedures without systematically questioning the social objective behind existing regulations. As a result, the regulatory framework continues to suffer from the unequal and discretionary application of rules, cronyism and privilege both in the economic and administrative spheres. In the wake of the revolution, reducing discretion, cronyism, and arbitrariness in the administrative and regulatory environment is a priority; and expectations are especially high.

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

opportunities for discretion will substantially help address this problem³⁷. In 2012 the government launched a comprehensive and participatory regulatory simplification reform (the “guillotine”) in nine ministries that have large interface with the private sector. The reform is inspired by similar experiences in the OECD (Mexico, the Netherlands, or Sweden) and in countries that have experienced substantial economic or political transitions (Croatia, the Czech Republic, the Republic of Korea, or Ukraine). The goal is to streamline procedures, increase transparency, and reduce the scope for arbitrary and discretionary behavior in the areas related to private investment³⁸.

4.4 / Conclusions

The onshore-offshore model initially contributed to Tunisia’s development in the 1970s and 1980s, but the weak economic performance over the past decade has shown that the dual economy model is no longer adequate to support the development of the Tunisian economy. The offshore sector attracted foreign investors and earned much-needed foreign exchange, while the heavily protected onshore sector facilitated the development of a local industrial base. The offshore regime successfully attracted foreign investors, fostering new firms entry and jobs creation, compared to the rest of the economy (see Chapter One)—and the relatively superior performance of the offshore sector proves Tunisia has the potential to catch up with developed countries and to grow quickly—provided incentives are aligned. As shown in this chapter however (and as also supported by a literature review of more than 70 studies on Tunisia’s Investment Incentives Code; IFC and Ernst & Young, 2012), besides having very high financial costs, the dual system has also introduced a series of profound distortions that have increasingly become detrimental to Tunisia’s development in several ways.

This chapter has explained how the Investment Code has segmented the economy between the onshore and offshore sectors, limiting the interaction between firms and thereby restricting competition. The dual corporate tax regime has contributed to this segmentation. Also the focus on fiscal and financial incentives has attracted mainly footloose investment in low value added activities. The analysis has highlighted several points:

- The duality introduced by the Investment Code is at the heart of many of the failed development outcomes that Tunisia is experiencing today, notably the persistent regional disparities and the focus on low value added activities and low quality jobs. Over 85 percent of projects and jobs benefiting from the incentives were created in the coastal regions, exacerbating the disparities with the interior regions. Further, it was shown that approximately 10 percent of eligible firms receive over 90 percent of the incentives. Further, these firms are concentrated in sectors that are not labor intensive, notably mining, energy, and banking.
- As a result of the segmentation between onshore and offshore, a few cronies have captured the substantial rents arising from market access restrictions to the onshore sectors, while firms in the offshore sector have remained trapped in low-value added activities. More than 60 percent of the Tunisian economy at present remains de facto closed to competition, fostering a system of cronyism and rent seeking.
- The offshore incentives entail high fiscal costs, which have given low returns in terms of attracting investment and jobs creation. The analysis of the costs and benefits of the Code has shown that the total cost of incentives is approximately 2.2 percent of GDO and that 79 percent of this amount is wasted, in that it benefits companies that would have invested even in the absence of incentives. In fact, the cost of each additional job created is extremely high for Tunisia, at approximately US\$20,000 per additional job.

- There is a need to drastically simplify the system of incentives, by removing incentives of little or no use (which however are expensive in terms of readability and administration). In fact the first four types of incentives (out of 68 different types) account for nearly 85 percent of incentives, as many incentives schemes are redundant and remain unused.
- Finally, the discussion in this chapter has highlighted that the success of the reform of the Investment Code is closely linked to at least two parallel reforms which are also at the core for the investment framework: the reforms of corporate taxation and the simplification of regulatory burden afflicting investment and private sector activities.

Revising the Investment Incentives Code to remove the onshore-offshore dichotomy and level the playing field would boost investment and jobs creation. It is important to substantially open up market access to investors, and to align the procedures to those used for sectors and activities that do not require authorization—in other words there is a need to make the onshore more like the offshore, and not vice versa. In addition, reform should remove the onshore-offshore dichotomy. Reducing the generosity of the incentives is also justified, as the incentives are very expensive compared to their limited impact—and of course there appears to be ample scope to drastically simplify the system by removing incentives of little or no use (which however are expensive in terms of readability and administration). The ongoing reform of the Investment Code has made some progress, but the fundamental problems have not been addressed. An ambitious overhaul of the Investment Code to create an open and investor friendly economic environment with a competitive tax rate and simple and transparent procedures would go a long way toward increasing investment and jobs creation in Tunisia. The proposed gradual unification and simplification of the tax code is in line with current best practice and has been followed by a number of countries, including most recently China, which eliminated tax holidays for foreign investors to level the playing field.

This chapter has also shown that the heavy regulatory and bureaucratic burden imposes a substantial cost on firms, which is partly the result of significant discretion in how policies and regulations are applied. The regulatory burden costs firms almost 13 percent of their turnover on average—and this amount is even higher for onshore firms. As also discussed in Chapter Two, the excessive regulatory environment stifles competition, by allowing inefficient firms to gain unfair advantages via privileges and corruption. And, as shown in Chapter One, these practices have a cost which goes beyond the corruption itself—they prevent the success of the best-performing firms and disincentivize the entry of new firms such that, more generally, they obstruct the process of creative destruction and thereby lower the performance of the entire economy. Discretionary application of the regulations appears to be most prevalent in the customs and the tax administration, suggesting these services are in urgent need of a significant regulatory simplification reform aiming to reduce the room for discretion. More generally a drastic simplification of the stock of regulations with a view to reducing discretion in their implementation is critical to improve the private sector environment in Tunisia. This should be pursued in parallel to the reform of the Investment Code ³⁹.

The next two chapters will explore specific policy-induced distortions in the labor market and in the financial sector, respectively. As discussed in Chapter Two and Chapter Three, the existence of widespread barriers to market contestability hampers productivity and gives rise to rent-seeking opportunities. As discussed in this chapter, Tunisia's investment policies have introduced additional distortions, which helped the development of the country in the 1970s but have now become an obstacle. The next two chapters will discuss how the policies regulating labor markets and the financial sector also undermine Tunisia's economic performance and contribute to hinder the creation of good quality jobs.

Notes

1. We do not assess the enforcement of the rule of law (for example, enforcing contracts and property rights), which has been examined by the 2013 AfDB/MCC/MDCI report on Growth Diagnostics—that report makes a compelling case that shortcomings in the legal environment constitute a real barrier to investment and growth.
2. Economic free zones (*zones franches*) are located in Zarzis and in Bizerte. Firms operating in these zones are under the same tax and foreign exchange regimes than fully exporting companies.
3. In addition, as discussed in Chapter Three, cronyism under the former regime allowed companies owned by relatives of the former regime to benefit from significant exemptions and incentives.
4. It is worth pointing out that these sector-specific laws often impose heavy restrictions to investment and the operations of markets in the sectors; the retail sector is a case in point as it imposes draconian restrictions on the establishment of large retailers (see also Chapter Two).
5. Corporate taxes for onshore firms are currently set at 30 percent of profits in most sectors, except in the financial sector, telecoms and oil sector with a tax rate of 35 percent, and in agriculture, fisheries, and handcraft with a rate of 10 percent.
6. As discussed in Chapter Five, the labor code has also contributed to this mismatch as it allows for fully flexible short-term contracts up to four years but introduces extreme rigidity for firing of workers under open-ended contracts, thus implicitly favoring short-term and low-skill jobs.
7. Similar results are obtained when focusing solely on the manufacturing sector. The share of investors in manufacturing sectors who said they would not have invested without incentives (marginal investors) is 52 percent (which is slightly above the share for the overall sample). Using the “truthful question” shows that 28 percent of manufacturing firms would not have invested (as they mention tax advantages as one of the three most important reasons in their Investment decision).
8. This sub-section draws on study by IFC and ECOPA (2012).
9. It is worth noting that these are only the direct costs. The overall economic costs might be higher still because of indirect costs in terms of distorting incentives.
10. No comprehensive evaluation was carried out prior to 2012, but a few studies sought to quantify the costs of incentives. The WTO (2001) estimates the fiscal costs of incentives at TND 557 million for the year 2000 (or approximately two percent of GDP). The IMF (2005 and 2012) estimates the tax expenditure on incentives at approximately 0.75 percent of GDP in 2005. Ghazouani (2011) estimates the cost of incentives at 2.9 percent of GDP.
11. These amounts are closely related to the “success” of the offshore regime. The tax benefits are widely used since they entail a simple application on the part of the investor. In fact the proportion of offshore firms that give a positive evaluation of Tunisia’s administration and tax system is much larger than the percentage of onshore firms (70 percent vs. 38 percent).
12. While the extractive/mining, energy, and financial sectors are not covered by the Investment Incentives Code, in fact the legislation governing such sectors provides them with a very similar incentive structure.
13. That is only counting those investments that would not have been created without incentives.
14. The marginal effective tax rate is a forward-looking measure that summarizes the incentives to invest in a particular asset as provided by complicated tax laws. The marginal effective tax rate on capital income is the expected pretax rate of return minus the expected after-tax rate of return on a new marginal investment, divided by the pretax rate of return.
15. In fact, 33 percent of value added is in sectors for which prior approval is required by the CSI and a further 18 percent is open to Tunisian nationals but restricted to foreigners (only a minority control is allowed).
16. Investment is allowed only in certain areas and land ownership or lease holding by foreigners is heavily restricted. In fact the text of the Code regarding land ownership by foreigners is unclear and may affect the predictability for investors: “the ownership of land and premises by foreign investors in areas other than those mentioned above is governed by the laws in force.”
17. The *Agence de Promotion de l’Industrie et de l’Innovation* (APII) is exploring the possibility of having a one-stop shop for companies not subject to declaration.
18. For a detailed discussion of access to agricultural land, see this note prepared by the FAO: Private, Collective and State Tenure in Tunisia; available at <http://www.fao.org/docrep/w8101t/w8101t07.htm#TopOfPage>; For a discussion of access to land in urban areas see the discussion promoted by the Center for Mediterranean Integration (CMI) available at http://cmimarseille.org/FR/E-letter_16-4.php#sthash.BTpc6U1g.dpuf
19. Still, in the 2012 Investors Motivation Survey, approximately 42 percent of firms report that corruption is a very or fairly important obstacle to their growth. Tunisia ranked 77 out of 177 economies in Transparency International’s Corruption Perception Index in 2013.
20. It should be noted that over half of the costs are triggered by losses associated with theft and spoilage (a widespread phenomenon after the revolution). In the absence of this, Tunisia would be slightly lower than regional peers, in line with Egypt but still above Morocco and Jordan.
21. This ranking is based on several indicators, such as the number of days and documents both to export and import as well as the relative costs based on the surveys of several professionals in the country.
22. Indeed several of the studies and analyses discussed in this Chapter have been produced as part of the preparatory work led by Ministry of Development and International Cooperation, with technical advice by IFC.
23. Sectoral priorities are much less easy to determine, but there is increasing talk about developing strategic high potential and high-value added sectors, notably in electric, mechanical, and electronic manufacturing industry, in ICT (notably offshoring and possibly software development), and in tourism.

24. For instance, Poland opted for the freedom of investment in all sectors, with prior ministerial authorization required only for five sectors (negative list).

25. Although some neighboring countries have a system similar to Tunisia, the number of sectors with restricted ownership is much lower than in Tunisia.

26. Multiple studies have advocated the benefits that would arise to Tunisia from opening the services sectors, by removing existing constraints in terms of the need for authorizations and the limits on the share of foreign ownership, which constitute barriers to foreign investors. Sector lobbies have been successfully fighting to keep privileges and rents at the expense of greater investment across the country and faster growth and jobs creation. Another argument frequently used is that government cannot open markets because this will hinder the free trade agreement negotiation process with the EU. However, multiple studies have shown that in several of these sectors Tunisia has a strong growth potential and should have an “offensive” trade policy, and not continue to remain passive waiting for negotiations with the EU (World Bank 2008). In fact, Morocco recently opened investment in services to foreign investors (financial sector, housing, import-export, industry, handicrafts, education, transport, and film production) and has seen a rapid increase in investment in the country.

27. Offshore firms are currently allowed to have only four non-Tunisian employees as supervisors, and are obliged to have Tunisian employees in the governance bodies in many activities. While skills and know-how transfer are becoming a key factor in global competition for innovation, Tunisia’s restrictive regulations against foreigners limit the attraction of expertise. The favorable position enjoyed by Eastern European countries for technological investment is partly due to the strong mobility of labor with Western Europe, while many East Asian countries have implemented specific and selective incentives that attracted expertise and promoted know-how transfer. For instance, Singapore has built a comprehensive strategy to attract talented people to develop R&D.

28. In Morocco, while the ownership of land for agricultural use by foreigners is prohibited as it is in Tunisia, it allows 99-year leases (against 40-year leases in Tunisia).

29. In this context, in line with best international practice, it is also recommended that all the fiscal and financial incentives would be best moved out of the new Investment Code and into the *droit commune*, such that in future they can be revised in the annual budget law.

30. Strategically incentivizing onshore firms to export could increase both output and revenue. In order for onshore firms to compete in export markets, it would be desirable to enhance incentives to invest for these firms—for example by enabling cheaper access to foreign inputs. To ensure that these incentives are cost-neutral, it is important to target them to sectors and activities which are currently dominated by offshore firms—and ones in which Tunisia has a latent potential that is currently not realized—since in such sectors there would not be significant loss of net tax revenue.

31. Further, as discussed in Chapter Five, the Social Security system is increasingly loss making. Social security contributions are raised from a narrow base with high rates, and include financing of several items (for example, training funds), which should not be financed through labor taxation. There is a need to reform the system to ensure its fiscal

sustainability, while decreasing labor taxes to favor greater jobs creation.

32. The METR on equity is the aggregate of tax on corporate profits and dividend distribution tax on marginal income from equity investment, expressed as a percentage of the marginal income.

33. In cooperation with the Ministry of Finance, the World Bank Group and IMF tax experts have conducted simulations on data of more than 55,000 enterprises in Tunisia to ensure that the convergence of the offshore and onshore rates is possible and will be revenue-neutral from the first year of the reform. This requires the introduction of complementary measures, notably introduction of dividend tax at source and a larger carry-forward alternative minimum tax (MAT) on turnover. Annex 4.6 provides a detailed explanation of the proposed reform of corporate taxation.

34. Tunisia METR after the reform would be 21 percent, compared to 24 percent in Morocco and Egypt. In terms of incentives for exporters, however, Morocco would become marginally more attractive. The tax incentives for exporting firms in Morocco include full tax exemption for the first five years of operation and a reduced rate of 8.75 percent for the 20 years thereafter for companies operating in export free zones. Regular investors pay a tax rate of 30 percent. Hence at present exporters in Tunisia have more generous tax incentives than exporters in Morocco, but under the proposed regime new exporters in Tunisia would be somewhat worse off.

35. Because the incentives already granted will be grandfathered, there will be no immediate revenue gains from the elimination of incentives. However, the sharp reduction in corporate tax rates will lead to an immediate drop in tax revenue that the government cannot afford. Therefore, to neutralize the erosion of the tax base, it is necessary to introduce dividend taxes at source and an alternative minimum tax (MAT) on turnover. The rate of MAT is calibrated so as to ensure that there is no loss of revenue, even in the first year of the reform. In addition, the sharp reduction in tax rates on corporations will significantly improve the competitiveness of the Tunisian economy, and can be considered as a large step toward establishing a modern tax system, creating a climate conducive to investment, and ensuring its long-term viability. The proposed reform is primarily focused on broadening the tax base and reducing the corporate tax rate for all firms to eliminate distortions in the economy, improve tax fairness, and improve compliance. The reform should be coupled with tax on dividends and a minimum alternate tax on turnover in order to maintain revenue neutrality.

36. This includes the development of e-government initiatives, or the replacement of prior authorizations for business entry with declarative systems subject to predefined sectoral specifications.

37. Transparency and simplicity can help curb corruption—the political economy context may imply that relatively sophisticated rules, while theoretically superior, might in practice prove inferior to simpler rules which are easier to monitor and enforce (and less vulnerable to corruption).

38. A first round of reforms was started in May 2011, when the Ministry of Finance launched a systemic, participatory, regulatory reform process to simplify administrative procedures and red-tape and reduce discretion and arbitrariness in the customs and the tax authorities. Out

of 446 “formalities” identified in the tax and customs, only seven percent will remain untouched, while approximately eight percent will be eliminated, and a further 85 percent are to be significantly simplified. The same methodological approach has now been extended to an additional eight ministries that deal with private investors, bringing the total of formalities identified for simplification to over 1,500. Following this listing of procedures, in partnership with private sector the administration plans to review each of them with the objective of elimination or simplification. Each concerned agency will have to provide justification for each regulation or procedure it administers, within a timeframe monitored by the Prime Minister’s office. The same justification will then in turn be asked of the private sector. Based on a synthesis

of the two points of view, a report will be provided with recommendations for regulatory simplification.

39. An argument can be made that the removal of the offshore tax incentives should take place after the problems with the business environment have been removed. In fact, given the vested interests that seek to perpetuate the tax-free regime for offshore firms, it is recommended that the two aspects of the reform proceed hand in hand, via a gradual convergence in the tax rates between onshore and offshore sectors, which will also increase the demand for significant progress in regulatory simplification.

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