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Cronyism, Economic Performance, and Unequal Opportunity 03

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

03
Cronyism, Economic Performance, and Unequal Opportunity

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

The prevalence of cronyism predates President Ben Ali and continues to hinder the development of the Tunisian economy after his departure. Over the past decade, extensive corruption and abuses were associated with the activities of the cronies and family of former president Ben Ali (Hibou 2006 and 2007). It is important to underline, however, that the Ben Ali clan arrived relatively recently on the Tunisian economic scene while the system of privileges has characterized the economic environment since the early post-independence period [1]. Similarly, it would be a mistake to assume that following the departure of President Ben Ali and his family the cronyism and rent seeking have disappeared in Tunisia. While predation likely has disappeared with the exit of President Ben Ali and his family, however, most of the system of rents and privileges remains untouched. Pervasive market restrictions and discretion in the (excessive) regulatory burden persist in Tunisia, maintaining the opportunities for firms to earn rents, via cronyism and corruption. Indeed as shown in this chapter, there is some evidence that these problems may even have gotten worse since the revolution. In sum, while Ben Ali has been toppled, corruption and regulatory abuse remain critical development challenges.

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

3.1 / Cronyism, Corruption, and Predation in Tunisia

It has been estimated that corruption costs Tunisia approximately two percent of GDP per year. Global Financial Integrity estimated that the amount of illegal money Tunisia loses from corruption, bribery, kickbacks, trade mispricing, and criminal activity between 2000 and 2008 was, on average, approximately two percent of GDP per year (approximately US$1.2 billion per annum). With a population of approximately 10.6 million that means almost $110 are lost per person per year in the unrecorded transfers of illegal capital (Global Financial Integrity 2011). Further, in the aftermath of the Tunisian revolution, assets of the Ben Ali clan were confiscated. The confiscation process involved the 114 individuals, including Ben Ali himself, his relatives, and his in-laws, and concerned the period from 1987 until the outbreak of the revolution. The confiscation commission estimates that the total value of these assets combined is approximately US$13 billion, or more than one quarter of Tunisian GDP in 2011 (which would correspond to a one-off transfer per person of approximately US$1,230 per person in Tunisia, about one quarter of average income). [2]

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

Box 3.1: The Definitions of "Cronyism," "Corruption," and "Predation"

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

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

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

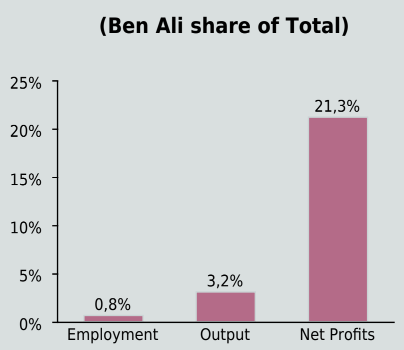
Predation takes many forms beyond simple theft. In many economies Mafia-like activities are rampant. Criminals collect extortion money and are also paid to provide protection, to collect debt, and to solve problems. One strategy is "straddling," whereby political insiders own firms that private sector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

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

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

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

Figure 3.1: Economic Significance of Connected Firms



Source: Authors' calculations

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

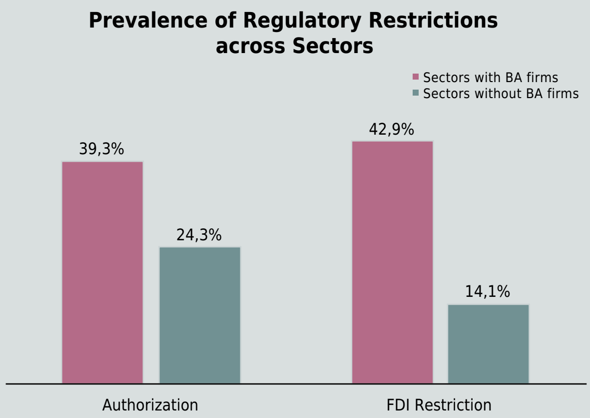
The results of econometric regressions confirm the spectacularly superior performance of confiscated firms on average. Confiscated firms are dramatically larger than their peers, both in terms of the number of people they employ and especially in terms of output and profits, and that they have higher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

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

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

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

Figure 3.2: Cronyism and Regulation in 2010



Source: Authors' calculations

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

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

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

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

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

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

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

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

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

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

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

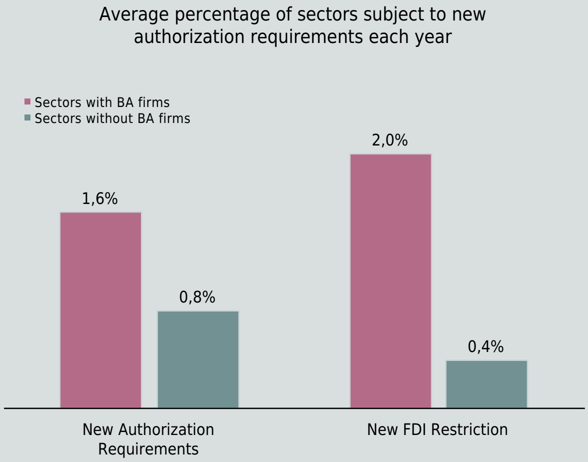
The government gave strong advantages to those who entered the tourism sector. It opened credit facilities up to 90 percent of the capital requirements on favorable terms, tax exemptions on the investment, and privileged access to state lands. This led to several distortions. First, it attracted a high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

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

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

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

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



Source: Authors' calculations

Moreover, the proliferation of regulation over time was strongly correlated with the presence of Ben Ali-owned enterprises. The list of activities subject to authorization evolved over time as it has been supplemented and amended by subsequent decrees, resulting in more than 73 amendments at the NAT96 level. Given the intimate association between the success of confiscated firms and regulatory density, an important question is whether or not the Ben Ali family might have manipulated the Investment Code to serve its business interests [10]. While the number of observations we have is very small, it appears as though novel restrictions were especially likely to be introduced in sectors in which confiscated firms were already active [11]. The probability of new FDI restrictions and authorization requirements being introduced is much higher in sectors in which confiscated firms are active than in sectors in which they are not. Sectors in which Ben Ali firms are active are two times more likely to be subjected to new authorization requirements than sectors in which they are not, and five times more likely to be subjected to new FDI restrictions (figure 3.3; see also annex 3.4 and Rjikers, Freund, and Nucifora 2014) [12]. In sum, if regulations did not protect a lucrative sector, Ben Ali would use executive powers to change the legislation in his favor.

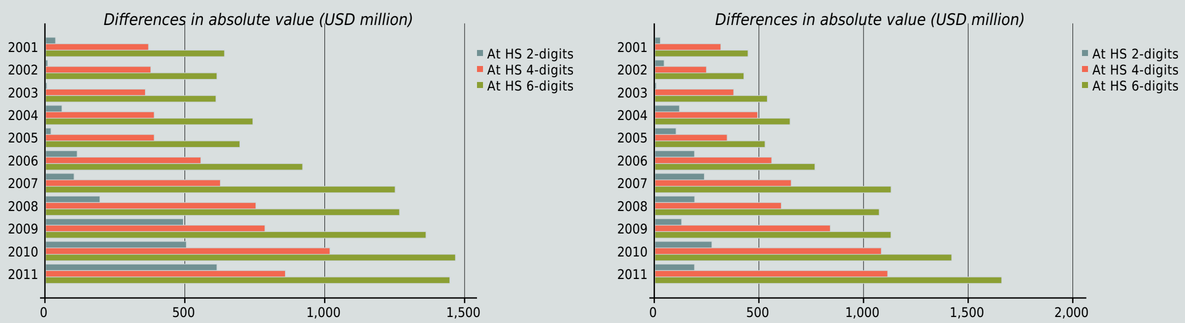
Discretionary Application of Tax and Customs Regulations

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

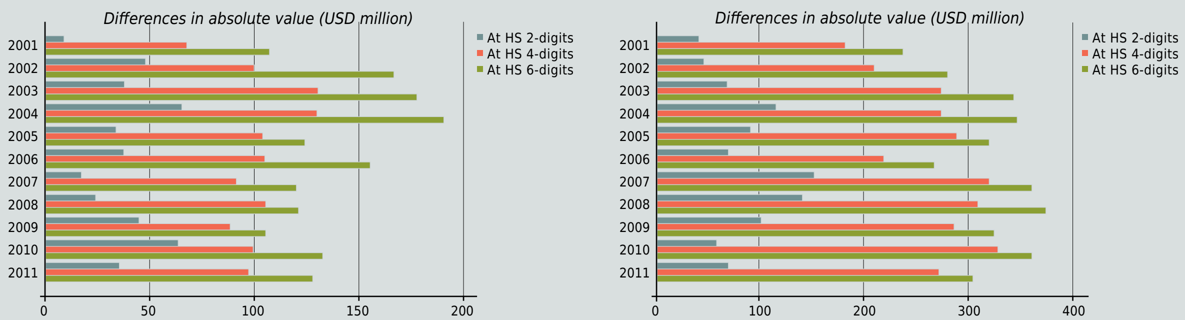
Tariffs and tax evasion hampers competition and gives a strong unfair advantage to the (larger and) better-connected firms. Using "mirror statistics" analysis techniques, we find strong evidence of discretionary implementation of customs regulations and tariff evasion (annex 3.1). Corruption in customs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

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

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



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

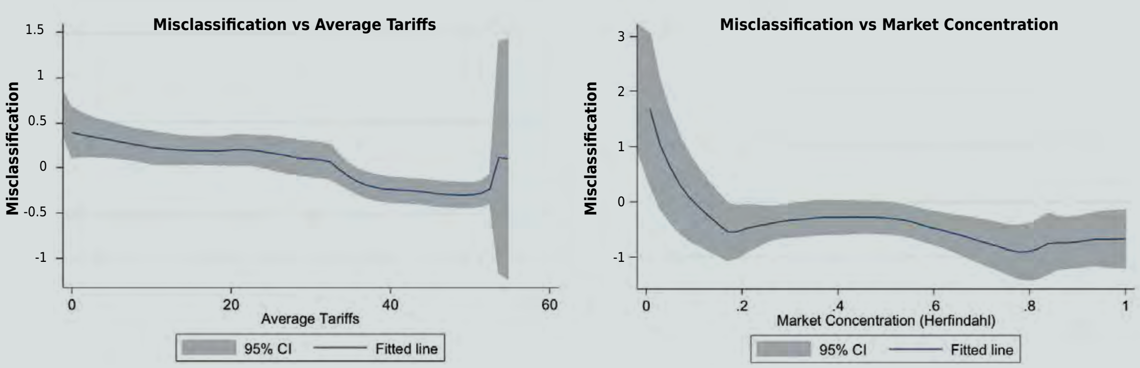


Source: Authors' calculations

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

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

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



Misclassification=Reported Imports - Mirror

Misclassification=Reported Imports (in Tunisia) - Reported Export (in sending countries)

Source: Authors' calculations

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

Box 3.3: Protecting Tunisia's Banana Growers?

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

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

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

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

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

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

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

Source: Interviews with market traders, April 2014.

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

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

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

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

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

Following the departure of Ben Ali and his close entourage, the level of informal trade appears to have grown strongly. A recent World Bank study[1] found that informal trade in 2013 accounts for only a small share of Tunisian trade as a whole (approximately 5 percent of total imports) but that it is nonetheless at least worth TND 1.8 billion (approximately US$1.2 billion, or 2.2 percent of GDP). Moreover, this type of trade represents an important part of the bilateral trade with Libya and Algeria, accounting for more than half of the official trade with Libya and for more than total official trade with Algeria. It is possible to estimate that roughly 20 percent of the fuel consumed in Tunisia is in the form of informal imports from Algeria.

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

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

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

Source: Ayadi, et al. (2013).

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

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

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

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

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

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

Source: Ayadi, et al. (2013).

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

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

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

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

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

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

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

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

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

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

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

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

The most widely adopted technique was to minimize exposure and try to remain hidden below the radar of the family; this distorted and hindered private sector performance in multiple ways. First, firms purposely kept a lack of transparency about structure of activities and subsidiaries. Doing so enabled family groups to increase their investments while keeping most of their activities at a relatively small size so as not to get on the radar screen of predators [18]. In that perspective, very few companies published the totality of their annual reports or had a full presentation of their activities. Second, staying below the radar screen entailed developing sub-optimal business strategies, typically through diversifying activities, selecting sectors outside the sphere of interest of the Ben Ali family, and limiting firms' size. This strategy prevented the exploitation of economies of scale in the Tunisian industrial landscape. It also required limiting risks by strictly limiting cooperation with peers, which is consistent with the widespread presence of family-run firms in Tunisia. Interviews also confirmed that firms avoid profitable lines of activities in sectors entrenched with interests or connections to the administration or the political power. Third, several interviewees mentioned that, notwithstanding opportunities this could have opened, they avoided asking for financial support by banks. If they needed financial support, they would go to the private banks reputed to have the lowest level of connections and avoid public banks because of the risk of exposure to predation. Fourth, even though there may be several explanations, the environment was biased against pursuing mergers and acquisitions because they would signal to predators the success of a firm [19]. Another consequence of this inhibition is the low rate of some necessary restructuring and the lack of efficient reallocation of factors among Tunisian firms, hampering the development of large groups and of "national champions" [20].

The only cooperation sought was with foreign partners, which indeed could also provide an opportunity to hedge against the risks of predation [21]. In line with this, the offshore sector was preferred as it was more transparent and allowed a more level playing field, there was less role or discretion by the administration, and the presence of foreign firms forced the Ben Ali family to moderate its abusive practices. Hibou (2011) explains, "Once [foreign firms] have passed the entrance gate into Tunisia, they are protected from the predatory activities of greedy intermediates." Note, however, that in many sectors the viability of this strategy was limited by presence of severe FDI restrictions. Worse still, it is precisely in protected sectors that Ben Ali firms were most important.

In sum, beyond the losses directly associated with corruption and rents extraction, the widespread cronyism, unfair competition, and the possibility of predation all negatively impacted private sector performance in Tunisia, hampering growth and jobs creation. Overall the consequence of unfair competition fed by the combination of administrative distortions and predation is that firms remain below potential, never reach their production possibility frontier, and rarely grow vertically on the value chain. Hence, there is a significant hidden economic cost inherent in having private sector pursue a strategy to avoid or limit the risk of predation and exposure to cronies. While there is no way to easily quantify these economic costs, the perception of lost opportunities by top entrepreneurs is very high [22]. What is clear is that this system was both extremely inefficient and supremely inequitable; only a small minority of entrepreneurs could credibly aspire to succeed.

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

The presence of pervasive cronyisms and the risk of predation help explain the private sector paralysis in Tunisia. The stunted private sector dynamics in Tunisia described in Chapter One result from several problems. As discussed below, the diagnosis presented in Chapter One is consistent with the narrative offered by the entrepreneurs that took part in our qualitative study and by the available quantitative evidence on the impact of cronyism presented in this chapter.

- The evidence presented in Chapter One highlighted that the private sector in Tunisia is skewed toward small-scale activities and that large firms are scarce, both in absolute and in relative terms. The absence of relatively large firms is also apparent when we examine the exporter size distribution. In fact Tunisian exports are significantly less concentrated than in other countries. The observation that Tunisia's private sector is specialized in small-scale activities and characterized by limited dynamism is consistent with firms trying to stay below the radar screen.

- We also found evidence that firm growth in Tunisia is only weakly correlated with productivity; and in fact the relationship between employment creation, productivity, and profitability is very weak. We observed that few small firms ever grow large, that small firms are more likely to die, and that most large firms had already been large for a while. Indeed job creation is not only hampered by limited entry, but also by a lack of (upward) mobility; very few firms grow both in the short and the long run, which is at odds with the existence of an up-or-out dynamic often observed in developed countries in which entrants tend to either survive and grow or exit. From a dynamic perspective we found that private sector performance has been weak and that the process of creative destruction that drives productivity growth is severely attenuated in Tunisia. All of the above are consistent with the impacts of cronyism on firms' dynamics highlighted in this chapter.

- We also found that the Tunisian economy does not rapidly reallocate resources to its most productive and profitable uses—which again is consistent with the fact that the process of creative destruction that should drive productivity growth and factor reallocation is severely attenuated in Tunisia-and the unfair competition discussed in this chapter has undoubtedly contributed to this outcome.

- We also discussed in Chapter One that the offshore sector is relatively better performing than the onshore sector, which is consistent with the discussion presented in this chapter, whereby cronies did not interfere much with the offshore and instead focused on extracting rents mainly in the onshore sector. The Investment Incentive Code stipulates which sectors are open to investors (discriminating between domestic and foreign) and grants a very generous tax regime and simplified regulatory burden for firms that export at least 70 percent of their output (offshore firms). At the same time, the duality in fact served as window dressing for regulatory capture by cronies. In this chapter we have found ample evidence that these restrictions are in fact abused by cronies to extract rents as a result of privileged access to onshore markets, at the expense of the entire country [23]. This also explains why the onshore sector is rife with regulatory requirements and market access is heavily restricted, both of which constitute opportunities for unfair advantages and rents extraction.

3.5 / Conclusions

This chapter has substantiated that state interventions and barriers to competition have introduced severe distortions in the choices of private investors and created ample opportunities for rents extraction by cronies, severely hampering the performance of the private sector in Tunisia. The distortions have important consequences for firms' behaviors, repressing enterprise growth and obstructing the process of structural transformation. Several tools were used to gain unfair competitive advantage and extract rents, such as the discretionary enforcement of regulations (notably barriers to market entry, tax administration, custom duties, and public procurement) and the (ab)use of public assets and public enterprises (including public banks). All of these practices undermine competition by favoring better connected firms and those who practice corruption.

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

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

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

These regulations continue to enable the capture of the country's wealth by a few privileged Tunisians at the expense of the majority, hampering investment and the creation of the well-paying jobs that Tunisians deserve. While regulatory barriers and authorizations are often presented as a way to protect Tunisian consumers, in fact in Tunisia they benefit a small elite at the expense of the vast majority of Tunisians [27]. The consequences of this use of regulations to extract rents (to appropriate wealth) is much worse than just the cost of the petty corruption: consumers pay monopolistic (that is, higher) prices, firms have no incentive to improve product quality, and the productivity gains and innovation that would come from new firms is halted. In other words, it undermines the competitiveness of the economy, hampering investment and the creation of jobs. In fact, most Tunisian businesses and unconnected firms continue to suffer because they face barriers to market entry and their efforts are stymied by the unfair advantages enjoyed by privileged firms. Further, these regulations also perpetuate social exclusion, as unconnected Tunisians face very limited economic opportunity. A few people who have access to those in power and in the administration can capture these benefits, while those who do not have those contacts are excluded from the economic system. Hence this system generates deep social injustice and arguably it is at the root of the frustration of most Tunisians who felt and feel excluded from economic opportunity.

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

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

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

Notes

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

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

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

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

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

6. It should be noted, however, that this is in part due to many firms reporting losses. Even though they are much more profitable on average, a substantial number of Ben Ali firms report losses; in fact, Ben Ali firms are more likely to report losses than non-connected firms despite generating higher profits on average. In fact a striking feature of the data is the high rates of non-reporting among confiscated firms. In 2010, the most recent year for which we have data, only 122 firms reported hiring any paid workers, whereas only 91 firms reported positive profits and output. While there are myriad possible explanations for the larger heterogeneity in returns to running Ben Ali firms, some of which will be explored later in this paper, one potential explanation for their higher propensity to incur losses is that this would minimize their tax obligations and because it may entitle them to various types of government support.

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

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

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

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

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

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

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

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

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

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

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

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

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

20. Indeed the track record of financial transactions in Tunisia is limited: the number of mergers between industries with high synergies is very limited, and the number of restructuring processes is also very small.

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

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

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

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

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

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

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

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

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

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