The Unfinished Revolution

Bringing Opportunity, Good Jobs And Greater Wealth To All Tunisians

WORLD BANK GROUP

Leaflet

Development Policy Review

Tunisia presents an economic paradox. It disposes of all the prerequisites required to become a "Tiger of the Mediterranean". Yet this economic potential never seems to materialize. On the contrary, the Tunisian economy is plagued by insufficient jobs creation, export performance has been weak, and corruption is widespread. And while poverty has decreased, regional disparities have persisted over time. Such problems have plagued the Tunisian economy for the past decade and ultimately triggered the 2011 revolution. Why? This report tries to untangle the problems and suggest possible solutions.

In the three years since the revolution, Tunisia has achieved significant progress on the political front, culminating in the consensual adoption of a new Constitution. However, the economic system which existed under Ben Ali has not changed significantly—and the demands of Tunisians for access to economic opportunity have not yet been realized.

The Unfinished Revolution is a challenge to Tunisians to rethink their economic development model and to dare to think big about policy reforms which can accelerate growth and shared prosperity, create quality jobs and promote regional development.

How is the "Health" of Tunisia's Economy? Symptoms of Economic Paralysis

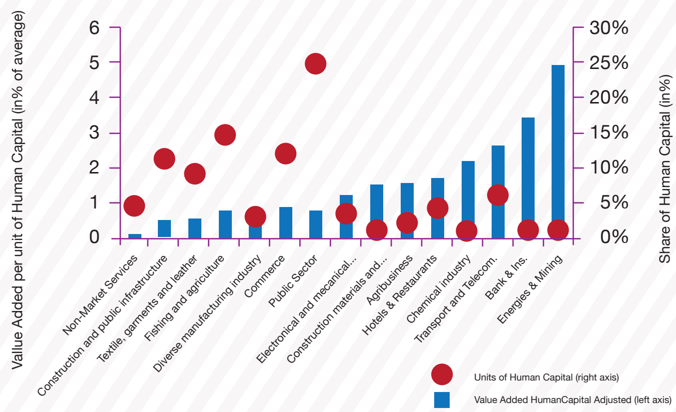
In Tunisia the productivity of the manufacturing sector is very low and the economy has not been expanding towards more remunerative higher productivity activities. **The productivity of the manufacturing sector remains close to that of agriculture.**

WHY?

These observations suggest the existence of distortions and barriers to the operation of markets which prevent a more efficient use of economic resources, thereby hampering economic growth and jobs creation. **77% of workers remain employed in low productivity sectors.**

WHY?

SECTORAL EMPLOYMENT AND LABOR PRODUCTIVITY IN 2009



The private sector is skewed towards small scale activities: **74% of new job creation comes from self-employment (one-person "firms") and there are very few large firms.** The lack of firms' creation is a key cause for the low rate of jobs creation. Yet job creation is also hampered by the fact that most existing firms do not grow. Overall the Tunisian private sector is in paralysis: most firms neither grow nor die, they simply stagnate.

WHY?

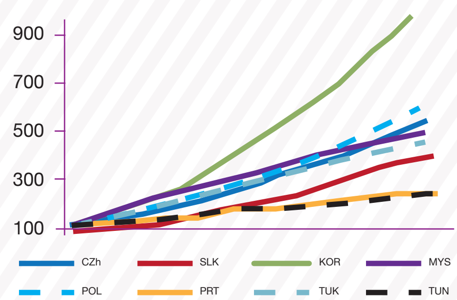
This observation suggests the existence of barriers to competition which prevent the most productive firms from growing and creating more and better jobs, while less performing firms continue to survive. In fact firms' growth is only weakly correlated with profitability and productivity of firms. In other words, **innovative and productive firms are not rewarded in Tunisia.**

WHY?

Tunisia's export performance has been very weak, especially when considering the content of exports. **Tunisia's integration with the EU is superficial: out of 28 countries, 55% of its exports are concentrated only on France and Italy.**

WHY?

VALUE OF EXPORTS OF GOODS AND SERVICES (1990 = 100),1990-2010



Further, Tunisia's export sophistication is low compared to benchmark countries. Tunisia does not produce much of its exports; a large share of Tunisian exports consists of goods assembled for France and Italy. In fact, Tunisian firms have been unable to move beyond the assembly and low value added processes.

WHY?

What Are the Causes of the Economic Impasse?

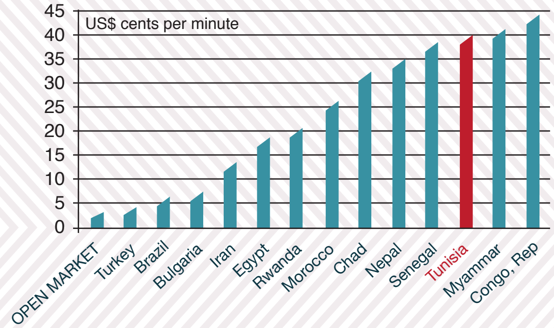
Barriers to Competition and Excessive Red-Tape Result in Privileges and Corruption

Tunisia is characterized by a protectionist regulatory framework which severely limits competition and private investment, notably FDI. More than half of Tunisia's economy is open to only a limited number of firms. **The lack of competition costs the economy over 2 billion dollars per year, nearly 5% of the wealth of the country.**

Many of the privileged firms allowed to operate in restricted sectors are public enterprises which account for 13% of GDP and 4% of total employment. They also often benefit from financial support from the government (3% of State budget in 2013) which makes it impossible for more efficient private sector firms to grow and compete with them.

A few private firms, mostly connected to family and friends of Ben Ali, were also granted privileged positions to operate in lucrative sectors such as telecoms, air transport, advertising, and many others. These sectors have not been opened, even after the revolution. As a result, these **few firms make enormous profits at the expense of everyone else: 220 firms confiscated to Ben Ali, account for only 1% of all jobs, but earn more than 21% of all private sector profits.** In fact these firms are able to charge everyone else higher prices because they face no competition. **Nearly four years after the revolution the system of economic policies and regulations which acts as a smokescreen for rents extraction remains in place unchanged.**

COST OF INTERNATIONAL CALLS FROM US TO COUNTRY FROM SKYPE



Protected firms do not need to perform well because they face little competition which enables them to produce low quality goods and services for higher prices. **The cost of international calls is 10 to 20 times higher than the international market price.** Similarly the cost of airline tickets is much higher than should be expected. And there are many more examples. Further the quality of these goods and services remains low.

Firms in the open part of the economy are forced to pay the high prices charged by these protected firms. These costs make firms less competitive, meaning they cannot produce at the same prices and quality of foreign firms.

In addition, satisfying **the heavy bureaucratic and regulatory burden on businesses drains 25% of the managers' time and almost 13% of firms' turnover.**

As a result Tunisian firms are only competitive in activities intensive in low-skill labor, like assembly, since the wages paid for low-skilled labor in Tunisia remain low compared to other countries. Hence, Tunisian firms limit themselves mainly to importing components made abroad and assembling them in Tunisia for (re)export. This results in fewer jobs, with lower salaries, and little demand for the many skilled Tunisian graduates.

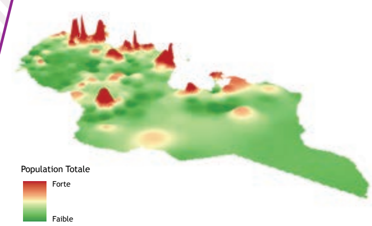
Excessive regulations and the pervasive role of the State have also resulted in a proliferation of corruption, cronyism, evasion of taxes and customs duties, etc. It is estimated that corruption costs Tunisia 2% of GDP per year. Tariff evasion, tax evasion and abuses of public procurement undermine competition by favoring better connected firms and those who practice corruption. **The result is an environment based on privileges and rents which inhibits the emergence of competitive firms** and an efficient reallocation of resources towards the most productive firms. The end result is less and lower quality jobs.

Many Largely Well Intended, but Misguided, Economic Policies

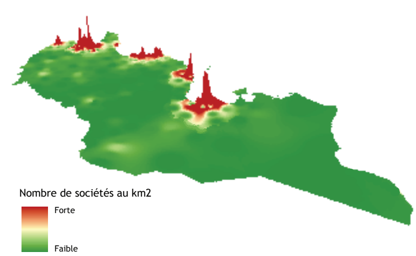
The labor code does not favor investments in labor intensive activities and paradoxically contributes to exploitation of workers and job insecurity. **The labor code introduces a dichotomy between rigid open-ended (CDI) and insecure fixed-term (CDD) contracts.** This dualism favors investments in activities which can easily use CDD jobs (which tend to be low-skill and low productivity activities), and results in excessive job mobility, informality and exploitative labor practices. In addition, **the social Insurance system fails to protect over 50% of workers. And yet the high cost of social security contributions (high level of taxation) encourages informality.**

The financial sector is underperforming. The overall level of credit provided by the banking sector to the private sector remains below potential by approximately 10% of GDP. In addition, the quality of the projects financed is also disappointing, as reflected in the high rate of projects which are unable to repay their loans. The banking sector has been characterized by significant governance failures. Notably, **the large State owned banks have been shielded from competition and repeatedly receive subsidies which allow them to continue to underperform and to continue to lend to connected entrepreneurs instead of selecting the best performing projects.** Connected people have easy access to credit, while at the same time approximately 34% of firms' complain that access to finance is a major constraint. As a result, **public banks have accumulates losses amounting to at least 3% of GDP (i.e., over US$1.5 billion) that will require a bail-out from the State budget.** The ineffective bankruptcy regime exacerbates these problems, as it allows low performing firms to continue to operate (even though they are not repaying their loans) which undermines the success and growth of more efficient firms.

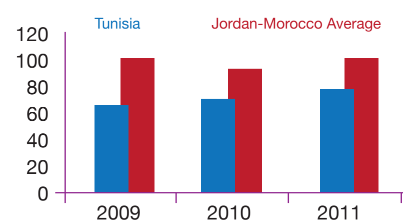
The investment incentives policy is expensive and has contributed neither to jobs creation nor to reducing regional disparities. Investment incentives are expensive (2.2% of GDP in 2009) and are largely wasted since only 21% of firms would not have invested without tax advantages. **The cost of each additional job created thanks to the incentives is approximately TDN 30,000 per job per year** (approximately US$20,000 in 2009). Further the incentives largely benefit exporting firms which are naturally located along the coast: Only 16 percent of jobs were created in the interior regions. Finally, the onshore-offshore dichotomy is now at the core of the low performance of the economy: the low efficiency of the protected 'onshore' sectors negatively affects the competitiveness of the 'offshore' sectors.



DENSITY OF POPULATION (TOP) AND DENSITY OF FIRMS (BOTTOM) PER SQUARE KM IN TUNISIA IN 2012



PRIVATE CREDIT TO GDP AS % OF GDP, 2000-2010



Things Can Get Better: Unleashing Tunisia's Economic Potential

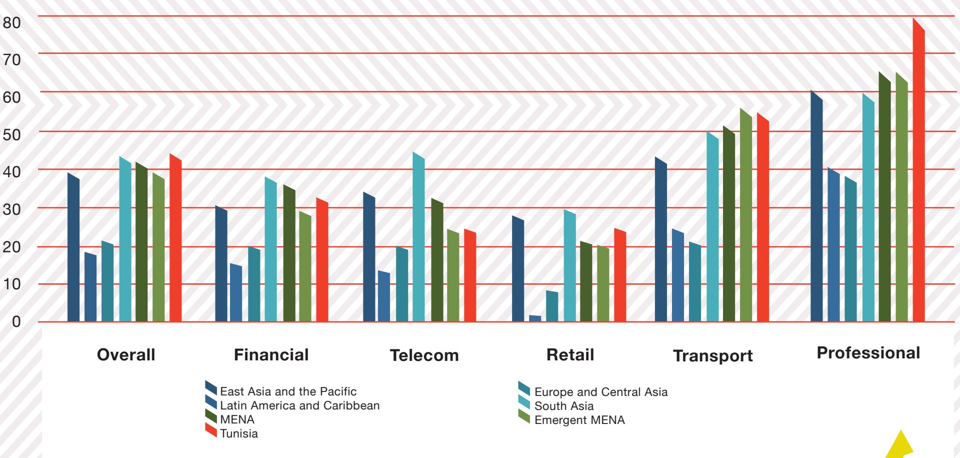
Increasing competition and reforming the banking sector could more than double jobs creation by bringing 100,000 additional jobs per year.

Allowing more competition and reforming the banking sector would be very beneficial to Tunisia: **We estimate that an increase in competition resulting in a 5% decrease in profit margins of firms would increase labor productivity by 5% on average, translating into higher GDP growth by 4.5% and approximately 50,000 new jobs per year. The gains are highest in "backbone" services to firms.**

Reforming the banking sector could result in an increase in private domestic investment of 2% per year, which would bring an additional 38,000 jobs per year. Additional jobs can be created by improving policies in industry, services and agriculture.

Tunisia has the potential to become a global leader in the export of wage-intensive manufacturing goods, such as: (a) textile and garments; (b) leather and footwear; (c) electrical and mechanical; (d) chemical; (e) glass, iron, metal materials for construction; and (f) home furniture and sanitary. **Tunisian manufacturing firms have so far been unable to move past simple labor-intensive tasks in these sectors largely because of the distortions and costs associated with current economic policies:** barriers to competition, distortions from the onshore-offshore duality, excessive red tape, and failures in labor markets and the financial sector. Addressing these problems would allow Tunisian manufacturing firms to become increasingly competitive in the higher-value added segments of these value chains, resulting in more and better quality jobs.

SERVICE TRADE RESTRICTION INDEX (STRI) BY SECTOR AND REGION



Opening service sectors could boost growth by 1% of GDP and contribute an additional 7,000 jobs per year, notably for graduates. Entry into services sector in Tunisia is among the most restrictive in the world. Barriers to entry have created rents and privileges, and as a result services sectors in Tunisia remain highly inefficient. This undermines the competitiveness of the entire Tunisian economy. High potential services sectors include the telecommunications and ICT, offshoring, professional services, air and maritime transport, logistics, tourism, and health and education services.

Tunisia has a large unexploited potential in Mediterranean agricultural products. However, Tunisia's agricultural policy is instead mainly geared towards ensuring food security and focuses the agricultural sector towards water-intensive continental products in which Tunisia is not competitive. Current policies exacerbate regional disparities and entail a net loss of 1% of GDP to the country. Further the redistribution of benefits from agricultural subsidies is highly inequitable as it mostly benefits large landowners and mainly in coastal areas. **A move away from the current agricultural policies, and to support agriculture instead with horizontal policies, could increase economic growth by 1% of GDP and generate an additional 14,000 jobs per year.** Further, this would result in gains for almost 70 percent of farmers and benefit mainly the interior regions of the country. The institutional and bureaucratic maze is also a severe barrier to investment in the agricultural sector.

Tunisia is at a crossroads: It can choose a new model, not only for the economy but more broadly for society

Tunisians need to debate a new vision for the development of the country. In addition to preserving macro economic stability, economic reforms are needed to create a healthier economic environment that encourages investment and productivity and improve competitiveness and jobs creation. In parallel, there is a need to elaborate an equitable redistribution of wealth to ensure no-one is left behind. **The report highlights the reforms necessary to increase growth and jobs creation: Increase competition and simplify the regulatory environment; Rethink the investment policy; Restructure financial sector; and, Improve the social protection system and reduce inequalities.**

Changing the development model will not be easy...

There are significant risks and barriers to the process of change. **The privileges and rents associated with the current system are deeply entrenched and those lobbies will argue strongly against any changes which remove their privileges.** Delaying the introduction of the economic reforms increases the risks that vested interests will capture existing opportunities for rent-seeking and be in a stronger position to prevent change. Also, **the gradualism of economic reforms cherished by Tunisia's administration poses a risk to Tunisia's future.** It is clear that marginal changes to the economic policies will not be sufficient.

International experience suggests some actions to improve chances of success: (a) Creation of a high-capacity "Reforms Unit" in the PM office; (b) Framing of the reforms program in the context of the broader regional and international economic integration process; (c) Launching a national dialogue process on the reforms program; and (d) Building on the experience in tripartite social dialogue as a powerful vehicle to facilitate a new social contract.

The report and related materials are available online at:
www.worldbank.org/en/country/tunisia/publication/unfinished-revolution

WORLD BANK GROUP