"Better Policies" Series

TUNISIA

A REFORM AGENDA TO SUPPORT COMPETITIVENESS AND INCLUSIVE GROWTH

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OECD

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FOREWORD

In 2011, Tunisians' thirst for a more inclusive, democratic society sparked a political transformation, first domestically then across the region. 2014 marked a new stage in the democratic transition, with the adoption of a new Constitution allowing for parliamentary and presidential elections later that year. The formation of a new, inclusive government in February 2015 marked another crucial milestone.

With democratic transition, however, come the high expectations of newly enfranchised citizens. They expect to see improvements in their daily lives. Tunisia's old model of economic development brought strong growth for a time, but it stored up problems for the future. High youth unemployment and stark regional inequalities, in particular, sowed the seeds of social unrest which ultimately gave rise to the political transformation we have witnessed since 2011.

Tunisia's new government faces many challenges, but also a unique opportunity to implement ambitious reforms, from which the benefits could be immense. For example, if labour force participation rose to the level of southern European countries, unemployment fell, and productivity picked up to the pace of Central European countries, Tunisia's GDP *per capita* could match that of Poland by 2060, 1.7 times the expected level in the absence of reforms.

But, stronger growth is not enough! The benefits must be shared by all Tunisians. Significant investment in infrastructure is needed to improve connectivity linking the coast with less-developed interior regions. Removing price controls in agricultural areas could increase farm production and help farm workers climb out of poverty. There is a need for development strategies tailored to local needs, backed by sufficient resources and political support.

Unemployment in Tunisia is not far from the OECD average, but this hides the very high levels in poorer regions and among young people, in particular. Public works programmes could be used to promote rural employment while also helping close the infrastructure gap. Active labour market policies should be better targeted and vocational and educational training strengthened. Meanwhile, a broad range of measures is needed to develop a thriving private sector in order to provide young graduates with attractive alternatives either to public sector jobs or to emigration.

The OECD continues to work closely with Tunisia across a range of policy areas, for example through the Deauville Partnership and the MENA-OECD Initiative on Governance and Investment for Development, which will celebrate its 10th anniversary in 2015. We also partner bilaterally on projects to tackle youth employment, improve the tax system, integrate Tunisia into Global Value Chains and implement Public Private Partnerships. We are a proud partner on Tunisia's path to 'better policies for better lives'.

Angel Gurría
Secretary-General, OECD

1. INTRODUCTION

Tunisia's development pattern has long stood out on the African continent, thanks to robust growth, openness to foreign trade and investment in its offshore sector, as well as better outcomes in health, education, poverty reduction and gender equality compared to its neighbours. However, the country's development model has also led to wide regional disparities, high unemployment among skilled workers, and heavy state intervention in the economy, which has stifled productivity growth. To kick-start growth, the government needs to address immediate economic challenges by cleaning up the financial sector and strengthening the fiscal and monetary policy frameworks. In addition, it should set out a broad structural reform agenda to boost productivity and make growth more inclusive.

The process of democratic transition initiated in 2011, followed by parliamentary and presidential election under the new Constitution in late 2014 open an extraordinary window of opportunity to implement ambitious institutional and structural reforms. An inclusive and broad-based programme of reforms could result in more transparent, accountable and efficient institutions as well as a policy framework capable of delivering on the high expectations of Tunisian citizens in terms of shared prosperity and good governance. Indeed, many of the social, economic and institutional challenges facing Tunisia are also shared by other countries in the MENA region undergoing transition and are being addressed with the support of the global community through the Deauville Partnership, in which the OECD is an active participant.

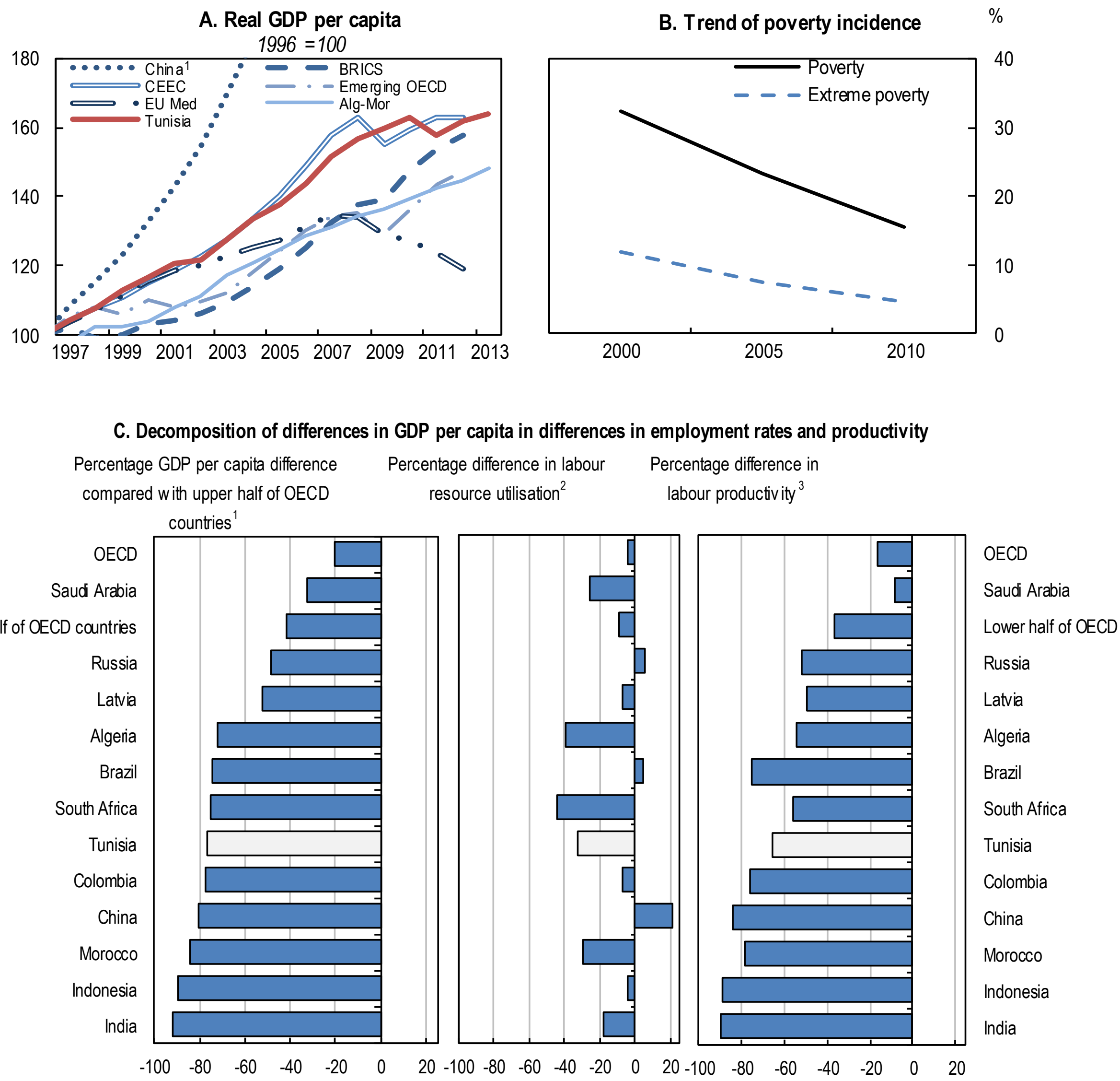
The growth model that Tunisia had pursued since independence, but before the recent revolution, is often described as having relied on three main pillars (Paciello, 2011; Hibou, 2011): *i)* a strong state that guaranteed stability -- although at a high cost in terms of civil and political liberties and corruption; *ii)* an implicit social contract that included an active education and social policy, the promotion of women's role in society, and the development of infrastructure; and *iii)* economic management based on broad openness to external trade and foreign investment in certain sectors, but with strategic economic decisions taken by the state.

Tunisia's development model produced reasonably good macroeconomic results in past, helping the country avoid major crises sparked by budgetary or external imbalances and keeping inflation under control. A solid growth performance allowed the country to narrow the gap with the more advanced countries in GDP *per capita* and to reduce the incidence of poverty, especially when compared with other countries in the Mediterranean region (Figure 1.1). Tunisia's relatively impressive and inclusive growth record was also achieved thanks to favourable performance in the key areas of health, education, and infrastructure (Figure 1.2).

However, major problems built up over time, including a rising unemployment rate among the most qualified workers, widening regional disparities, a growing current account deficit, unreported public-sector liabilities, poor lending standards in the banking sector, and increasing use of price controls (**Chapters 2 and 3**). The 2011 revolution has laid bare some of these shortcomings, leading to calls for reform.

Tunisia has ample room to boost both productivity growth and employment rates, while further tackling income inequality and poverty. Success on this front will require making better use of accumulated human capital. Tunisia needs to reduce its high unemployment and bring more of the population into the workforce. This is especially true for women, 60% of whom have secondary or higher education (a rate well above that for other Middle East and North Africa [MENA] countries) but very low participation and employment rates of 25% and 20%, respectively. By comparison, 70% of men have a secondary or higher level of education, and their participation rate is 70%, and their employment rate is above 60%. There is a need for family-friendly policies both to help improve female labour market participation and to help families achieve a work-life balance. This is especially important in light of the important demographic changes in recent decades. Tunisia also needs to make better use of its skilled workers, especially graduates, who have a higher unemployment rate than the average person of working age.

Figure 1.1 Key economic and social indicators



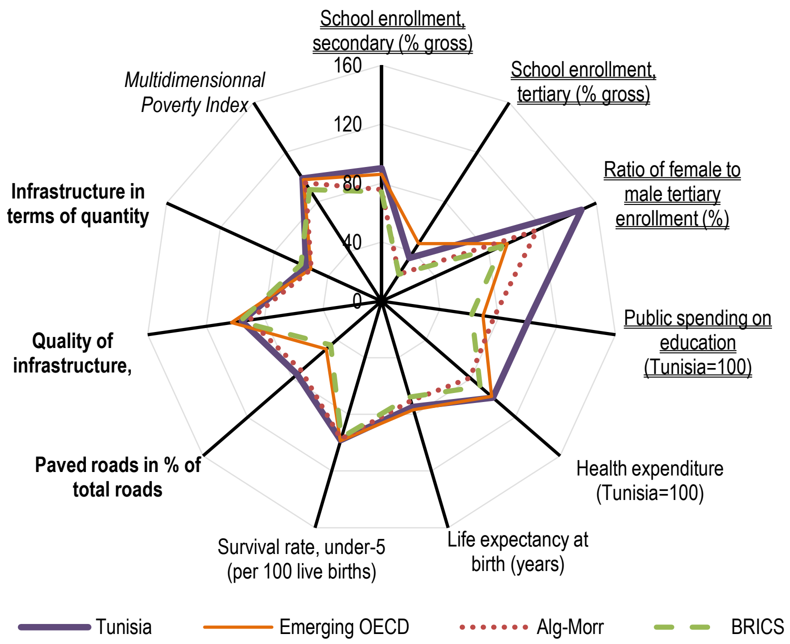
1. The index for China reached 424.4 in 2013.
2. Compared with the simple average of the highest 17 OECD countries in terms of GDP per capita in 2012, based on 2012 purchasing power parity (PPP). The OECD average is based on a simple average of the 34 member countries. The sum of the percentage gap in labour resource utilisation and labour productivity does not add up exactly to the GDP per capita gap since the decomposition is multiplicative.
3. Labour resource utilisation is measured as employment as a share of population.
4. Labour productivity is measured as GDP per employee.

Selected comparative groups: **Alg-Mor**: Algeria, Morocco; **BRICS**: Brazil, Russia, India, China, South Africa,; **CEEC**: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia; **Emerging OECD**: Chile, Mexico, Turkey; **EU Med**: Greece, Portugal, Spain.

Poverty indicators are estimated by the Tunisian statistical institute, with the poverty threshold set at DT 1277 per year and capita in large cities and DT 820 in rural areas in 2010. Extreme poverty threshold is set at DT 757 per year and capita in large cities and DT 571 in rural areas in 2010. For more details see (INS, 2012)

Sources: International Monetary Fund World Economic Outlook (IMF WEO), World Bank, OECD Economic Outlook and National Accounts, ILO (International Labour Organisation), Key Indicators of the Labour Market (KILM), Statistics South Africa, India National Sample Survey, China Ministry of Human Resources and Social Security and Institut National de la Statistique (2012), "Mesure de la pauvreté, des inégalités et de la polarisation en Tunisie 2000-2010.

Figure 1.2. Relatively solid performance in education, health, infrastructure and poverty indicators
160=best, 0=worst

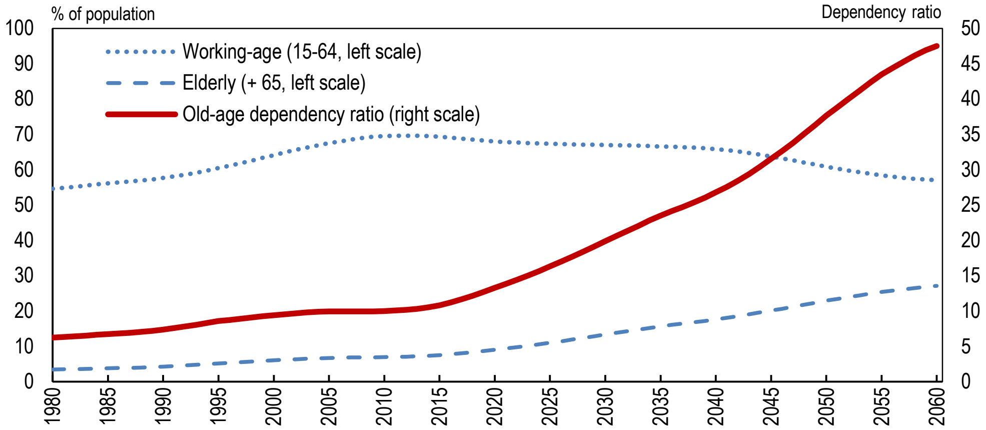


Sources: World Bank, World Economic Forum, Tunisian National Statistics Institute (INS).

Ambitious reforms could boost GDP per capita by an extra 70% by 2060

A forward-looking OECD extrapolation of the pre-2010 growth performance, based on long-term demographic projections, shows the level of GDP *per capita* remaining well below its level in the poorest OECD countries by around 2060 (Figure 1.4). This benchmark scenario, however, points to a clear deceleration of the country’s trend growth over the coming decades (Table 1.1), reflecting demographics. Tunisia’s demographic profile is in fact similar to that of many OECD countries, characterised by a marked downturn in the fertility rate and an increase in life expectancy. The speed of these demographic changes has led many social and economic players (including trade unions) to advocate in favour of more family-friendly policies. The old-age dependency ratio is projected to rise from 20% today to nearly 50% in 2060 (Figure 1.3), similar to that of countries such as France and the United Kingdom. Unless immigration, which is now occurring from Libya for example, continues indefinitely, the growth in the working age population will grind to a halt by the 2030s and start declining thereafter (as a share of total population, the proportion has already peaked; Figure 1.3).

Figure 1.3. Old-age dependency ratio at an inflexion point



Source: UN Long-term demographic projections.

Table 1.1 Long-term growth scenarios for Tunisia

Annualised percentage changes (unless otherwise specified)

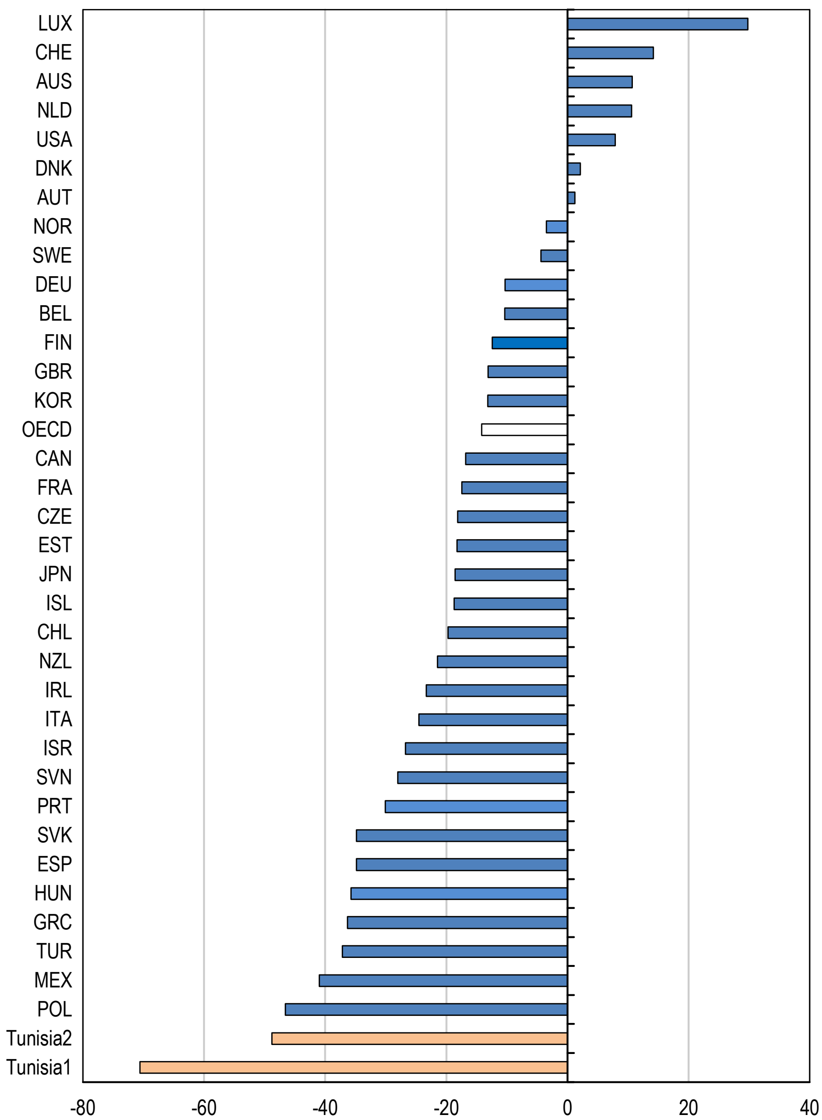
	1981-90	1991-2000	2001-10	2011-20	2021-30	2031-40	2041-50	2051-60
Scenario 1. Extrapolation of trends until 2010								
Per capita GDP	**1.0**	**2.9**	**3.2**	**2.1**	**2.2**	**2.3**	**1.7**	**1.7**
of which:								
Total population	2.5	1.6	1.1	1.0	0.6	0.3	0.2	-0.1
Trend GDP	3.5	4.5	4.3	3.1	2.9	2.6	1.9	1.6
of which:								
Labour productivity	1.0	2.0	2.3	2.2	2.2	2.2	2.2	2.2
Employment	2.6	2.5	2.0	0.9	0.7	0.4	-0.3	-0.6
of which:								
Labour force participation	-0.3	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment effect	-0.2	0.1	0.1	0.1	0.3	0.3	0.1	0.0
Working-age population	3.1	2.7	1.9	0.8	0.5	0.1	-0.6	-0.7
Memorandum items:								
Labour force participation level (in per cent)	52.6	50.9	50.1	50.3	50.3	50.3	50.3	50.3
Unemployment level (in per cent)	15.3	15.8	14.4	14.4	12.0	9.5	7.3	7.0
Scenario 2. Active structural reforms								
Per capita GDP				**3.0**	**4.0**	**3.7**	**2.4**	**2.4**
of which:								
Total population				1.0	0.6	0.3	0.2	-0.1
Trend GDP				4.0	4.7	4.0	2.6	2.4
of which:								
Labour productivity				2.2	2.3	2.6	3.1	3.1
Employment				1.9	2.3	1.4	-0.5	-0.7
of which:								
Labour force participation				0.7	1.3	1.1	0.1	0.0
Unemployment effect				0.3	0.6	0.1	0.0	0.0
Working-age population				0.8	0.5	0.1	-0.6	-0.7
Memorandum items:								
Labour force participation level (in per cent)				52.0	58.2	65.7	70.0	70.0
Unemployment level (in per cent)				13.7	8.9	5.6	5.5	5.5

Sources: UN long-term demographic projections and OECD calculations.

The growth slowdown highlighted in this first scenario could be partially offset by an increase in the employment rate and by greater productivity gains, but these require significant reforms. For example, if the participation rate rose gradually to the level of southern European countries by 2060, unemployment fell and productivity growth picked up to the pace of Central European countries, Tunisia's GDP *per capita* could catch up with that of Poland by 2060 (Table 1; Figure 1.4). This would see it surpassing by that time 60% of the OECD average (from 29% in 2012) and half the average of the upper half of OECD countries (from 23% in 2012). By contrast, the baseline scenario would suggest that Tunisian GDP *per capita* would otherwise remain barely a third of the OECD average by 2060 and less than 30% of the average of the upper half of OECD. In short, Tunisia's per capita GDP could be more than 70% higher by 2060 in the reform scenario, underlining the massive long-term potential for reforms today to improve living standards in the future.

Figure 1.4. Successful reforms could move Tunisia up the ranks of developed economies by 2060

(Projected per capita GDP gap by 2060, in percentage points)



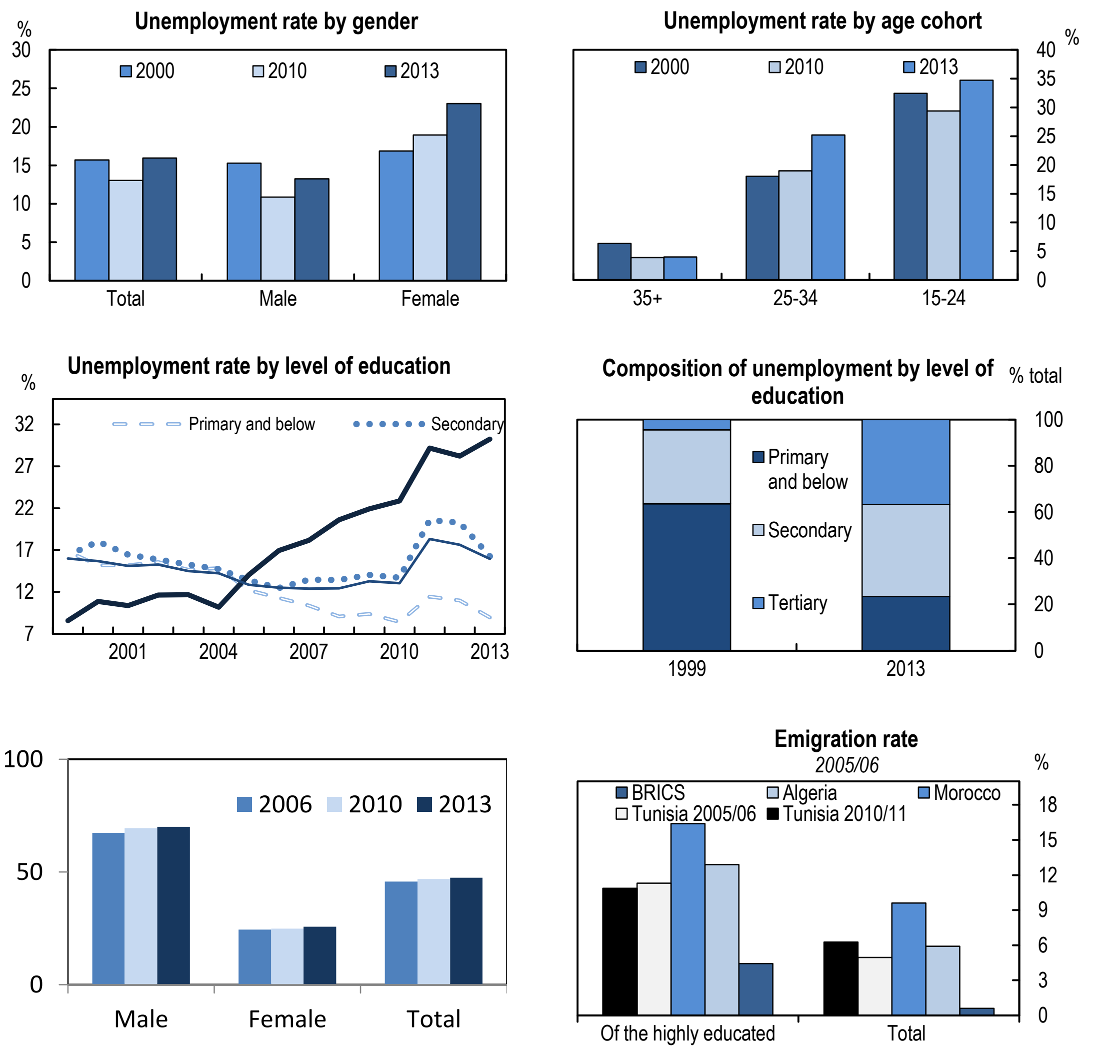
Note: Per capita GDP gap is measured by comparison with the upper half OECD countries' average. TUNISIA_1 shows the projection based on the extrapolation of past performance. TUNISIA_2 shows the projections assuming that the participation rate rises to the level of southern European countries by 2060, unemployment falls and productivity growth picks up to the pace of Central European countries.

Source: *OECD Long-Term Baseline 95 and calculations.*

High unemployment, informality, and regional inequalities need to be tackled

The average unemployment rate has not only remained higher than in most other emerging economies, but has jumped for highly skilled workers (Figure 1.5). Unemployment is also particularly high for women and for young people, who must often resort to informal employment. Although employment in the informal economy appears to have diminished since 1997, it still accounts for around 50% of workers between 15 and 24 (OECD, 2015). Since 2011 there has also been a significant increase in contraband activities in certain disadvantaged regions, with adverse impacts on the labour market and school enrolment. Youth employment problems also encourage a high rate of emigration, with a disproportionate impact on skilled workers, a phenomenon also evident in countries of the Maghreb (Figure 1.5). While remittances from emigrants are an important source of income for many households, and of foreign currency for Tunisia, labour market and emigration trends nevertheless undermine the effectiveness of, and return on, investment in education. Unemployment of skilled workers also has a marked negative impact on the middle classes (Paciello, 2011), and because social protection relies heavily on an employment-based insurance system, a prolonged period of unemployment raises the threat of poverty.

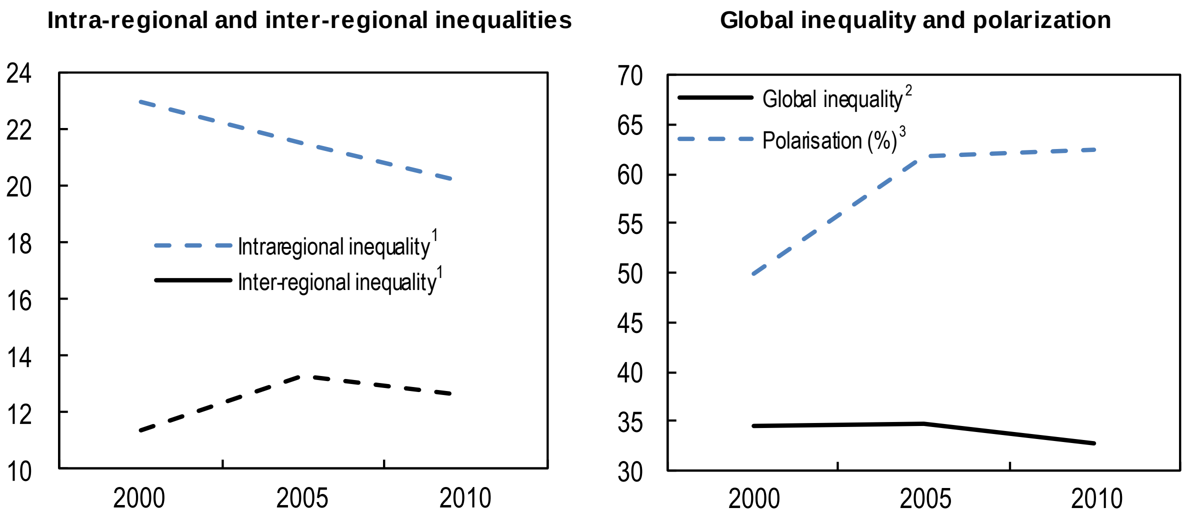
Figure 1.5. Unemployment and emigration



Source: *INS, National survey on population and employment, Connecting with emigrants OECD (2012), OECD Publishing.*

The benefits of growth have been unevenly shared. This is illustrated by the growing unemployment gap between young and old and between women and men , and by inequalities between workers in the private sector, whose jobs are often insecure, and those in the public sector, who enjoy high salaries, job security and better working conditions (Gatty *et al*., 2013). The latter phenomenon, when combined with the nature of the unemployment insurance system, incentivises highly skilled people to wait to be offered a public sector job rather than taking a job in the private sector. Above all, not all regions have benefited from the decline in poverty to anything like the same extent. Interregional inequalities widened in the past, worsening the polarisation between inland areas and coastal zones, although they have diminished somewhat in recent years (INS, 2012; Figure 1.6). Lastly, these tensions have been exacerbated by the spread of corruption in certain areas of the public administration. In 2010, the 220 businesses that were confiscated from members of the family of the former President, Zine El Abidine Ben Ali, accounted for more than 20% of profits in the entire economy (Rijkers *et al*., 2014).

Figure 1.6. Trends in inequalities are mixed



1. Gini index. Gini index varies between 0 (which reflects complete equality) and 100 (which indicates complete inequality).
2. Gini index. The global inequality index is measured as the sum of inter-regional and intra-regional indices.
3. The polarization index is the ratio between inter-regional and intra-regional indices.

Source: Poverty, inequalities and polarisation measures in Tunisia (2012), INS.

Overall, the Tunisian growth model has often excluded the most dynamic and well-trained individuals, while failing to help some of the most vulnerable groups in inland areas to close the living standards gap with the rest of the population. This stems in part from the contradictions between ambitious social policies, especially in education, and an inability to put educated people to effective use. Nor has the country established institutions for distributing the benefits of growth fairly, reflecting to a large extent weaknesses in product and labour markets and in the banking system.

Tunisia must also address its high regional inequalities (**Chapter 5**). Its past development model focused largely on the coastal areas, leaving the rural hinterland underserved both in terms of social and physical infrastructures. Ceilings on agricultural prices have also had an adverse impact on rural economies, distorting production and depressing farmers' incomes.

Excessive state intervention hinders competitiveness

Tunisia does not have as many high-value-added activities as might be expected given its solid endowments in human capital and infrastructure (**Chapter 6**). This situation can be blamed in large part on excessive state intervention, which has distorted product markets and held back the emergence of a dynamic private sector (**Chapter 9**). Moreover, regulation of product markets is too restrictive and heavy-handed, and there are many monopolistic public enterprises subject to poor governance.

Since the early 1970s, the authorities have pursued an industrial policy focused on export promotion, using tax incentives to attract foreign firms that are geared essentially to external markets (the so-called “offshore sector”; **Chapter 10**). This policy framework has stimulated the emergence of an important export sector dominated by these offshore companies, whose share of total employment increased from 12% in 1996-97 to 23% in 2013 while accounting for 60% of exports. The offshore sector is concentrated in low-value-added activities that are relatively stagnant, such as the textile sector, where required skill levels are fairly low (Table 1.2). The strong incentives on which this industrial policy is based have tended to attract entrepreneurs looking for subsidies and public assistance, and they have subsequently had trouble coping with competition from low-cost countries. While the tourism sector is one of Tunisia’s most important export sectors, tourism policy has largely focused on developing the low-cost sector, with very slim profit margins and limited added value, in comparison with Morocco, for example (Figure 1.7).

Table 1.2. Tunisian export structure by region and product and world trade development

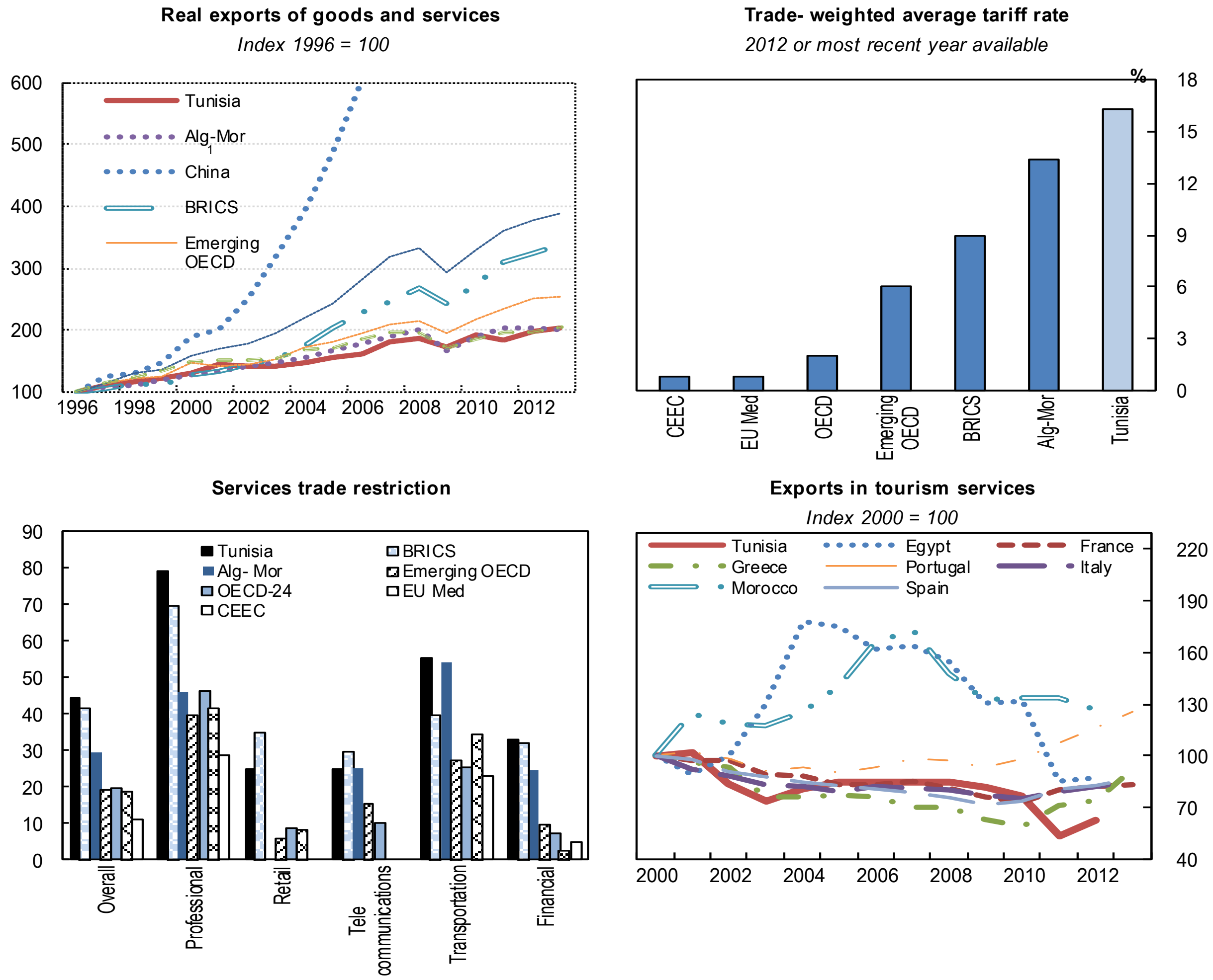
	Tunisian export structure	Annual % growth of total world imports	
	2007-2011	2007-2011	1997-2011
By product:			
Food, Agriculture	9.1	9.4	7.8
Chemicals	10.7	7.8	10.1
Machinery and transport equipment	25.0	4.0	7.6
Other manufacturing, incl. textile	37.8	4.1	7.4
Energy, minerals, and crude materials	16.8	12.5	13.4
Unclassified products	0.5	5.9	10.8
All commodities	100.0	6.5	8.9
By region:			
ALENA[1]	1.8	3.4	6.9
ASEAN[2]	0.2	9.1	8.3
BRICS	2.9	16.3	16.5
EU	74.8	2.7	8.4
Maghreb[3]	4.4	15.5	12.5
Middle East[4]	6.1	9.8	25.0
World	100.0	6.6	9.0

1. Alena: Mexico, USA, Canada
2. ASEAN: Brunei, Cambodia, Laos, Thailand, Malaysia, Singapore ,Philippines, Vietnam
3. Maghreb: Algeria Morocco, Egypt
4. Middle East: Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates.

Sources: Comtrade and OECD calculations.

Overall, Tunisia’s exports have been growing more slowly than those of its competitors, and they have not kept pace with global trade growth for many years. Part of the reason is Tunisia’s high tariffs (Figure 1.7), as the country has been slow to negotiate free trade agreements with major countries and regional groupings (Utica, 2012). The resulting higher cost and lower availability of imported intermediate inputs has undermined export development. In addition, the destination of Tunisian exports is highly concentrated in Europe and they have therefore benefited little from the growth of emerging countries while depending heavily a European economy that has failed to generate vibrant external demand.

Figure 1.7. High tariffs and restrictions on services trade have undermined export performance



1 The index for China reached 1123.1 in 2013.

Sources: INS, IMF WEO, World Bank, OECD Economic Outlook (EO) database, WEF global competitiveness 2013-14 report.
Note: The World Bank's Services Trade Restrictiveness ranges from 0 (complete absence of service trade restriction) to 100 (sector completely close to foreign services and service providers).

Foreign direct investment has generated few positive spillovers to the rest of the economy, despite the authorities' recent efforts to open up the offshore and domestic sectors. Since 2007-08, offshore companies had been allowed to sell up to 30% of their output on the domestic market. However, the administrative barriers between the two sectors – especially slow customs procedures – have made it difficult or impossible to take advantage of these opportunities. For instance, it is often easier to import from France than to buy from a nearby offshore enterprise (AfDB-OECD-UNDP, 2014).

Many other obstacles in product markets hold back the development of high-value-added activities and the growth of Tunisian firms more generally (Rijkers *et al*., 2013). Some sectors, such as energy and services, are hindered by overly strict regulation (Figure 1.7). Price controls, which apply to around a third of consumer goods, also dampen competition. Prices for goods are too low to make private investment profitable in certain sectors, for example in renewable energy such as solar. Anecdotal evidence suggests, moreover, that price controls affect the behaviour of entrepreneurs, reducing their incentive to sell below the top price even if they are able to do so. There are also barriers to foreign direct investment in several sectors. For example, foreigners are not allowed to purchase agricultural land or to hold a majority interest in a joint venture in the agri-food sector, and there are many restrictions in other sectors, such as transport, communications, construction, tourism and information technology (IT) services. A recent study suggests that many of these barriers have their origin in regulatory manipulation under the previous regime, which sought thereby to protect vested interests (Rijkers *et al*., 2014).

Indeed, a lack of effective institutions to ensure public sector accountability, the rule of law, and checks and balances on power in Tunisia results in weak protection of property rights, corruption, and barriers to entry (AfDB, 2013). Establishing a sound framework of economic governance, including institutions that provide investors with a clear and transparent set of rules and assurance that they will be able to reap the fruits of their investments, will be key to supporting sustainable private sector development.

The fact that large public enterprises have a monopoly in many lines of business is a further hindrance to growth. These enterprises operate, for example, in the collection, storage, and marketing of products such as wheat, sugar, coffee, and cooking oils (World Bank, 2013). They generally operate at low efficiency levels and have no incentive to boost their productivity under the system of price controls. In fact, their inefficiency is to some extent encouraged by subsidies. There is also a serious problem of governance in public enterprises, which must be addressed if they are to function like private firms and not as agencies in the service of the state (OECD, 2013a).

The government's presence in the banking sector illustrates these issues. Before 2011, the large state-owned banks, which dominate the sector, were seen as an extension of the government for implementing its industrial policy, to promote tourism or the textile sector for example. The private interests of the previous regime, and those close to it, further weakened the public financial institutions by receiving credit on conditions more favourable than those of the market (World Bank, 2013). These practices, together with problems of governance and a lack of expertise in risk selection, have distorted competition by disrupting the supply of credit. That supply is, moreover, restrained by strict limits on interest rate spreads imposed by the central bank. The banking sector as a whole is weakened by a high level of non-performing loans, particularly in the tourism sector, as well as by undercapitalisation and inadequate loss provisioning (**Chapter 3**). An immediate challenge for economic policy, then, is to preserve the country's financial stability while removing the obstacles to the financing and development of private firms, particularly Small and Medium-sized Enterprises (SMEs).

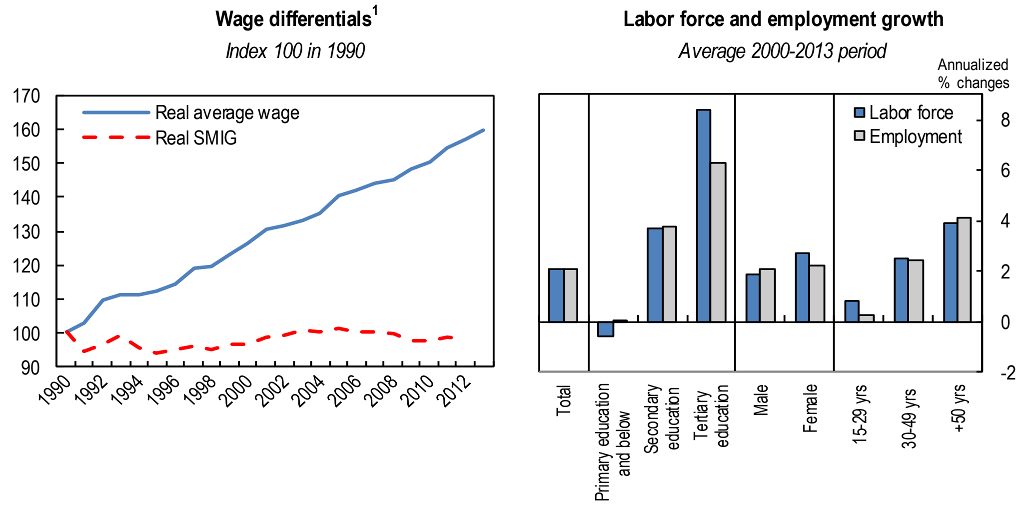
The labour market suffers from multiple deficiencies

Thanks to a solid education policy, the number of workers with a tertiary education level has risen sharply since the late 1990s, such that even strong employment growth among this cohort has been insufficient to prevent a rising unemployment rate. At the same time, the number of unskilled workers has dropped, resulting in a fall in their rate of unemployment despite the low demand for these workers (Figure 1.8).

This unusual situation reflects a number of factors (**Chapter 4**). First, the demand for labour by private firms has been distorted by regulations, giving rise to a high degree of dualism. The marked difference in the protection offered to workers under permanent contracts and those under fixed-term contracts has segmented the market. Private firms, needing flexibility, have preferred fixed-term contracts, and as a result experience high staff turnover (Stampini and Verdier-Chouchane, 2011). Second, Tunisia faces a problem of transition from school to work, reflecting mainly the lack of opportunities for students in the private sector (OECD, 2015). Tunisian firms are still for the most part small (Rijkers *et al*., 2013). This constrains the creation of skilled jobs, thus many well-trained young people are working in positions that do not reflect their skillset, and that are temporary, and poorly paid. A third significant distortion lies in the tax wedge on labour, which is similar to that of Sweden or Finland (OECD, 2015) and arises mainly from high personal income tax rates.

The labour market is also heavily influenced by the large contrast between working conditions in the public and private sectors. This situation reflects not only the government's desire to attract competent staff, but also the distortions created by the many monopolistic public firms that are little concerned with efficiency and profitability, and even offer jobs with advantages similar or higher than those of government itself. In 2007 the average government salary was 67% above the national average (Mahjoub, 2010), and this gap seems to have widened in recent years. In addition, before the revolution the authorities exerted strict control over low wage increases to preserve the country's cost-competitiveness. The ratio of the average salary to the official minimum wage (s*alaire minimum interprofessionnel garanti*, or SMIG) rose from 1.7 in 1990 to 2.7 in 2012, i.e. by 160 % (Figure 1.8), yet nearly half the employed workforce is paid at the SMIG. These trends have not only deepened the inequalities between workers in the public and private sectors but have also influenced the choice of training, distorted the allocation of skilled labour in the economy, and boosted the reservation wages of the most highly trained workers (OECD, 2012a).

Figure 1.8. Labour market indicators



1. The average salary and the official minimum wage (s*alaire minimum interprofessionnel garanti*, or SMIG) are deflated by the CPI.

Source: INS, National survey on population.

Major reforms are indispensable to improve the functioning of government

The structure of expenditure is distorted by the large subsidies for food, energy and manufacturing, which in 2013 represented 7% of GDP (**Chapter 7**). These subsidies are not efficient for combating poverty. Beneficiaries include the country's 6-7 million foreign tourists, as well as nationals from neighbouring countries (Algeria and Libya) through cross-border trade and smuggling. Government expenditure therefore needs to be restructured to make it more effective, and the government decentralisation plan called for in the new Constitution provides an opportunity to do so.

On the other hand, the tax burden does not seem especially heavy, although the weight of direct taxes in relation to indirect taxes is too high (**Chapter 7**). This situation, together with an extremely complex taxation system, creates significant distortions in production, penalises the country's competitiveness and encourages tax evasion (Tunisian National Statistics Institute, 2014). The level of gross public debt, at about 45% of GDP in 2013, is not very high when compared to countries in the south and east of the EU for example, despite the sharp deterioration in the budget balance since the revolution (**Chapter 2**). To keep the public accounts healthy, however, these budgetary slippages will have to be corrected promptly, and the pension systems will have to be reformed to contain rising pension costs (**Chapter 7;** also**,** World Bank, 2013; Utica, 2012).

More generally, there is a need to strengthen public governance by increasing the transparency, integrity, and accountability of public institutions (**Chapter 8**). Strong public governance can help rebuild citizens' trust in the state. In turn, trust can help foster an environment conducive to growth-enhancing reforms.

Key OECD Recommendations - Highlights

- **Boost banking sector stability** by extending due diligence to the entire banking sector, encouraging the recapitalisation of distressed but viable banks, and winding up non-viable banks.
- **Tackle the fiscal deficit** and the contingent liabilities with structural fiscal reforms.
- **Active labour-market policies need to better target the disadvantaged**, the low-skilled (i.e. non-graduates) and the long-term unemployed.
- **Introduce an unemployment insurance system** to help individuals and households smooth consumption when out of work.
- **Reform public-sector recruitment rules** so that they no longer reward those who have been longest out of a job.
- **Give more support to families to help them juggle work and home responsibilities.** In particular: maternity and paternity leave entitlements should be increased, and the government should do more to help parents (in particular the poorest) to meet the relatively high costs of child care.
- **Make Vocational Education and Training more attractive** by: i) integrating the technical track into general lower-secondary education, ii) expanding VET at the upper-secondary level and linking it to strong quality-assurance mechanisms, iii) introducing career guidance in all lower-secondary schools and iv) improving articulation between vocational and academic programmes.
- **Use public-works programmes to stimulate employment in rural areas**, while helping to close the regional infrastructure gap and helping the country in its transition to a greener economy.
- **Gradually remove price controls in rural and agricultural areas**, as they hamper farm production and keep many farmers trapped in poverty. Improve the management of plots owned by the central government.
- **Develop a co-ordinated, national strategy for infrastructure** and update infrastructure development priorities. Prioritise the maintenance of existing infrastructure.
- **Bolster the decision-making capacity and resources of local authorities** so they can better meet the needs of the population and exploit local resources.
- **Involve stakeholders in the policy process** by institutionalising participation mechanisms at the national and local level.
- **Promote policy coherence and co-ordination by developing the capacities of the Prime Ministry** to take on the role of the Centre of Government, co-ordinating whole-of government policies across different levels of government.
- **Accelerate the completion and adoption of the draft Investment Code** in order to create greater coherence and predictability for investors, streamlining the necessary information on the entry, establishment and protection of investments.
- **Step up efforts to attract higher added value tourism**, capitalising on the country's rich natural and cultural heritage.
- **Pursue further trade facilitation reforms** to improve access of local firms to foreign inputs and facilitate the penetration of global markets. In particular, focus efforts on shortening the average time spent at the border by all firms, notably in the country's principal ports.

2. SECURING MACROECONOMIC STABILITY

Tunisia's short-term economic outlook is improving, thanks in large part to a recovery in the agriculture sector. External vulnerabilities, although rising, remain moderate, reflecting past policy prudence. However, the growing current-account deficit, still high inflation, and high unemployment are symptoms of underlying structural weaknesses in the economy that need to be corrected. To strengthen its macroeconomic management, Tunisia should also modernise its monetary policy framework and enhance transparency in, and control over, the public finances. Improving the structure of the economy and dealing with structural rigidities would facilitate macroeconomic management and reduce the build-up of vulnerabilities.

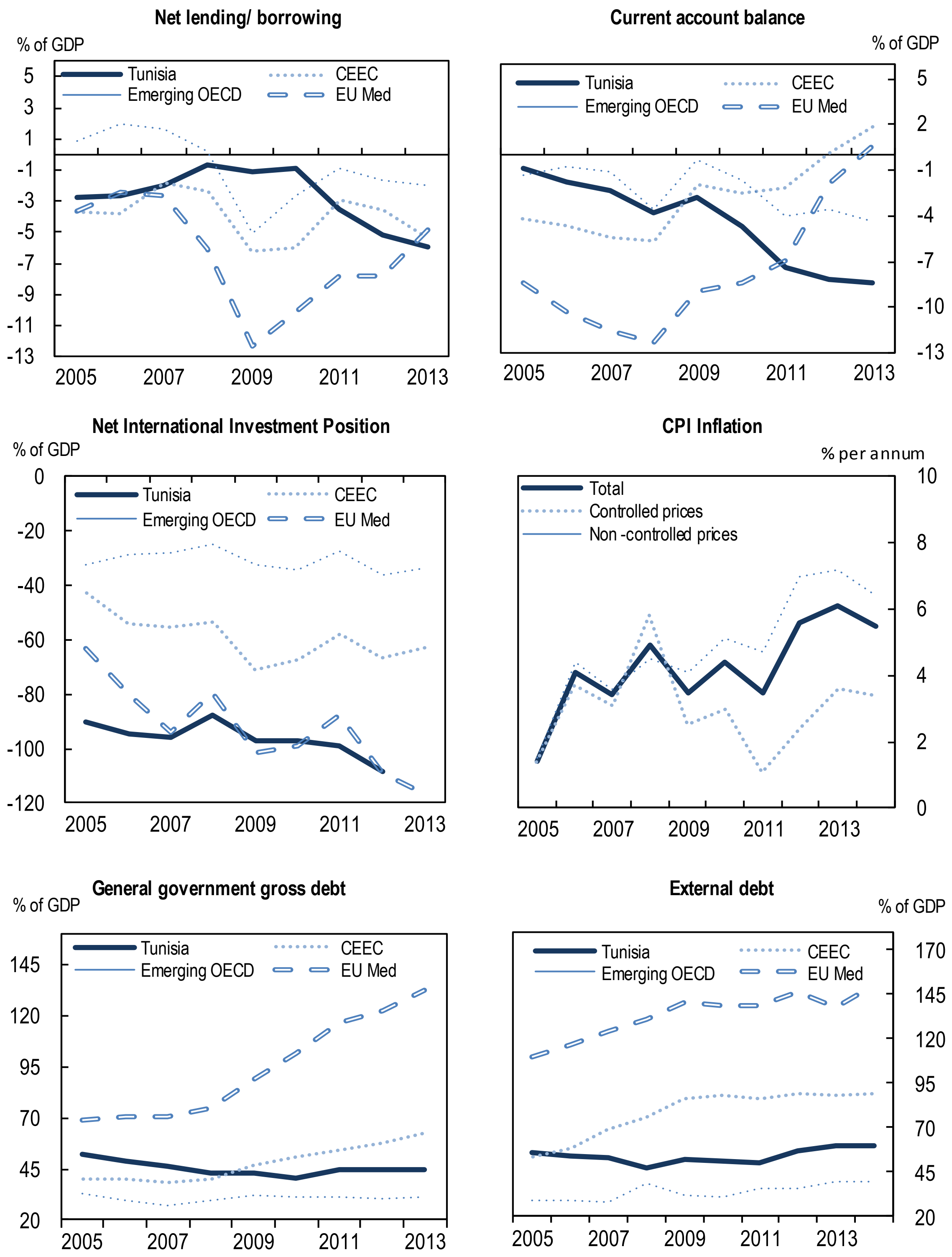
Since the 2011 revolution, growth has been relatively modest (3.9% in 2012, 2.4% in 2013, and 2.3% in 2014). Activity has largely been supported by public and private consumption boosted by wage increases in the public sector. Weak confidence, political uncertainty, and firms' restructuring (including the banking sector) have slowed investment and net exports, including in the traditionally strong tourism and mining sectors. Weak investment, in turn, has kept unemployment high, especially of the increasingly educated cohort of young people who suffer from both job mismatches and perverse incentives arising from hiring rules for desirable public sector jobs. While unemployment fell slightly in 2013, job creation has been weak overall, with most of the new jobs having been created in the public sector. The informal sector is also an important employer in the economy.

The short-term outlook is for a pick-up in growth after recent weakness. GDP rose by 2.3% in 2014 and is projected to accelerate in 2015 (to 3-3.5%), driven by an expected recovery in exports, notably tourism.

Risks to the outlook are mostly on the downside. Slow growth in major export markets can dampen the outlook for investment and exports. The fragility of the European economies, which are Tunisia's main trading partners, are a particular concern here. Continued social tensions risk deterring investment and production in some regions, as well as tourism. Tensions may also impede the implementation of badly needed structural reforms, including the reining in of subsidies. Rising domestic vulnerabilities can affect investor sentiment and make it harder to finance external imbalances. On the other hand, there is significant scope to boost investment and growth through the adoption of an ambitious structural reform programme. As net importer of fuels Tunisia may also benefit from lower world oil prices in terms of a lower current account deficit.

Financial sector fragility is holding back private sector development. Banks face high non-performing loans (NPLs) -- especially the state banks, which have made loans to loss-making public enterprises and the tourism sector (**Chapter 3**). Liquidity has been provided by the central bank, and central-bank refinancing has helped banks to rollover existing loans. To return the financial system to health, however, bank restructuring and recapitalisations will be necessary. Caps on interest rates reduce banks' willingness to extend loans, especially to small companies, and should be phased out.

Figure 2.1 Macroeconomic imbalances are rising



Selected comparative groups: **CEEC**: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia; **Emerging OECD**: Chile, Mexico, Turkey; **EU Med**: Greece, Portugal, Spain.

Sources: IMF, Central Bank of Tunisia, WEO.

Inflation is coming under control

Consumer price inflation has fluctuated between 3 and 6 % per annum in recent years (Figure 2.1). Cost pressures stem from wage increases in the public sector, as well as demand (especially for food) fuelled by an estimated 2 million recent refugees from Libya. Some pressure may also come from smuggling of foodstuffs to neighbouring countries where higher prices prevail.

The central bank aims to keep inflation around its long-term average of about 4% while taking into consideration growth prospects; over time, it plans to adopt inflation targeting. To contain inflationary pressures, it has raised policy rates twice over the past year to 4.75%, and since 2013 it has substantially tightened the refinancing conditions of the commercial banks at the central bank (with higher haircuts applied to private credit claims, and a higher minimum quota of government bonds for these refinancing operations). This is appropriate in view of the signs of higher underlying inflation and the potentially large fiscal deficit. However, policy effectiveness and transmission are weakened by the price and interest rate controls and by the weak banking sector. Implementation of the structural reforms to the central bank (greater functional, institutional, personnel and financial independence in a new central bank law, clarification of its objectives, missions and instruments, liberalisation on interest rate caps) envisaged in the IMF programme would strengthen the effectiveness of policy and is therefore advisable. Enhanced communication on policy would over time help anchor inflation expectations.

Inflation has been partly contained by price controls, which cover about a third of prices in the Consumer Price Index (CPI). Indeed, the much higher inflation of uncontrolled prices may mean that underlying inflation pressures are much stronger than suggested by the overall CPI, which is rising at a rate close to 6% annually (Figure 1). The widespread price controls also create distortions for production and raise public spending on subsidies. In addition, they undermine monetary policy transmission. Removing price controls will be very difficult, but durably raising growth, employment, and living standards will eventually require replacing them with cash transfers to vulnerable groups and prices that reflect market values within a more open and competitive business environment.

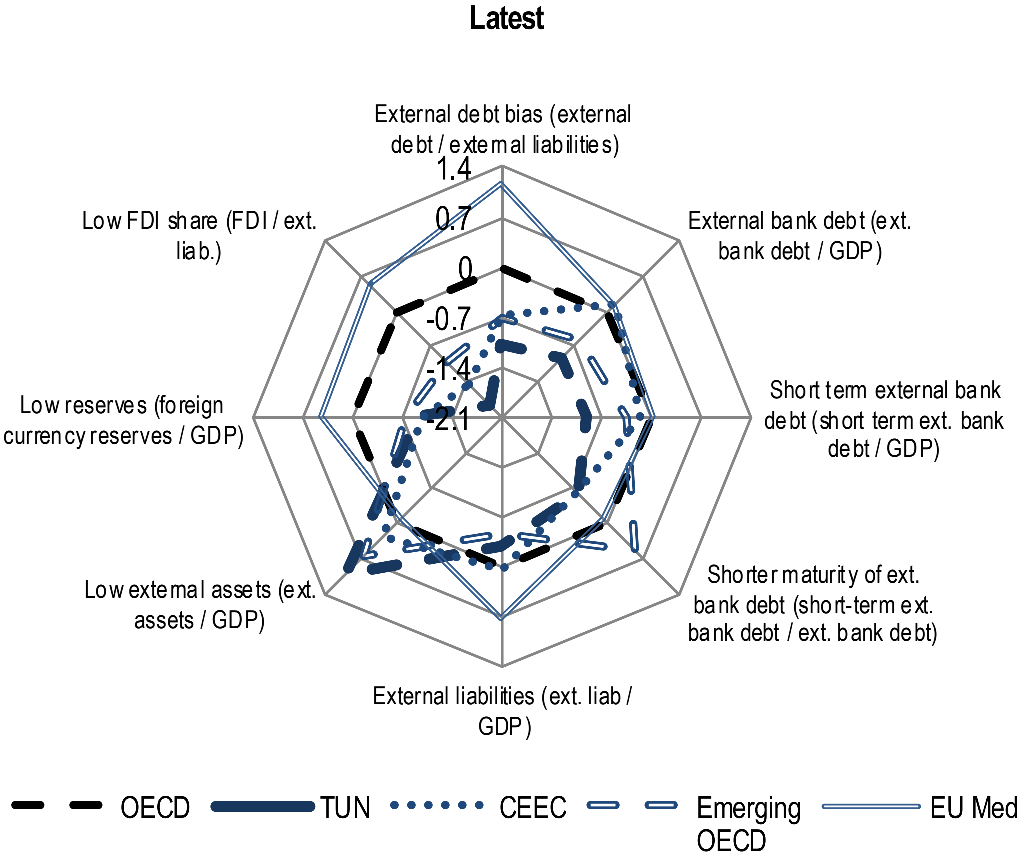
External balances are deteriorating

Tunisia has lost export-market share as wage increases and weak productivity have pushed up unit labour costs in recent years. Low-value-added exports, especially from the processing zone, have been hit by rising competition from lower-cost producers. Tariff protection is high compared with that of other emerging markets (Figure 1.7), potentially affecting the attractiveness of exporting and access to imported inputs and, by extension, international value chains by raising overall costs of production and pulling resources to import substitution activities.

The depreciation upon the introduction of a more flexible exchange rate since mid-2014 may help export competitiveness. The exchange rate is partly managed by the central bank through foreign-exchange (FX) transactions and capital controls. The depreciation that took place in 2013 was first reversed in the first half of 2014, despite the widening external deficit (8.3% of GDP in 2013, estimated to have remained broadly at the same level in 2014). This can perhaps be explained by the government wishing to maintain subsidies that hold down domestic prices of imported energy and food, thereby supporting demand for these products. However, depreciation resumed during the second half of 2014 upon the introduction of more flexibility to the foreign exchange market. Nevertheless, the overvaluation of the currency was estimated at 5-10% at end-2014.

Figure 2.2 External vulnerabilities remain manageable

The higher it is the score, the more vulnerable



Selected comparative groups: **CEEC**: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia; **Emerging OECD**: Chile, Mexico, Turkey; **EU Med**: Greece, Portugal, Spain.

Source: IMF

Macroeconomic vulnerabilities are manageable, but are also on the rise. In recent years, weak productivity growth and the intensification of structural bottlenecks have contributed to a widening current-account deficit. The decline in tourism and other exports, and rising imports of subsidised food and energy, have only partly been compensated by larger remittances. The gap has been financed partly by declining central bank reserves, and by grants or loans from international donors. As a result, reserves have declined to three months of imports while external debt has risen from 49% of GDP in 2011 to about 55% at end-2014. The large negative net international investment position poses another vulnerability in the event of further financial market turbulence, and should not be allowed to continue to rise indefinitely.

Fiscal policy has been expansionary, and there may be large hidden liabilities. The central-government deficit has widened substantially in recent years, owing to wage increases and rising subsidy payments as well as to weakening tax revenues, as growth has slowed. As a result, public debt, although still moderate, continues to rise. The large losses in many state enterprises as well as potential further recapitalisation needs in the banking sector raise the potential liabilities of the state. A rapid increase in public indebtedness caused by a large fiscal imbalance should be avoided, as it could undermine Tunisia’s long-term economic performance. Reducing the deficit by broadening the tax base and improving the structure of spending is a major challenge for fiscal policy. In this sense, the envisaged reductions in the large energy subsidy payments are particularly welcome.

The overall fiscal stance is difficult to assess, however, because of lack of data on non-central government entities, such as pension and social funds and local governments. Some estimates put the overall deficit close to 10% of GDP[1], in a no policy-change scenario, compared with 5-6% of GDP for the central government. Improving transparency by obtaining better statistics on the general government's financial position is urgently needed.

Key recommendations

- Reform the monetary policy framework by **removing interest-rate caps and making the central bank more independent.**
- **Remove gradually price controls** to reduce distortions to economic activity and enhance the transmission of monetary policy.
- **Enhance exchange rate flexibility further** to boost competitiveness, and build reserves as a buffer.
- **Audit the general government fiscal position**, and improve general government fiscal statistics.
- **Tackle the fiscal deficit and the contingent liabilities with structural fiscal reforms.**

[1] According to, for example, Mr. Nidhal Ouerfelli, Minister to the Head of Government: http://www.webmanagercenter.com/magazine/idees-et-debats/2014/06/13/151251/tunisie-economie-si-le-deficit-budgetaire-passe-de-6-9-a-9-9-nous-allons-droit-dans-le-mur-estime-nidhal-ouerfelli

3. RESTORING FINANCIAL STABILITY AND FINANCING GROWTH

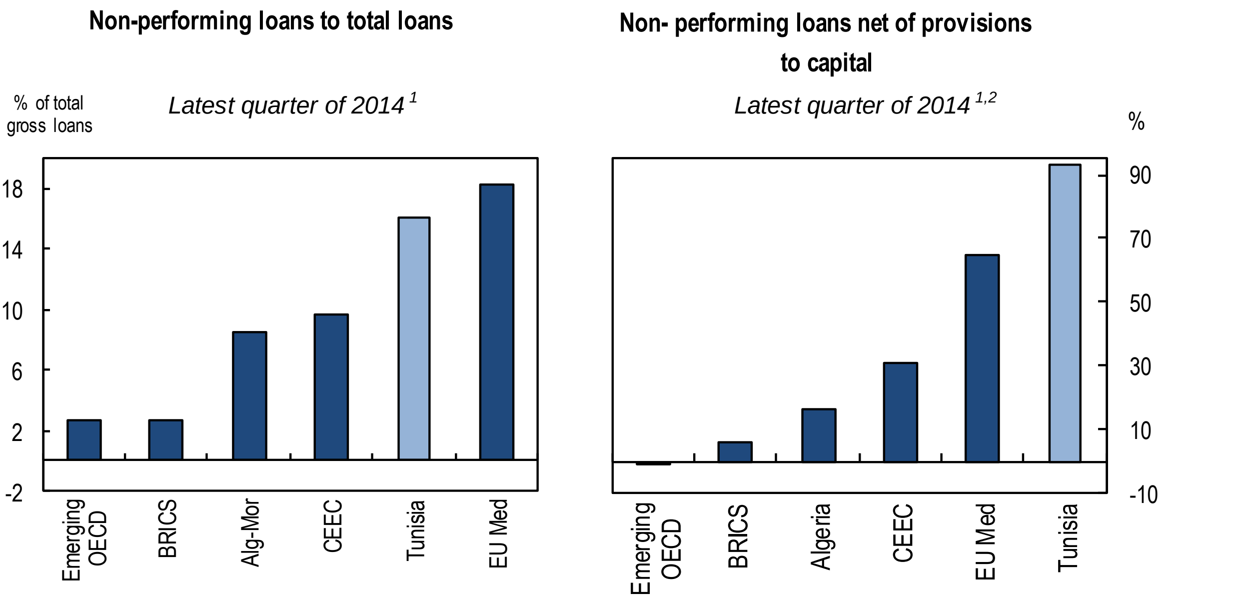
Many Tunisian banks, particularly those that are state-controlled, are distressed and burdened by high non-performing loans and require urgent policy action. The authorities have been taking steps to tackle banking-sector vulnerabilities, but current plans need to be implemented more quickly and supported by additional comprehensive measures. If the prevailing difficulties are not addressed rapidly and decisively, they could give rise to substantial financial instability, disrupted access to finance and larger fiscal costs. Structural measures are also needed to ensure the sustainable development of both bank and non-bank sources of finance.

The Tunisian banking sector faces significant solvency risks. First, non-performing loans (NPLs) amount to about 15% of total loans, or close to 20% when considering bank-affiliated asset-management companies, and are high by international comparison (Figure 3.1, Panel A; IMF, 2014a). Loans to the agriculture and tourism sectors are particularly impaired, the latter accounting for slightly more than a quarter of the total NPLs. Second, insolvency risk is high as financial buffers to absorb losses are relatively low. This is reflected in high ratios of NPLs not covered by loan loss provisions against bank capital (Figure 3.1, Panel B). For instance, provisions are such that banks' Tier 1 capital would be cut by nearly 95% if current NPLs were fully written off in the worst-case scenario, notwithstanding the value of banks' collateral linked to loans. Third, banks have been mainly expanding their lending to households and at a faster rate than deposits (Figure 3.2). Large refinancing operations by the monetary authorities help to bridge this gap, but expose the central bank's balance sheet to ailing banks. Finally, the state-controlled banks (with the three largest accounting for about 40% of banking sector assets, deposits, and loans) are more troubled than private banks: they notably have twice the rate of NPLs and 50% lower capital-adequacy ratios (at slightly above 5%) and are the major contributor to the aggregate loan-to-deposit funding gap (IMF, 2014b). State-controlled banks also account for three-quarters of lending to loss-making SOEs.

Stabilising the banking sector

The authorities have sought to address these banking-sector fragilities. Due-diligence reports of the three largest state-controlled banks have helped to identify key weaknesses, which include high costs, poor human and operational capacities, weak governance and management, insufficient service quality, and rising NPLs and other contingent losses. Banks falling short of minimum capital standards have been requested to meet a Basel II capital adequacy ratio of 10% by May 2015, against overall capital adequacy of the banking system at nearly 9.0% in June 2014 (IMF, 2014a). Supervisory authorities have resumed on-site and credit-risk inspections of banks. Steps have been taken to boost banks' loan-loss provisions and reduce their reliance on central-bank refinancing by tightening collateral requirements. The government has also announced plans to create a universal asset-management company (AMC) or "bad bank" to resolve all bad loans, starting with impaired loans of the tourism sector. Although the AMC has formally been established, draft legislation underpinning its operation was rejected by Parliament in 2014 amid protests, notably by the hotel owners' association.

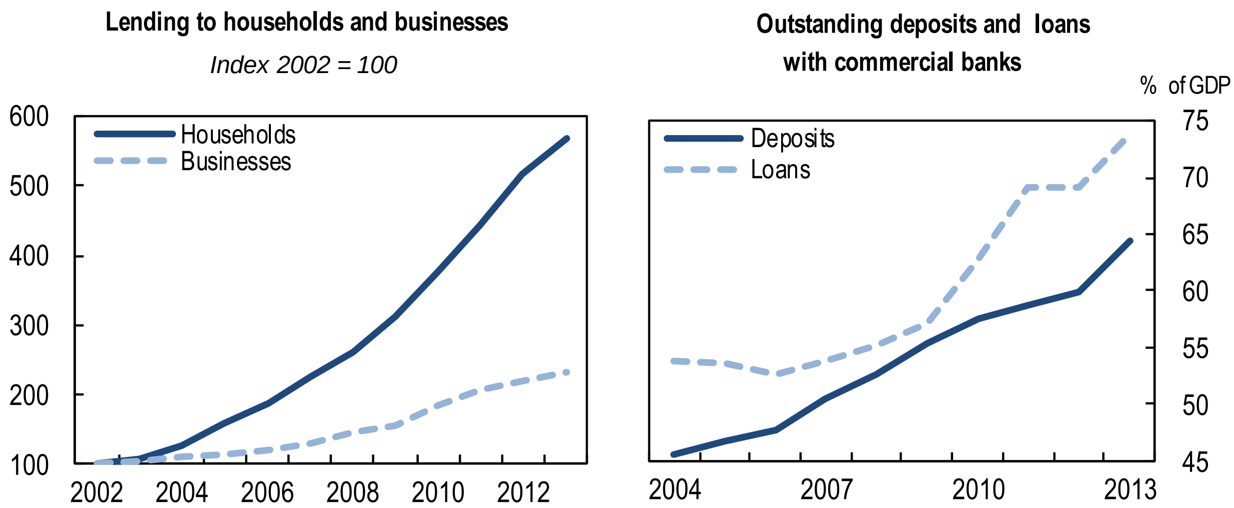
Figure 3.1. Banks' credit risks are high



1. Q2 or Q3 2014 except 2012 for Algeria; 2013 for Morocco and Q4 2013 for Spain.
2. Tier 1 capital for Tunisia. Note: Taking Tier 1 instead of total capital leads to a higher ratio than otherwise.
How to read the second panel: Potential reduction of banks' capital to absorb losses assuming that all non-performing loans net of loan loss provisions are written off, notwithstanding the value of banks' collateral linked to loans.

Source: *IMF - Financial Soundness Indicators (database) and IMF (2014a).*

Figure 3.2. Banks have expanded household lending and deposits are low



Sources: *Central Bank of Tunisia, Financial Access Survey – IMF.*

Following due-diligence reports on two major state-controlled banks, the authorities have identified additional capital needs of 1.2% of GDP, but public spending for this purpose, initially planned for 2014, has been delayed. Broader fiscal costs of bank restructuring are projected to amount to 1.6% of GDP in 2015 (IMF, 2014a). Nevertheless, overall costs could be much larger. In 2012, stress tests indicated potential banking sector recapitalisation requirements of almost 3% of GDP in the baseline scenario, of more than 5% of GDP under an adverse scenario and up to 7% of GDP when applying more conservative assumptions to the public banks (IMF, 2012).

As many banks remain fragile, comprehensive restructuring is needed. Due diligence should be extended to the whole banking sector. Based on the results of this exercise, banks should be divided into four groups, as has been done in the bank resolution plans implemented in other countries with banking crises (Sweden and Spain): *i*) solvent banks, *ii*) distressed but viable banks that can solve their problems without intervention, *iii*) distressed but viable banks that require intervention, and *iv*) non-viable banks. To stabilise the banking sector and support lending, only viable banks that are currently distressed should be recapitalised, while non-viable banks should be closed in an orderly way. Existing private shareholders should bear losses before new public funds are injected so as to reduce taxpayer costs and contain moral hazard. Therefore, it is important to rapidly adopt the draft banking law which includes a resolution framework for insolvent banks, prepared in line with best international practices (IMF, 2014a). As poor lending standards prevailing under the previous regime contributed to banking-sector problems, any legitimately confiscated assets (some of which are depreciating rapidly) could be disposed of and the proceeds used for banks' recapitalisation.

With 21 banks – many of them small – operating in the country, winding up non-viable banks would help remedy the fragmentation of the banking sector. Bank closures would also require the swift implementation of the deposit-guarantee and lender-of-last-resort mechanisms, currently being developed, to ensure the stability of deposits and to maintain confidence in the sector. Consolidation of the banking system would support larger-scale economies, on foot of advances in information technology and better diversification (Huges and Mester, 2013). At the same time, Tunisia should avoid excessive concentration in the banking sector so as to mitigate the implicit government subsidies and incentives for risk taking associated with "too big to fail" institutions. As larger banks generally impose greater financial stability risks, they would also require tighter supervision. To reduce risks, the authorities could also consider the establishment of ring-fenced, non-operating holding companies, which would separate core and non-core activities of the banks (Blundell-Wignall et al., 2014).

Efforts to bolster banking supervision need to be sustained, in particular by increasing human and financial resources, conducting supervision on a consolidated basis, and pursuing in-depth off-site and on-site inspections. Moreover, the authorities should also continue their efforts to align prudential norms with international standards on loan classification, provisioning, and valuation of collateral, and gradually implement Basel III capital and liquidity requirements. Following banks' restructuring, the publication of regular stress tests with credible assumptions would reassure financial markets and depositors. More generally, enhanced transparency and data disclosure of soundness indicators for the banking sector would strengthen market discipline.

The creation of the AMC to resolve NPLs would contribute to the cleaning up of banks' balance sheets, but the new entity should, ideally, specialise in resolving bad loans in the tourism sector (as initially considered by the authorities) rather than aiming to tackle impaired loans in all sectors. International experience suggests that the implementation of universal AMCs might prove challenging in countries with weakly developed banking sectors. This is linked to a lack of change in bank culture, difficulties in recovering impaired assets, and a moral-hazard problem driven by expectations of renewed state intervention should the bad-debt problem reappear (Kawalec and Kluza, 2003). These concerns apply particularly to Tunisian public banks, which have benefited from several significant recapitalisations over the last 20 years without any subsequent strengthening of their lending practices or corporate governance (World Bank, 2014). The government has started cutting subsidies to SOEs, but a further hardening of their budget constraints as well as an overhaul of their privileged relationship with public banks will be needed. Such a changed disposition would not be guaranteed simply through the creation of an AMC.

When establishing the regulatory framework for the AMC, it is important that the selection and pricing of assets, and their subsequent management, be conducted in a transparent, independent, and accountable way (OECD, 2013b). To reduce adverse selection, banks should transfer either all or none of the impaired assets to the AMC, whatever the extent of impairment. The price of transferred assets should not be overestimated, as this would delay the recognition of losses and would put the financial soundness of the AMC at risk. The expected capital of the AMC of TDN 150 million (around 0.2% of GDP) also appears low. Rather, the new entity should be well-capitalised to increase its financial independence and enhance incentives for managers, while the participation of private investors would both reduce the immediate cost for the budget and strengthen corporate governance. The AMC should be governed by experienced managers, including foreign professionals (which is currently not planned) and selected through a public call for applications. Ideally, the transferred assets should be disposed to investors rather than restructured by the AMC itself, given the difficulty for a new entity like the AMC to successfully restructure companies (Klingebiel, 2000). The authorities are considering establishing a sunset clause which would see the operation of the AMC conclude after 12 years. A shorter mandate could induce higher costs for the taxpayer when the assets are sold, but this would allow for a more rapid restructuring of underperforming hotels, thereby supporting medium-term growth.

To address NPLs outside the tourism sector, Tunisian authorities could draw on the Polish experience of the early 1990s. Their aim was to tackle corporate and bank problems simultaneously in a decentralised way, and the overall assessment of this programme has been positive (Montes-Negret and Papi, 1997; Stone, 2002). Banks were requested to establish a work-out department for bad loan portfolios, ring-fenced from the credit department. The main feature of the programme was the recapitalisation of large state-owned commercial banks, contingent upon the elaboration of a debt-restructuring plan approved by the Ministry of Finance. The initiative for the preparation of such plans was shifted to banks, which were given temporary powers to: *i*) lead out-of-court conciliation agreements with financially distressed firms, or *ii*) sell impaired loan assets on the secondary market, or *iii*) implement debt-for-equity swaps. Banks used mainly the first option, which led to improved loan recovery as debtors accounting for 57% of NPLs at end-1991 had made full or partial repayments by 1994. Banks were banned from extending new loans to delinquent companies unless a restructuring plan was agreed, which also contributed to the success of the programme. Overall, the programme was instrumental in containing moral hazard (there was no further recapitalisation of Polish banks), improving corporate culture and standards of banking activities, and ensuring a cost-effective approach to bank restructuring (World Bank, 2003).

Once viable state-controlled Tunisian banks are cleaned up, their operation should be supported by a clear ownership policy and high corporate governance standards, consistent with international best practice (OECD, 2014a, 2013c, 2005). Privatisation would further improve incentives for sound corporate governance, enhance profitability, and thus potentially strengthen banking-sector stability. Nevertheless, privatisation does not obviate the need to ensure sound banking supervision. The authorities should consider divesting to the point that government no longer retains a blocking minority shareholding, as partial privatisation does not remove the risk of potential political interference and could deter strategic investors. The experience of Central and Eastern European countries (CEEC) suggests that selling a majority-controlling stake to a strategic foreign owner would help improve technology and human capital and would lead to stronger profit and cost efficiency over time (Bonin *et al*., 2005).

For privatisations to be successful, however, they need to be carried out under strict controls (competitive bidding procedures, objective criteria for selecting bids, and effective monitoring of the programme) to ensure high levels of transparency. The experience of past privatisation deals, with allegations of corruption and unfair preference given to certain investors, should be avoided. In order to garner public support and allow broader participation in potential benefits, the authorities could also consider a limited part of the privatisation to be carried out as “mass” privatisation aimed at distributing ownership rights (vouchers or certificates to purchase shares in banks) on an egalitarian basis to the population. This part should be limited to avoid overly dispersed ownership structures and the undermining of effective corporate governance and banking-sector efficiency (as empirical evidence for CEEC suggests; see Estrin *et al*., 2009: Bonin *et al*., 2005).

Financing Growth and Entrepreneurship

Banks play a key role in Tunisia as they provide more than 90% of financial intermediation, but this intermediation is weak and access to finance is often challenging, especially for small firms (**see Chapter 9**). The non-banking financial sector plays only a minor role in the financing of the economy, despite widespread tax incentives for domestic issuers and investors. Given the level of economic development, there is scope to improve the financing of the economy and to increase the share of credit to GDP from its current level (around 75%). This would require a rise in stable funding resources, most notably deposits. According to World Bank statistics, only 32% of adults have an account at a formal financial institution, which is on a par with Algeria but below the rate in Morocco (40%).

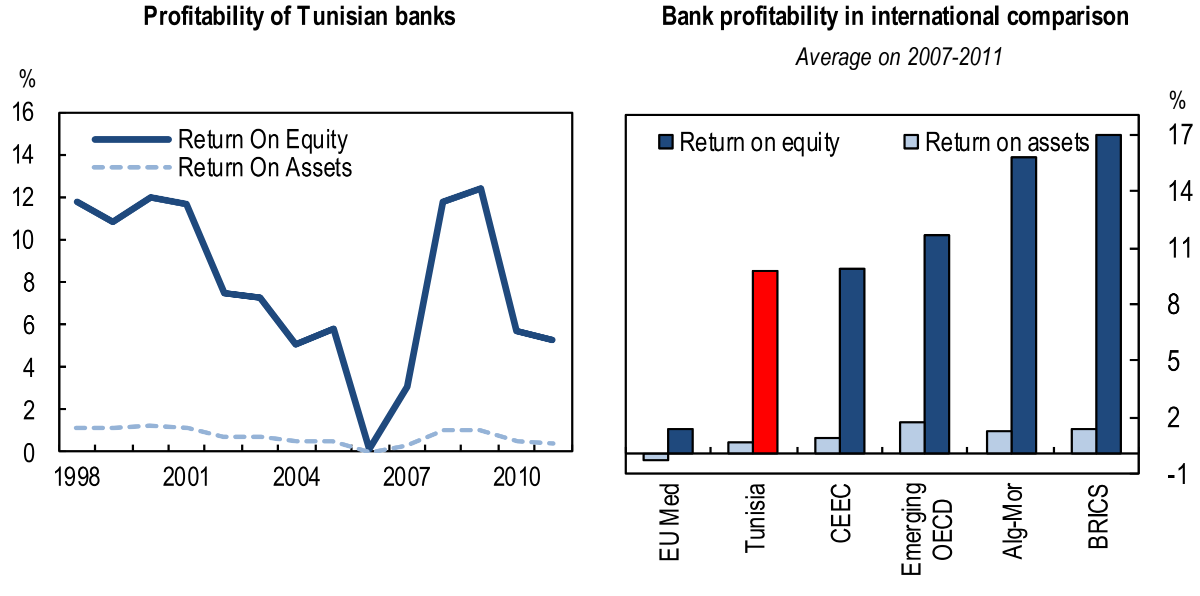
Allowing the national postal service to operate as a bank could expand access to finance and boost interbank lending. The postal service operates a large network of branches throughout the country (more than half of them in the countryside), and manages almost 5.5 million savings and deposit accounts, with total wealth estimated at around 15% of GDP. Financial-inclusion data of the World Bank show that only 16% of Tunisian adults belonging to the 40% bottom of the income distribution have a bank account. Financial inclusion of the poorest households could be improved, for instance, by linking the planned unique identification number for social assistance cash transfers to a bank account, as is currently being implemented in India (the "Aadhaar" programme). In Tunisia, such accounts could be hosted by the postal service. Educating women and youth, in particular, on the available financial products and on how to approach banks would improve their ability to obtain the financial services they need.

SME financing is largely handled by the *Banque tunisienne de solidarité* (BTS) for loans under TND 100 000 (nearly USD 60 0000 or EUR 44 000) and the *Banque de financement des PME* (BFPME) for loans up to TND 5 million (nearly USD 3 million or EUR 2.2 million). The BTS requires entrepreneurs to put up 10% of the investment applied for, thus indirectly discriminating against young entrepreneurs and those starting businesses (OECD, 2012b; OECD, 2015). Its micro-credit programme may lead to undercapitalised ventures with low survival prospects, as they may have an insufficient resource base to deal with liabilities during the first months and years.

More generally, the microfinance market as a whole is still under-developed and under-served, although it is undergoing rapid transformation with the new Microfinance Law having been passed in 2011 and the creation of a new supervisory body (AfDB, OECD, UNDP and UNECA, 2012). Recently established microfinance institutions and the crowding in of investment are initial indicators of the initial positive effects of the microfinance law. Further development of the sector would also enhance financial inclusion and reduce the relative weight of the informal sector by: *i*) promoting mobile banking to lower transaction costs and improve access (such as in Kenya, Senegal, or the Philippines), *ii*) ensuring a sound prudential regulatory framework (such as in Peru); and *iii*) broadening the range of available financial services – while micro-credit exists in Tunisia, neither micro-savings nor micro-insurance are present.

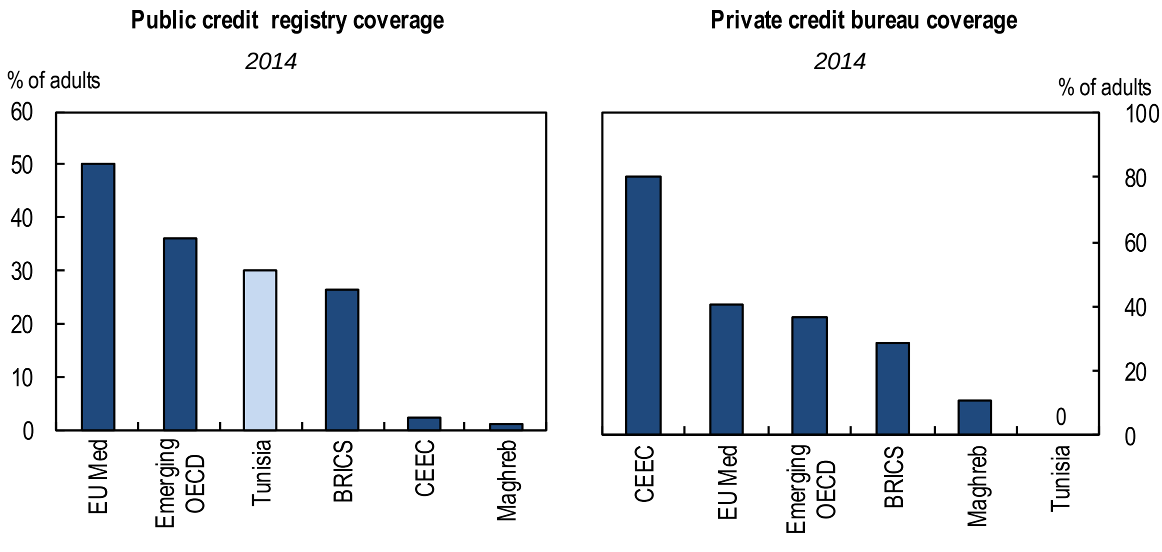
To support bank lending and profitability (Figure 3.3), banks should also be better equipped to overcome information asymmetries and manage their loan portfolios. Tunisia was lagging behind other countries in terms of access to credit information (Figure 3.4), but it has recently launched a project to start its first credit bureau from June 2015. This should lower the cost of intermediation and ease access to credit, but it is important that both positive (outstanding loan amounts, pattern of repayments, etc.) and negative (late payments, number of defaults, etc.) credit information about individual loans be collected and shared. Improved efficiency of insolvency legislation for businesses would also support lending. In particular, there is scope to increase debt-recovery rates for a given number of years needed to clear up insolvency, which is comparatively short in Tunisia (Figure 3.5). The authorities have been preparing a new insolvency law, whose adoption has been delayed. Streamlined in-court procedures, a legal framework for out-of-court restructuring of distressed businesses, and incentives for firms to apply early for insolvency would help ensure the effectiveness of new regulations. A well-designed credit guarantee system can also be effective in mobilising a larger amount of bank credit and reduce collateral requirements for sound businesses. In this respect options could be explored to further develop SOTUGAR, the joint stock corporation owned by the Tunisian state (37%) and banks (63%), which specialises in managing the system of guarantees for credits to SMEs.[2]

Figure 3.3. Banks' profitability is weak



Source: World Bank and IMF (2014a).

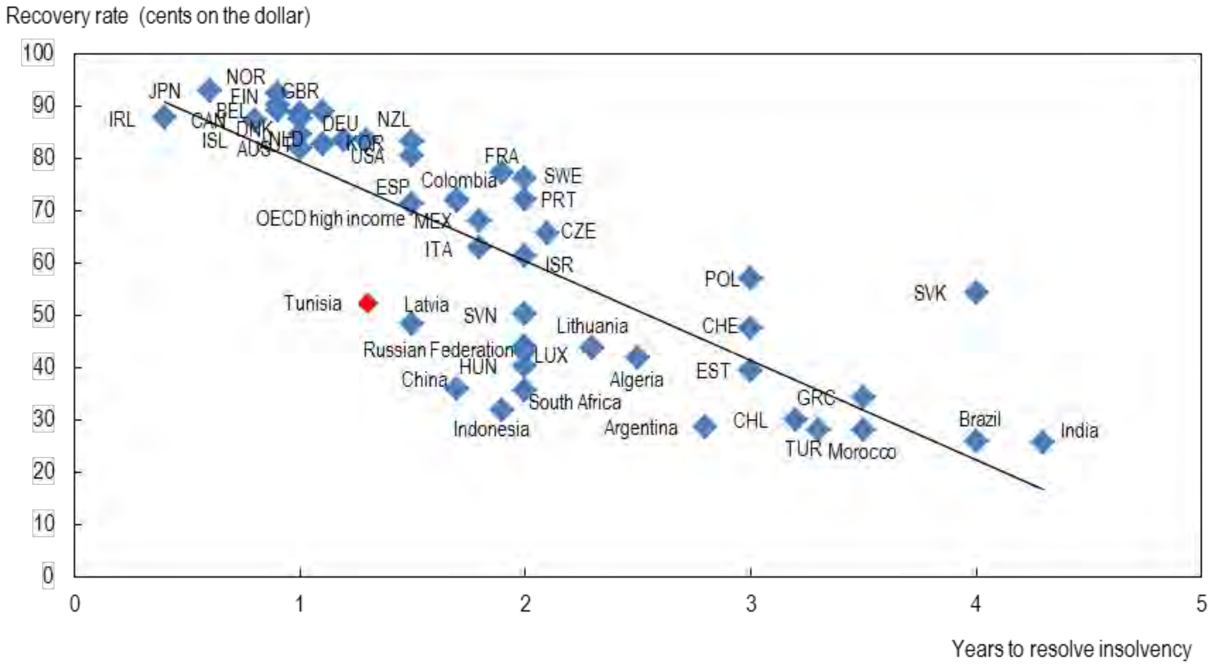
Figure 3.4. The availability of credit information is poor



Source: World Bank Doing Business report (2015).

2 OECD (2013), "Thematic Focus: Credit Guarantee Schemes", in *Financing SMEs and Entrepreneurs 2013: an OECD Scoreboard*, OECD Publishing, Paris.
DOI: 10.1787/fin_sme_ent-2013-5-en

Figure 3.5. There is scope to improve the efficiency of insolvency legislation

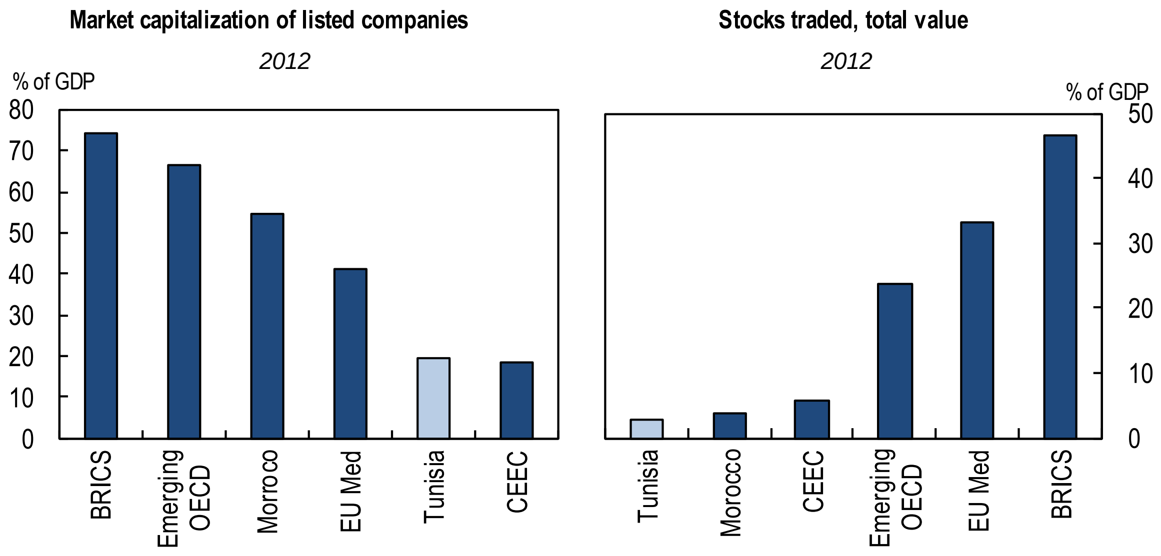


Source: *World Bank Doing Business report (2015).*

Another issue is to allow banks to price risks. The central bank has recently removed its temporary cap on deposit interest rates, which is a welcome step. Yet, it is also necessary to abolish the permanent cap on lending interest rates that stipulates new loans can carry an interest rate only 1.2 times higher than the average of interest rates observed in the last six months. This regulation hampers bank lending and leasing as it excludes the financing of riskier but viable projects, such as of small, young, or innovative businesses. Moreover, as banks are inhibited from reflecting risks through higher interest rates, they tighten non-price credit conditions. This is conducive to a large over-collateralisation of loans at almost 180%, the highest rate in the MENA region (World Bank, 2014). Such high requirements either exclude firms with insufficient collateral or can generate a misallocation of resources to build excessive collateral (for instance, by developing unnecessary commercial real estate). Indeed, there is some evidence of a mismatch between supply and demand in the real estate sector, suggesting that developments should be carefully monitored so as to avoid any negative knock-on impact on the banking sector, and thus on macroeconomic stability as well as social and private sector development. The difficulty in pricing loans depending on maturity is another consequence of the cap on lending interest rates, which could contribute to the predominance of short-term lending (Ben Aissa, 2013).

Tunisian capital markets remain underdeveloped and make only a marginal contribution to the financing of economic activity. The stock market is not representative of the structure of the economy (assets of financial companies are dominant) and is shallow by international comparison, both in terms of stock-market capitalisation and liquidity (Figure 3.6), despite having experienced significant growth even in the face of the global financial crisis . There has been an increase in the number of listed companies driven by tight bank lending supply and efforts to promote financial education more recently. The privatisation of SOEs via initial public offerings could further support the development of the stock market, as has the flotation of large enterprises, such as *Tunisie Telecom*, in the past.

Figure 3.6. The stock market is shallow



Source: World Bank.

Lifting structural bottlenecks would also help with financial deepening. Heavy regulatory requirements may obstruct access of SMEs to the alternative market (only a dozen firms are listed). As financial regulation and supervision are bolstered towards international standards, remaining capital controls in the form of investment restrictions should be eased to allow greater use of foreign savings (foreign ownership accounts for about 20% of stock market capitalisation). This would be consistent with Tunisia's adherence to the OECD *Declaration on International Investment and Multinational Enterprises* in May 2012 (OECD, 2012a).

Foreign investors face a limit of 20% per issue for corporate and public bonds (Mouley, 2014). Buying a 50% stake in a listed company is subject to administrative approval, but certain sectors have lower limits (for instance, 30% in the automobile sector) or are closed to foreign investment when they are considered to be "strategic" by the authorities (such as the retail and real estate sectors, and – unless authorised by the central bank – the financial sector). This contrasts with Egypt and Morocco, where foreign investors can freely buy stakes in listed companies and do not face sectoral restrictions. Finally, the establishment of a yield curve for sovereign bonds would provide a benchmark for the corporate bond market and support long-term investment.

The private-equity sector is composed mainly of venture-capital investment companies (*Sociétés d'Investissement de Capital à Risque* – SICAR) that are controlled by banks. The sector remains under-developed with a limited product range and investor base (EBRD, 2011), although ATIC *(Association Tunisienne des Investisseurs en Capital*) reported in 2012 that TND 1.2 million worth of liquidity in investment firms was still searching for investment opportunities (GIZ, 2013). One of the challenges is identifying good projects; another is the weak culture of entrepreneurship and capital investment (ATIC, 2013). Furthermore, this could be partly explained by cultural preferences of family-owned businesses to use bank debt and insufficient information about private-equity financing. Also, strict investment restrictions in terms of targeted companies and their location are currently the main barriers to the development of the industry (Alsina, 2013). Widening the range of available financial instruments (stock options, stock warrants, preferred shares, etc.) would also support the development of private equity.

Key recommendations

- **Boost banking sector stability by extending due diligence to the entire banking sector, encouraging the recapitalisation of distressed but viable banks, and winding up non-viable banks.** Fast-track the introduction and operationalization of the relevant enabling draft legislation on bank resolution, deposit guarantee, and lender of last resort.
- **Strengthen the prudential regulation and supervision of the banking sector by pursuing convergence with international norms,** stepping up on-site and off-site inspections, and ensuring better availability of data and analyses of banks' financial soundness.
- **Ensure that the Asset Management Company focuses on the resolution of tourism-sector bad loans and has sufficient capital, and that its assets are transferred transparently** and at a credible price, and that managers meet high-quality professional standards.
- **Beyond the tourism sector, make the recapitalisation of state-controlled banks conditional on the elaboration of bank-led restructuring plans for corporate debt**. Prohibit the extension of new loans to delinquent enterprises until such plans are agreed upon.
- **Develop a plan for the privatisation of state-controlled banks to strategic investors.** Such sales should be carried out under strict conditions of transparency and, as appropriate, the state should not retain a blocking minority shareholding.
- To boost financial inclusion, **link the planned unique identification number for social assistance cash transfers to a bank account** and further support the development of micro-finance.
- **Promote access to finance for SMEs** by increasing competition in the banking sector and improving creditors' rights.
- Improve banks' ability to price risks and manage loans by **removing the cap on lending interest rates and reforming insolvency legislation**.
- To support non-bank finance, **gradually lift the remaining investment restrictions on the purchase of financial assets by foreign investors** and remove requirements in terms of firms' type and location for venture capital investments.

4. CREATING MORE AND BETTER JOBS

The Tunisian labour market is beset by high rates of unemployment and informality. Economic growth will be essential for creating jobs and lowering unemployment, but growth alone will not solve all the difficulties that individuals face in gaining access to productive and rewarding jobs. Indeed, it will have to be accompanied by: *i)* policies that equip workers with the skills required in the modern labour market, *ii)* interventions aimed at tackling structural labour-market barriers that affect the willingness and ability of employers to hire, *iii)* labour market and social policies to support the employability of individuals, and *iv)* gender and family policies to boost the participation of women.

In the first quarter of 2014, the overall unemployment rate in Tunisia stood at 15.2%, down from a peak reached in the year following the revolution of 18.9% (fourth-quarter 2011) but significantly higher than in 2010 (13.0%). The overall unemployment rate hides significant differences between groups. Women (21.5%) are considerably more likely to be unemployed than men (12.7%), as are youth (37.6%) and university graduates: 2 in 5 female graduates and 1 in 5 male graduates are unemployed. There are also important regional differences, with unemployment rates significantly higher in the more deprived Centre West and Southern areas of the country.

In addition, high unemployment rates give only a partial view of the poor labour-market outcomes in Tunisia: female labour-force participation rates are particularly low (25.8%, compared with 70.3% for men); informality affects one in three workers in the private non-agricultural sector and one in two in the private agricultural sector (Ben Cheikh, 2013). Many workers are engaged in precarious working relationships, with nearly a quarter employed on a temporary contract.

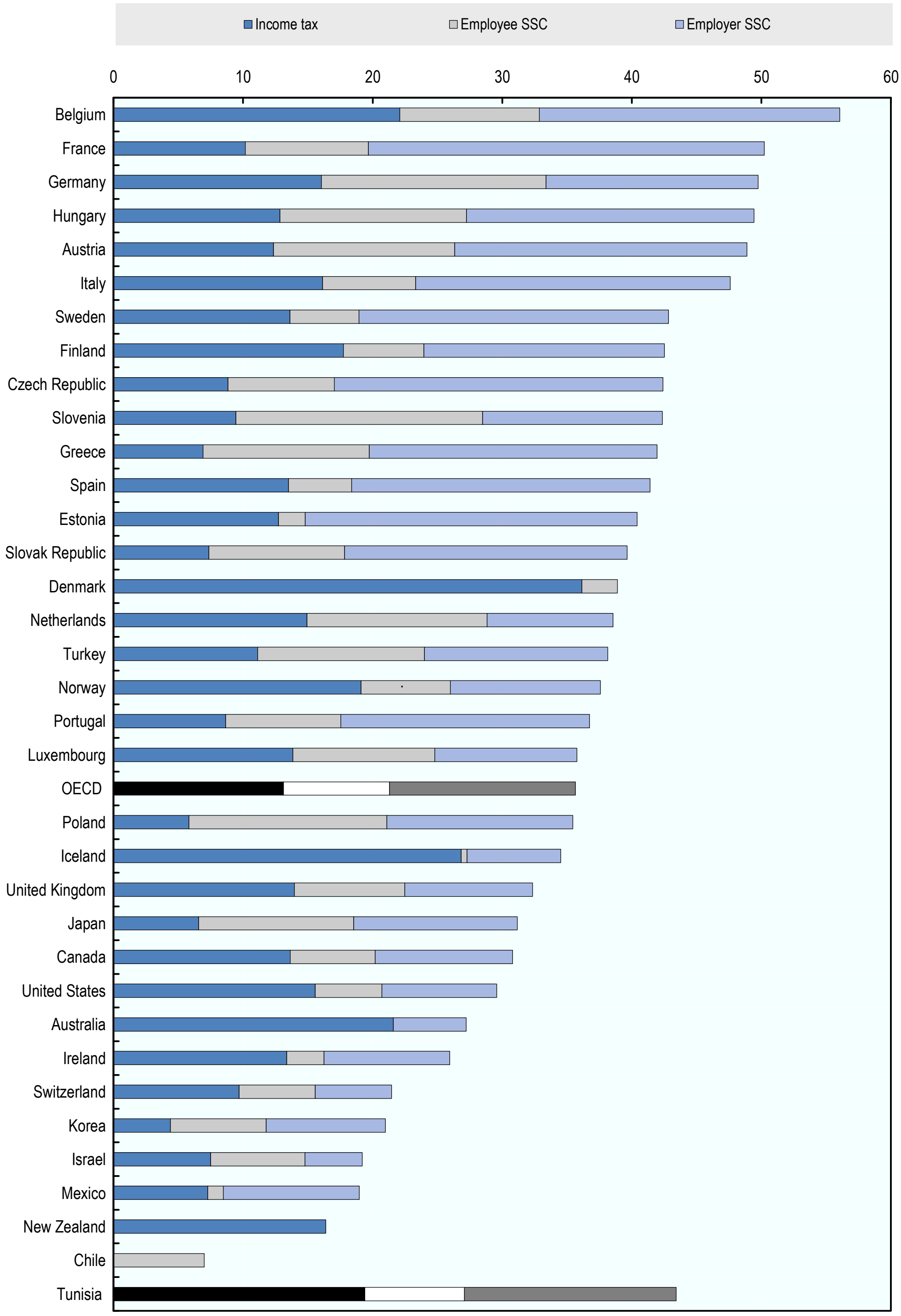
While labour market informality is symptomatic of Tunisia's stage of economic development, some badly-designed measures related to social security, wage bargaining, and labour protection currently in place in Tunisia in order to enhance the pay, benefits and economic security of workers in formal employment have been counterproductive due. They create incentives for informality, and for firms to remain small and to use a variety of means to circumvent the formal requirements of employing workers. This limits their ability to adjust employment as a response to market conditions, ultimately discouraging them from growing and benefitting from economies of scale and from investing in worker training. Going forward, this may reduce productivity growth and make Tunisian firms less competitive internationally.

Addressing demand-side barriers to employment

While the minimum wage is not set at a particularly high level in Tunisia at 46.9% of the median wage (and is therefore unlikely to contribute to high unemployment levels), sector bargaining agreements result in pay scales with starting salaries often significantly above the national minimum wage (25% above the minimum on average across all sectors). Furthermore, the tax wedge (income tax plus social-security contributions) appears to be rather high, compared both with other countries at Tunisia's level of economic development and with OECD countries (Figure 4.1). However, this is primarily due to significantly higher income tax rates, which could generate disincentives to work in the formal sector. On the other hand, social security contributions and payroll taxes in Tunisia are only marginally above the OECD average – suggesting that non-wage costs are unlikely to present a major impediment to hiring.

Figure 4.1. Relatively high burden of income tax, employer, and employee social-security contributions in 2012[a]

As a percentage of labour costs[b]



a. Data for Tunisia refer to 2011. Gross median wages in Tunisia are calculated using net median wages of TND 422 for full-time private-sector workers as calculated by Centre de Recherches et d'Études Sociales (CRES) and International Labour Organization (ILO) (2012) and estimating the social-security contributions and income tax rate assuming a single person without children.

b. The total cost of labour is the sum of gross average wage earnings, employer social-security contributions, and payroll taxes, where applicable.

Sources: OECD (2013r), Taxing Wages 2011-2012, OECD Publishing, Paris; OECD calculations based on CRES and ILO (2012), Enquête sur la Structure des Salaires [Salary Survey], Centre de Recherches et d'Études Sociales, Tunis (for Tunisia).

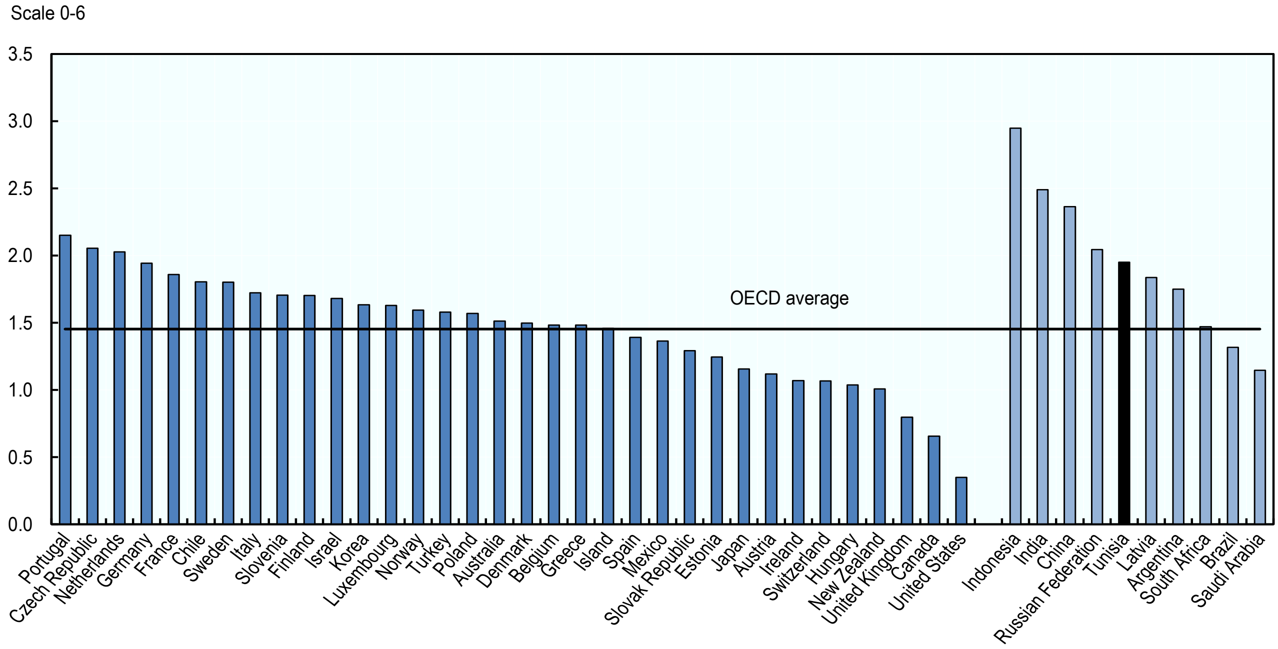
While research is needed on the exact effect of these wage agreements and the tax wedge on employment levels and formality, it is likely that they have negative effects on labour-market outcomes and the quality of jobs – particularly for those nearer the bottom of the income distribution (*e.g*. youth and the low-skilled). In addition, public-sector wages and benefits are set significantly above what is offered in the private sector. As an illustration, a graduate tracer study[3] showed that, in 2007 and three years after graduation, the net wages of graduates employed in the public sector were about 35% higher than those of graduates working in the private sector. More recent analysis for 2010, shows a much higher concentration on the high end of the wage distribution for public sector workers than the distribution for private sector workers.[4] Combined with significant public-sector hiring, now and in the past, these policies serve to raise reservation wages, generate "public sector queuing", and make it harder for the private sector to hire at the prevailing wage rate. In addition, public-sector recruitment rules (which favour candidates with the longest unemployment spells) introduce incentives for people to work informally while queuing for a public-sector job.

Strict regulations against individual dismissal for workers on permanent contracts also reduce the attractiveness of formal labour contracts to employers (Figure 4.2) – particularly given that employment-protection legislation for temporary contracts is very lax (Figure 4.3). For instance, 50.1% of youth are on temporary contracts – compared to an OECD average of 36.6%. This results in a dual labour market with protected groups on the one hand and marginalised, excluded ones on the other, and few conversion opportunities between the two. By reducing workers' motivation, flexibility, willingness to assume new duties, and incentives to invest in firm-specific skills, as well as by increasing work-related stress and worker turnover, job insecurity reduces productivity and increases recruitment costs for firms. Firms, in turn, are less encouraged to invest in the up-skilling of workers who are unlikely to keep their job, thereby further contributing to lower productivity.

3 Ministère de l'Emploi et de l´Insertion Professionnelle des Jeunes and World Bank (2009), L´Insertion des Jeunes Diplômés de l´Enseignement Supérieur – Promotion 2004 : Analyse Comparative des Résultats de Deux Enquêtes (2005 et 2007)

4 Angel-Urdinola, D.F., A. Kuddo and A. Semlali (2012), "Public Employment Services in the Middle East and North Africa", Draft dated May 2012, World Bank, Washington, DC.

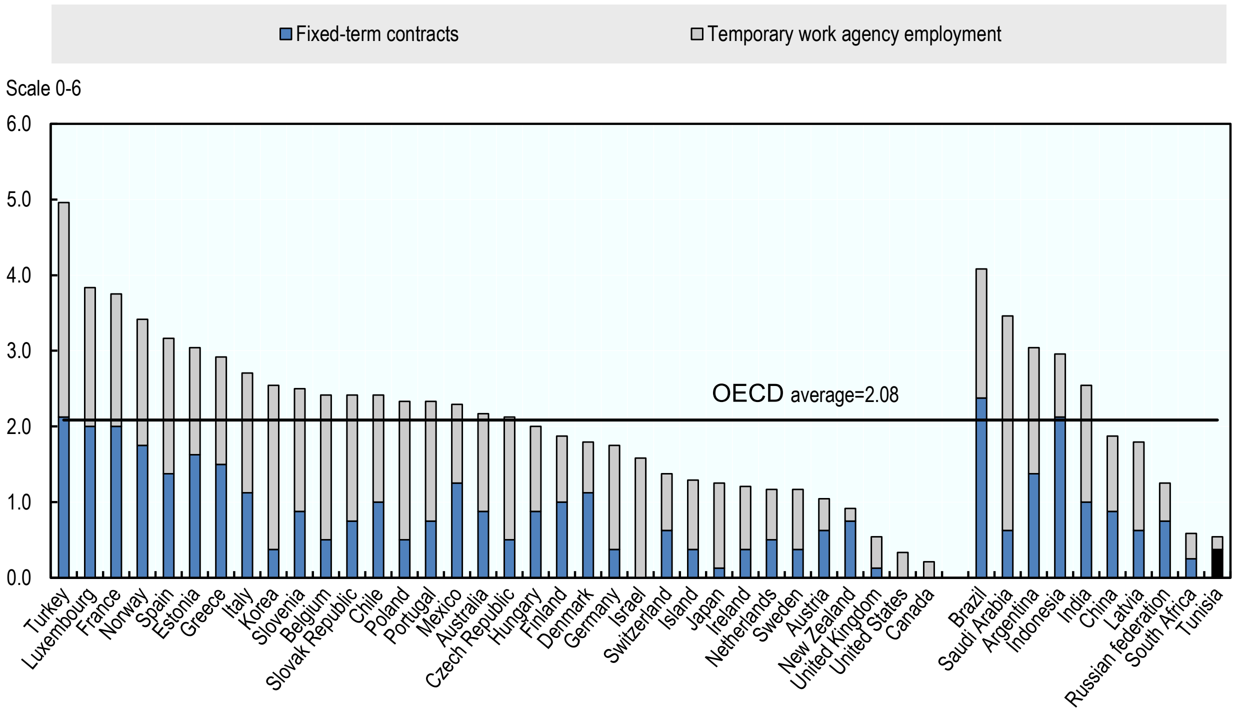
Figure 4.2 Employment protection legislation on regular employment (individual dismissal), Tunisia, OECD and selected other countries, 2013[a]



a) Data correspond to 2012 for Argentina, Brazil, China, India, Indonesia, Russian Federation, Saudi Arabia and South Africa.

Source: *OECD Employment Protection Database, 2013 update,* *http://dx.doi.org/10.1787/lfs-epl-data-en*.

Figure 4.3 Employment protection legislation on temporary employment, Tunisia, OECD and selected other countries, 2013[a]



a) Data correspond to 2012 for Argentina, Brazil, China, India, Indonesia, Russian Federation, Saudi Arabia and South Africa.

Source: *OECD Employment Protection Database, 2013 update,* *http://dx.doi.org/10.1787/lfs-epl-data-en*.

Improving labour market and social policies

Public employment services (PES) can play a central role in improving the employability of job seekers through the provision of information, placement and counselling services, and active labour-market programmes. Few people in Tunisia find work through ANETI -- Tunisia's PES -- however, which in turn reduces its attractiveness among jobseekers. This reflects a lack of resources, poor geographical coverage - with just over three offices per governorate - and high caseloads per staff. Additional financial and staff resources are therefore required for the PES to improve its effectiveness. One option would be to establish public-private partnerships. The PES has already started working more closely with NGOs in the delivery of active labour-market programmes. Allowing private employment agencies (currently forbidden by law, though some are tolerated) could also help improve employability and labour-market efficiency. In many OECD countries, specific functions of the PES are outsourced– *e.g.*, job-search and training activities in Finland and "job clubs" in Norway with the latter consisting of a combination of regular group-based training and individual activities aimed at raising participants awareness of their skills. There is considerable differentiation across countries in the extent of this contracting out.

Part of the reason behind the unattractiveness of the PES among jobseekers in Tunisia is that active labour-market policies (ALMPs) target mainly higher-education graduates. Few programmes and services are aimed at helping low-qualified and disadvantaged individuals. Combined with the lack of unemployment insurance, this imbalance means that very few non-graduates register with the public employment service. While it is true that graduates are disproportionately unemployed, they represent a relatively small portion of the total number of the unemployed. Active labour-market policies should thus be improved to reach out to a broader population, notably the low-skilled and long-term unemployed. In addition, the criteria for participation in ALMPs should be aligned to real needs (*e.g.* as measured by length of unemployment). Currently, participation is decided on a 'first-come, first-served' basis.

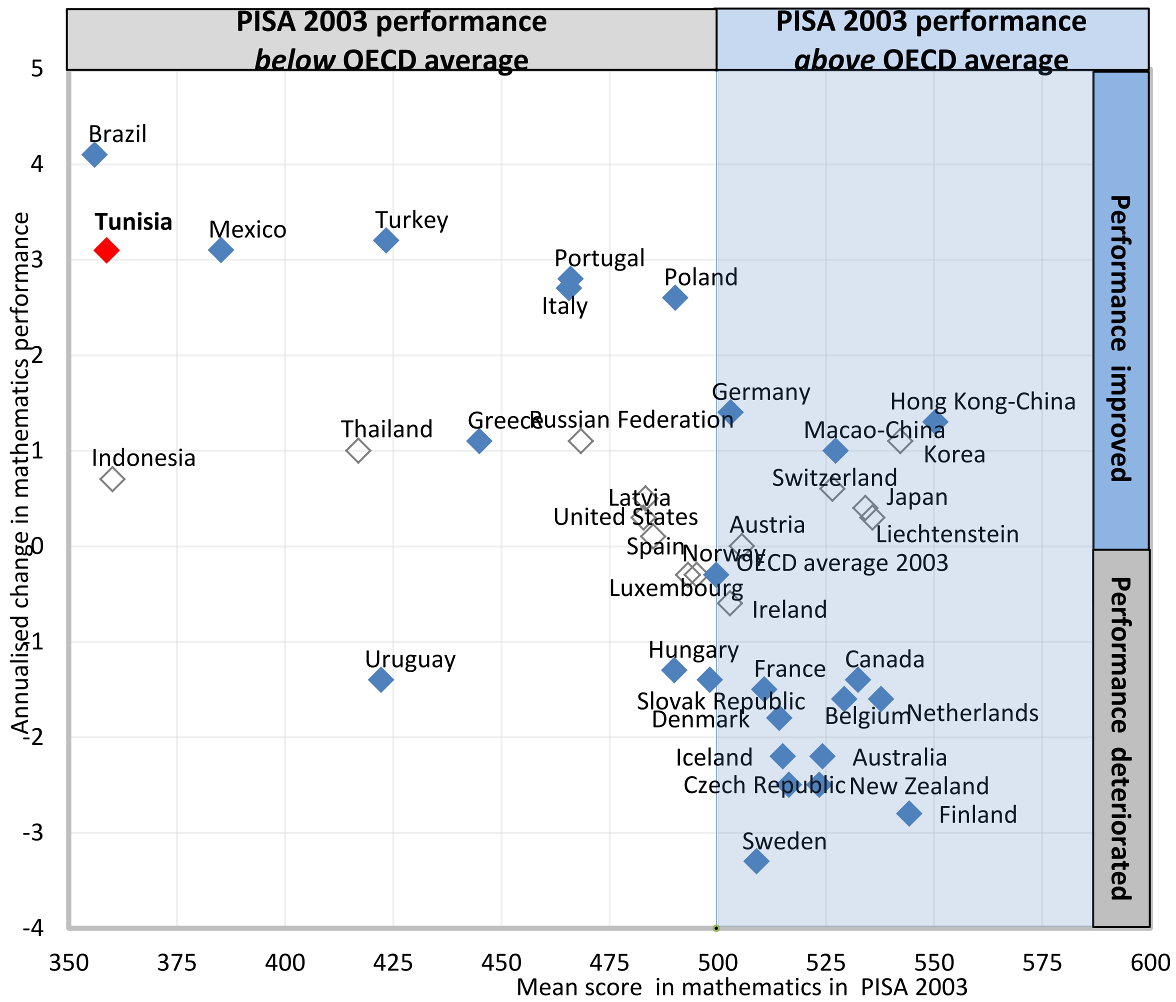
Given the significant interregional disparities in employment rates in Tunisia, attention should also be paid to ensuring that labour-market and training policies are adapted to local contexts. For example, while a focus on wage subsidies may be more effective in urban regions, it is unlikely to have the same outcomes in a rural region where existing employment opportunities are scarce. Public-works programmes (and employment guarantees) may be more appropriate in those regions. While such programmes exist in Tunisia, they need to ensure that they target those who need them most, and that the participants are selected more transparently. Such programmes appear particularly promising where they are set up with the involvement of the local community and offer participants training to help them find a longer-term and sustainable route out of poverty. Well-known examples of public works programmes implemented along these lines include South Africa's Community Work Programme, the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) in India, Ethiopia's Productive Safety Net Programme (PSNP) and Argentina's *Jefes de Hogar* (Heads of Household) programme. Moreover, public-works programmes can be targeted to help reduce regional infrastructure gaps as well as supporting the transition towards a green economy if projects are aligned with the country's sustainable-development strategy.

Finally, social protection systems can play a key role in providing an adequate safety net for those who are out of work, not only in shielding them from poverty but also in giving them the means to look for new and productive employment. Even though Tunisia has a comprehensive social insurance system in place, high unemployment and informality rates mean that many workers will not be contributing, and therefore benefiting, from such protection. Even those who are covered by social insurance are unlikely to receive unemployment benefits in the case of job loss, as eligibility criteria for the current scheme are very strict. Unconditional cash transfers (like the *Programme National d´Aide aux Familles Nécessiteuses*) and free/subsidised health care for the poor exist, but are poorly targeted.

Enhancing education and training

Human-capital development is the cornerstone of inclusive growth, driving both productivity and employment while opening up opportunities for workers to progress in their careers. Tunisia's educational performance, as measured by the OECD Programme for International Student Assessment (PISA) tests, has improved over the past decade (Figure 4.4). The adoption of policies aimed at promoting student learning may have helped to improve educational outcomes. On the other hand, Tunisia's education spending as a share of GDP decreased from around 5% between 1990-2005 to 4.6% between 2006-10. The *École de demain* [School of Tomorrow] established the framework for these policies, with planned implementation between 2002 and 2007; however, it has never been fully adopted. Despite progress in educational attainment, the average performance of Tunisian 15-year-olds on the PISA tests remains low by international standards. Continued emphasis is therefore needed to promoting learning.

Figure 4.4. Annualised change in performance between 2003 and 2012 and average PISA 2003 mathematics scores



Notes: Annualised score-point changes in mathematics that are statistically significant are indicated in a darker tone.
The annualised change is the average annual change in PISA score points from a country's/economy's earliest participation in PISA to PISA 2012. It is calculated taking into account all of a country's/economy's participation in PISA.
Only countries and economies with comparable data from PISA 2003 and PISA 2012 are shown.
The correlation between a country's/economy's mean score in 2003 and its annualised performance is -0.60.
OECD average 2003 considers only countries with comparable data since PISA 2003.

Source: *OECD, PISA 2012 Database; Figure I.2.18.*

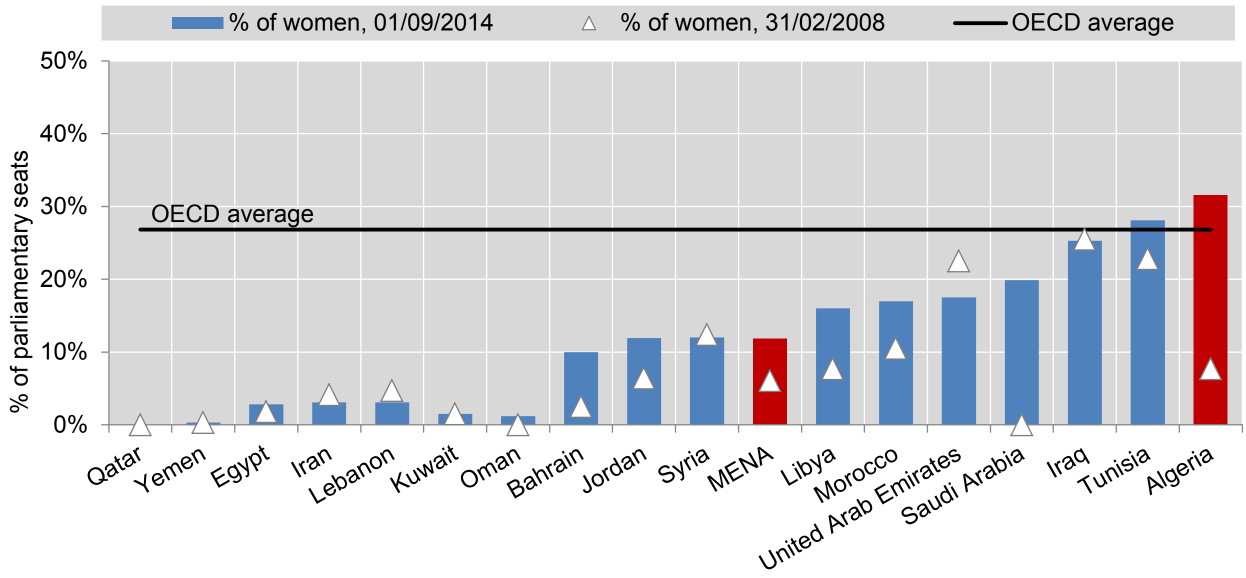
Incentives for pursuing academic education in Tunisia remain strong, but given high levels of unemployment among graduates, there seems to be a need to encourage vocational education and training (VET). This will only be possible, however, if the latter is transformed into a truly attractive and high-quality alternative. Despite significant increases in recent years, the number of students graduating from VET programmes remains very low. This is largely because VET is seen as an unattractive option, given the low status of *collèges techniques* at the lower-secondary-education level and the underdevelopment of high-quality options at the upper-secondary level. Moreover, the mix of provision of different fields of study is driven mainly by the capacity of the system and does not sufficiently reflect the needs of the economy. Labour-market signals are weak in the VET system, and employer engagement is limited. Employers and graduates are often ill-informed about what VET programmes offer.

One aspect of the VET system that deserves particular attention is its support of entrepreneurship. While efforts to embed entrepreneurship in vocational training are ongoing, the system faces three challenges (OECD, 2015). First, learners, trainers, training-centre management, and representatives of local business-support providers do not share a common understanding of the objectives of entrepreneurship promotion. Second, there are challenges in implementing and co-ordinating entrepreneurship activities in the VET training centres. A large number of ministries (six) and agencies (seven) are involved in supporting entrepreneurship in the VET system. Third, improved co-ordination is needed between the training centres and business start-up support structures. One of the keys to developing an entrepreneurial culture and supporting students in business creation is to build links between learning and practice.

Developing gender and family policies

Tunisia has been among the top performing countries on gender equality in the MENA region. As early as 1956, Tunisia confirmed the principle of gender equality in relation to socio-economic, cultural and political rights in its Code of Personal Status, which is critical to support women's economic and public participation. Following this initial step, many subsequent reforms advanced women's rights and status, accompanied by supporting mechanisms and measures to implement these reforms. In particular, the new 2014 Constitution contains ground-breaking provisions on gender equality. Furthermore, Tunisia has the highest representation of women in the legislature in the MENA region, which is also comparable to OECD average (Figure 4.5). In addition, while in 2010, women constituted over 40% of public sector workforce, they held 45% of senior manager positions in the civil service, which is comparable to the top performing OECD countries (Figure 4.6).

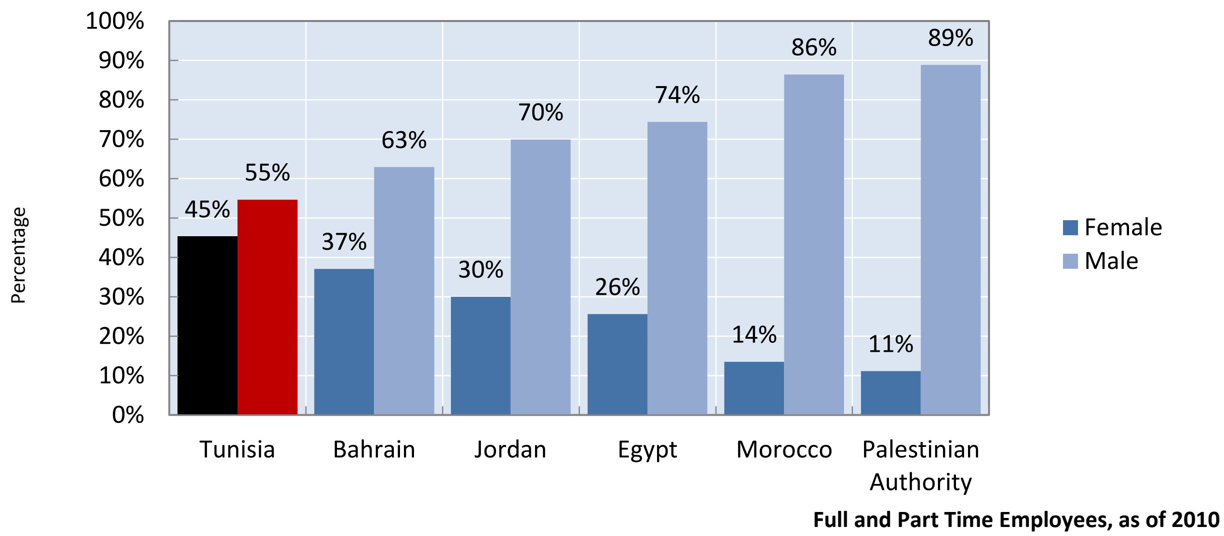
Figure 4.5. Representation of women in legislature across the MENA region, 2008-13



Notes: Bahrain did not have any elections between 1975 and 2002. Oman had partial suffrage in 1994 and universal suffrage in 2003. Qatar only has women's suffrage for municipal elections. Saudi Arabia has announced suffrage for 2015. The data for Yemen is according to the year of suffrage for the Democratic Republic of Yemen. The Arab Republic of Yemen had women's suffrage in 1970.

Sources: OECD (2015), Women in Public Life: Gender, Law and Policy in the MENA region (forthcoming), based on Inter-Parliamentary Union and national official documents.

Figure 4.6. Women and men employed in senior management in the civil service of MENA countries, 2010



Source: OECD-MENA Survey on National Gender Frameworks, Gender Public Policies and Leadership (updated in 2014).

While Tunisia has considerably strengthened the legal status of women in the workplace, gender gaps are still significant and may reduce women's incentives to join and stay in the labour force. For instance, women with the same level of education as men tend to hold jobs with a lower level of qualification (Stampini and Verdier-Chouchane, 2011). Policies to reduce the gender gap, particularly in the private sector, include strengthening public awareness of anti-discrimination laws, promoting pay transparency, and improving enforcement of equal-pay provisions. Also, temporary quotas to ensure participation of women on company boards and in senior administrative positions should be introduced, but should be preceded by a full regulatory economic impact assessment (OECD, 2012c). Tunisia also needs to promote policies that support women's empowerment, such as facilitating their access to finance and business-development services, and encouraging their participation in the public sector.

Women in Tunisia carry out the bulk of caring responsibilities which, in combination with a lack of adequate support from the government, often results in their permanent disengagement from the labour market. There are two aspects of family policy in particular that would help the government tackle the low female labour-force participation. The first of these is child-related leave entitlements, which are particularly low (30 days of paid maternity leave, with no unpaid-leave entitlement, and just one day of paternity leave). The second policy area where more could be done is helping families meet the costs of child care. The relatively high cost of childcare in Tunisia is likely to be a significant factor behind its low uptake, although the government should also do more to increase the provision, particularly for the poorest families. Both of these factors may also explain why women in Tunisia reveal a strong preference for public-sector employment, where family-related benefits tend to be more generous than in the private sector.

Key OECD recommendations

- **Promote moderation in real wage growth** by *i)* avoiding large (real) increases in the minimum wage, *ii)* reducing differences in remuneration and benefits between the public and private sectors, and *iii)* avoid using public-sector job creation as a means of social appeasement.
- **Reduce the gap in protection between permanent and temporary contracts** both through an easing of employment-termination regulations on permanent contracts and through an increase in protection for workers on temporary contracts.
- **Reform public-sector recruitment rules** so that they no longer reward those who have been longest out of a job.
- **Provide additional resources to ANETI**, extend its geographic network, and ensure better use of its existing resources. Efforts should be made to work more closely with NGOs in the delivery of ALMPs should be stepped up, and Tunisia should legalise and regulate private-employment services.
- **Active labour-market policies** need to better target the disadvantaged, the low-skilled (*i.e.* non-graduates) and the long-term unemployed.
- **Introduce an unemployment insurance system** to help individuals and households smooth consumption when out of work.
- **Use public-works programmes to stimulate employment in rural areas**, while helping to close the regional infrastructure gap and helping the country in its transition to a greener economy.
- **Make VET more attractive** by: *i)* integrating the lower-secondary technical track into general lower-secondary education, *ii)* expanding VET at the upper-secondary level and linking it to strong quality-assurance mechanisms, *iii)* introducing career guidance in all lower-secondary schools and *iv)* improving articulation between vocational and academic programmes.
- **Expand the mix of VET provision and involve the social partners** by: *i)* extending mandatory work-based learning to the *licences appliquées* [professional bachelor's degrees], *ii)* better engaging employers, and *iii)* establishing a co-ordination body to reduce the fragmentation of VET across ministries and improve the responsiveness of the system.
- **Develop a national strategy to mainstream entrepreneurship** within the VET system. **Strengthen gender policies** with the aim of reducing the wage gap as well as increasing women's achievement of senior positions in both the public and private sectors.
- **Give more support to families to help them juggle work and home responsibilities**. In particular: maternity and paternity leave entitlements should be increased, and the government should do more to help parents (in particular the poorest) to meet the relatively high costs of child care.

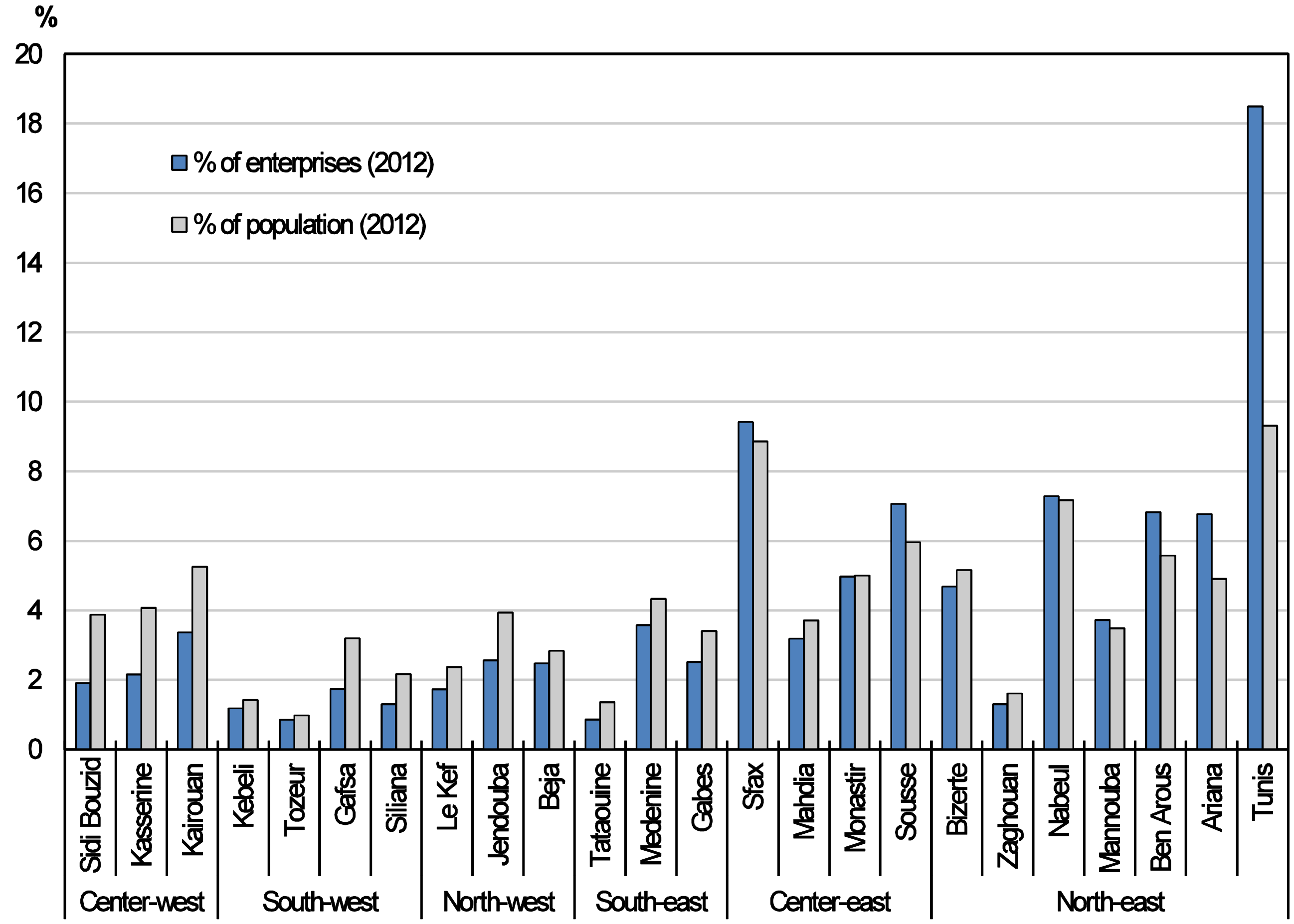
5. ADDRESSING REGIONAL DISPARITIES

While reducing regional economic and social disparities in Tunisia has been a key objective for some years, activity remains highly concentrated in coastal regions and inequalities in living standards remain very large by international standards. An inclusive regional-development strategy needs to be developed, with public investment at its core. For public investment to be effective, good governance is critical. Decentralisation would bring governance closer to citizens and can contribute to economic development. Striking the right balance is important as excessive fragmentation of territorial authorities may hamper cost-effective public service delivery. Decentralisation should also be accompanied by enhanced transparency and fiscal rules for sub-central governments in order to ensure fiscal discipline.

Substantial efforts have been made to reduce inequalities of living conditions between regions, especially in the latter half of the 1990s. Assessing developments in regional disparities and drawing international comparisons are often made difficult by the lack of appropriate data. However, various indicators suggest that regional inequality in living conditions has shrunk. For instance, the rate of household connections to potable water in the Centre West region, which is one of the poorest, rose from 38% in 1994 to 63% in 2012. Progress has also been made in terms of access to health care, although these have been less pronounced: in 2012 there were still three times as many hospital beds per capita in Tunis than in the Centre West governorates – Kairouan, Kasserine, and Sidi Bouzid. Even within governorates, the disparities between rural and urban areas are still stark, with most of the poverty, as measured by the Oxford multidimensional approach, concentrated in the rural areas (OPHI, 2013). For instance, in rural areas of Kasserine, the rate of household connections to potable water nearly quadrupled since the mid-1990s but was still low (at 27%) in 2012 (INS, 2012).

Despite efforts to reduce regional disparities in living conditions for households, the regional concentration of economic activity has continued to increase. Of all private enterprises accounted for in the National Registry, 74% were located in the Northern and Eastern regions, along the coast, up from 69% in 2000 (Figure 5.1). The governorates of Tunis, Ariana and Ben Arous attract a very high share of private enterprises, even compared to their population share. In addition, private companies in coastal regions tend to be larger, and hence be more productive and to able to pay higher wages, thus exacerbating income inequality. In sharp contrast, governorates from the Centre West (Sidi-Bouzid, Kasserine and Kairouan) had in 2012 a very low share in private enterprises compared to their population share.

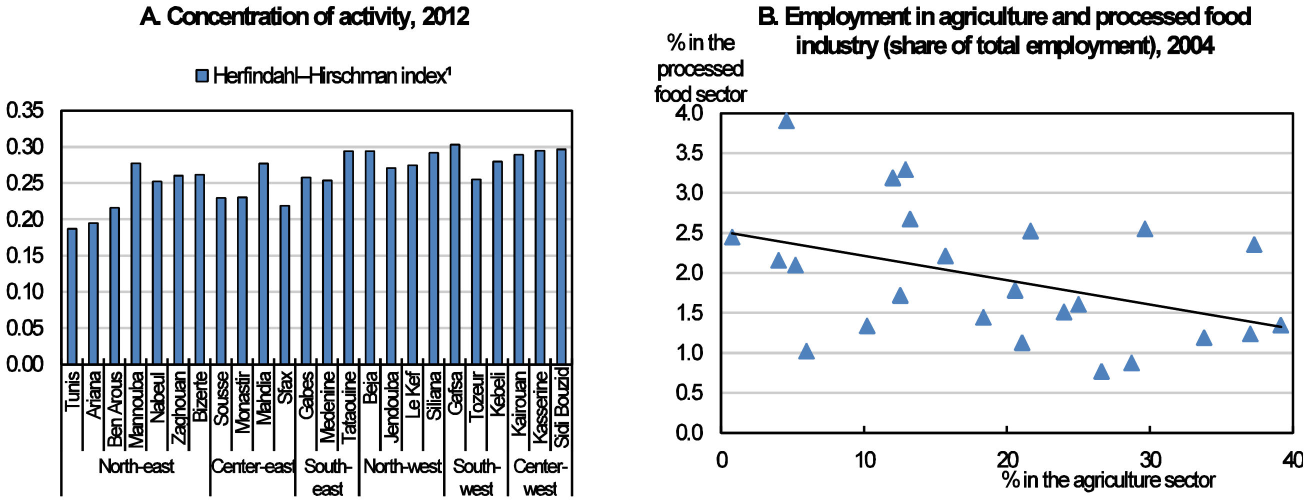
Figure 5.1. Private firms are highly concentrated in northern coastal regions



Source: *National Institute of Statistics of Tunisia.*

Not only do interior regions host relatively few enterprises but those firms tend to operate in the same sectors, increasing output volatility and making these regions more vulnerable to shocks. Interior regions are typically highly dependent on a narrow range of traditional primary products, with little horizontal or vertical transformation. As an illustration, those regions where employment in agriculture, fishing and forestry account for a large employment share tend to have below average employment share in food industry (Figure 5.2, panel B). Economic activity is much more diversified (as measured by the number of private firms in each sector) in coastal regions.

Figure 5.2. Economic activity is highly concentrated in primary products in interior regions



1. The Herfindahl–Hirschman Index is calculated based on the number of entreprises. The higher the index, the higher economic activity is concentrated in a few sectors in the region.

Source: *OECD calculation based on data from National Institute of Statistics of Tunisia.*

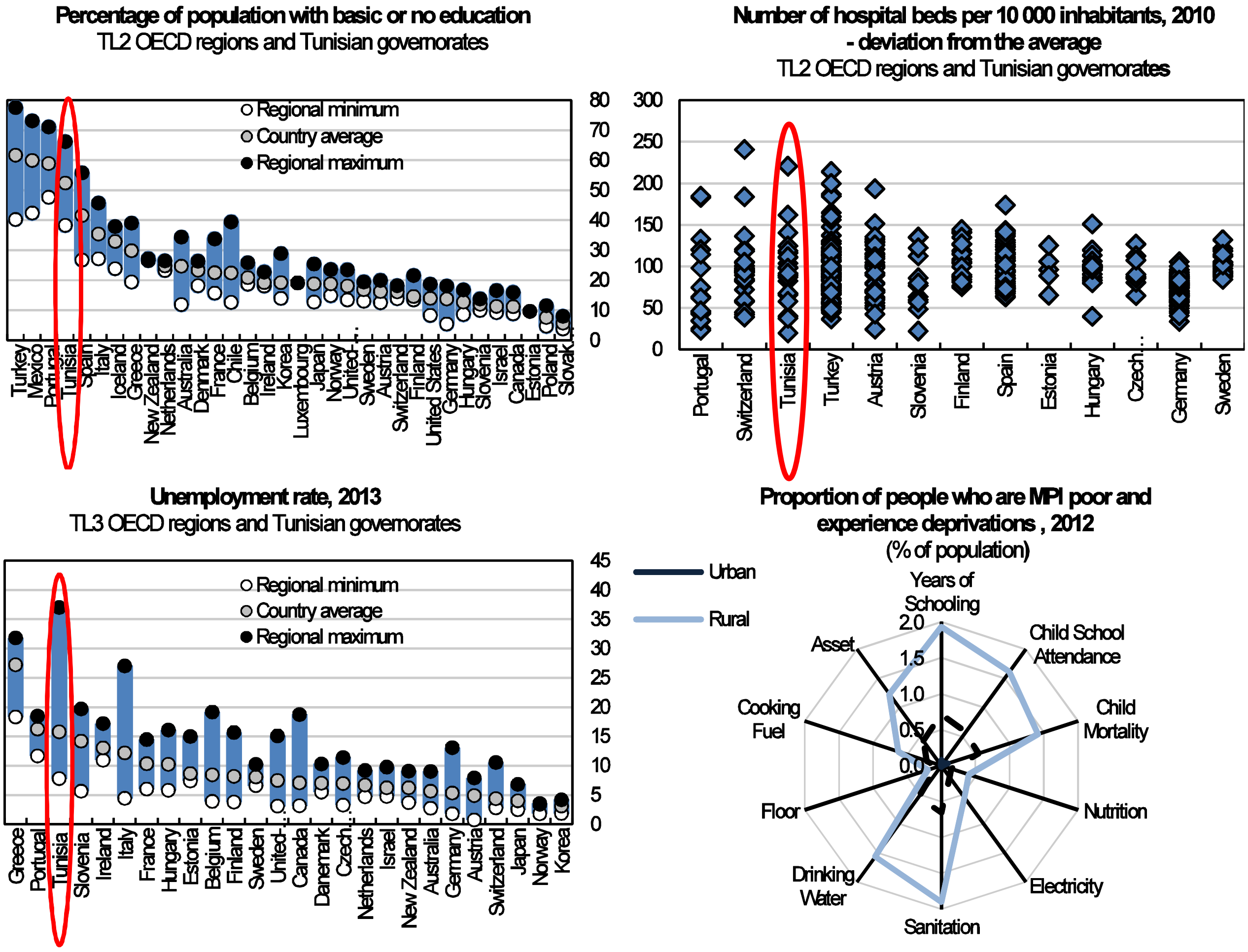
Regional inequalities appear to be sharper in Tunisia than in most OECD countries, as evidenced by information on unemployment as well as access to key public services. Regional income and employment data by governorates are not readily available for cross-country comparisons. However, unemployment data is revealing (Figure 5.3 and OECD, 2013d). The unemployment rate stood at 13.3% for the country as a whole in 2013 – above the OECD average but significantly lower than the rates observed in Greece (27.3%), Portugal (16.3%), or Spain (26.4%). That said, no region in the OECD experienced a jobless rate as high as the 37% observed in the Tunisian governorate of Tataouine. Unemployment rates tend to be higher than the national average in the North West and the South East.[5] Disparities in access to education and health services are also important.

Such regional disparities have fanned the flames of political protest, the 2011 revolution having begun in the disadvantaged cities and governorates least well-endowed with public infrastructure – Sidi Bouzid, and Kasserine, for instance (Béchir *et al.*, 2011) -- and those hit hardest by unemployment. To address these disparities, the April 2011 government budget dedicated 75% of the regional development allocation to marginalised interior regions, including a special investment budget for infrastructure. However, there was a low level of budget implementation. The government also offered tax relief to businesses locating in the interior regions until the end of 2012 and an exemption from salary taxes for an initial period.[6]

5 ADE (2011b), “Les défis de la compétitivité et de l’emploi dans le cadre de la transition démocratique en Tunisie”, p. 178.

6 Information on the success of these policy initiatives is not readily available.

Figure 5.3 Regional inequalities – unemployment, education, and access to health care, poverty



Sources: OECD regional data base, INS, and OPHI.

Past policies have contributed to economic polarisation and rural poverty

Historic policies were conducive to a high concentration of industrial activities in coastal areas, and to scant development of agricultural operations in the rural hinterland. The development of offshore areas, situated for the most part along the coast, added to this process of agglomeration. These areas, which enjoy substantial tax breaks -- but above all streamlined administrative, tax, and customs procedures -- saw their share of aggregate employment rise sharply, from 12% of private employment in 1996 to 23% in 2012. The knock-on effect on the industrial fabric and the constitution of economic activities, *e.g.* in agro-food, has been limited by the cumbersome administrative, tax, and customs procedures to which trade with onshore enterprises is subject. Poor inter-regional connectivity has also played a role. Moreover, business surveys reveal that access to finance is an important constraint for many companies, but the constraint is particularly binding in remote areas, hindering investment and growth in these regions. Some industrial firms find it difficult to relocate executives and their families to interior regions, given that they offer less in the way of healthcare, education and cultural facilities.

Controls on agricultural prices may also have further heightened regional disparities. Some highly labour-intensive agricultural operations, in which inland regions had been competitive, were penalised by prices kept artificially low in order to preserve food security. Thus, after the unemployed, farm workers are the group most affected by poverty (29% in 2010). Even farmers themselves experience a relatively high poverty rate (20%). Poor management of plots owned by the central government has also hindered farm output and aggravated rural poverty.

Towards a new regional development policy

The regional development policies implemented in OECD countries have changed considerably. Once based essentially on sectoral subsidies and aid to disadvantaged territories, today OECD countries adopt multi-sectoral policies, drawing on the particular features of each territory, and mobilising local players (Table 5.1). The key growth factors at the regional level include the availability and quality of infrastructure, human capital, innovations, and agglomeration effects. To make the most of this entails recognising the complementarity of these factors and thus implementing an integrated approach in which they are mutually reinforced (OECD, 2012d).

Table 5.1. The paradigm shift in regional policy

	Traditional regional policies	New paradigm
Objectives	Balancing economic performance by temporary compensation for regional disparities	Tapping underutilised regional potential for competitiveness
Strategies	Sectoral approach	Integrated development projects
Tools	Subsidies and state aid	Soft and hard infrastructure
Actors	Central government	Different levels of government
Unit of analysis	Administrative regions	Functional regions
	Redistributing from leading to lagging regions	Building competitive regions to bring together actors and targeting key local assets

Source: *OECD (2009), Regions Matter: Economic Recovery, Innovation and Sustainable Growth, OECD, Paris.*

But there are obstacles to the development of regional policies: the way some ministries operate like silos; co-ordination with local players that have different levels of institutional capacity, especially in terms of the impartiality of public services, respect for the rule of law and control over corruption; and administrative fragmentation, which makes it difficult to institute policies on the proper scale. Good governance is essential to overcoming these obstacles and will be essential to develop an effective and inclusive regional development strategy in Tunisia, led by growth- and equity-enhancing public investment (see OECD Principles on Effective Public Investment Across Levels of Government, 2014).

Decentralisation: Tunisia's plans in the light of OECD countries' experiences

Decentralisation can help restore confidence in political action and enhance the legitimacy of reforms by narrowing the gap between citizens and the policy design process. From an economic standpoint, transferring responsibilities to sub-central authorities can improve the effectiveness of public action and its power to redistribute resources among regions, rural areas, and cities. Recent work in this area (OECD, 2014b; OECD, 2013e) shows that investment in human and physical capital is higher in decentralised countries, as is educational performance as measured by PISA test results. The highest-ranking OECD member countries in terms of well-being are either federal or highly decentralised countries.

Decentralisation emerged as a major goal for Tunisia as early as the first transitional government in 2011. According to its white paper on regional development (*Une nouvelle vision du développement régional*), the transitional government planned to transfer certain responsibilities – particularly in the areas of education, water supply and treatment management, health, and actions targeting the elderly – to sub-central governments. Besides ensuring political legitimacy, granting greater autonomy to territories can improve the effectiveness of government action. Education is a good case in point (OECD, 2014b).

In order to benefit fully from decentralisation and minimise the risks of inefficiency and budgetary slippage, OECD studies show that certain conditions need to be met. In particular, it is necessary to:

1. **Avoid excessive fragmentation of territorial authorities.** The number of sub-central administrations in Tunisia has increased significantly since 1956, from 13 to 24 governorates and from 86 to 264 delegations. There are also cantons. The 2011 decentralisation plan provided for the creation of two new types of body – communes and regions – to be followed by the abolition of delegations. The risks of duplicating functions and diluting responsibilities, and the adverse impact this would have on the quality of public services, would seem to be high. In addition, the experience of certain OECD countries – France and Spain for example – shows that the decentralisation process is often accompanied by an increase in the number of civil servants and fiscal slippage (Joumard and Giorno, 2005; OECD, 2007). Creating a sub-central level of government without reconfiguring the responsibilities and revenue-raising powers of existing sub-central governments can lead to overlaps and duplication, as shown by France's experience with the creation of groups of municipalities with tax-levying powers (OECD, 2013f). To keep this risk to a minimum and ensure that public management is efficient, it is essential to properly define the responsibilities of each level of government and to avoid excessive territorial fragmentation that could lead to diseconomies of scale. Many countries (in particular Denmark, Greece, Finland, Japan, and Turkey) have recently encouraged communes to merge in order to reduce the costs of delivering public services and improve their quality (OECD, 2014c).
2. **Choose local taxes that have the least number of perverse effects.** Very few taxes can be decentralised without damaging the potential for growth or redistribution (OECD, 2014b). Transferring taxes on businesses (whose revenues are often volatile) to municipalities, as set out in the white paper (proposal 45), runs the risk of destabilising local finances and jeopardising the financing of recurrent expenditures – as Finland's experience shows. There is also a risk that inequalities between territories might widen further. A tax on immovable property is the most appropriate measure. While the lack of an up-to-date land register often poses problems, Korea's experience demonstrates that solutions do exist – the central government there has set up a country-wide property valuation system that determines the property tax base, while municipalities have some freedom to set tax rates and raise tax revenues.
3. **Ensure financial transfers among levels of government strike a good balance between encouraging local development and equalisation** (Bergvall *et al.*, 2006 and OECD, 2014c). These transfers must reflect the size of the population, on the basis of data that are regularly updated, and key socio-economic characteristics (for example number of children, poverty rate) to ensure some equalisation. Excessively complex transfers, based on historical or overly specific expenditures, should be avoided, however, because of their adverse impact on the transparency and efficiency of sub-central administrations (Bloechliger et *al*., 2004). The approaches adopted by the Nordic countries could serve as an example to Tunisia.
4. **Enhance transparency and introduce fiscal rules for sub-central governments** in order to ensure budgetary discipline. Most OECD countries limit the indebtedness of sub-central bodies by making it mandatory for accounts to be balanced or by introducing a 'golden rule' whereby debt can be used solely to finance investment (OECD, 2014c).

Key recommendations

- **Gradually remove price controls in rural and agricultural areas,** as they hamper farm production and keep many farmers trapped in poverty. Improve the management of plots owned by the central government.
- **Leverage regional development to support inclusive national growth** by formulating development strategies; tailor policies to the realities of the urban, rural, and intermediate areas in which people live, rather than to administrative perimeters; and exploit the complementarity of policies for competitiveness and innovation, as well as those for combatting inequalities.
- **Bolster the decision-making capacity and resources of local authorities** so they can better meet the needs of the population and exploit local resources without jeopardising the macroeconomic goals of efficiency, equity, and stability. Develop co-ordination among public authorities at all levels of government, especially as concerns public investment and the delivery of basic public services.

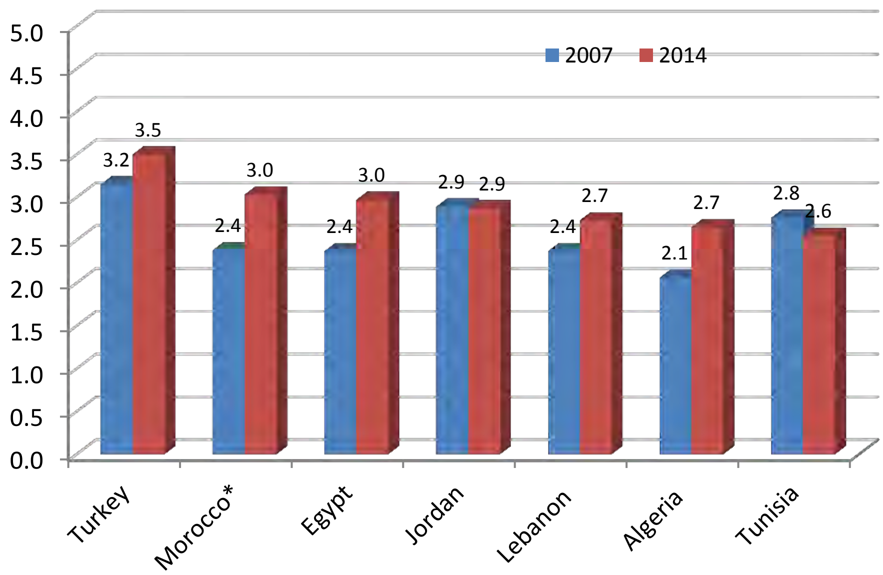
6. IMPROVING TUNISIA'S INFRASTRUCTURE: THE CASE OF TRANSPORT AND WATER

Tunisia's well-developed physical infrastructure has played an important role in the country's development. It can still be reinforced, however, notably the transport network and in terms of broadband connectivity. Moreover, its infrastructure suffers from growing imbalances and deficiencies. First, Tunisia has witnessed a geographic imbalance in the development of its infrastructure between the coastal regions and the hinterland, which prevents inland regions from fully sharing the benefits of economic growth. Second, the country is poorly connected with neighbouring countries. The construction of highways and railroads connecting the country with Algeria and Libya has been delayed, hampering intra-Maghreb trade. Third, some infrastructure, notably in the maritime sector, faces efficiency and capacity challenges and requires urgent upgrading. Finally, there are missing links that go beyond the physical infrastructure – notably the insufficiency of appropriate transportation services and the existence of logistical bottlenecks. Targeted policy reforms can help Tunisia redress this situation in order to better exploit its economic potential.

Tunisia's infrastructure is strong by regional standards. In 2013, the transport sector; telecommunication and postal services; and the water, electricity and gas sectors contributed respectively to 7.3%, 6.3% and 1.1% of GDP. The country ranks highly in terms of the availability of basic services: 99.5% of households have access to electricity and more than 95% to drinking water. By contrast, its trade and transport related infrastructure (e.g., ports, railroads, roads, information technology) deteriorated in recent years as its score dropped from 2.8 to 2.6, and its ranking dropped the 60th to 118th, place in the World Bank's Logistics Performance Index (LPI) between 2007 and 2014.

Figure 6.1. Trade and transport related Infrastructure - regional ranking 2014

(scores from 0 to 5; 5 = best performance)



* 2012 figures for Morocco

Source: *World Bank – Logistics Performance Index*

A more coordinated national infrastructure is needed

The Tunisian authorities have, since 2007, embarked on ambitious projects aimed at upgrading the country's infrastructure. The 2007 national infrastructure plan was centred on the following priorities: *i)* reinforcing existing infrastructure, with a special focus on maritime and rail infrastructure; *ii)* increasing the interconnectivity and use of intermodal freight transport; and *iii)* developing a logistics strategy. Logistics costs amount to about 20% of Tunisian GDP (compared with less than 10% in some OECD countries), whereas the contribution of logistics to GDP represents only 5%. The overall objective of the government was to reduce logistics costs to 15% of GDP. The national plan also included the building of logistics facilities and warehouses, as well as the creation of a sound legal and institutional framework.

The instability triggered by the revolution, combined with the global economic crisis, has led to delays in the roll-out of key infrastructure projects, however, as well as the maintenance of existing infrastructure. Infrastructure is becoming a growing concern for the government, as its deterioration could become a binding constraint on further economic growth if left unaddressed. For instance, the condition of the maritime transport infrastructure, through which more than 95% of Tunisia's exports must transit, is a particular concern for investors. Radès, the main port of Tunisia, has been saturated for years, notably due to its limited capacity for container traffic and to the more recent deterioration in the quality of its services. The extension of the Radès port, and the projected construction of a deep seawater port in Enfidha, have yet to be initiated. The maintenance of existing infrastructure has also been neglected. For instance, in the energy sector, the lack of maintenance off the existing network increased losses in the transmission and distribution of electricity, which reached 14% in 2013 - its highest level in a decade.

Tunisia is also facing difficulties in building a co-ordinated strategy for its infrastructure. Before the revolution, the government approach to the country's infrastructure needs was formulated by sector, within the broader Five-Year Development Plans for economic and social development. However, these have since been abandoned, and the government is now facing serious difficulties in building a necessary co-ordinated strategy for its infrastructure. For instance, the national transport plan that built on the last Five-Year Development Plan (2010-2014) was hardly implemented, leaving the government with no long or medium term plan to address its transport infrastructure needs.

These infrastructure shortfalls pose first-order policy challenges for the new government, especially in light of the ambition to upgrade Tunisia in global value chains (GVCs). There is a need for a consultative long-term strategy that identifies priority projects and ensures consistency with the overall development model that the country has chosen. This should be backed by a broad and efficient mechanism that involves local authorities and the private sector, and that considers the imperatives of inter-modal infrastructure development. National infrastructure planning should not only aim to expand infrastructure networks and increase private investment in physical capital, but also focus on improving the quality of existing services – notably by enhancing competition and regulation of network industries while improving the governance of SOEs.

Improving the efficiency of state-owned utilities

The historic Tunisian model of infrastructure-service development, organised around strong SOEs, has shown its limitations. Though SOEs have proved an asset for Tunisia and have underpinned state-led development of infrastructure and services, their efficiency has declined and their dominance in infrastructure markets significantly affects how much space is left for private investment. The majority of SOEs managing infrastructure in Tunisia today are not commercially viable, owing to low cost recovery through tariffs and budget pressures that undermine the sustainability of government subsidies. As an example, after being commercially viable for years, Tunisia's water utility SONEDE is facing important financing challenges attributable to unpaid bills, wage increases, and rising costs of production – coupled with insufficient and sporadic tariff increases. It only recently started benefiting from tariff increases, bringing up its cost recovery rate to 82% in 2013 (see Case Study based in OECD (2014d)). SONEDE considers that these increases will be sufficient to regain its financial equilibrium by 2016. The recurring financial losses of SOEs bear heavily on the national budget, increase debt levels, and result in a shortage of funds for business expansion as well as infrastructure maintenance. This, in itself, is likely to deter private participation, especially when combined with tariffs that are kept artificially low. In the energy sector, for instance, although power generation has been opened to private actors since 1996, very few independent power providers have entered the market alongside the state-owned operator. Meanwhile 60% of the transport sector (all sub-sectors combined) remains operated by SOEs.

The efficiency of SOEs, and their potential to act as complementary partners to private investors and to actively contribute to economic growth and competitiveness, can be enhanced by reforms in the fields of corporate governance and competition (see also Chapter 9). Tunisia's competition council has investigated the anti-competitive behaviour of several state-owned public utilities in the past (most notably Tunisia Télécom). Weak technical and personnel capacity within the competition council, however, prevents it from undertaking broad-ranging studies of specific infrastructure markets (**see Chapter 9**). In addition, there is no clear division of responsibility between the competition council and infrastructure-sector regulators, which limits the effectiveness of the council's advisory functions as regards elements that may constrain market entry for private infrastructure operators. Among other matters, this includes questions of privatisation, bid-rigging, market exclusivity, and tariff-setting.

Enhancing public procurement procedures and PPP governance

Improving the transparency and fairness of public procurement procedures can also help create a more level playing field between SOEs and private investors in Tunisia's infrastructure markets. As noted above, bid-rigging for public procurement contracts can severely limit upstream competitiveness of infrastructure project development. Addressing this risk requires a solid framework for public governance of infrastructure projects, including through intelligible and reliable public procurement regulations. As Tunisia updates its framework for concessions and public procurement, and as it develops a law and regulations for Public-Private Partnerships (PPPs), it will have to ensure coherence among these new frameworks – as well as consistency with the broader regime for competition and sector-specific market regulation.

PPPs can be a viable solution to meet Tunisia's needs in infrastructure and public service delivery if the right governance framework is in place. As experienced by OECD member countries, well-designed PPP projects can allow for on-time and within-budget delivery relative to traditionally procured projects, and can also contribute to heightened quality standards. On the legal front, a draft PPP law was presented to the Tunisian Parliament in 2013, but is still subject to debate and revision. On the institutional front, the Prime Minister's office took a positive step by setting up a concessions unit ("unité de suivi des concessions" – USC) in late 2013 as a precursor to the future PPP Unit. The unit will provide the institutional backing and expertise necessary for the government to manage PPPs at the central level. The Deauville Partnership project on operationalising PPPs in Tunisia, a partnership between the African Development Bank and the OECD, aims to support the USC's work in implementing the future PPP law.

More generally, sound public financial management will be essential to ensure that infrastructure projects are selected and designed in such a way as to generate maximum social and economic returns for the public money spent. There are three main challenges involved in structuring and managing PPPs: i) appropriate risk sharing, ii) sufficient technical capacity in the public sector, and iii) transparent accounting. A balance must be struck between incentivizing private sector participation and ensuring value for money from public funds. Decision makers must therefore carefully balance the risks taken by the private sector and those retained by the public sector in light of a realistic assessment of the price of these contracts. Steps must also be taken to ensure that the relevant public sector authorities, supported by a dedicated and centralised PPP unit, have the requisite technical skills and resources to appraise what are often complex and infrequently used projects and contracts. Strong budgetary capacity is needed to shoulder the fiscal implications of infrastructure projects, especially in the case of PPPs. In order to reflect the government's long-term exposure to PPPs, fiscal reports disclosing Tunisia's full liabilities arising from PPPs should be made available. The UK's Whole-of-Government Accounts report provides a useful example in this regard.

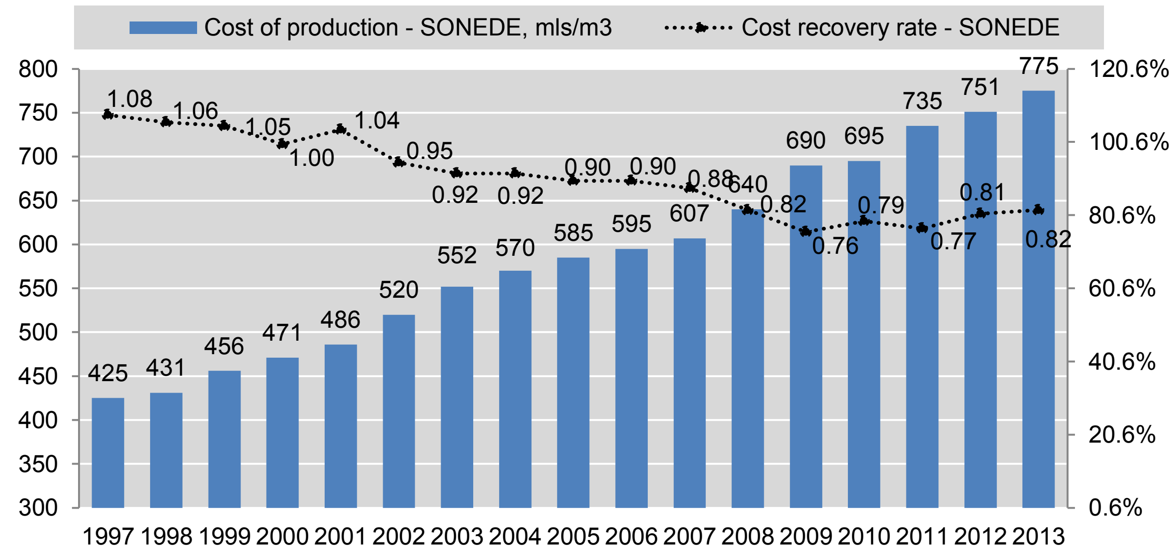
Positive steps are being taken in this direction: Tunisia's draft PPP law and its draft application decree provide for specific measures to ensure the sustainability of PPP projects, which can feed into their longer-term assessment. Fiscal feasibility reports will be requested for all PPP projects before they can receive the green light from the Ministry of the Economy and Finance. As there is still public resistance to private-sector participation in the delivery of public services and infrastructure, such measures to clearly disclose, explain, and treat public expenditures linked to PPPs will be essential in order to ensure that PPPs are both affordable and provide value for money for the government as well as end users of infrastructure services.

Underpinned by strong political will for reform and effective co-ordination across the administration, Tunisia's public financial management (PFM) system is also undergoing an ambitious reform programme. It aims to modernise budgeting procedures and improve performance by implementing results-based budgeting ("gestion du budget par objectifs"). The development of a medium-term expenditures framework (MTEF) is one of the main pillars of Tunisia's PFM reform. The forward estimates of MTEFs create more accountability on the specific results to be achieved through programmes and projects, including PPPs. The gradual adoption of an MTEF alongside results-based budgeting, which is expected to reach all non-sovereign ministries by 2015, can notably enhance the long-term fiscal sustainability of infrastructure projects. Against this background, the government is planning to adopt a revised Organic Budget Law (OBL), which could usefully draw on existing OECD instruments such as the new OECD Principles of Budgetary Governance or the OECD Journal on Budgeting's special issue on The Legal Framework for Budget Systems.

Case study: the Water sector in Tunisia

Despite outstanding past performance, the Tunisian water sector has experienced a deterioration in its infrastructure and performance, as well as increasing difficulties in securing financing. The sector's governance, based on strong centralisation of responsibility and decision-making power, is also showing its limitations. On-going post-revolutionary reconstruction offers a good opportunity to reflect also on the governance framework and the potential role of private-sector participation (PSP) in the development of the water sector. This will require, however, greater institutional buy-in to ensure a sense of ownership and commitment to reform by the responsible authorities.

Figure 6.2. Financial sustainability indicators for the drinking water sector in Tunisia



Source: *OECD (2014d), Water Governance in Tunisia: Overcoming the Challenges to private Sector Participation, OECD Studies on Water, OECD Publishing.*

Strengthening the financial viability and fiscal sustainability of the water sector is essential to ensure the sustainability of the management of water services in Tunisia and the success of PSP. This involves a combination of factors including improved operators' autonomy, greater transparency of budgeting processes, and the adoption of a financial planning tool that allows strategic decision-making based on alternative funding scenarios in the sector. A reconsideration of the modalities of price setting (structure, equalisation principle and level) is critical to improving the viability of operators while preserving users' affordability in the long run.

A participatory and territorial approach, placing the different levels of government and non-governmental actors at the heart of the debate on water policies, is necessary. Collection and wider dissemination of data on water and sanitation services – including indicators on the quality of services according to different territorial scales – would strengthen transparency requirements in the water sector. To be effective, the establishment of a solid base of information should be accompanied by capacity building and communication tools for the Tunisian government and operators. Meanwhile, the role of non-governmental organisations (NGOs) in the water sector should be reinforced in order to support the reform process.

Source: *OECD (2014d), Water Governance in Tunisia: Overcoming the Challenges to private Sector Participation, OECD Studies on Water, OECD Publishing.*

Legal certainty needed to achieve green energy goals

Renewable energy made up 7% of installed electric capacity in Tunisia in 2013 (of which nearly 60% was wind-based, 39% was hydro and 1% was solar). In view of these relatively low levels, Tunisia's Solar Plan aims to expand renewable energy generation and targets a generation capacity of 1,000 MW by 2016 and 4,700 MW by 2030 (wind and solar combined). Tunisia has also established a legislative framework to incentivise investment in renewable energy. Law No. 2009-7 relating to energy management allows independent power production from renewable sources, and offers a series of tax benefits for investors in this sector. In September 2014, a law on electricity generation and renewable energy was then passed with the aims of: liberalising the production of renewable energy, including for export and self-generation; enabling unsolicited bids in the sector; facilitating consumption by local communities as well as by public institutions; and establishing a national programme for renewable energy production, to be implemented at sub-national level.

However the law was rejected by Tunisia's Constitutional Court in November 2014, in view of its non-compliance with Article 13 of the new Constitution. If the law were to be reintroduced, some improvements could usefully be made in order to facilitate its implementation and enhance certainty for investors. For instance other existing laws and regulations regarding Tunisia's energy regime (especially those pertaining to independent power production and to self-generation) could be better integrated within the law; and the law could specify clear guidelines and quantified targets for the deployment of renewable energy, rather than leaving this to future ministerial discretion.

Key OECD Recommendations

- **Develop a co-ordinated, national strategy for infrastructure and update infrastructure development priorities.** The process should involve all stakeholders including the private sector and local authorities to ensure a balanced and coherent development model. It should focus on the efficiency of infrastructure related services (that are mostly provided by SOEs) and include an updated logistics strategy (where Tunisia lags behind by regional standards).
- **Prioritise the maintenance of existing infrastructure.** Ministries in cooperation with government agencies and SOEs need to review, plan and prioritise their maintenance activities over the life cycle of infrastructure assets to ensure the best value for money.
- **Put together a pipeline of bankable projects**. Instruments such as the *OECD Principles of Budgetary Governance* can provide guidance for infrastructure projects so that they generate maximum social and economic returns. In addition, the OECD Principles on Private Sector Participation in Infrastructure can also help enhance the framework conditions for private financing of public infrastructure.
- **Enhance the technical capacity and requisite political support for Tunisia's Competition Council** to play an effective advocacy role regarding infrastructure markets – both upstream (bid-rigging in infrastructure procurement, preparation of privatisation and divestiture plans, etc.) -- and downstream (monitoring the operation of infrastructure markets, in close collaboration with the relevant regulatory authorities).
- **Work towards greater independence of regulatory authorities in Tunisia's infrastructure sectors**, so as to enhance predictability of pricing and strike a better balance between cost recovery for private operators on the one hand, and affordability for end users on the other. Address the specific corporate governance challenges of infrastructure SOEs.
- In developing Tunisia's new PPP framework, ensure maximum coherence with the evolving frameworks for concessions and public procurement, as well as the existing sector-specific laws (on telecommunications, ports, etc.). Capacity-building efforts for public authorities should accompany the development of this new legal framework.
- **Reintroduce and improve the law on electricity generation and renewable energy**, to ensure alignment with the Constitution, and specifying quantifiable targets for renewable energy.

7. REFORMING PUBLIC FINANCE INSTITUTIONS AND PROGRAMMES TO PROMOTE INCLUSIVE GROWTH

Tunisia is planning major reforms to strengthen its fiscal institutions, ensuring a more effective public financial-management system. An important goal should be to improve transparency and accountability over public finances. The government should also reform public spending programmes to ensure that they are more conducive to inclusive growth. Energy and food subsidies should be replaced by cash transfers, for example. Public spending pressures stemming from the pension system should be contained by adjusting key parameters. This should help create more fiscal space for social and physical infrastructure programmes that contribute most to support growth and reduce inequalities. The tax system should also be made less distortive, and efforts to fight tax evasion should be stepped up.

Budget and financial-management reforms can help contain fiscal pressures by generating fiscal space for strategic national priorities. The 2013 OECD Review *Strengthening Fiscal Transparency for Better Public Governance in Tunisia* underscores the urgency for the government to implement substantive reform of its public financial management system. This will support prudent fiscal management in light of growing constraints and pressing development needs. The Tunisian government is committed to this reform, with the support of international organisations such as the World Bank and the EU. Budgetary reforms should create a more robust overall framework for capital projects, such as PPPs, and improve accountability towards citizens about the different costs and benefits. Notably, the adoption of performance-based budgeting by several ministries, and increased transparency around budget processes, can help the government achieve its socio-economic goals.

Results-oriented budgeting ensures that money is spent wisely and according to priorities. It helps to monitor and evaluate progress and re-adapt underperforming programmes. The creation in 2008 of a unit in the Tunisian government responsible for implementing a performance-based budget has accelerated the reform agenda. Accordingly, results-based budgets are presented by programmes for 19 ministries (5 ministries in 2012, 4 in 2013, and 10 additional ministries by the end of 2014), which are referred to as "missions" under the Tunisian Organic Budget Law. Several elements to support its adoption government-wide are being prepared, such as a move towards analytical accounting and the development of a medium-term expenditure framework, which is an essential element of good fiscal planning.

Efforts to increase transparency have been undertaken in the last two years, resulting in the creation of the first 'citizens' budget' (**Chapter 8**) in Tunisia and the establishment of a joint committee between the ministry of finance and civil society. In addition, since 2013, Tunisia has published the executive budget online, which is critical to ensure effective public scrutiny. Nevertheless, Tunisia needs to further improve stakeholder involvement in establishing multi-annual expenditure frameworks that give an accurate picture of the country's economic situation and credible macroeconomic assumptions while establishing a clear link with the National Development Plan. In line with the greater focus on decentralisation, the *OECD Review* further highlights the need to improve the co-ordination and performance of internal and external control functions across government levels. The role of parliament should also be reinforced in the budget process to counter corruption and to ensure that the budget is spent wisely.

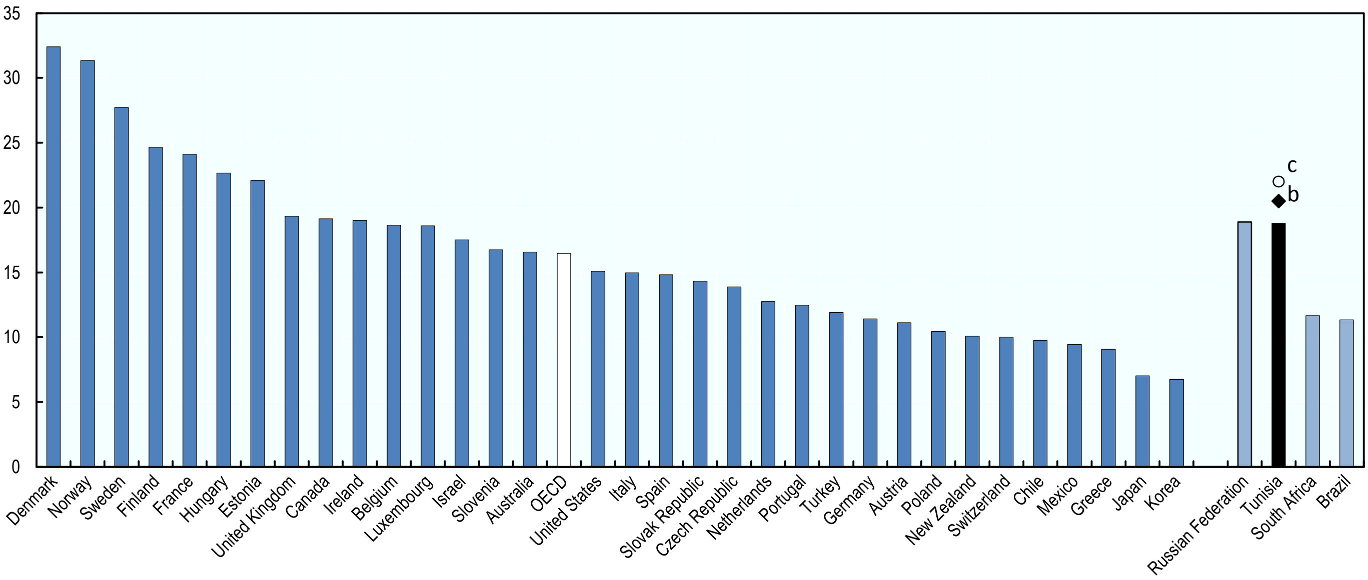
Public spending must be better targeted

The government wage bill was high before the revolution and has since increased further. Public-sector employment has been used to address high unemployment and is elevated by international standards

(Figure 7.1). Between 2010 and 2013, employment in the general government increased by 26% (*i.e.* 142 thousands net jobs were created). It also increased steadily in some public enterprises (*e.g.* Compagnie des Phosphates de Gafsa and Tunisair). In addition, wage and benefit levels are substantially higher for public employees than for private ones. Overall, the wage bill of public enterprises increased by 12.5% between 2010 and 2012 while their operating surpluses declined by 6%. In 2014, the interim government controlled promotion and froze net hiring and salaries in the public sector as part of its efforts to limit the fiscal deficit. Pressures for pay rises remain strong, however.

Figure 7.1 General government employment is very high

As a percentage of total employment, 2011[a]



a. Data for Australia and Chile refer to the public sector (general government and public corporations). Data for Austria, Czech Republic, Italy, the Netherlands and New Zealand are expressed in full-time equivalents (FTEs). Data for Germany, Ireland, Norway, Sweden, the United Kingdom and Ukraine are for 2010. Data for Hungary, Japan, Mexico, Brazil and the Russian Federation are for 2009. Data for Chile, Greece, Portugal and Switzerland are for 2008. Data for France and South Africa are for 2006.

b. Tunisia 2011 with public enterprises (Boughzala, 2013).

c. Tunisia 2013 Ministère des Finances [Ministry of Finance] calculations based on the Enquête Nationale sur la Population et l'Emploi (ENPE) [National Population and Employment Survey] for Tunisia.

Sources: ILO LABORSTA (database); OECD Labour Force Statistics (database). Data for Korea were provided by government officials. OECD calculations based on the Enquête Nationale sur la Population et l'Emploi (ENPE) [National Population and Employment Survey] for Tunisia. Boughzala, M. (2013), "Youth Employment and Economic Transition in Tunisia", Global Economy and Development Working Papers, No. 57, Brookings Institute, Washington, DC, for Tunisia.

Tunisia relies extensively on price subsidies for energy and food products to protect poor households' purchasing power. Their fiscal cost increased from less than 2% of GDP up to the mid-2000s to 7.3% in 2013, reflecting the increase in international prices (of oil, in particular), the coverage of new products since the revolution (*e.g.* milk and sugar), and the arrival of about 2 million Libyans in the wake of the 2011 events. In 2013, the government spent more on subsidies than on public investment. Although they contribute somewhat to reducing poverty, these subsidies are regressive overall. Only 12% of the food subsidies benefit the poorest 20% of households. And 23% of the subsidies are captured by restaurants, bars, tourists, and illegal cross-border trade (Tunisian National Statistics Institute [INS] and CRES, 2013). Even worse for fuel subsidies: 70% of the benefits accrue to the 20% wealthiest households while only 7% of the benefit from gasoline and diesel subsidies reach the poorest 5% households (World Bank, 2014). Further, energy subsidies encourage over-consumption and pollution.

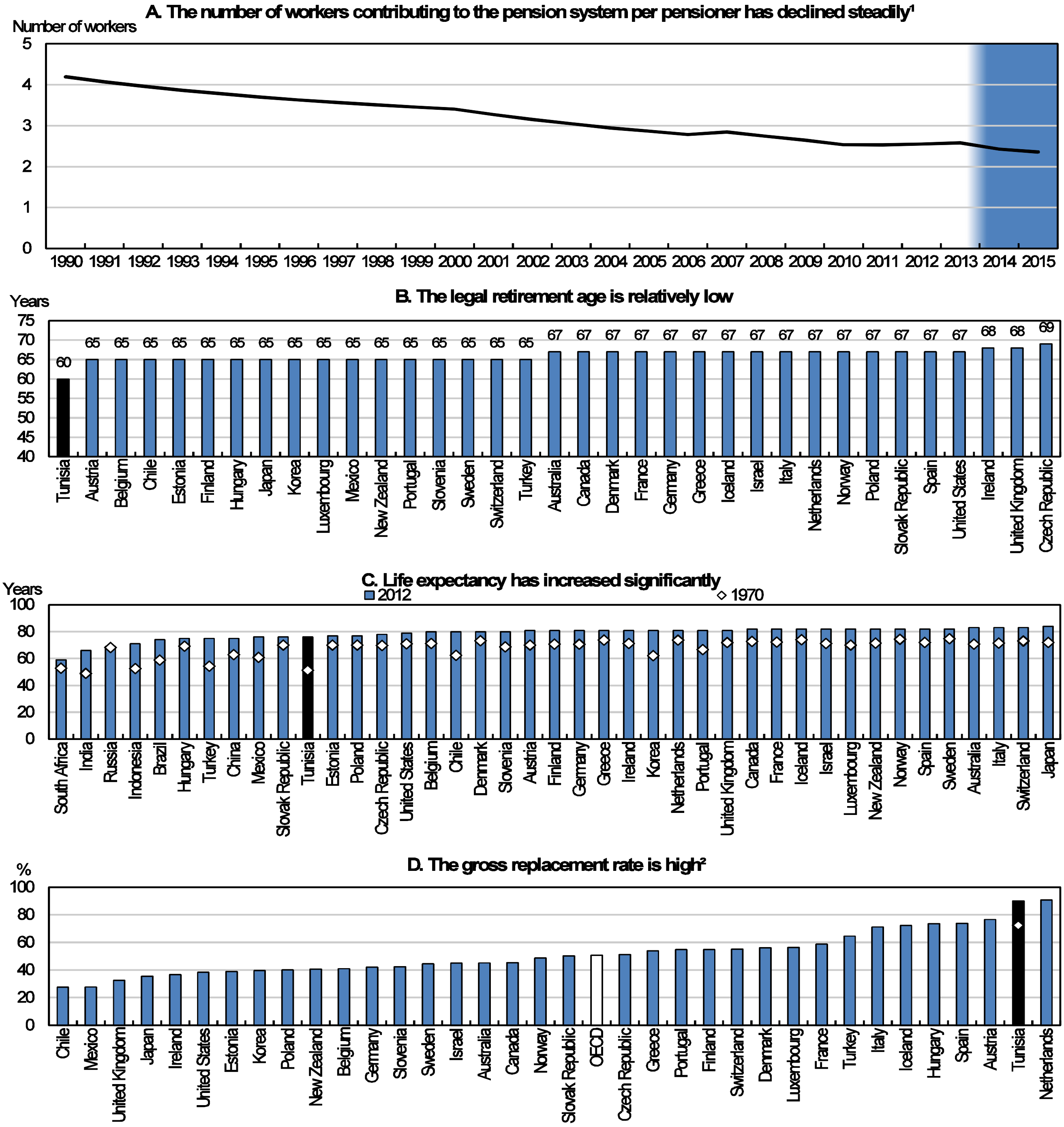
Efforts to reduce the cost of subsidies and increase their redistributive impact should be continued. All energy subsidies to the cement sector have been eliminated since 2013, for example. Recent increases in electricity and fuel prices, and the introduction of a reduced electricity tariff for households consuming less than 100 kwh, are also steps in the right direction. Public spending savings from these measures are estimated at 0.2% of GDP. Eliminating energy subsidies for the other energy-intensive industries and increasing electricity and fuel prices for industrial users will result in an additional reduction in public spending of 0.5% of GDP in 2015. However, more should be done. Energy subsidies should be gradually phased out, or at least capped and targeted. Reducing food subsidies is politically more challenging. A recent study (INS and CRES, 2013) revealed that a universal cash transfer would be more effective in reducing income inequality. To lower the fiscal cost and improve the redistributive impact, food subsidies could be replaced by such a financial transfer, which could gradually become targeted to those in need and merged with the National Support Programme for Needy Families (*Programme National d'Aide aux Familles Nécessiteuses*, PNAFN). Rapidly implementing the unique identification system would help. India's experience with the unique identification number (Aadhaar) and the shift from products- to people-based subsidies suggests that potential savings here are large. Coupled with the development of Aadhaar bank accounts, this approach has also helped promote financial inclusion and support entrepreneurship in India.

Pension costs are rising, while health and education spending are under pressure

The pay-as-you-go pension system is putting further strain on public spending and, in the absence of reform, pressures will increase as the population ages. Public spending on pensions increased to 3.3% of GDP in 2013, up from 2.3% in 2006. Population ageing, combined with the maturation of the pension system, has played an important role in this evolution. Life expectancy has increased dramatically in Tunisia – from 70.3 years in 1990 to 75.6 years in 2013, i.e. above the level in all BRIICS and in some OECD countries. Meanwhile, the legal retirement age has remained set at 60, a rather young age compared to OECD countries. Overall, the ratio of workers contributing to the pension system to recipients of retirement pensions – a key parameter for the financial sustainability of PAYG pension systems – has declined steadily (Figure 7.2, Panel A).

Adding to ageing pressures, the calculation of pension benefits is relatively generous in Tunisia. The gross replacement rate – the ratio of gross pension in retirement to pre-retirement earnings – is higher than in virtually all OECD countries (Figure 7.2, Panel D). It stands at 90% for a person who has worked a "full career", defined as working each year from the age of 20 to 60. The average replacement rate, at 72.4% in 2014, is also high as almost half of retirees received a pension amounting to 80 to 90% of the reference wage – the last wage or highest wage during the two-year period before retiring. Further contributing to public spending pressures is the indexation of pension benefits on wages, as opposed to prices – the most common approach in OECD countries.

Figure 7.2. The Tunisian pension system in an international perspective



1. Data for 2014 and 2015 are Tunisian government's projections.
2. For OECD countries, the replacement rate shown here is for a single worker, who started working at 20 years in 2012, will work up to the country's standard retirement age and earns the average wage. For Tunisia, the replacement rate for those who have worked 40 years is 90%. The actual average replacement rate in July 2014 stood at 72.4%.

Source: *Government of Tunisia; OECD Pensions at a Glance 2013; OECD Health Status database; World Bank Development Indicators Database; WHO; and OECD Pensions database.*

Reforms are needed to ensure that the pension system is financially sustainable while giving citizens an adequate income in retirement and promoting work in the formal sector. Successive increases in the contribution rate – from 14.2% of the gross wage in 2000 to 20.7% since 2011 – have helped contain the deficit of the pension system to 0.3% of GDP in 2013. However, raising contribution rates again cannot be the only solution due to the large size of the informal sector, while price competitiveness also remains an issue for concerns.

OECD countries' experience suggests that various other options should be explored (OECD 2013, *Pensions at a Glance*). Adjusting the retirement age to reflect past and future changes in life expectancy is one of them. In most OECD countries, pension ages have increased and a retirement age of 67 is now becoming more common. Some have linked the pension age directly to changes in life expectancy – an interesting approach Tunisia could follow. In addition, linking pension levels to full contribution histories, rather than final salary, would both reduce the relatively high replacement rate and reinforce incentives for formal work. Switching pension indexation from wages to prices, fully or partly, could also be envisaged. In addition, Tunisia may consider protecting low-income workers from old-age poverty by providing higher replacement rates for them than for average earners, as most OECD countries do.

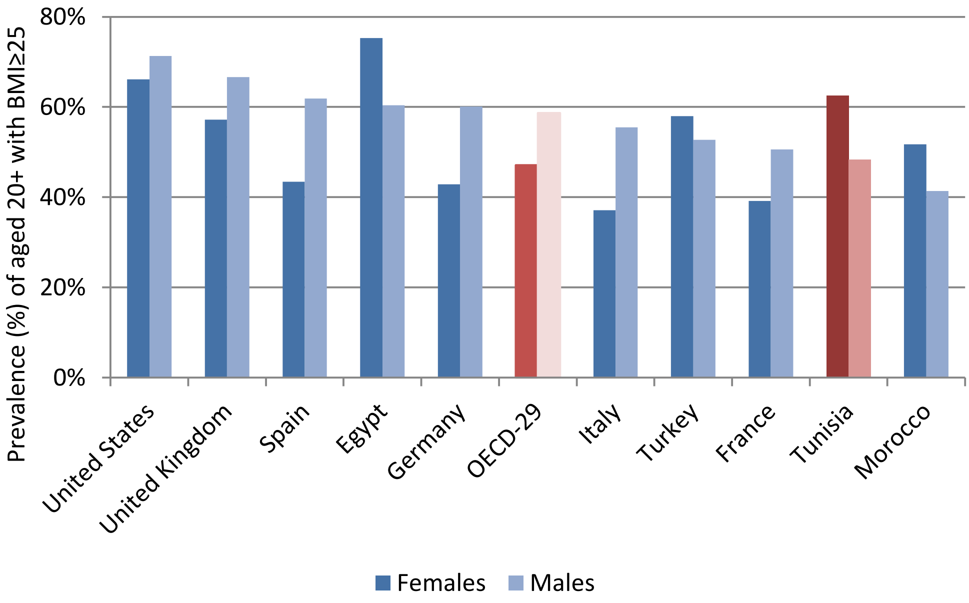
While the fiscal cost of subsidies has soared, public spending on education and health has declined as a share of GDP since the late 1990s. Tunisia's public spending on health stood at 1.7% of GDP in 2009, down from 2.2% in the late 1990s and the number of hospital beds per capita is lower than in Chile, China, Turkey, and South Africa, with many regions left behind (**Chapter 5**). Tunisia also presents growing weaknesses in its physical infrastructure that need to be urgently addressed (**Chapter 6**). Increasing public investment in social and physical infrastructure and improving its effectiveness, in particular in remote regions, should remain a priority for the government since these are core assets to boost economic growth and employment creation as well as to reduce inequality.

Tunisia has made great strides towards universal health care coverage and health outcomes are relatively good. The health insurance system covers public and private (formal) employees and reimburses their own spending and spending of other members of their family – 68% of the Tunisian population – up to a ceiling and with co-payments. Uninsured households are covered by an assistance programme, which allows free or heavily subsidised access to public health care centres – 8% and 22% of the population, respectively (Achour et al., 2012). Health outcomes – e.g. life expectancy and infant mortality, maternal mortality rate and prevalence of tuberculosis – are generally very good compared to countries with similar income level, partly reflecting the high quality of the education and training system for health professionals. The 2007 reform of the health insurance system has improved equity by granting full spending coverage for serious illness and by putting public and private employees as well as public and private providers on an equal footing.

Relatively high out-of-pocket payments (OOPs) and the low density of doctors and hospital beds in interior regions still limit access to care for some groups of the population. As public spending on health has not kept pace with income and demand for services since the late 1990s, citizens have increasingly relied on private services and doctors have often increased their tariffs, thus inflating OOPs (Arfa and Elgazzar, 2013). OOPs now account for about 40% of total health expenditure, a rather high share by OECD standards. Regional disparities in access to care are also large by international standards (see **chapter 5** and Achour et al., 2012). Redressing them may require better working conditions and pay in deprived areas, as well as appropriate regulatory policies, such as obliging rural service. Australia and Canada for instance use medical education to give students greater experience of work in rural communities while some Indian states oblige medical students to practice in a rural area as part of their clinical education. Greater reliance on information and communication technologies may also bring citizens from interior regions closer from health care, e.g. for diagnosis, preventive and follow-up care, and thus reduce inequality in access to health care.

More resources should be allocated to preventive actions. Non-communicable diseases such as diabetes, heart disease, and cancer are the biggest cause for concern for population health in Tunisia. According to the latest edition of the global burden of disease study, cardiovascular and circulatory diseases account for almost 20% of the morbidity in Tunisia, followed by road-traffic injuries (7% of the burden of disease) which are the first cause of death for people under 40 (IHME, 2014). Diabetes is also rapidly becoming one the predominant diseases. Unhealthy behaviours – unhealthy diet, lack of physical activity, smoking – and related physiological risk factors (*e.g.* obesity and high blood pressure) are fuelling the rise in non-communicable diseases, particularly among people of a lower socio-economic status. The incidence of overweight and obesity are higher in women (62.5%) than in men (48.3%), and twice as high in urban areas compared with the countryside (Figure 7.3). Conversely, smoking is more widespread among men (52.8%) than women. Addressing unhealthy behaviours requires a shift in focus from simply treating diseases to promoting good health outcomes via prevention.

Figure 7.3. Overweight and obesity (Body Mass Index ≥ 25) among adults, 2012 or nearest year



Source: OECD Health Data & Institute for Health Metrics and Evaluation (non-OECD countries)

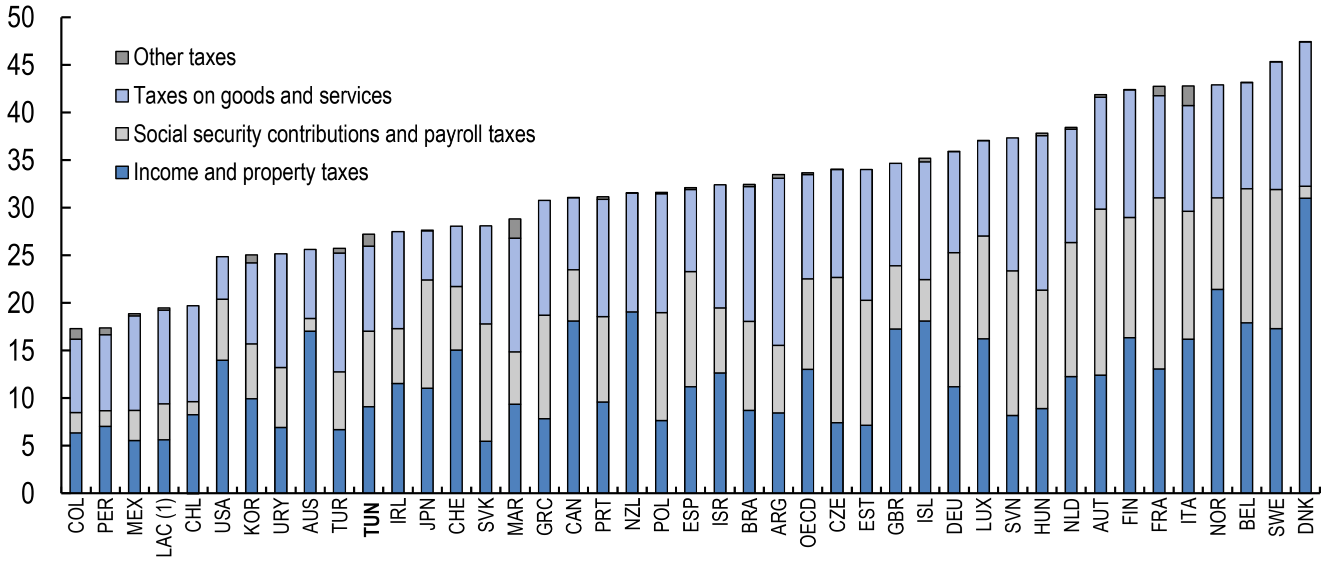
Making the tax system less distortive, unequal, and conducive to evasion

Tunisia will need to raise more public revenue to fulfil social commitments, in particular towards vulnerable families and regions, as well as to face public spending pressures arising from an ageing population (in particular on pensions and health care). This will require reforming the tax system so as to improve horizontal equity as well as incentives to work and invest.

Tunisia's tax-to-GDP ratio is slightly higher than its Latin American peers, though below that of Morocco (Figure 7.4). It also has a bias towards income taxes and social-security contributions, which tend to have a larger negative impact on growth and employment than consumption taxes (Arnold *et al.*, 2011). Income taxes fall excessively on wage earners – taxes on wages account for about 80% of personal income tax revenue – while professionals, shopkeepers and craftspeople pay very little tax as they rely on the rather loose forfeit system (ITCEQ, 2012). The non-adjustment for inflation of tax brackets and allowances for more than 15 years has raised the tax burden on wage earners significantly, creating incentives to work in the informal sector. To mitigate this impact, in 2014 the government introduced a special tax allowance for those earning the minimum wage, but such an approach results in very high marginal tax rates just over the minimum-wage level and further increases the complexity of the tax system.

Figure 7.4. Income taxes and social security contributions are relatively high while consumption taxes are low

(% of GDP)



1. Data from Tunisia are from Tunisian official sources, but have not been cross-checked or verified by the OECD.
2. LAC : Latin American and Caribbean Countries.

Source: OECD Revenue Statistics 2013.

In 2013 Tunisia launched a tax reform project focusing on direct taxation, VAT, transparency and fair competition, the modernisation of the tax administration and the "régime forfaitaire". However, much more remains to be done, and the overall diagnosis is clear: the current Tunisian tax system is overly complex and unstable; it is not transparent, distorts economic activity and suffers from serious tax evasion and non-compliance. The tax system is highly fragmented, with a multitude of taxes and levies operating in an uncoordinated (often cascading) manner, and riddled with beneficial treatments (exemptions, reduced rates) which often have contradicting effects (one tax incentivising certain behaviour and another tax penalising it, or even being exploited for tax evasion purposes). This results in a poor tax compliance culture, large distortions of economic activity and disincentives for investment and overall a strong sense of unfairness. There is consensus that fundamental tax reform is needed to make the tax system simpler, fairer, more transparent and more competitive.

The taxation of companies also raises serious equity issues, with a large variety of tax incentives and 1% of the firms accounting for 80% of total corporate income tax revenue. Dispersion in tax rates has been reduced in 2014, as the corporate income tax rate for companies in the designated offshore zones was raised from 0% to 10% while the "normal" rate for onshore companies was brought down from 30% to 25%. The 0% rate remains however applicable for 10 years under certain conditions for companies in the designated offshore zones in activity on 31 December 2013. The Tunisian government presented the plan for tax reform at the "*Assises Nationales de la Fiscalité*" on November 2014. Among the main recommendations are:

- Progressive reduction of the corporate tax rate further to 20% while broadening the tax base and increasing of the recently introduced rate of taxation on dividends from 5% to 15%
- Limitation of the benefit of the « *régime forfaitaire* » applicable to small businesses that meet objective criteria;
- Continuation of the reform of income tax with increased tax deductions for low income households;
- Generalisation of the normal VAT rate of 18% and limitation of the special rates of 12% and 6%;

- Creation of a specialised structure to detect tax crimes;
- A strategy to bring the informal sector in the tax net;
- Improvement of international tax cooperation ;
- Increased financial autonomy of local authorities, and
- Improvement of taxpayers' services.

The 2015 Finance Bill already introduces some important changes with respect to direct taxes and tax incentives. First, a provision to treat in the same manner distributions of dividends by resident companies subject to a 5% withholding tax as of 1 January 2015 and deemed distribution by Tunisian permanent establishments. A branch profits tax is introduced at the rate of 5% on the after-tax profits of Tunisian permanent establishments (PEs) of non-resident companies. Second, for the financial year 2015, companies producing goods or rendering services wholly for export are exceptionally allowed to sell up to 50% of their revenues realized in 2014 on the domestic market without losing their status as export companies under the Investment Incentives Code (IIC) or under Law No. 81 of 1992 related to economic activities parks. In principle, the percentages of the overall revenues that could be sold domestically are 30% for export companies licensed under the IIC and 20% for companies operating in economic activities parks.

Efforts have also recently been made to transfer some licensed professionals from the pressumptive tax regime (*imposition au forfait*) to the normal income tax system (*régime réel*). Various tax incentives remain in place, however, for companies in designated sectors and areas, while the VAT has a reduced rate for several industries, including tourism, legal services, and architecture.

Tunisia should continue to streamline the large number of incentives and ensure that the remaining ones effectively support the higher-value-added, longer-term investments likely to create permanent high-skilled jobs and reduce the economic disadvantages felt in isolated regions. Ultimately, a single system with a low but broad tax base would be preferable, but there should be a sufficiently long adjustment period to avoid disrupting investment projects. This would also simplify administration and help improve tax compliance. A simpler tax system would also make it easier to bring back small firms and professionals into the common tax regime, thus mitigating tax inequity. Establishing a fiscal analysis department that could monitor tax policy and analyse the revenue effects of special provisions could also help Tunisia more effectively assess and assure on an ongoing basis a coherent approach to investment incentives.

Tunisia is among the first countries to take part in the first OECD edition of *Revenue Statistics in Africa* to be launched later in 2015 and presenting a unique set of internationally comparable tax data in a standardised format. These statistics will enable Tunisia to identify and compare the relative importance of various sources of government revenue and provide a basis for tax policy analysis. They will provide Tunisian tax policy makers with a foundation for informed dialogue about better policy making in respect of the overall size of the tax burden, the share of different taxes in the tax mix, setting tax rates and thresholds for individual taxes, and the attribution of taxes by levels of government.

Improving transparency and fighting tax evasion and avoidance

The Tunisian government identified, as one of six main tax-reform areas, addressing transparency, ensuring fair competition rules, and fighting tax fraud and evasion. Putting in place a transparent and balanced tax system will build a stronger citizen-state relationship, creating a more accountable government and a more engaged population. Through improvements in transparency and effectively tackling financial crimes, including tax evasion, trust in government will be enhanced, with positive knock-on effects including for voluntary compliance and revenue. Improving tax transparency means ensuring that Tunisia's tax administration can access the information it needs relating to taxpayers (including the beneficial owners of companies, trusts and similar vehicles), accounting information, and banking information, including on funds held in accounts and transfers made and received. It also requires Tunisia to ensure that it has in place effective administrative processes to manage the exchange of tax information with its partners in a timely manner.

Tunisia has already committed to the international standard on tax transparency and exchange of information on request, when it joined the Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) in 2012. Membership in the Global Forum includes a peer-based review of the country's ability to meet its commitment. Tunisia must now ensure it implements that commitment, in particular by ensuring that its legal framework will allow its tax administration to access all relevant bank information for exchange-of-information purposes.

Importantly, meeting the international standard will allow Tunisia to benefit from the exchange of information to counteract offshore tax evasion and avoidance by its own residents and multinationals operating in Tunisia. The country has taken an important first step with the 2014 Rectificative Finance Bill by lifting bank secrecy as of 2015. The tax administration can now request information on bank transactions and bank statements concerning taxpayers who have not filed a tax return. It can also request such information in case of an in depth tax audit if the taxpayer has refused to provide the bank information requested or produced incomplete information. In such a case, the tax examiner must produce to the financial institution a Court order. To meet its commitment to the international standard, Tunisia will need to ensure that it is able to access bank information for exchange of information purposes even where there is no domestic tax interest in the information.

Also in support of this objective, Tunisia has signed and ratified the multilateral Convention on Mutual Administrative Assistance in Tax Matters (the multilateral Convention), which entered into force on 1 February 2014. On 1 January 2015, there were 84 jurisdictions participating to this instrument which allows Tunisia to exchange information for tax purposes. In particular, it can be used to exchange information for civil and criminal tax purposes but also for assistance in the recovery of tax claims, which may also assist in asset recovery. The Convention provides also the ideal instrument to swiftly implement the new common global standard for automatic exchange of financial account information, once Tunisia is ready to move to exchanging information on an automatic basis. Tunisia must take steps to build its capacity to put these tools into action, and can draw on the assistance available through its membership in the Global Forum. Tax evasion sits within a broader group of financial crimes – such as corruption, terrorism financing, and money-laundering – which require a whole-of-government approach to be effectively tackled (**Chapter 8**). The multilateral Convention can be a useful tool to fight financial crimes as it allows under certain conditions the use of information received for tax purposes to be shared with law enforcement and judicial authorities to combat money laundering, corruption or the financing of terrorism.

Fighting base erosion and profit shifting (BEPS)

Tunisia is participating directly in the OECD BEPS Project. The project addresses tax planning strategies of multinational enterprises designed either to artificially shift their profits to low or no tax locations where there is little or no real activity, or to avoid taxation altogether on some or all of their income. Tunisia needs to put in place comprehensive transfer pricing legislation in line with the international standard and other measures to protect its tax base against aggressive tax planning of MNEs as well as profit shifting or other means, to ensure that profits attributable to Tunisia are effectively taxed in Tunisia and to provide a certain and predictable investment climate for business.

Key OECD recommendations

- **Continue the implementation of a framework for performance budgeting**, including developing the medium-term expenditure framework. Complement MTEFs with fiscal projections and integrate risk analysis into the MTEF. Once this is in place, establish a clear link between the Economic and Social Development Plan and the Annual Budget and strategic planning.
- In line with the new Constitution, **increase financial and administrative decentralisation of the control and audit function**. In this regard, create internal audit units across government-levels and improve the co-ordination with external audit functions.
- **Avoid using public employment and wages as a social policy**.
- **Gradually abolish energy subsidies,** which benefit the rich most and contribute to excessive consumption and pollution. **Better target food subsidies** to those in need or replace them by a cash transfer paid to households, which could become gradually targeted. Rapidly implementing the unique identification system would help.
- **Reform the pension system** to make it financially sustainable while giving citizens an adequate income in retirement and promoting work in the formal sector.
- **Continue to gradually expand social security to the informal sector** and the self-employed, and shift the focus of the health system from treating disease to promoting good health outcomes via prevention. Promote equity in access to health care by improving the delivery of services in remote areas and by reducing out-of-pocket payments.
- **Simplify the tax system** by reconsidering tax breaks and incentives, to reduce inequity and raise compliance.
- **Shift the tax mix to less distortive taxes (*i.e.* from labour to consumption and property taxes)** to reduce adverse effects on economic growth and lower barriers to formal job creation. In particular, income tax bands should be adjusted automatically so that formal work pays. The use of reduced VAT rates should be reconsidered.
- Build the necessary legal and administrative capacity to ensure that Tunisia can benefit from the **effective implementation of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters,** including the new international standard for automatic exchange.
- Ensure **bank information is sufficiently accessible for exchange of information purposes**, in line with Tunisia's commitment to the international standard on tax transparency and exchange of information on request.
- **Put in place in place comprehensive transfer pricing legislation** in line with the international standard and other measures to protect the tax base against aggressive tax planning by MNEs.

8. BUILDING A PUBLIC ADMINISTRATION FOR AN INCLUSIVE SOCIETY

Tunisia has a well-functioning public administration that demonstrated its resilience during the turmoil of the revolution. Yet, the uprising also required Tunisia's public administration to respond to the call for democracy and a more inclusive society. The government embraced a new form of governance, as enshrined in the new Constitution of January 2014, and embarked on an ambitious programme of reforms. Following the parliamentary and presidential elections of late 2014, the formation of a new government in early 2015 opens a window to renew the reform impetus and focus on implementation by mobilising adequate human and financial resources, and continue building the capacities of its civil service. Integrity efforts, such as the systematic implementation of United Nations Convention Against Corruption's recommendations, will help fight corruption and support a level playing field for businesses. These reforms have been recognised internationally, with Tunisia's membership in the Open Government Partnership.

Successful economic and social policies depend largely on the ability of the government to co-ordinate policy design and implementation. The Centre of Government (CoG; Prime Ministry in Tunisia) must be capable of co-ordinating initiatives horizontally and vertically across the different levels of government, including at local level. While some measures to co-ordinate policies have been introduced in recent years, these initiatives remain sporadic. Tunisia's new government should focus its efforts on developing the capacity of the CoG to provide leadership and develop strategies linked to clear performance management, monitoring, and evaluation. OECD experience has shown that a coherent strategy led by the CoG is crucial to ensure policy coherence in implementing reforms, measuring performance, and tracking progress.

While Tunisia's civil service is relatively professional and well-educated, efforts to upgrade the overall skill levels should continue in order for the government to promote an innovative, open, and efficient public sector. The civil-service Law should also be modernised in order to develop better Human Resources Management tools. Training should be used to develop civil servants' capacities and competencies, to promote change, and provide better service. Some flexibility on hiring temporary staff seems necessary. The number of special statutes is cumbersome and should be reduced and simplified. Mobility should be promoted. Costs related to the public service have increased in recent years, and the salary system has lost some of its consistency and internal fairness. Measures to control staff numbers and salary costs are therefore urgently needed to ensure medium-to-long-term fiscal sustainability. A more comprehensive reform of the entire salary system is also necessary to make it more transparent, to restore internal fairness, and allow better control of public expenditure. For instance, there is a particular need to streamline the different salary supplements and bonuses.

Modernising the public administration and improving service delivery

Equal access to public services, in addition to efficient and effective service delivery, is an important foundation for an inclusive society, as it ensures that citizens can benefit from essential services such as education and health care. Tunisia has engaged in efforts to modernise its public administration for several years, intensifying these in the wake of the revolution. Efforts include regulatory reform and administrative simplification (see **Chapter 9**) to reduce burdensome procedures for citizens and business, reform of public financial management (see **Chapter 7**), and the use of ICT for innovative service delivery.

Since 2009, the government has launched *maisons des services,* which provide a single space for citizens to access services. The *maisons des services* have great potential to increase citizens´ access to basic services and facilitate business activities, and have therefore truly become one-stop shops. Nevertheless, they would benefit greatly from a regional extension and an improved institutional framework clarifying leadership, co-ordination and financial capacities. In this sense, legal certainty should also be reinforced, establishing the distribution of tasks and responsibilities among service providers, the central government, and local authorities. Finally, the *maisons des services* should be linked to Tunisia's administrative simplification efforts and its e-government strategy.

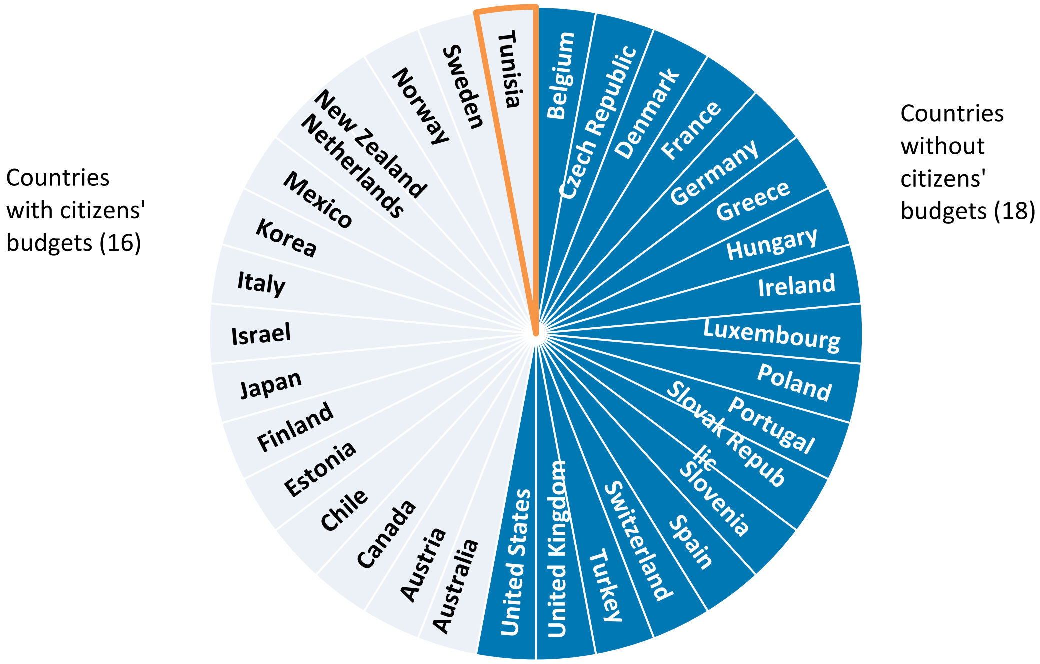
The Tunisian government has shown a commitment to proactively use new technologies to improve its administration and has developed an "E-Strategy 2010-2014". Its main goal is to improve online service delivery. ICT can support more cost-effective service delivery, yet to derive more benefits from the use of technology, the government should ensure greater follow-up of online services, as well as their monitoring and their evaluation. Equally important is the development of ICT skills among the public administration. Tunisia's strong domestic ICT industry should also be considered as an important partner. Given the digital divide in the country, Tunisia cannot rely on boosting online services alone, but needs to continue improving its overall service delivery through innovative solutions, particularly in rural areas. Open data is another tool that many OECD countries are relying on to support economic growth and improve public services. Important steps have been taken in establishing an open data portal, data.gov.tn, on which Tunisia is publishing data in a reusable format. Yet, a clear picture about the demand for datasets is still missing. Engaging stakeholders can foster a more comprehensive approach to opening up government data, which holds great potential for economic growth as the private sector can reuse the data to create new kinds of products and services.

Creating an inclusive public administration

An inclusive public administration is one that includes its citizens from a political, social, and economic point of view. Tunisia is still struggling with widespread regional disparities in socio-economic development (**Chapter 5**), a high level of unemployment and poverty (**Chapters 1 and 4**), and challenges to ensure gender equality (**Chapter 4**).

The government is experimenting with approaches to engage stakeholders in the policy-making process through promoting its online consultation portal, consultations-publiques.tn, inviting them to conferences on specific reforms and acting in the framework of its open-government work. In this sense, the publication of the first citizens' budget is a commendable step, fostering citizen participation and transparency (Figure 8.1). Yet, many initiatives remain *ad hoc* and are focused on the national level. Structures such as "Eau et développement" (Water and Development) and "Eau dans la Constitution" (Water in the Constitution) have contributed, for example, to reforms in the water sector (2014d). These efforts need to be enlarged, however, to include marginalised groups especially in rural areas, and they require more financial support as well as measures to educate future generations to play an active part. Overall, Tunisia should consider institutionalising participation mechanisms, which can be improved by increasing their consistency, transparency, and feedback methods. Inclusion of stakeholders at the local level is particularly important to address local challenges and to fight poverty.

Figure 8.1. Use of citizens' budgets in OECD countries and Tunisia



Source: *2012 OECD Survey on Budgeting Practices and Procedures (Data unavailable for Iceland. Information on data for Israel: http://dx.doi.org/10.1787/888932315602)*

Access to information can be a useful tool to build an inclusive administration. It allows stakeholders to have information about the public administration, fostering public scrutiny while equally giving enterprises crucial information to detect business opportunities. Tunisia's access to administrative documents provides a good starting point. Now, the efforts should focus on implementing its provisions, establishing an information commission and enacting the Action Plan on access to information.

Promoting integrity and fighting corruption in the public and private sector

Promoting integrity and fighting corruption are major challenges to socio-economic development in Tunisia. The country is still confronted with the challenge of corruption, as evidenced by its score of 41/100 in Transparency International's Corruption Perception Index 2013, which sees Tunisia ranked 77/177). Preventing and fighting corruption will have a direct, positive impact on the trust of the business sector in the state and will help create a level playing field on which companies can compete. Since the revolution, Tunisia has worked closely with the OECD to develop a comprehensive corruption-prevention system in order to curb this phenomenon in both the public and private sectors.

Tunisia has ratified the UN Convention Against Corruption (UNCAC) and is currently implementing reforms to systematically establish the policy tools set out in it. These include establishing an anti-corruption agency, promoting ethical values, and fostering corruption denunciation and integrity in public procurement. Reforms are implemented in collaboration with international partners to align them with international best practices.

In order to establish ethical values in the public sector, a Code of Conduct for Public Officials was recently developed. Effective implementation is now key. At the same time, the current asset-declaration system needs reform to ensure that declarations are verified and that the system is manageable. Publications of declarations should be considered to allow for public scrutiny. Tunisia has also already advanced in discussions on establishing whistle-blower protection. The ability to anonymously report corruption would greatly support bringing such cases to justice.

Public procurement, which represents a high share of GDP in the country, is a high risk area for corruption. Tunisia has taken important steps in improving the transparency and integrity of public procurement through approving a new decree on the regulation of public procurement and creating “Tuneps”, an e-procurement system. Full implementation would have an immediate positive impact in the private sector.

These measures also need to be complemented by effective control institutions. Tunisia has a strong tradition of inspections and horizontal controlling bodies with different layers, but the audit function appears to be less developed. Some measures were adopted to promote better co-ordination among the different inspection and control bodies and to improve the role of the Court of Accounts. The overall architecture of the system could be simplified, with a stronger focus on internal control and audit functions. Inspection and audit methodologies should be developed, and the role of parliament and its capacity to undertake a control function should be strengthened.

Reforms to Tunisia’s Penal Code are also needed, including a definition of the offence of ‘active bribery’, corresponding sanctions, and the establishment of the liability of legal persons for bribery. Certain institutional arrangements, in particular prosecutorial independence vis-à-vis the executive branch, should be reinforced. Tunisia should also ensure that law-enforcement agencies are independent and vigilant in conducting investigations, and endowed with the resources and technical capacity necessary to uncover often complex schemes.

These measures should be accompanied by initiatives to promote business integrity in the private sector. Companies need to take an active anti-corruption position, clean up their own operations, and refuse to pay bribes solicited by public officials or by other companies. Already, many Tunisian companies, especially publicly traded ones and companies with foreign interests, are introducing codes of conduct and internal controls on a voluntary basis and are taking other measures to improve their own integrity. Indeed, several business associations take an active role in promoting business integrity measures and take an active part in the MENA-OECD Business Integrity Networks.

Nonetheless, actual progress in controlling corruption in Tunisia has been limited. In the framework of the OECD Integrity Scan of Tunisia, business associations suggested that the integrity of companies has declined since the recent political changes, partly owing to the degradation of the state control environment. The government should consider establishing corporate governance rules on a statutory basis, and enforcing them. To improve the effectiveness of anti-corruption efforts, a person or entity in the government should be designated to co-ordinate business-integrity work. Equally important is a structured dialogue between the business sector, government, public enterprises, and other relevant stakeholders to identify and implement joint projects. Pilot projects targeting risk areas that produce visible and tangible results could demonstrate the willingness and ability to fight corruption.

Bribery, as well as other financial crimes including tax evasion, terrorism financing, and money laundering, require a whole-of-government approach to be effectively tackled. A three-pronged approach must be supported for Tunisia to address illicit financial flows: first, through ensuring they have the framework and processes for co-operation among different government authorities such as tax, law enforcement, and public prosecution; second, by sharing information with their international partners, as most illicit flows seek to take advantage of fiscal and regulatory arbitrage opportunities between jurisdictions in the increasingly globalised economy; and third, by ensuring appropriate training on the latest risks, trends, and investigative techniques. Taking advantage of the information and support available under the Oslo Dialogue, Tunisia can build on its commitment to addressing illicit flows across these three areas, benefiting from exchanges with international experts.

Key OECD Recommendations

- **Promote policy coherence and co-ordination** by developing the capacities of the Prime Ministry to take on the role of the Centre of Government, co-ordinating whole-of government policies across different levels of government.
- **Upgrade the skills of Tunisia's public officials** through training and reform the civil service.
- **Ensure the financial stability and consistency of the public service** through controlling staff numbers and salary.
- **Modernise service delivery by continuing administrative simplification efforts and harnessing new technologies**. Online services, as well as an improvement of the *maisons des services*, can greatly facilitate life for citizens and business, and increase integrity, transparency, and cost-effectiveness.
- **Take advantage of open data** in linking the publishing of data to demands of citizens and business, creating opportunities for innovative products and services.
- **Involve stakeholders in the policy process by institutionalising participation mechanisms** at the national and local level.
- **Improve transparency** through the implementation of the provisions on access to administrative documents.
- **Promote integrity and fight corruption by systematically implementing UNCAC's provisions:** *i)* ensure the effective implementation and dissemination of the Code of Conduct, *ii)* establish a tailored legal framework for reform whistle-blowing protection, *iii)* strengthen the asset-declaration system, *iv)* fully implement the new e-procurement system Tuneps and *v)* simplify control systems, with a stronger focus on internal control and audit functions.
- **Ensure that a dedicated person in government is familiar with business-integrity issues** and ensures a dialogue with the business sector in view of co-ordinated actions.

9. STRENGTHENING THE BUSINESS ENVIRONMENT

Policy reforms introduced in Tunisia in recent decades to attract investment did not address underlying structural issues such as lack of competition, and market distortions caused by state intervention and cronyism. This led to economic duality consisting of a private sector that developed successfully in some regions and sectors but that remains underdeveloped in others. With limited productivity gains, the economy has been unable to provide sufficient jobs for a growing, young, and increasingly educated population. The transition process provides a unique opportunity to engage in far-reaching reforms and adopt measures aimed at incentivising opportunity-driven entrepreneurship and private sector-led growth, in support of more inclusive economic, social, and territorial development.

Tunisia has a relatively favourable business environment compared to the average country in the MENA region. According to the 2015 *Doing Business* report, the country ranks 60 out of 189 economies, above all other MENA economies outside the Gulf Co-operation Council (GCC). Among the country's main assets are its strategic geographic location, a well-educated population and a relatively diversified industrial base. Yet, it also faces a number of challenges, as discussed earlier.

Thus far, the transition has achieved only limited success in promoting private-sector development and further strengthening the business environment. The passing of important laws such as on collective procedures (bankruptcy), competition, public-private partnerships and the investment code have been delayed, but the new government has an opportunity to renew the necessary legislative impetus. While a wide range of policy settings have an impact on the business climate (including trade, investment, infrastructure, labour, education and innovation), this chapter focuses on the core policies related to investment, enterprise development and competition.

Stimulating investment

Over the past two years, Tunisia has made important efforts to improve the regulatory regime for investment, notably through the elaboration of a draft Investment Code and other related reforms. At present, investments in Tunisia (both for local and foreign operators) are governed by the 1993 Investment Incentives Code. This code allowed Tunisia to attract a high number of foreign investors, stimulate economic development and facilitate integration in the global economy. It is however nowadays recognised as complex, confusing and limited to the granting of incentives, hence deemed to be out of sync with Tunisia's development objectives. The incentives system is inefficient, while falling short of addressing its objectives in terms of job creation, high value-added investments and regional development. In particular, the existing code allocates large subsidies to low-skill, labour-intensive and low value-added sectors, which may divert resources from being deployed in higher-productivity and income-generating activities (**Chapter 10**). Moreover, it generates distortions in the business environment by creating a dichotomy between the exporting companies (*totalement exportatrice*) and those targeting the local market (*partiellement exportatrice*). The 2014 Finance Law has partly addressed the fiscal dichotomy, notably by increasing the corporate tax rate from 0% to 10% in the wholly-exporting regime (offshore) and reducing it from 30% to 25% for partially or non-exporting firms (onshore). Nevertheless, further efforts to simplify and streamline the incentives system in the new draft Investment Code are warranted in order to achieve a level-playing field between firms operating under different regimes.

The new draft Investment Code broadens the scope beyond investment incentives, in order to create a more open and transparent regime. The draft Code, the development of which has been supported by a number of development partners (including the OECD), benefitted from an exemplary broad-based consultation process, including active engagement by the private sector and civil society. It features significant improvements such as increased transparency, streamlined tax incentives and sound protection guarantees for investors. It introduces elements of market access and would help remove or lessen key restrictions currently imposed on foreign direct investment (FDI). According to the OECD FDI Regulatory Restrictiveness Index, equity restrictions and screening procedures account, respectively, for 50% and 38% of all statutory restrictions to FDI in Tunisia. These could be progressively reduced, notably in the distribution, air transport, and certain financial services sectors (**Chapter 10**). The elaboration of a readily available negative list of sectors in which foreign investors do not benefit from freedom of establishment would contribute to greater transparency.

Fostering enterprise development

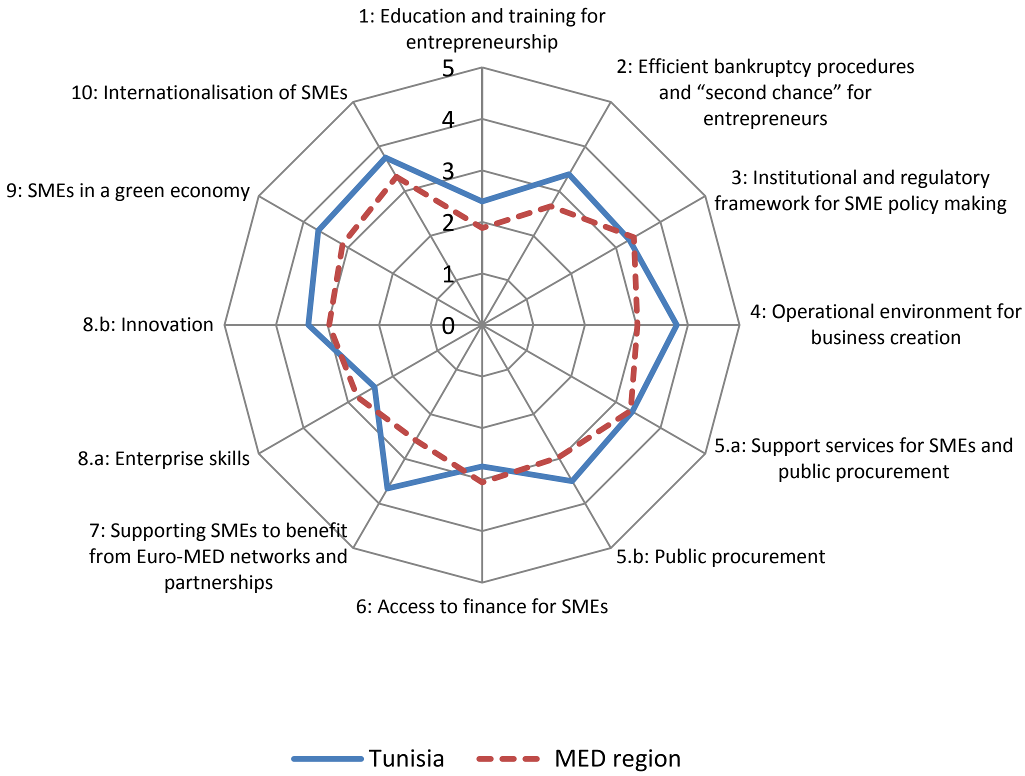
Tunisia has put in place a number of policies, mechanisms and institutions to support enterprise creation and growth, and its policy framework for small and medium-sized enterprises (SMEs) is more developed than that of other North African and Levant economies, according to a recent SME policy assessment (OECD *et al*. 2014), especially in terms of the ease and costs of creating a new firm and access to public procurement (Figure 9.1).

Nonetheless, important distortions affect the performance and development of the private sector, which is fragmented into a relatively efficient, albeit incentive and subsidy-dependent, off-shore sector on the one hand, and a large number of micro, low-productivity, and often informal enterprises on the other. Enterprise creation is limited and largely concentrated in coastal areas. The level of women's entrepreneurship is particularly low, with an activity rate of 2.9% versus 6.8% for men (GEM 2012). Moreover, only 2% of people aged 18 to 24 were involved in creating a business in 2012 (Belkacem and Mansouri, 2013). Enterprise growth is weak: 40% of the jobs created between 1996 and 2010 were attributable to the expansion of self-employment, and only 4% of enterprises existing in 1996 had registered growth by 2010. As a consequence, 97% of all private firms are micro-enterprises with fewer than six employees, accounting for just 10% of total employment and operating for the most part in low-productivity economic activities (Rijkers *et a*l. 2013; Ghali and Rezgui 2013; World Bank 2012).

Large private enterprises employing 200 people or more represent just 0.1% of all firms but account for over 40% of salaried employees. Off-shore firms represent 3.2% of all enterprises but account for about a third of total employment (Ghali and Rezgui 2013). The focus on assembly activities and the limited market diversification restricts the export performance of these firms.

To promote a more balanced and vibrant private sector, Tunisia needs to address the distortions giving rise to economic dualism and adopt targeted measures to support enterprise development. While attracting more and better investment to the country, it could also promote measures to foster linkages between local firms and the offshore sector. This could be accompanied by initiatives to increase specific local content, promote technology transfer to add value to exports, develop intermediate supplier firms and support enterprise creation in the regions. The implementation of the new industrial policy focusing on strategic sectors (aeronautics, basic electronic components for automotive, pharmaceutical, textile, ICT services, health services and tourism –identified by the international conference "Invest in Tunisia: Start-up Democracy" organised in September 2014) would provide a good basis for strengthening the links between domestic enterprises, including SMEs, and the offshore economy. As in many jurisdictions, accessing finance is particularly challenging for start-ups and SMEs, requiring particular efforts to ensure this segment is well served (**Chapter 3**).

Figure 9.1 Tunisia's SME policy performance
As measured by the OECD SME Policy Index



Policy dimensions are structured around five levels of policy reforms, with 1 being the weakest and 5 the strongest. The MED region is formed by North African and Levant economies.

Sources: OECD et al. (2014), SME Policy Index, The Middle East and North Africa 2014, Implementation of the Small Business Act for Europe, OECD Publishing, Paris.

Regulatory burdens have a disproportionate impact on SMEs by diverting scarce resources to compliance with regulations and administrative procedures. Therefore, streamlining procedures at the central and subnational/local government levels is needed (e.g. 2013 OECD Review of Regulatory Reform in the Middle East and North Africa). Tunisia has taken steps to introduce administrative simplification, including the "regulatory guillotine" embedded in a clear legal framework through a decree published on 14 August 2012.

The public-private sector dialogue on regulatory reform in Tunisia needs more attention as well as tools to ensure that existing and new regulations are fit for purpose and serve the public and private interests. For example, electronic and physical one-stop shops could build on the "maison des services" that have been launched in Tunisia since 2009 and further expanded to local authorities. An "SME-Test" (a component of a Regulatory Impact Analysis -RIA) could assist in reducing the regulatory burden for businesses (**Chapter 8**). In line with the 2012 OECD Recommendations on Regulatory Policy and Governance, this requires a concerted and inclusive approach involving consultation with the private sector early in the process.

In support of enterprise creation and expansion, business development services (BDS) by public or private actors could be further developed and better co-ordinated (OECD, 2012b; OECD, 2015). Such services could represent a new business sector for development, but awareness of available supports is low, the quality is highly variable and support structures are not integrated into a cohesive system. The current approach focuses on access to finance; access to information, training, advice and counselling; and the provision of infrastructure for new and young businesses. BDS are frequently tailored to specific target groups (*e.g.* unemployed graduates, high-technology businesses) and heavily focused on business launches rather than business development and growth. BDS should also target women and young entrepreneurs, compensating for a possible lack of business experience and socio-cultural barriers they may face. Finally, Tunisia should encourage enterprise formalisation, but also consider reduction of the scope of the *régime forfaitaire*. This tax system, initially aiming at reducing informality, creates distortive effects as it exempts otherwise eligible tax payers from the payment of value-added tax (**Chapter 7**).

Promoting a level playing field by fostering competition and reforming SOEs

One of the main barriers to investment and private sector development is the lack of a level playing field for business. Addressing market distortions caused by inefficient competition policies and weak governance of state-owned enterprises (SOEs) would support the development of a sound business climate. Important barriers to entry remain, particularly in those sectors in which the former president's family and associates had an interest. Regulations were often put in place to protect politically connected firms from the entry or expansion of competitors. The impact was significant: 220 firms confiscated from the Ben Ali family[7] accounted for 21% of all net private sector profits (Rijkers *et al.* 2014).

Since the 2011 revolution, important measures have already been taken to enhance competition and promote a level playing field. For example, the Competition Council issued a TND 1.2 million (USD 712 000 or EUR 523 000) fine against *Tunisie Télécom* on the grounds that the company had practiced discriminatory pricing, squeezed margins, and refused to provide access to copper wire (October 2013). The decision has not yet passed through all levels of the appeals process, but it shows the competition authority's will to act in favour of a competitive business environment. A draft competition law that reinforces the role and independence of the Competition Council is under consideration and is expected to be adopted in 2015. The Council can play a key role in stimulating competitive forces to the benefit of consumers, including lifting barriers that may be preventing retail and wholesale prices from falling towards their competitive levels. Enhancing the independence of the authority would constitute a valuable step towards ensuring it can fulfil this role.

Many of the regulations and practices that create market power rents still exist and many companies continue to benefit from them. Entry regulations are supplemented by price and margin regulations that establish price levels for dozens of products, including flour, rice, milk, oil, sugar, tobacco, petrol, coffee, tea, beer, and telephone services (**Chapter 2**). Extensive price controls combined with restrictive regulation suggest some sectors or laws could be usefully submitted to an in-depth review of competitive impacts of laws and regulations, using the model of the *OECD's Competition Assessment Toolkit*.[8]

Tunisian sSOEs have historically played an important economic and social role through their contribution to GDP, as employers and as providers of basic goods and services. Since 2011, the role of SOEs has increased further as a result of the confiscation of equity and assets in hundreds of enterprises linked to Ben Ali's clan. Tunisia is attaching increasing importance to transparency on SOEs' ownership and operations, with the controlling entities reporting directly to the head of the state. It is now one of the few countries in the region with a complete registry of SOEs.

7 Sources did not allow confirming the total number of confiscated firms.

8 For example, a one-year project reviewing four sectors in Greece resulted in 329 recommendations for revising regulations to improve competitive conditions in sectors accounting for about 21% of GDP.

The *Commission d'assainissement et de restructuration des entreprises à participation publique* (CAREPP), created as an *ad hoc* standing committee in 1989, has limited clout in enforcing good governance standards as the committee is convened only on a case-by-case basis whenever the privatisation or restructuration of a given SOE is underway. Strategies, benchmarking and cross-comparisons to enhance the overall governance and performance of the state-owned sector are limited.

To improve SOEs' governance, the Tunisian Corporate Governance Centre is undertaking, in collaboration with other relevant governmental entities, a national survey of governance practices of local SOEs building on the *OECD Guidelines on Corporate Governance of SOEs*. To improve SOEs' performance and competitiveness, it is recommended that a clear ownership policy be defined; that regulations and rules be established clarifying the process for selection and appointment of board members, who should in any case have relevant professional qualifications and experience; that their financing and subsidising are clearly signalled; and that a level playing field be created to ensure fair competition for private companies. The ownership and regulatory functions of SOEs should also be separated, subjecting them to stricter oversight by independent bodies rather than by their own line ministries. Moreover, Tunisia lacks a national code of corporate governance, of which a chapter (or perhaps a parallel code) could help provide guidance for SOEs.

Levelling the playing field for enterprises also entails tackling corruption, promoting business integrity and the emergence of responsible business conduct. The OECD has developed international standards and tools in these areas which could support Tunisia's efforts. In particular, as an adherent to the *OECD Declaration on International Investment*, Tunisia should further leverage the implementation of the *Guidelines for Multinational Enterprises* through its National Contact Point. Tunisia could also further promote public-private sector dialogue through the MENA-OECD Business Integrity Network with a view to raising awareness and promoting compliance of Tunisian businesses with international integrity standards.

Key OECD Recommendations

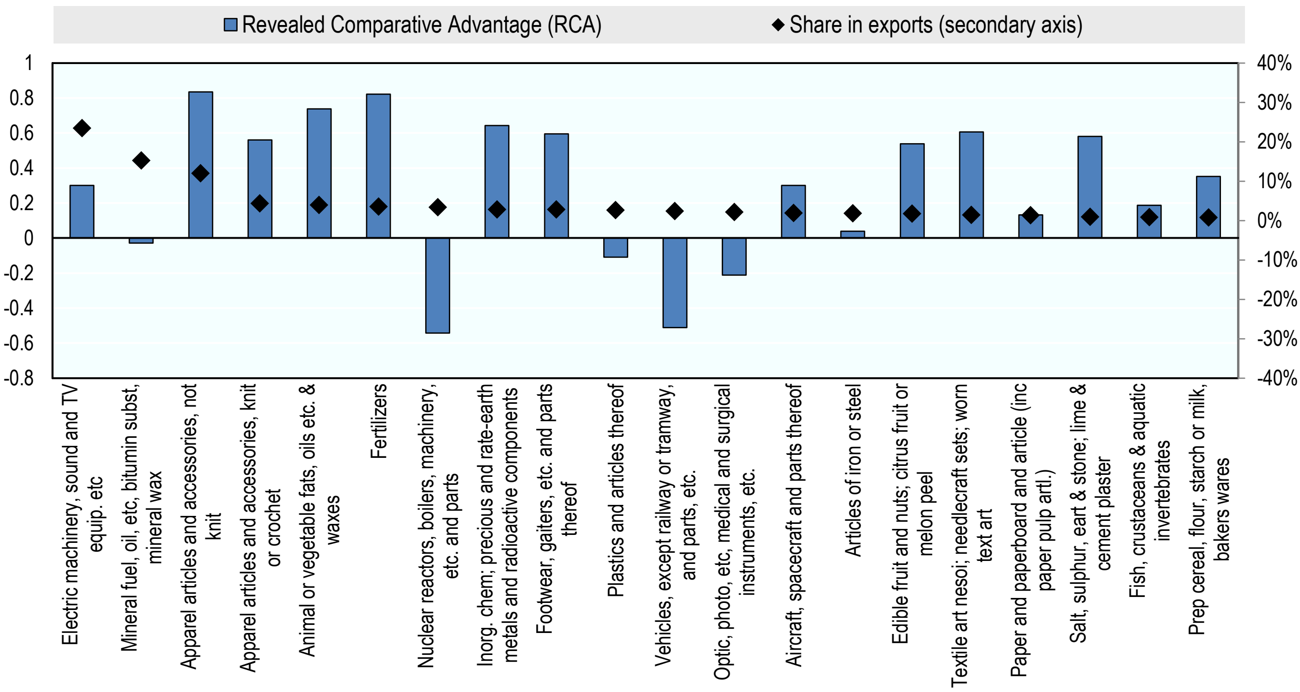
- **Accelerate the completion and adoption of the draft Investment Code** in order to create greater coherence and predictability for investors, streamlining the necessary information on the entry, establishment and protection of investments.
- **Enhance the level of openness and transparency in Tunisia's investment regime**, including rendering procedures more predictable and institutionalising mechanisms of consultation.
- **Foster linkages between domestic firms and the offshore sector** and introduce market-based initiatives to add local value to exports.
- Increase access to and quality of business development services, including for women and youth, to nurture entrepreneurship.
- **Reduce the administrative burden for enterprises** by scaling up the 'guillotine' project and by building institutional capacities to improve co-ordination among entities across different government levels.
- **Enhance the independence of the Competition Council** and extend its mandate to more effectively cover SOEs so as to ensure it will best be able to achieve the benefits of competition.
- **Improve the performance and competitiveness of SOEs** through a clear ownership policy and regulations and rules on selection and appointment of board members, on financing and subsidising, on corporate governance of SOEs (following the OECD guidelines), and more generally, on ensuring a level playing field between SOEs and privately-owned companies.
- Undertake an in-depth review of the impact on competition of laws and regulations, using the model of the *OECD's Competition Assessment Toolkit*.
- **Promote business integrity and responsible business conduct** through the MENA-OECD Business Integrity Network and the *OECD Guidelines for Multinational Enterprises*.

10. MOVING UP GLOBAL VALUE CHAINS

Global value chains have become a dominant feature of world trade and investment. The ensuing fragmentation of production across borders implies the need for a new, more co-ordinated approach to policy-making, taking into account the inter-dependence of investment, trade, and innovation decisions for firms operating in GVCs. Tunisia has managed to penetrate certain GVCs, but its exporting power is concentrated both sectorally and geographically. In order to increase the sophistication of its activities in GVCs, Tunisia needs to reduce regulatory barriers to trade in services, continue trade facilitation efforts and broaden its trade links to regions beyond the EU. These initiatives should be applied throughout the economy, accompanied by complementary innovation and skills-development policies.

Tunisia has historically integrated well into GVCs, notably in three industries: textiles, textile products, leather, and footwear; food products, beverages, and tobacco; and electrical and optical equipment. These three sectors account for 75% of the country's exporting firms and more than 65% of jobs in industry, while Tunisia reveals a comparative advantage in several of their sub-sectors, when measured on gross trade terms (Figure 10.1).

Figure 10.1 Tunisia's Revealed Comparative Advantage (RCA) in its top 20 export products, 2013.

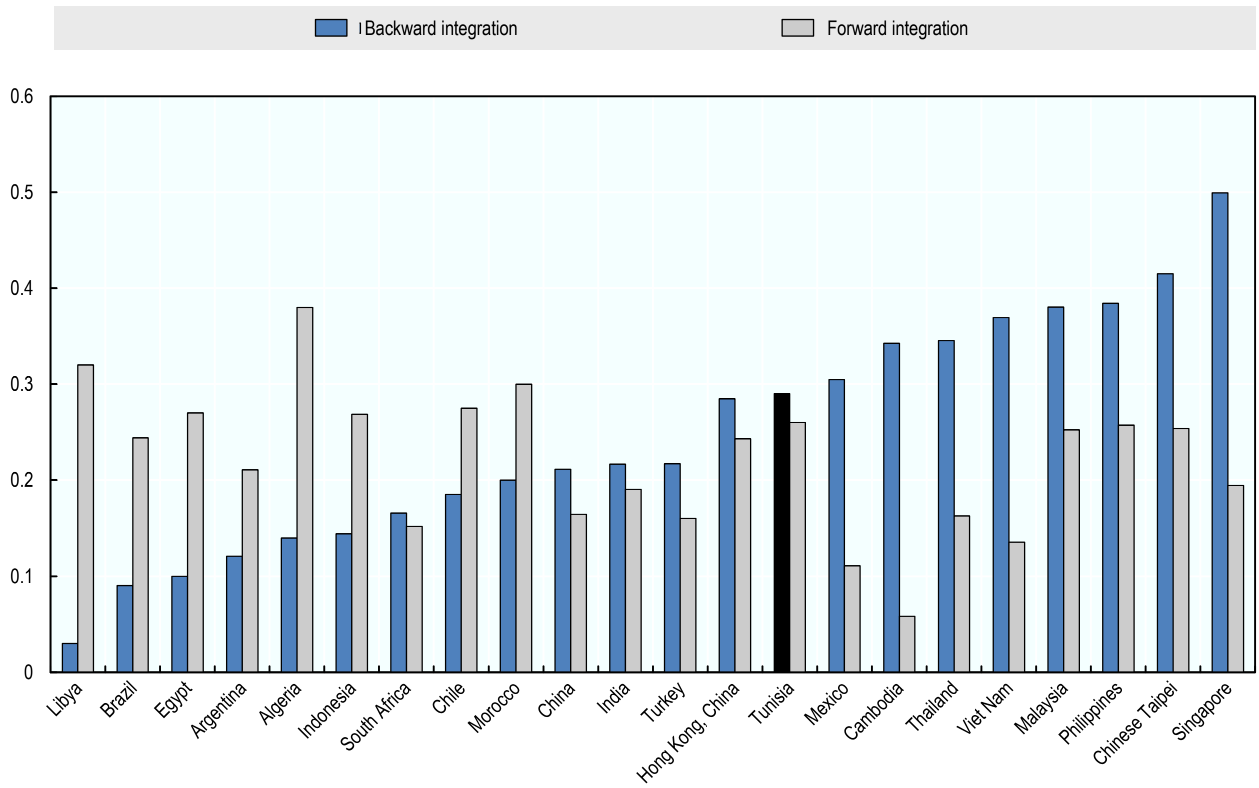


Note: Industry revealed comparative advantage (RCA) is calculated as country industry shares of country total exports of goods and services divided by world industry shares of world total exports of goods and services. The RCAs are normalised around zero so that a figure >0 reveals a comparative advantage. High dependence on imports of some of the Tunisia's leading export means that the country's comparative advantages may look differently once measured in value-added terms.

Source: UN COMTRADE

To obtain a clearer picture of Tunisia's comparative advantage, however, it is necessary to take into account trade in intermediate goods. Foreign affiliates play an important role, being responsible for 57% of total exports, and 325 000 jobs. Still, over the past 20 years, four of Tunisia's top five main exported intermediate products have remained the same; the same holds for imports, indicating that there is scope for improving product diversification. While new activities in the ICT and electronics sectors have developed (such as in aeronautics), their integration into GVCs has been limited to subcontracting links with limited added value to the Tunisian economy, while they also remain geographically concentrated along the coast in the absence of adequate infrastructure in inland regions.

Figure 10.2 Backward and forward GVC participation of Tunisia and other selected economies, 2009.



Note: Backward participation refers to foreign value-added embedded in country's exports; forward participation refers to country's value-added embedded in other countries' exports.

Source: *AfDB-OECD-UNDP (2014), African Economic Outlook "Global Value Chains and Africa's Industrialisation".*

The country's GVC integration strategy to date has principally relied on progressive trade liberalisation and the creation of a free trade zone with the European Union (EU), in addition to the long-standing existence of the "offshore regime" – which provides investment incentives in the form of exemption from corporate tax and import duties on inputs for exporting companies – as well as public investment in human capital and infrastructure. There is an appetite within the country to move from a strategy based on insertion into GVCs via an incentive-based system – that has accomplished a certain degree of integration into the global economy (Figure 10.2) – towards engaging in structural reforms to improve Tunisia's position in GVCs more generally and attract more and better-quality investment. To avoid the pitfalls of choosing and promoting any particular chains, or chain segments, the government could consider reducing barriers to GVC participation faced by all firms (not only offshore investors), including investment and trade barriers in services, in order to better leverage the presence of foreign investors to improve domestic firms' capacity to engage in GVCs.

Innovation will be key to upgrading in GVCs

Investment in innovation has an important role to play in helping countries move up the value chain (or upgrade). Disaggregation of production into separate stages allows firms not only to find their place on the ladder, but also to move up the rungs as their skills and know-how improve. GVCs encourage that upward movement by rewarding skills, learning, and innovation. Knowledge-based capital (KBC) – data, software, patents, designs, and new organisational processes – is particularly important in this regard. In some countries, investment in KBC accounts for more than 25% of labour-productivity growth, and OECD estimates that between 13% (Turkey) and 28% (USA) of the workforce in OECD countries is involved in the generation of KBC, demonstrating the importance of skills as the foundation of innovation.

Tunisia spends more than 1% of its GDP on research and development (R&D), which is more than several OECD countries and more than many other countries in the region. It has a large number of research institutes and a range of policies to support research and innovation. An important challenge for Tunisia, however, is that more than 95% of its firms are SMEs have a limited capacity to innovate. Strengthening innovation performance will require a comprehensive approach, which should consider not only advanced-technology sectors, but also traditional sectors and services that can benefit from the adoption of other countries' technology and innovation. If Tunisia were to increase the percentage of high knowledge content in production significantly (currently at around 25%), this would require a dramatic increase in the transfer of knowledge and technology from universities and research institutes to private sector SMEs. There are 15,000 researchers and 670 research units in Tunisia, but there are major deficiencies in the system for encouraging research-based spin-offs and the commercialisation of R&D.[9] Attention to skills development will be crucial in this context. Improving the efficiency and effectiveness of Tunisia's current set of policies will be important, too, in order to reduce fragmentation and ensure that public spending has the largest possible impact. Finally, as in many countries, the framework conditions for innovation are crucial. These include improving access to financing for innovative firms (**Chapter 3**), ensuring openness to global markets so as to gain access to foreign knowledge and technologies, and strengthening competition in the economy (**Chapter 9**) in order to underpin firms' incentives to innovate and encourage a healthy process of resource reallocation to rising firms.

Improved trade facilitation can lower costs and delays in traded goods

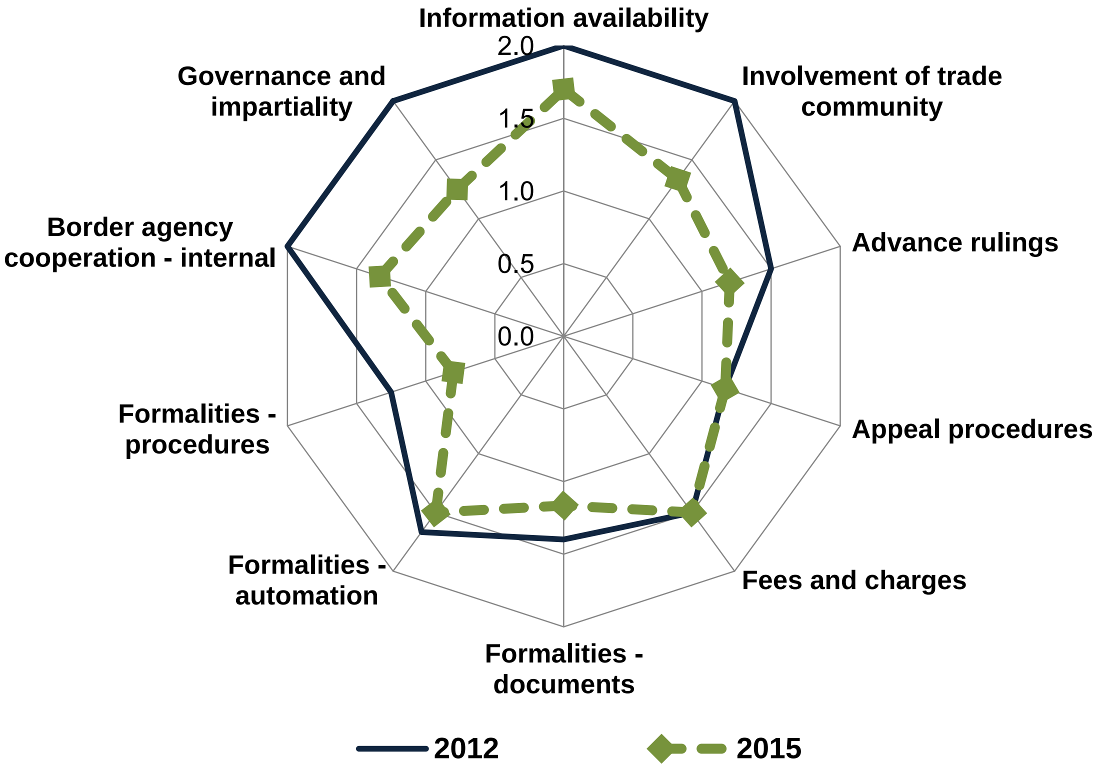
Recent OECD work on GVCs also reveals that success in international markets today depends as much on the capacity to import world-class inputs as on the capacity to export. Data on Trade in Value-added (TiVA) also better reveal how GVCs magnify the costs of tariff protection, since tariffs are cumulative when intermediate inputs are traded across borders multiple times. Fast and efficient customs and port procedures are equally important. Unduly complex processes and documentation raise costs and cause delays and, ultimately, businesses, economies, and consumers bear the cost. Initial research on Tunisia finds that more than 50% of value-added in key exporting sectors (*i.e.* textiles, chemicals, and electronics) is imported.[10] This evidence therefore points to the importance for countries like Tunisia to pursue trade-facilitating measures as a way to reduce border bottlenecks and facilitate supply chains. It also underlines the importance of maintaining open trade policies for attracting investors.

While Tunisia has benefited from important advances in trade facilitation early in the reform process (*e.g.* implementation of a Single Window for Trade or the SINDA customs system), as reflected in the country's scores in the OECD trade facilitation indicators in 2012, this reform momentum appears to have lessened. OECD trade facilitation indicators 2015 show that Tunisia's performance has deteriorated in a few key

9 Wiki Start-up (2012), "État de l'art de l'essaimage en Tunisie & son impact sur la dynamique de création d'entreprises".
10 These numbers are based on the initial estimations for Tunisia. Final results will become available at the time of the next Trade in Value Added (TiVA) database release.

areas, including governance and impartiality, internal border coordination, information availability as well as involvement of the trade community (Figure 10.3).[11] As a result, the country has started falling behind its direct competitors on a few key metrics, such as the overall time spent at the border and customs efficiency, as measured by the World Bank's Logistics Performance Index, for example. In addition, key logistical hubs in the country, such as port Radès, are facing major bottlenecks (**Chapter 6**).

Figure 10.3 Tunisia's trade facilitation performance: OECD indicators, 2012 and 2015.
Latest available data, where 2 = best performance



TFIs values range between 0 and 2, where 2 denotes the best performance possible that can be achieved. Analysis is based on TFIs latest available data as of February 2015 and the set of TFIs as constructed in "Trade Facilitation Indicators: The Potential Impact of Trade Facilitation on Developing Countries' Trade" (OECD Trade Policy Paper No. 144, 2013) for 107 countries outside the OECD area.

Source: OECD Trade Policy Paper No. 144, 2013.

OECD analysis shows that upper-middle-income countries like Tunisia could reduce costs by as much as 12.9% by fully implementing trade facilitation reforms as articulated in the WTO Trade Facilitation agreement. In particular, reforms in the area of simplification and harmonisation of documents, automation, and the streamlining of procedures are found in other countries to have the greatest impact on increasing bilateral trade flows and lowering barriers to trade. Improvements to mechanisms of advance rulings and fees and charges could also have a big impact on trade flows, particularly in manufactured goods.

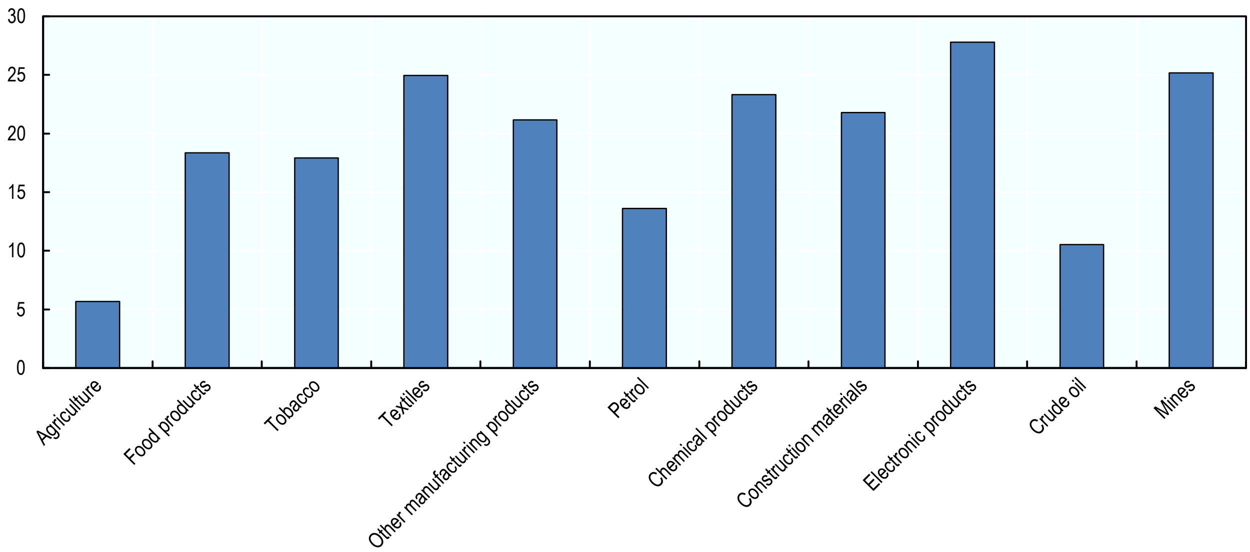
[11] The 2015 Trade Facilitation scores for Tunisia are preliminary and are in the process of being verified by the Government.

Key services sectors have too many barriers to trade and investment

Global value chains are particularly sensitive to the quality and efficiency of services. There would be no GVCs without well-functioning transport, logistics, finance, communication, and other business and professional services to move goods and co-ordinate production along the value chain. In fact, examining trade flows in value-added terms reveals that services play a far more significant role than suggested by gross trade statistics: on average, in countries covered by the OECD's Trade in Value Added (TiVA) data, services represent more than 30% of the total value added in manufacturing goods and almost 45% of global trade (25% of gross trade). Initial estimates suggest that the situation may be similar in Tunisia, with services accounting for more than 45% of total exports in value-added terms. In Tunisia, this number is significantly bolstered by the tourism sector (see below). For many individual sectors, shares are around 25%, lower than in many developed economies, suggesting that further gains in competitiveness could be achieved through outsourcing non-core activities (Figure 10.4). Efficient services sectors are not just important for the service components of Tunisia's economy, but are essential for the competitiveness of its manufacturing sectors as well, as illustrated by the large services content of Tunisia's value-added exports in the electronics, textile and other manufacturing sectors (between 21-28%).

Figure 10.4 Services content of exports in Tunisia, by industry, 2009.

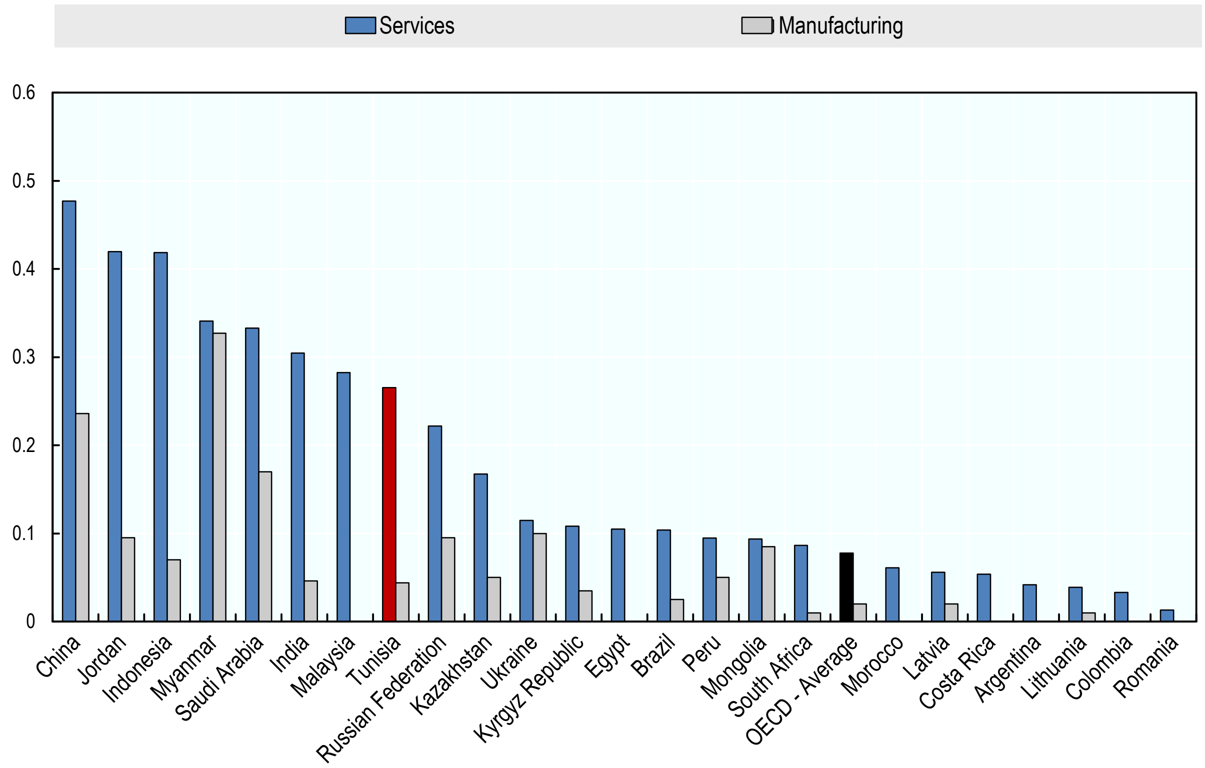
In percent



Source: *OECD, INS.*

Despite the importance of services to export performance, there remain numerous obstacles to services trade and investment in Tunisia. According to the OECD FDI Regulatory Restrictiveness Index, Tunisia has a more restrictive regulatory environment for foreign investors compared to OECD and non-OECD averages particularly for services sectors (Figure 10.5). Most of the barriers relate to foreign equity restrictions and prior-approval requirements in key services sectors (such as distribution) but also agriculture. According to the 1993 Investment Incentives Code, foreign investment that results in equity interest above 50% in certain services sectors are subject to prior authorisation by the Investment Commission. Opening services markets would offer a major opportunity to stimulate growth and jobs across all sectors of the economy. Recent OECD analysis using the Services Trade Restrictiveness Index (STRI) shows that even modest reforms to liberalise services can offer significant benefits. Depending on the sector, modest reforms can increase exports by 3-7% and lower import prices by as much as 10%.

Figure 10.5 OECD FDI Regulatory Restrictiveness Index: manufacturing and services sectors, Tunisia and selected OECD and non-OECD economies, 2013.



Note: The OECD FDI Regulatory Restrictiveness Index covers only statutory measures discriminating against foreign investors (e.g. foreign equity limits, screening & approval procedures, restriction on key foreign personnel, and other operational measures). Other aspects of an investment climate are not considered (e.g. the quality of implementation of regulations or existence of state monopolies).

Source: OECD.

All of this highlights the importance of the “whole-of-supply-chain” approach that the Tunisian government needs to adopt as it seeks to maximise the benefits associated with participation in GVCs. Trade liberalisation and investment policy reform must go hand in hand to be mutually reinforcing. Trading costs could be reduced for all firms, not only those in the offshore sector. Business linkages between foreign firms and Tunisian SMEs should also be further encouraged. The examples of Costa Rica and Malaysia (OECD 2013e and OECD 2013f) illustrate how proactive and sustained linkage promotion measures can help local companies move up the value chain thanks to transfers of skills, know-how and technology. These examples could be instructive for Tunisia as it aims to transition from a largely dichotomous private sector to one based on strong linkages between exporting firms and their domestic suppliers.

Greater predictability and stability of investment policy will also play a key role in attracting investors and facilitating their interactions with local firms. The Government has undertaken extensive public consultation on the new Investment Code that was to replace the 1993 Investment Incentives Code. The adoption of a new Code would provide investors with a greater degree of transparency as well as provide the Government with an opportunity to introduce some of the long planned reforms, including a progressive opening of services sectors.

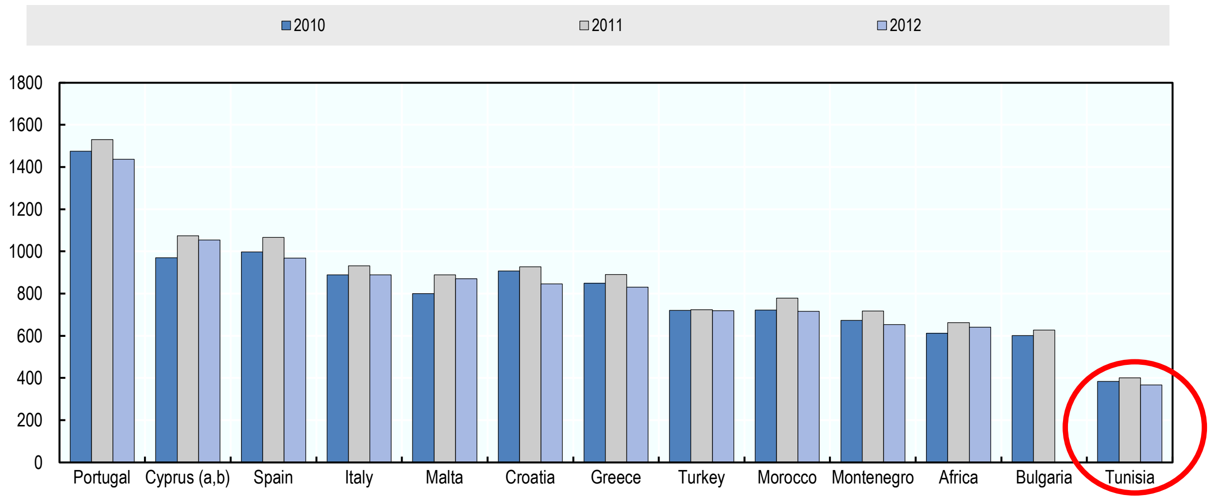
Finally, the further development of infrastructure and human capital (**Chapters 6 and 4**, respectively) will help ensure that the widest possible range of Tunisian firms and individuals across the country can successfully reap the benefits of opportunities created by GVCs.

Attracting higher value added tourism

In addition to broad-based investment, trade and innovation reforms, the Government could also step up its efforts in promoting the development of high-value added niches in some of its leading export sectors, including tourism. In 2012, Tunisia attracted nearly 6.0 million international visitor arrivals (11.2% of total arrivals to Africa), behind only South Africa (9.5 million) and Morocco (9.2 million) on the African continent. Provisional figures for 2013 suggest that Africa continues to enjoy sustained growth, attracting 5% more international arrivals. Following the sharp decline in 2010, the number of visitors to Tunisia continued to recover, also rising by 5% in 2013.

Representing 6.5% of GDP, employing 11% of the active population, and as the second largest source of foreign income, tourism is a key sector of the economy and will play a critical role in its socio-economic stability and future development (UNWTO 2013a). The bulk of the available capacity, however, rests on mass tourism, based on beach resorts, while opportunities for cultural, sport and eco-related tourism activities remain largely unexploited. As a result, comparison with other Mediterranean countries shows that on average receipts per tourist arrival in Tunisia are low (see Figure 10.6).

Figure 10.6. OECD Receipts per tourist arrival in selected Mediterranean destinations, 2010-12



a) Note by Turkey: The information in this document with reference to “Cyprus” relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the “Cyprus issue”.

b) Note by all the European Union Member States of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

Source: OECD calculations from UNWTO (2013b)

Despite wide cyclical fluctuations in overall tourism receipts during recent years (-30% in 2011, +24% in 2012), the revenues per tourist have not varied, suggesting that the limited diversification of the structure of Tunisia’s tourism sector is a structural issue, with low value tourism or very short stays predominating. Action is therefore necessary both rejuvenate existing accommodation and attractions, and support the diversification of the tourism offer to take better advantage of Tunisia’s rich natural and cultural heritage. Doing so will allow Tunisia to spread the benefits of tourism more widely, reduce seasonality associated with sun and beach tourism, and enable tourism businesses and marketing agencies to focus on attracting higher yield customers (e.g. eco-tourism, meetings and conventions).

Key OECD Recommendations

- **Improve the competitiveness of key services to smooth firms' operations in GVCs,** including by lessening restrictions to trade and investment (notably screening requirements), through the new Investment Code.
- **Pursue further trade facilitation reforms** to improve access of local firms to foreign inputs and facilitate the penetration of global markets. In particular, focus efforts on shortening the average time spent at the border by all firms, notably in the country's principal ports.
- **Promote actively business partnerships between foreign investors and domestic firms** that can act as suppliers or local partners, so as to facilitate knowledge transfer and GVC penetration. Experience of successful countries show that coordination of investment and trade promotion activities can play a critical role in this regard.
- **Step up efforts to attract higher added value tourism**, capitalising on the country's rich natural and cultural heritage.

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ABBREVIATIONS AND ACRONYMS

ALMP	Active labour-market policy
AMC	Asset-management company
BDS	Business-development services
BFPME	Banque de financement des PME (Tunisan SME financing bank)
BTS	Banque tunisienne de solidarité (Tunisian solidarity bank)
CEEC	Central and Eastern European countries
COG	Centre of Government
CPI	Consumer Price Index
CRES	Centre de Recherches et d'Études Sociales (Tunisian Centre for Social Research and Studies)
EU	European Union
FDI	Foreign Direct Investment
FX	Foreign exchange (transaction)
GCC	Gulf Co-operation Council
GDP	Gross domestic product
GVC	Global Value Chain
ICT	Information and Communications Technology
ILO	International Labour Organization
IMF	International Monetary Fund
INS	National Statistics Institute of Tunisia
IT	Information technology
KBC	Knowledge-based capital
MENA	Middle East and North Africa
NGO	Non-governmental organisation
NPL	Non-performing loan
OECD	Organisation for Economic Co-operation and Development
PES	Public employment services
PFM	Public financial management
PISA	Programme for International Student Assessment (OECD)
PNAFN	Programme national d'aide aux familles nécessiteuses (National program for needy families)
PPP	Purchasing Power Parity; Public-Private Partnership
PSP	Private-sector participation
R&D	Research and development
RIA	Regulatory Impact Analysis
SICAR	Société d'Investissement de Capital à Risque (venture-capital investment company)
SME	Small and Medium-Sized Enterprises
SMIG	Salaire minimum interprofessionel garanti (official minimum wage in Tunisia)
SOE	State-owned enterprise
STRI	Services Trade Restrictiveness Index
TiVA	Trade in Value Added
UNCAC	United Nations Convention Against Corruption
VAT	Value-added tax
VET	Vocational and educational training
WB	World Bank

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