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Republic of Tunisia
Private Sector Assessment

November 1994

Country Operations Division
Country Department I
Middle East and North Africa Region
World Bank

Corporate Planning Department
CME Regional Department
International Finance Corporation

Currency and Exchange Rates

Currency Unit: Dinar (TD)

TD per US$

Period Averages

1987	=0.8287
1988	=0.8587
1989	=0.9493
1990	=0.8783
1991	=0.9246
1992	=0.8844
1993	=1.0037
1994	=1.0181 (January 1st - June 30)

Fiscal Year

January 1st - December 31st

ABBREVIATIONS AND ACRONYMS

AFI	Agence Foncière Industrielle
APB	Association Professionnelle des Banques
API	Agence de Promotion de l'Industrie
ATPE	Agence Tunisienne de Formation Processionnelle
BIS	Bank for International Settlements
CAREPP	Commission d'Assainissement et de Restructuration des Entreprises Participations Publiques
CAVIS	Caisse d'Assurance Vieillesse, Invalidité et Survie
CENT	Caisse d'Epargne Nationale Tunisienne
CETIME	Centre Technique des Industries Mécaniques et Electriques
CETTEX	Centre Technique pour les Textiles
CNCC	Centre National pour les Cuirs et Chaussures
CNI	Centre National de l'Informatique
CNRPS	Caisse Nationale de Retraite et de Prévoyance Sociale
CNSS	Caisse Nationale de Sécurité Sociale
CREGT	Caisse de Retraite et de Prévoyance Sociale des Services Publics d'Electricité, du Gaz et des Transports
CTMCCV	Centre Technique pour les Matériaux de Construction, Céramiques et Verres
CTN	Compagnie Tunisienne de Navigation
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
FIAP	Fonds d'Insertions et d'Adaptation Processionnelle
GATT	General Agreement on Tariffs and Trade
ICSID	International Center for Settlement of Investment Disputes
INNORPI	Institut National de la Normalisation et de la Propriété Industrielle
INS	Institut National de Statistiques
MFA	Multi-Fiber Agreement
MIGA	Multilateral Investment Guarantee Association
OFPE	Office de Formation Professionnelle et de I'Emploi
OPNT	Office des Ports Nationaux de la Tunisie
OTC	Office de la Topographie et de la Cartographie
SICAF	Closed-end Mutual Fund
SICAV	Open-end Mutual Fund
STAM	Société Tunisienne d'Acconage et de la Manutention
STAR	Société Tunisienne d'Assurance et de Retraites
STEG	Société Tunisienne d'Electricité et de Gaz
TFP	Taxe sur la Formation Professionnelle
UGTT	Union Générale des Travailleurs Tunisiens
UNCTAD	United Nations Conference on Trade and Development
UTICA	Union Tunisienne de l'Industrie, du Commerce et de I'Artisanat

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Tables and Diagrams

This report is based on the findings of two missions that visited Tunisia in November 1992 and February 1993 and a number of papers prepared for the mission by the Union Tunisienne de l'Industrie, du Commerce, et de l'Artisanat. The mission members were: Ms. Jane Hallow (IFC) for foreign investment; Ms. Claudia Pardinas (LEGMN) for legal issues; Ms. Susanna Barsella (Consultant) for data collection and processing; Mr. Richard Brun (MN1CO) for financial markets; Mr. Fazle Hasnain (Consultant) for telecommunication issues; Mr. Pierre Hiriart (Consultant) for customs procedures; Mr. John Nellis (PSD) for privatization issues; Mr. Hung Nguyen (MN1IE) for interviews with enterprise managers; Mr. Dominique Pannier (EMTPM) for technology and public sector support institutions; Mr. Didier Selles (Consultant) for technology; and Mr. Dimitri Vittas (FSD) for insurance and social security. The task manager was Mr. Sikander Rahim (MN1IE/CO). Mr. Hamid Alavi (MN1IE) provided the analysis of the private sector.

EXECUTIVE SUMMARY

1. This report is an assessment of some of the main policy and institutional issues that affect the private sector in Tunisia. Its point of departure is the observation that the main determinant of economic development in a country the size of Tunisia will be its export performance, and the report's focus is on measures to make the private sector more competitive on world markets.

2. This outward orientation marks a new stage in Tunisia's development. In the stage that has ended private entrepreneurship developed, protected from external and domestic competition, from almost nothing in 1970 to being preponderant in the economy now. The private sector now accounts for the bulk of production and investment in almost all major sectors, the exceptions being mining, which includes the troubled phosphates sector and petroleum; public utilities; banking and insurance; and some forms of transport. Most of the private sector's dominance in each sector has been due to the growth it generated, but in some sectors, such as agriculture and transport, there has been a transfer of activities as well from the public to the private sector. Nevertheless, even where the private sector is dominant, the public sector is usually significant, though its presence is often a fraction of what it used to be.

3. In the new stage, the private sector must adjust to generate rapid growth and diversification of exports. The export performance has been fairly consistently strong since the early 1970s, and most of it has been due to the private sector, but all the main traditional exports face constraints. Almost all manufactured exports, with some exceptions, are technically simple, requiring little skill and yielding a low value added. Their main source of growth, "textiles, clothing and footwear", will soon meet competition from East European and Asian producers with higher skill levels and/or lower wages once the European Union members' quotas that protected Tunisia's exports are removed with the ending of the Multifiber Agreement (MFA). Tourism has been the other main source of export growth and consists mainly of low cost package tours. Because it is technically easy and because of booming demand and generous tax and credit incentives, entrepreneurs, both established and newcomers, are neglecting other sectors to invest in it. But tourism is vulnerable to tensions in and around the region and will be limited by the fragile ecology. Agricultural exports, a mixture of private sector (fruits, vegetables, and nuts) and public sector (olive oil), are constrained by scarcities of soil and water.

4. The policy environment needed to bring about this adjustment by the private sector needs to aim at three objectives. One is progressively to increase competition, both domestic and external. Like many other countries in the 1970s and early 1980s, Tunisia fostered the growth of its private sector by protecting it from external and domestic competition and by granting it credit and tax privileges. That, despite this, its exports of manufactures grew strongly during that period was due to its adoption of an export processing zone type of arrangement, the so-called "off-shore" sector. Its balance of payments was also helped in the late 1970s and early 1980s by a surge in oil export earnings, which have since ebbed as oil prices have fallen and oil reserves have been depleted. But the consequence has been that the

domestic manufacturing sector has not had the stimulus to competitiveness that normally results from external trade and the off-shore takes virtually no tradable inputs from the domestic economy.

5. Reforms have been under way since 1986 to remove barriers to competition in goods and service. These have included removing controls on imports, investment, and credit, and allowing free entry into a range of activities in which competition had been restricted or the public sector was active. Prices and interest rates have been largely freed, the current account has been liberalized and a limited inter-bank foreign exchange market has started. There remain some controls and barriers that need to be removed, though they are a small part of what existed earlier. These include certain controls on interest rates and some of the last few import restrictions. A timetable should be established for reaching the Government's goal of a uniform rate of protection of 25%. At present the maximum tariff is 43%, and, combined with the temporary tariff surcharges to tide enterprises over the adjustment to the removal of import restrictions, effective protection is much higher.

6. The second objective is to remove obstacles to the correct functioning of markets. Direct and indirect taxes have been reformed so as to reduce their distortionary effects and lower their rates. The numerous sector investments codes have been replaced by a unified code giving less generous special incentives according to "horizontal", rather than sectoral, criteria. The basis for a sound financial sector has been laid with new prudential regulations and revision of banking legislation. Administrative controls are a fraction of what they used to be. Nevertheless, some that remain are redundant and many that are justified are more ponderous than need be. Attitudes often need to change as well; although higher ranking officials support the reforms, there is often mistrust of the private sector in the middle and lower ranks that manifests itself in the way regulations are applied. Continued progress in these respects can be achieved through closer collaboration between the State and the private sector in identifying problems and their solutions.

7. The third objective is to acquire and assimilate technology. For entrepreneurs and government officials this is the challenge. Many are not convinced that competition and efficient markets alone will induce the private sector to enter technically more difficult activities and diversify their exports. But the daring methods used by some East Asian economies to master difficult technology are not open to Tunisia. These economies in some cases relied on captive domestic markets to develop their competitiveness in certain products, but the small size of the Tunisian market would limit that to a few cases. The government subsidies and cross-subsidies from profits on domestic sales that were frequently used are no longer tolerated by the developed countries. Sometimes the governments of some of the East Asian countries applied harsh sanctions to enforce compliance with the objectives they had set for enterprises, and it is doubtful that such practices would conform to the traditions of Tunisia.

8. To achieve the objective of acquiring and assimilating technology, greater reliance should be placed on joint management by the State and the private sector of the country's technology and training infrastructure. Tunisia has several avenues for acquiring technology,

including foreign investment, subcontracting, and the efforts of its own entrepreneurs. It also has a better supply of skill than many developing countries. But its education and training systems and public sector support institutions, though often maintaining technically high standards, are, on the whole, insufficiently responsive to the needs of the economy. The remedy is to associate the private sector more closely in their management and financing.

9. An important conclusion of this report is that collaboration between the State and the private sector is often the most effective way of removing obstacles to the development of the private sector. Complex problems can often be solved by entrusting the responsibility for defining and implementing measures to deliberation councils constituted of representatives of the concerned parties, a method that has been used regularly in the successful East Asian economies. Such a council is given a clear objective with instructions to make a proposal by an agreed date that the Government can readily implement. The conditions for its success are that it has autonomy and that it answers to an authority above the sectoral level.

10. Since the report focuses on making the private sector more competitive internationally, some of the priorities of the Government are not discussed, except incidentally. International competitiveness is where the private sector faces its greatest challenge and where the Government faces some of the most complex issues. Other priorities for the private sector, such as the development of agriculture or small enterprises, have necessarily been left aside. A major set of issues that will be analyzed in a separate study by the Bank (their complexity and social importance warrant fuller discussion than can be managed in the scope of this report) concerns labor legislation and wage determination.

The Financial Markets

11. Extensive reforms of banking and the capital market are causing the financial sector to evolve rapidly. Liberalization of banking and the introduction of new prudential regulations are changing banking from the simple, narrow system of a few years ago as new institutions, such as leasing companies and investment banks enter the market. The application of the prudential regulations has shown that the large public sector deposit banks cannot yet meet the capital adequacy requirements because of portfolio problems, and that they need to strengthen their internal management. In overcoming these problems the Government needs to aim at ending the public sector's predominance in banking in the near future. At present banks controlled by the public sector account for 70% of banking assets. A large part of the portfolio problems arise from public enterprises and will be solved through privatization. But the development banks, which lend long term and do not take deposits, were designed for a financial sector that no longer exists and need to find new roles. The postal savings system also should be given a new role as a provider of basic financial services to low income groups, following the highly successful experience of countries like France, Germany, and Japan.

12. Activity on the stock market, the *Bourse,* has been increasing rapidly over the last year as a result of the reforms, but the market remains minute. Private enterprises are largely

controlled by families and small groups, who prefer not to raise capital through equity issues to the public to avoid the disclosure requirements for issuing stocks and the risk of loss of control. Such attitudes will change as the economy evolves, especially if the export performance is strong and firms are encouraged to grow and compete more on the international market.

13. But old attitudes are at present being reinforced by certain tax advantages that discourage the issue and trading of equity on the market and which need to be removed. These include the advantages available for the issues of equity with repurchase agreements, which are simply subsidized loans, and the advantages from parking equity in enterprises in closed-end mutual funds (SICAFs) controlled by owners of enterprises. Tax advantages for purchases of primary issues of equity are unnecessary since the demand for equity is strong. They should not be available to enterprises. If it is felt that there is a strong case for making them available to individuals, they should be redesigned to include equity purchased on the secondary market, e.g. through "equity savings accounts" along the lines of the present "bond savings accounts".

14. The Treasury's cessation of issues of its own *bons d'équipement* (ten year bonds with a coupon of 8 1/4 %) in 1991 and its resort to bidding among financial institutions has removed the main obstacle to the development of a bond market. It is also redeeming practically all the outstanding *bons d'équipement* by the end of 1996. It now needs to set up mechanisms for issuing bonds that allow an efficient secondary market to develop. It should also allow reputable enterprises and institutions to issue bonds at interest rates of their own choice. Private rating agencies should be allowed to develop, but the Government should not try to rate bond issuers itself since that would require it to examine the enterprises and could be interpreted as a guarantee on its part.

The Institutional Investors and Social Security

15. The institutional investors will soon become major sources of funds seeking investment opportunities on the financial market. The social security funds, which were obliged to invest mainly in *bons d'équipement*, are now free in their investment decisions, subject to prudential regulations, while the insurance companies' obligation to hold 50 % of their technical reserves in Treasury paper has been reduced to 35 %. This freedom and the redemption by the Treasury of its *bons d'équipement* will strengthen the financial position of these institutions and allow them to structure their portfolios in line with their commitments.

16. The social security funds are the basis of an extensive system of social protection that was established before an insurance industry had developed. The economy has evolved since, and requires a greater variety of products to meet the needs of households and enterprises, while providing basic social protection for all. But, while the funds' ability to provide in the future the same services as now is being eroded by financial strains, they are crowding out the development of the insurance industry, which is also hindered by shortcomings in the regulatory framework.

17. The links between the benefits provided by the funds and the contributions to them need to be made firmer. The manner of provision of health care benefits is a political choice, but if the present contributory system is to be maintained, health care for zero or nominal charge should be limited to those whose contributions are in order and to the really poor. Pensions should be based on contributions over a long period. This will reduce the incentive to evade contributions and inflate claims, and, hence, the distortionary effects on enterprise employment caused by the cost of social security contributions. Contributions for family benefits should also be removed, since they are in economic terms a tax on employment, and the revenue should be raised by other taxes. A system of social protection in keeping with the evolution of the economy would be to provide basic cover through compulsory social security contributions, while additional cover could be provided through the insurance industry. The insurance industry itself would need to be put on a sounder footing. Stricter regulations based on solvency monitoring need to be adopted soon. The loss-making State insurance companies need to be restructured, through privatization, recapitalization, mergers, and closures. Partnerships with foreign companies should be sought. The initial capital requirements are unnecessarily high and should be reduced to encourage new entrants. The technical skills of the companies and the actuarial database need strengthening.

Special Incentives and the Off-shore Sector

18. A new unified investment code has been introduced to replace a number of sectoral codes. It is a major improvement since the sectoral codes to a great extent competed among themselves at a substantial cost to the budget but little identifiable gain to the economy. The tourist sector was the winner; the advantages it received are estimated to have amounted to 25% of its investment. Given its technical simplicity and low investment costs, these advantages helped it drain investment from the other sectors. Under the new code the main criteria for according special incentives are "horizontal", notably exports, disadvantaged regions, and acquisition of technology. The main sectoral element left is agriculture, which follows the pattern of many developed countries and is aimed at slowing rural-urban migration.

19. But the manner of application of the new code needs to be modified in two respects for it to be effective. One modification is that the code should not be applied through sectoral committees, since that would reintroduce the sectoral bias whose removal was the principal objective of the code. Instead there should be a single body for all sectors with powers to consult sectoral experts. The other modification needed is to enable partial and indirect exporters to benefit from the same advantages as direct exporters. This is needed to break through the dichotomy between the off-shore enterprises, which export all their output and enjoy exemption from taxes and normal customs procedures, and the rest of the economy. The off-shore regime had two objectives: to allow the growth of manufactured exports while the domestic economy remained highly protected and to attract foreign direct investment. It was successful in the first, but it has hindered exporting from stimulating efficiency and competitiveness in the domestic economy, from which it takes almost no inputs except untradables. Its own technical level has, with few exceptions, remained simple, consisting

mostly of garment assembly. To integrate exporting more into the domestic economy, trade facilitation procedures, similar to those in other countries, need to be introduced to enable partial and indirect exporters to receive the same advantages regarding customs procedures and tariffs as off-shore enterprises.

Foreign Direct Investment (FDI)

20. The off-shore regime's success in attracting foreign investment has been modest, although the procedures for establishing new enterprises are simple and fast. The inflow of FDI (leaving aside extraction and transmission of oil and gas) has not been large and almost none has been on -shore, and has thus brought little of the benefits of training and know-how that could have been expected. It would be unrealistic to expect inflows of FDI to grow quickly before Tunisia has established itself as a successful exporter, since the domestic market is so small. Nevertheless, steps should be taken to encourage investment that provides training and know-how, which means investment in partnership with Tunisian enterprises. One obstacle to this has been that the procedures that work so well for new investments become onerous for foreign investment in existing enterprises, whereas this may be the form that should be encouraged most. The procedures for authorization of FDI should, as far as possible, be the same for new and existing firms, with the possible safeguard against short term, speculative investments of a tax on short term capital gains.

Education and Training

21. The demand for skills and for labor with good basic education will grow rapidly with the economy's export orientation, and a greater role of the private sector in providing and financing education and training will be necessary. To maintain high standards and keep within budget constraints, the largely public sector education and training system has been selective at the primary school level, resulting in high dropout rates in the first six years of school. This reduces the potential productivity of the labor force since it prevents illiteracy falling below about 35%. A large part of the dropouts from primary, and also secondary, schools are accommodated in public sector vocational training schools, which cost several times as much as formal education and do not produce the skills needed by enterprises. There is also a shortage of skills between the basic level and the high standards of the universities. The shortages are due to the constraints in the education system; there is unsatisfied demand on the part of individuals and enterprises for more education and training and for greater diversity.

22. The Government recently began to extend basic education (years 1-9) to all children with the necessary aptitude. Since this reduces the number of pupils in vocational training, which is by nature costlier than ordinary schools, standards need not be sacrificed. At the same time the Government is trying to make the existing public vocational training responsive to enterprise demands and to establish an apprenticeship system along the lines that have proved successful in Germany. It needs, however, to prevent the public training system

from crowding out private training. Consequently, the levy, the *Taxe pour la formation professionnelle,* which is refunded to enterprises according to their expenditure on training their employees, should be refunded equally for private and public training, while public training should be on a full cost basis. Establishing an apprenticeship scheme is a delicate task when there is not a tradition already. Appropriate incentives, covering wages and taxes, need to be designed and tested to ensure that firms have an incentive to take on apprentices, train them correctly, and not use them only as cheap labor.

23. To meet the growing demand, the Government is expanding secondary and higher education at a high rate. This is the area where the private sector can make the greatest contribution complementing the Government's efforts. Consequently, the authorities are preparing legislation to give recognition to private institution diplomas and to prescribe standards. A further step would be to provide tax benefits for private educational institutions. The need for financing of private education will grow and steps should be taken to introduce student loans following models used in some developed countries.

The Technical Centers

24. The technical centers provide expertise in activities that are well established in the country, but they need to perform this function without crowding out private firms that could also supply expertise. Where they provide services that private firms might also provide, they should charge the full costs. For instance, the *Centre National d'Informatique* (CNI) should be withheld from public sector procurement until it has established cost accounting. The technical centers should concentrate on functions that private firms are unlikely to provide, notably collecting and disseminating information on technology, representing their sectors on technological issues, formulating and monitoring training programs, and monitoring performance under the special incentives of the investment code. Organization and financing of the centers should be on the basis of cooperation across their sectors. The private sector has already been given majority representation on the centers' boards and the power to nominate the board chairmen. The status of the centers should be changed to free their staff from civil service regulations and the levies paid by enterprises for the centers should be paid into special accounts with the Treasury and be freely accessible to the centers.

Trade Facilitation

25. The passage of goods through Tunis area ports, the country's main ports, and customs and the shipping to and from foreign ports are costly and often slow. Port procedures are complex, often based on ill-harmonized and outdated legislation governing the different port operators. In the Tunis area ports there is a lack of competition because of interlocking interests of the port authority, the national shipping line (CTN), and the cargo handling monopoly, the

STAM. In addition the main freight forwarding agency is in the public sector and controls the only TIR trucks in Tunisia. Cargo handling productivity in the Tunis ports is one fifth that of Sfax, where there is competition, and the national average is less than half that of Algeria. The CTN has a right of first refusal and, until it was formally dissolved, belonged to a regional shipping conference. But the cartel practices of the former conference continue, so that shipping costs are high and there are often delays while the CTN seeks to charter ships. Tunisia also lacks a competitive international transport system of its own. The CTN's fleet is obsolete and, because of the high import duties on trucks to protect domestic truck assembly, a Tunisian TIR enterprise cannot be competitive, although TIR trucks are essential for competitive delivery across Europe.

26. The customs are also slow and not sufficiently aware of the needs of enterprises, though their standard of integrity is high. Aside from off-shore enterprises and certain special procedures, normal customs procedures are full inspection with further checks of goods and documents. There is no good channel for the private sector to communicate with higher level customs officials to prevent arbitrary actions or to rectify mistakes.

27. A trade facilitation program needs to be implemented to simplify passage of goods through ports and customs, and needs to be accompanied by the removal of obstacles to private competition. The needs of exporters and importers should be formulated and implemented through a permanent institutionalized process representing the main interest groups. Competition between port operators should be opened up, the CTN's right of first refusal should be abolished, and, in keeping with trends in Europe, the cartel arrangement for shipping should be abandoned. The customs should institutionalize a two-way channel of communications with the private sector that is transparent and does not allow their integrity to be questioned. This channel should include a speedy and impartial disputes settlement procedure. Inspection of goods should be reduced by relying more on knowledge of operators and on indicators. The computer based customs clearance system should be replaced by an up-to-date system.

Privatization

28. The Government has been withdrawing from direct economic activities since 1988 in two ways: allowing the private sector to take over activities that had been in the public sector and privatizing public enterprises. It has made considerable progress in the former, notably in agriculture and transport, but privatization has been slow. The Government judged that goodwill for privatization did not exist; the motives for quick privatization in other countries, an electoral mandate, economic transition, or big deficits, did not exist in Tunisia. The institutional framework for privatization aimed at caution and consensus. Proposals for privatization came from the enterprises themselves or their ministries, and the terms were negotiated with prospective buyers with extensive consultation across the Government. This framework did not allow fast action or planning ahead. These negotiated placements have two weaknesses: in a small economy, like Tunisia, the risk is high that prospective buyers may collude, instead of competing, and the method is unsuitable for large enterprises.

29. Privatization has now won goodwill and needs to be accelerated. The goodwill arises from the improved performance in activities where the State has allowed the private sector to take over and the favorable experience with the limited privatization that has taken place. The performance of firms improved after privatization and the job losses were smaller than expected. In some cases employment increased. A plan for future privatization is needed. The responsibility for formulating such a plan and privatization strategies has been given to the Ministry of Planning and Regional Development. A new privatization mechanism - selling a large block to a single bidder (who could be a group), who would manage the enterprise, and then selling shares to the general public, with the Government retaining a share for a transition period - has been successful so far and meets several objectives, including transparency, ensuring managers have a stake in the enterprise, and supplying equity on the Bourse. Competition for the management block of shares can be ensured by calling for bids in major foreign papers, as was done in some recent cases.

Removing Gaps in the Legal System

30. The legal system is basically modern, although it has not kept up with some changes in business practices. To ensure that it evolves continually with the economy's needs, there should be permanent collaboration among the authorities, the legal profession, the private sector, and other concerned parties through suitable representatives. There will also often be a need to harmonize legislation with that of major partner countries.

31. The main gaps in company law are the lack of recognition of holding companies or corporate groups, the absence of the unipersonal company, and the lack of legislation governing restructuring of private firms. These lacunae leave the way open to abuses and can deter valid businesses. Contract law mainly lacks legislation governing forms of contract that were unfamiliar in Tunisia until recently, such as leasing and franchising. Bankruptcy legislation is still rooted in past attitudes and needs to be modernized to make it more helpful in overcoming the difficulties of firms and less harsh in its penalties. Businesses complain that judicial procedures are slow, although the reasons why they should be are not clear. This is an issue that needs to be studied jointly by the legal profession and the private sector, to identify causes and remedies.

Land and Housing

32. Markets for land and housing function poorly, with the consequence that the price of housing is rising faster than incomes and there is a shortage of land for businesses. One reason is that registration of land is so cumbersome that only a small proportion of properties have titles fully in order. Registration is a judicial act, which is rare outside Tunisia, and the coordination between the different agencies involved in registration can be poor. Another reason is that the development of undeveloped land is the monopoly of public sector agencies that have problems of administration and financing. The taxation of property does not encourage the sale or development of underutilised land, and the Government is examining possible reform. Recent legislation aims to put pressure on owners of property to register and removes one source of

difficulties, problems of documentation. But without overcoming the other administrative problems, its effect will be limited. In particular, the need for judicial review should be limited to disputes. The development of land should be handed to the private sector within a suitable framework of zoning and environmental protection.

Infrastructure and Public Utilities

33. These have been well managed, with the signal exception of industrial and commercial land, which is in short supply and badly maintained. The provision of such land should be transferred to the private sector within an appropriate regulatory framework. The costs of rehabilitating existing industrial estates and providing new ones will be substantial and should not fall on the budget.

34. Extending the role of the private sector to providing infrastructure and utility services should be considered, both to reduce public sector outlays and to stimulate productivity and innovation. The telephone agency, after having made a major improvement in the quality and range of its services, is now being transformed into an autonomous body, which could attract foreign partners. The electricity company is considering partnerships with foreign private firms for power generation, which could be relatively simple given its high efficiency and expertise.

Improving Economic Data

35. The collection and processing of economic data need to respond more to the users in the public and private sectors. Excessive resources are spent on gathering large amounts of data of uncertain quality that cannot be processed quickly, when more reliable results can be obtained cheaper and faster through appropriate sampling and from tapping other existing data sources.

P A R T 1: PAST AND PRESENT

CHAPTER I: INTRODUCTION

A. THE HISTORICAL BACKGROUND

1.1. From around 1970 to the present economic and social development have been continuous; there have been fluctuations about a trend, but the trend has been maintained. The closest the economy came to a crisis was a moment of balance of payments difficulties in 1986, which were quickly overcome but whose long-term significance has been that they led to a revision of economic policy towards a liberalization and outward orientation of the economy. The Gulf crisis in 1990-91 created another difficult moment for the balance of payments that reinforced the trend of policy reforms.

Table 1: THE EVOLUTION OF THE ECONOMY 1970-1993
(Ratios to GDP in %)

	1970	1980	1986	1993
Agriculture	19.7	16.3	15.3	16.2
Industry	23.8	36.0	32.9	30.4
Manufacturing	9.7	13.6	15.1	17.3
Oil, Gas	4.9	12.3	8.5	5.2
Services	40.6	35.7	37.5	39.5
Tourism	2.6	4.5	3.5	4.6
Exports	25.4	46.5	35.5	45.6

Source: Ministry of Planning and Regional Development

1.2. Over this period income per capita in Tunisia rose to $1,800, which is close to the average of the group of lower middle income countries. It rose at an average of 3.1% a year, though it rose faster after 1980, at 3.6%, as compared to the group's average of 2.7%. The composition of Tunisia's GDP does not diverge greatly from that of a typical lower middle income country. Its share of manufacturing of 17% is lower than the group average of 23%, but it has risen faster, from 10% in 1970 as compared to the group's average of 20%. Closely related to this is the rise in the ratio of exports to GDP from the roughly average level of about 20% to 40%, which is among the higher ratios for the group. Nearly all this increase has been due to manufacturing.

1.3. Other indicators show that macroeconomic policies have, on the whole, been prudent and that social policies have consistently been a priority. Inflation since 1970 has averaged 8.1% and has now fallen below 6%. Tunisia has never rescheduled external debt, although it actively mobilized external financing throughout the period. But it was cautious about the amounts and terms, so that its present external debt is equal to 59% of GDP, with an average maturity of 17 years and an average interest rate of 6%. Income seems to be more evenly distributed than in most comparable countries and the incidence of poverty to be correspondingly low. An estimate of the Gini coefficient for 1989 is 0.42, about the same as for the United Kingdom now. Adult literacy is 65%, life expectancy is 69 years, infant mortality is 43 per thousand and annual population growth has declined to 1.9%.

1.4. The change of economic policy in 1986 divides the period into two distinct economic policy phases. In the earlier phase a priority of economic policy was to develop a private sector where practically none existed. The little Tunisian entrepreneurship that had existed before independence in 1958 and the years immediately after, mainly in agriculture and commerce, had been mostly suppressed in the 1960s, when extreme socialist policies were adopted and ended in failure. The course adopted in the 1970s was to encourage private investment by limiting domestic and external competition and by providing financial and fiscal incentives. Consumers were protected against monopolistic practices by price controls. The change of course in 1986 aimed at making the economy more competitive internationally: broad programs for liberalizing markets and reforming taxation were adopted and have been largely implemented.

1.5. During the earlier phase the State's role was pervasive. Apart from administering the extensive system of controls needed to implement its policies, it entered directly into a wide range of economic activities. A number of these activities were chosen because of doubts about the private sector's willingness to enter them or how well it would perform. They included the delivery of inputs for agriculture, the collection of certain crops, and the distribution of some foodstuff. But the public enterprise sector also grew because earnings from oil exports accrued to the State. From the mid-1970s on, as world oil prices rose and Tunisia was able to increase its oil extraction, oil's contribution to government revenue grew to reach, at its peak in 1980, 21%. Much of this additional revenue was spent on infrastructure, subsidies on widely consumed foods and agricultural inputs, and higher salaries for government employees. But a considerable number of public enterprises were also established. The corresponding swings in public sector investment are illustrated by the manufacturing sector (Table 2).

Table 2: RELATIVE SHARES OF PUBLIC & PRIVATE SECTORS IN GROSS FIXED CAPITAL FORMATION IN MANUFACTURING 1962-1988 (%)

	1962-1969		1970-1976		1977-1980		1988	
	Public	Private	Public	Private	Public	Private	Public	Private
Agro-Industries	72	28	30	70	38	62	17	83
Construction Material	93	7	69	31	79	21	58	42
Electro-mechanical	92	8	54	46	46	54	51	49
Chemicals	62	38	70	30	91	9	60	40
Textiles	83	17	18	82	13	87	18	82
Other Industries	79	21	23	77	18	82	4	96
TOTAL	84	16	47	53	61	39	32	68

Source: Signoles, 1985, and INS

1.6. There were three main economic reasons why these policies did not quickly end in another failure. One was that the authorities showed pragmatism and integrity in applying their extensive

powers of control. In particular they did not use them to regulate macroeconomic balances; reliance was placed instead on prudence regarding budget deficits, credit, and external financing, and on flexible exchange rates. Hence, import controls, whose primary purpose was to balance protection of domestic producers against domestic demand, were used sparingly as a means of regulating the volume of imports for balance of payments reasons, and did not just benefit a privileged group. Similarly, price controls were used to protect consumers and not to suppress inflation. As a consequence, parallel markets in goods and foreign exchange have been insignificant.

1.7. The second reason was that Tunisia had three major sources of export earnings that were largely independent of the highly protected domestic economy and therefore not impeded by its reliance on import substitution.

- An export processing zone (EPZ) arrangement for individual enterprises, the so-called "off-shore" sector, offered total exemption from taxes and simplified customs procedures for enterprises that exported all their output. The purpose was to encourage investment in exports of manufactures and to attract foreign direct investments, in both of which it has been moderately successful up to now.

- Oil exports earnings rose in the late 1970s and at their peak in 1980 accounted for 38% of exports of goods and non factor services. Tunisia, nevertheless, remained a minor exporter in the world oil markets.

- Tourism began to grow in the 1970s and became a major export. At present it accounts for about 17% of imports.

1.8. The third reason has been the emphasis on social development ever since independence. The education system expanded to allow almost every child to enter primary school, though it is highly selective after that. A social security system covers employees in larger enterprises and government, while free health care is available to almost all citizens. In addition there is a system of relief for the very poor. More doubtful in their long-term effects have been the extensive subsidies of food and agricultural inputs, which the Government has since narrowed to subsidies targeted on qualities of foods consumed primarily by the poor, and labor policies that made dismissals difficult and prevented wage flexibility, which the Government is at present trying to reform.

The Period of Economic Reform: 1986 to the Present

1.9. The balance of payments difficulties of 1986 brought out how much Tunisia's future depended on non-oil exports. The immediate cause was a misjudgment that oil prices would resume the trend of the 1970s, although they had been weakening since 1980. The loss of export earnings from the decline in oil prices, combined with a decline in extraction because of the depletion of Tunisia's reserves (which had been foreseen) was large: in current dollar terms by 1986 the earnings were $919 million less than in 1980 (equivalent to 10% of GDP in 1986). But domestic expenditures had continued at high levels; fixed investment, mainly in the public sector, had risen to around 30% of GDP in 1980 and stayed at that level up to 1986, while continued high budget expenditures kept the budget deficit fluctuating around 6% of GDP. By 1986 it was clear that oil prices were not likely to recover soon and the deficit

on the current account was threatening to become unfinanceable, especially as the world debt crisis had begun.

1.10. The economy recovered quickly once stabilization measures were implemented because rapid growth of manufactured exports and tourism quickly compensated for the loss of earnings from oil. Investment by the public sector was sharply curtailed, and, with restraint on Government wages, a reduction in the budget deficit, and a tightening of credit, the current account deficit fell to 0.9% of GDP in 1987 and was even in surplus in 1988. Exports of manufactures accelerated in the wake of a devaluation by 10% in August 1986. They had been sluggish in the preceding years, mainly because there had been a rapid rise in real wages, beginning in the late 1970s, and the real effective depreciation of the dinar of less 1% year had not been enough to offset it.

1.11. Since then there has been an overall improvement in the economy's performance. (See Table 3). On the one hand macroeconomic balances have been healthier. On the other, GDP growth has been slightly higher and robust enough to remain positive through shocks, such as droughts in 1988 and 1989 and the Gulf crisis, whereas similar shocks had caused declines in previous years. Much of this robustness was due to the growth of manufactured exports, which averaged 10% p.a. from 1986-93. Tourism also benefited from a diversion of tourists from the Balkans and the opening up of new European markets, in particular the newly federated states of Germany. A sign of improved overall economic efficiency, and fundamental to the improved balance of payments, has been a fall in fixed investment to around 23%, as compared to around 30% before 1986.

Table 3: SECTORAL SHARES IN GDP AND GROWTH RATES

	Shares in %	Growth in % p.a.	
	1993	1980-86	1986-93
Agriculture	16.2	2.2	4.6
Industry	30.4	3.0	3.8
Manufacturing	17.3	6.6	6.2
Non-Manufacturing	13.2	0.5	1.5
Services	39.5	13.0	5.6
Tourism	4.6	0.9	8.0

Source: Ministry of Planning and Regional Development

1.12. The reforms begun in 1986 can be broadly classified as liberalization and measures to improve the functioning of markets. Liberalization has covered, among other things, import restrictions, price controls, investment and credit authorizations, and most interest rates. The only remaining administrative constraint on domestic interest rates is on tax advantaged time deposits; a cap of three percentage points on each bank's average lending spread over the one-week interest rate was removed in mid-1994. At the end of 1992 the Government announced that all current account transactions, along

with repatriations of dividends and investments by foreign investors, were being liberalized. Recently a limited inter-bank foreign exchange market has been authorized. Further market liberalization has been to allow the private sector freely into a range of activities from which it had either been excluded, such as distribution of fertilizers and some other agricultural inputs, or where entry had been restricted, such as wholesaling.

1.13. Reforms to ensure the correct functioning of markets have covered a wide terrain. Direct and indirect taxation had consisted of numerous taxes and modifications that had agglomerated over time and had become inefficient, unfair, and complicated. They have been replaced by simple value-added and direct taxes with moderate rates. The normal corporate tax is 35%, for wholly exporting enterprises it is 17.5%, and for agriculture it is 10%. Dividends are not taxed and the highest personal income tax rate is 35%. Reforms of stamp duties and registration fees and of local taxation are being implemented. The tax reforms have permitted reform of the numerous special tax incentives available under the sectoral investment codes and under laws governing financial markets. A unified investment code is being promulgated and will accord less generous tax advantages according to "horizontal" criteria, e.g., exports, acquisition of technology, and regional development, rather than on a sectoral basis. Certain tax advantages, associated with financial instruments, that prevented the development of markets have been removed. The liberalization of banking has been followed up by the strengthening of prudential regulations and revision of banking legislation to bring it into conformity with market mechanisms.

Trends in Growth and Income

1.14. Since the reforms began the economy has overcome the loss of income from oil exports that had prompted the reforms, mainly by doing more of what it had been doing before rather than by doing something new. The main trends of the 1970s and early 1980s have continued, the most important changes having been declines of oil and phosphates, which had begun around 1980. Consequently the main changes in the sectoral composition of GDP has been a decline in the share of non-manufacturing industry, of which oil and phosphate extraction were major parts, and a smaller rise in the share of manufacturing, which has maintained relatively high growth rates. Much the greater part of the decline of industry's share in GDP has been taken up by the services sector, whereas the share of agriculture has remained stable.

CHAPTER II. THE PRIVATE SECTOR

A. AVENUES FOR FUTURE GROWTH

2.1 But doing what it has been doing before will not suffice for the economy's future. What have been its main sources of growth up to now face serious constraints.

- Tourism is vulnerable to regional disturbances. This has been repeatedly demonstrated, most recently by the Gulf war, when it fell by 25%. It will also be limited by Tunisia's fragile ecology.

- Agriculture will be constrained by the availability of soil and water, although it accounts for 10-13% of exports and, allowing for its relatively low use of traded inputs, its contribution to net foreign exchange earnings is much higher.

- Import substitution is limited by the size of the market, which would pose problems of scale for the production of consumer durable and capital goods

- Hydrocarbons are not expected to regain any of their former share in total export earnings since world prices are not expected to rise significantly in the foreseeable future and, despite recent openings of gas fields, ouput will continue to decline as reserves are depleted.

2.2 The Government has formulated its own view of the economy's future, taking into account these constraints. It envisages Tunisia as an outward oriented economy, with exports of manufactures as the main source of growth. As a manufacturing and services base directed to the European market, it would attract foreign investment, which it seeks primarily for technical and managerial know-how and for market access. The Government also intends to maintain its emphasis on social welfare, especially on ensuring that the benefits of economic progress are spread across the population. As the experience of the most successful Asian economies shows, these objectives can - and should - be mutually reinforcing. But success in exporting comes first. For East Asia it gave rise to the inflow of foreign investment and to a rapid rise in the earnings of labor.

2.3 For Tunisia the necessary improvement in export performance, particularly of manufactures, can only be assured through product diversification, which implies higher technological content and upgrading of quality. At present 50-60% of manufactured exports consist of textiles (taken here to comprise textiles, clothing and footwear), whose future growth will be limited by trade restrictions and competition. About 80% go to Europe under a system of quotas administered through voluntary export restraints and, even though these quotas have not yet been a serious constraint, they could easily become binding as the former centrally planned economies of Europe try to gain market shares. Quotas are, nonetheless, preferable for Tunisian producers to unbridled competition since they exist because of the restraints imposed on Asian exporters by the Multi-Fiber Agreement (MFA). Were the MFA to be discarded or weakened, as agreed under the Uruguay Round of trade negotiations, Tunisia and some other Mediterranean exporters could face competition from Asian producers of higher quality products, who sometimes pay lower wages.

2.4 There is also scope for diversification of exports of services. Tunisia is well endowed with a wide range of technical and professional skills, thanks to its own education policies and to the training and experience many Tunisians have acquired abroad. One export of skilled services that is occurring is consulting services provided by Tunisians in various countries. Another possibility might be to provide certain forms of health care to Europeans in Tunisian hospitals and clinics, where the price advantage might be considerable. This can be linked to a potential off-shoot of tourism, retirement centers for Europeans. Tunisia's advantages of climate, amenities, and communications are obvious, but it might also benefit from the skills of many retired people, who are often glad to remain partly active. In due course financial and commercial services, especially provided by international companies, will become important; but it is unlikely that this will happen before there has been a strong and sustained performance in exporting manufactures and other service. Before that efforts to attract off-shore financial services, for example, could merely result in post-box offices.

2.5 Moreover, both growth and diversification of exports have weakened after 1990 (see Table 4).

- The growth of textile exports has been lower than it was in the late 1980s.
- Electrical and mechanical exports, which had risen to 10% of the exports of manufactured and agricultural goods in 1989, only grew at an annual average of 3.7%.
- "Other" manufactures, which does not include phosphatic chemicals, declined to less than 60% of their volume in 1989.
- Phosphatic chemicals have been stagnating both because of a trend in Europe away from phosphate fertilizers and because Tunisia's own ores are marginally competitive.

Table 4 : GROWTH OF EXPORTS:1986-93
(in % p.a.)

	1986	1987	1988	1989	1990	1991	1992	1993
Total	5.2	13.4	21.4	5.0	1.0	-3.0	11.5	4.8
Total Goods	11.7	5.8	6.9	20.0	1.4	3.0	6.0	1.6
Manufactures	13.1	13.9	13.9	19.1	10.5	3.4	3.9	5.0
Agro-Industrial	-7.7	21.5	-2.0	1.9	14.9	38.7	-24.5	21.5
Textiles	9.4	8.7	11.2	21.7	26.3	4.4	9.6	7.2
Chemicals	19.8	13.2	9.3	1.7	-11.4	-3.9	9.5	-9.8
Electr.-Mechanic.	26.0	11.0	26.5	11.1	43.2	5.9	-1.6	7.1
Other	9.8	52.2	48.3	93.3	-11.7	-6.3	-1.7	15.9
Primaries	10.3	-3.3	-2.4	21.4	-12.6	2.1	10.3	-4.8
Tourism	-5.4	39.3	83.9	-25.2	-10.5	-30.0	53.0	7.3

Source: Ministry of Planning and Regional Development

B. THE PRESENT AND FUTURE ROLES

Private and Public Sector Shares

2.6 The policies that the Government adopted in the early 1970s resulted in the private sector becoming predominant in almost all sectors, though the public sector remained significant everywhere. Table 5 probably understates the shares of the private sector because it was based on a sample that is biased towards larger firms and, hence, gives too much weight to public enterprises.

Table 5: SHARE OF PRIVATE SECTOR IN PRODUCTION (%)

	1983	1986	1988
Agriculture & Fishing	95	94	94
Industry	57	55	55
Manufacturing	62	67	62
Non-Manufacturing	50	44	41
Services (excl. Government)	62	60	60
Tourism	92	92	92

Source: INS

2.7 Since 1988 the private sector's predominance has increased. Few enterprises or agencies in the public sector have grown and many have shrunk. The reduction of jobs in the phosphates sector alone has probably been a multiple of the public sector jobs created outside government. The public sector has also let private firms take over numerous activities and there has been a modest amount of privatization. But no figures are available that permit a comparison of the present size of the public sector to compare with its size in 1988, because the definition of a public enterprise was changed in 1989 and restricted the term to about 230 enterprises in which the State had a majority share. The administrative consequence was to give managerial autonomy to some 400 enterprises in which the private sector's shareholding was a minority, although the State's direct holding was also a minority, by releasing them from the supervision of their sector ministries. But it also had the effect of separating the data on these enterprises from those of properly private firms.

2.8 The Industrial Promotion Agency lists 5,661 industrial enterprises. This does not include agro-industry, which comes under the Ministry of Agriculture, of which there are about 3,500. A breakdown by activity is given in Table 6.

Table 6: INDUSTRIAL ENTERPRISES

	No. of Enterprises	Employment
Industrial Enterprises (as of 1994) 1/		
Electrical, Mechanical, and Metal working	965	33,863
Construction materials, Ceramics, and Glass	557	20,911
Chemicals and Rubber	298	9,297
Textile, Leather, and Shoes	2,654	120,998
Other	1,187	21,759
Total	5,661	206,828
Agro-Industrial Enterprises (as of 1992) 2/		
Sugar, milk, and products	77	
Oils and fats	1,209	
Cereals and products	1,920	
Canning, Beverages, Wine	189	
Cold storage	120	
Other	52	
Total	3,567	

1. Source: API
2. Source: Ministry of Planning and Regional Development

2.9 Power consumption data reveal how medium and large enterprises have been growing. Diagram 1 gives the growth of the number of enterprises with medium voltage connections, their power consumption, and the value added by sector. (There are 12 high voltage consumers, public enterprises in phosphates, cement, metallurgy, cellulose, and transport.) The growth of textiles and tourism stand out. Excluding "agriculture and pumping", the number of medium voltage connections has been growing at an annual average of 4.2% since 1986. The diagram also shows that power consumption per enterprise has been rising in all sectors, except chemicals and mining. This rise confirms the national accounts data, which show output per enterprise rising. In part it can be attributed to improvement in the balance of payments and import liberalization after 1986, which eased input supplies and allowed higher capacity utilization, in contrast to the years 1980-86, when the number of enterprises grew faster, at 8.6% p.a., but power consumption and output per enterprise declined.

2.10 The public sector dominates in the utilities, in the extraction and processing of certain minerals, and some forms of transport. In all of these it is allowing the private sector a growing role. Telephone services, potable water, waste disposal, and electric power are supplied by public enterprises, hydrocarbons are extracted by major foreign companies, but the Tunisian partners and the distribution system are in the public sector. It is unlikely that the private sector would take over the phosphates sector, which has been in difficulties because of the low grade of the ores and unfavorable world prices, but it probably would be interested in the cement plants, which the Government is preparing to privatize. Otherwise minerals are largely exploited by private firms.

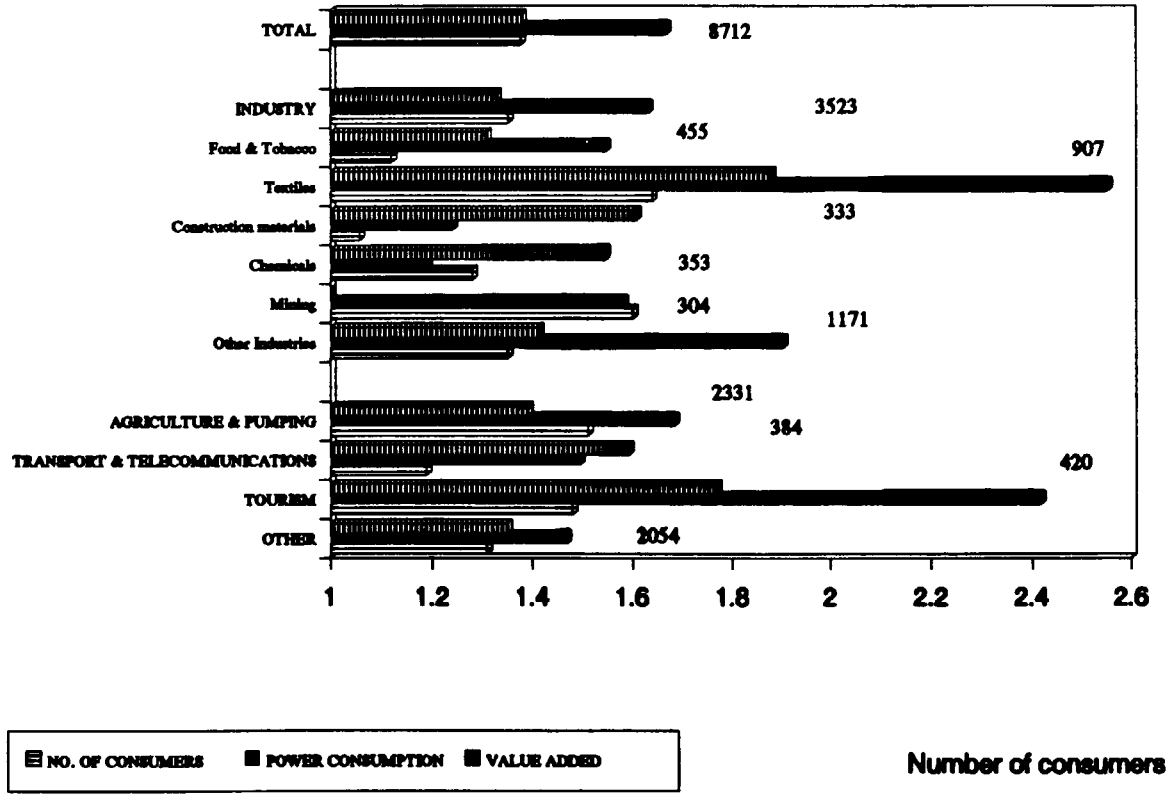
Share of GDP in 1993

29.8
3.3
5.6
2.4
1.0
5.8
11.7

16.8
7.4
4.6
48.6

Diagram I

MEDIUM & HIGH VOLTAGE POWER CONSUMPTION & VALUE ADDED BY SECTOR: INCREASE FROM 1986 TO 1993 (1993/1986) AND NUMBER OF CONSUMERS IN 1993



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2.11 Public transport remains mostly in the public sector. The public sector monopoly on interurban road transport of merchandise has been removed and the private sector's share is growing fast. But interurban passenger transport, except taxis, and the railway system are public. Private air services and new private shipping lines have been allowed to open, though the national shipping line is in the public sector and has right of first refusal on some types of cargo.

2.12 Financial sector institutions are mostly in the public sector, but the sector is evolving rapidly and the change is mainly in the private sector. Out of 20 banks, the public sector controls 14 accounting for roughly 70% of banking assets, though it is a minority shareholder in some of them. All the social insurance system and a majority of the insurance industry are public. Private activity, including foreign direct investments, does not face special constraints and generates nearly all the growth of the sector; diversification and creation of new institutions are entirely private.

More Responsibilities with More Freedom

2.13 Successful outward orientation of the economy goes hand in hand with changes in entrepreneurial practices and management of enterprises. Faster growth and diversification of exports, to be sustained, require that enterprises break out of the mould of the past and adopt practices that make them more competitive. Some of the characteristics of Tunisian private firms, notably in industry, that need to evolve are outlined below. Many firms will not share some or any of them, but they are representative enough to be of interest to policy makers and leaders of the private sector.

2.14 Changing these characteristics is mainly the task of the market. The private sector acquired its characteristics as a result of the incentives and constraints under which it developed. If these are suitably changed, the enterprises themselves will address their weaknesses. For the Government the issue is how effectively and quickly the sector will adjust, if these changes are made, so as to become more competitive on international markets. The best assurance is that Tunisia's private sector has two crucial strengths. One is an abundance of entrepreneurship, which enabled it to avoid stagnation and balance of payments problems in recent years. The other is the relatively high levels of education and training, despite some important gaps. Enterprises will need substantial technical assistance and many complex issues will need to be analyzed by the authorities and the private sector, but the aim should be to ensure that the incentives and constraints induce enterprises to make economically effective choices.

2.15 Instead of trying to help enterprises adjust by providing more subsidized services and special programs of assistance, the Government should aim to transfer to the private sector a greater share in the provision and cost of services that have, up to now, been provided by the public sector, sometimes for little or no payment. In Tunisia, as in other countries where the private sector has had to progress from infancy to international competitiveness in one generation, the dependence on the public sector covers a wide range of services, such as those provided by the technical centres, export promotion agencies, and public sector data bases. In most countries the private sector's role in supplying such services has been increasing, partly because the private sectors, themselves, have evolved and can assume broader responsibilities and partly because this is often the best way to meet the more exacting requirements, in terms of product specificity, quality, and timeliness, that firms impose as production grows more complex and competition more intense. As a rule, charging for a service reveals whether or not there is a need for it. Often an agency is active in providing a service and creates an

illusion of demand for it, but finds that the demand vanishes when there is a charge. In such a case, it is doubtful that the service met a real need. Subsidies of services provided by public sector agencies also hinder the private sector from providing competing services, even though they may be better and cost less to the economy.

2.16 The experience of developed and rapidly growing economies is that the production of common goods (which can be used independently by several users) and goods with externalities may best met through some form of association of suppliers with users that better enables the former to discern and respond to the latters' needs. It is dangerous to generalize further. The forms of association vary according to the good and the country, and they evolve. The users may, themselves, be the suppliers or a supplier may be a public sector agency that keeps in close touch with the users. Various forms of cooperative arrangements among enterprises or between groups of enterprises and the public sector have been successful. The same type of product may be supplied in more than one way; thus technical training is successfully provided in all these forms, sometimes in the same country. Cooperative ventures of groups of enterprises, often with state backing, have helped countries assimilate difficult technology (and have failed in others).

2.17 Changes of regulations are needed in several areas to allow the private sector greater freedom. Some initial steps have been taken in these areas, but regulations are still too restrictive for an effective private sector response. For instance, to solve the long-standing problem of the management of industrial estates, the responsibility has been transferred to the occupants of the estates, but on a non-profit basis and subject to a number of administrative controls. The initial results appear not to have been a success. There is no reason why the development and management of industrial estates should not be left to the private sector for profit, as in most countries. The regulations need to be designed to make this efficient. Similarly, the regulatory and legal frameworks can be lightened to allow markets to function more efficiently and to attain the Government's economic and social objectives in other areas, among them being employment and wages, insurance, transport, technical training, land titling, housing, and wholesale of agricultural produce. A comprehensive guide to such reforms is beyond the scope of this report, which only outlines a few of the possibilities.

C. SOME CHARACTERISTICS OF PRIVATE FIRMS

Ownership, Control, and Size

2.18 Enterprises tend to be owned by families and groups. Partners from outside are almost invariably banks that provide finance in the form of equity but have little say in the management, or foreign partners who bring technology. Thus no non-financial enterprise has voting stock quoted on the stock market (*Bourse*). In the early development of a private sector this is hard to avoid since markets for capital and for technical and managerial skills are little developed, so that personal acquaintance and trust are essential. Protection may have fostered family ownership by encouraging a wider range of people to invest in starting new enterprises, which would have tended to be family ventures. The Government also had programs to encourage new and small entrepreneurs.

2.19 This pattern of ownership is associated with a preference for close control over the firm by the owners, which is often an obstacle to the growth of the firm. Financing is limited to own resources and bank loans; the first issue of stock (non-voting) on the *Bourse* by a private firm was in July 1994. Often the founding entrepreneurs who made an enterprise successful have difficulty in becoming managers or delegating to professional managers, a classic problem of success in developed countries. There have been cases of technically

progressive enterprises turning down or delaying export orders rather than expand beyond what the owner could control. Possibly the most serious drawback with small firms is that their operations have been narrow and that the owners frequently lack the technical or business background for branching out.

2.20 Private enterprises tend to be small. The average employment of the industrial enterprises listed by the API was about 35. Agro-industrial enterprises are nearly all much smaller. According to the survey data of the INS, 72% of manufacturing enterprises have fewer than 50 employees, and the true proportion is probably higher since the firms omitted from the survey tend to be smaller. Protection has made it easier for firms to remain small even when being bigger might have advantages, as is indicated by comparing the domestic and off-shore enterprises in textiles: the median size of domestic enterprises is about 30 employees and that of off-shore enterprises over 100.

Technology, Quality, and Marketing

2.21 The technology in Tunisian enterprises is, on the whole, simple, the reason being, it seems, the structure of incentives rather than shortages of trained or trainable workers. Import substitution encouraged investment in the simplest activities first, while the off-shore sector attracted principally investment seeking low-cost unskilled labour and tax advantages. (These questions are discussed in Chapter V.) The changing of the incentives structure appears to have stimulated many firms to upgrade their products and production lines in recent years, to gain access to better technology through investment partnerships and subcontracting relations with foreign firms, and to move from assembly to manufacture. But these are the more progressive firms. Some indications of the general technical level of enterprises are that there appears to be no enterprise with technical staff and laboratory devoted full-time to monitoring technical developments in its specialties or to product development. Only a few large firms even have laboratories. A high proportion of firms making electrical or mechanical goods have only a single product line or model.

2.22 The low degree of competition has permitted the quality of products for the domestic market to remain, as a rule, below international standards. Consequently firms are often not equipped or managed so as to compete on quality, but rely on occupying market niches. This is reflected in the management and organisation of enterprises. They frequently need more shopfloor technical and management personnel to remove inefficiencies in production lines, reduce interruptions, and lower rejection rates of finished goods. To respond to the consumer pressure for better quality that arises from competition, and which is often linked to demand for more varied models, enterprises need either to have their own capabilities for designing and testing products or to contract such work out to specialized firms. In either case the management of production, sales, and market research need to aim for quality standards set as the firm's objective.

2.23 Firms tend to be ill equipped for winning and holding markets. Protection placed the on-shore enterprises, as a rule, in a seller's market in which they could expect customers to present themselves. Just as market niches have warded off pressure on many firms to raise quality, they have given firms quasi-monopolies. Consequently the sales departments of most are mainly concerned with administrative tasks of delivery, billing, and management of stocks, as opposed to prospecting for new customers, detecting new product opportunities, or promotion. The off-shore firm faces competition as an exporter, but it has analogous weaknesses since it is often linked to a foreign firm and simply responds to that firm's requirements.

2.24 Industrial enterprises obtain few of their inputs, other than raw materials, locally. This is again a common effect of industrialization behind high protection and is discussed further in Chapter IV. Highly

protected domestic suppliers are unlikely to be internationally competitive, and even if they are, they may be at a disadvantage in supplying exporters on internationally competitive terms because the procedures for customs and for reimbursement of indirect taxes, if they exist, may be cumbersome. Greater integration of the export economy into the domestic economy has long been an objective of the Government; two prerequisites are that these procedures be quick and simple and that there be pressure on potential domestic suppliers to become competitive.

Jobs and Productivity

2.25 If strikes and lock-outs are taken as the measure, labour relations in Tunisia compare favorably with most countries. The performance of the economy has helped by limiting unemployment and giving prospects for jobs in the future. Moreover, the extensive social protection system has lessened some of the hardships arising from unemployment or low earnings, while the Government has enough influence, through the public sector and the trades unions movement, to guide wage movements. But, equally important, strikes and lock-outs must be preceded by arbitration procedures, which can impose decisions, otherwise they are illegal.

2.26 Nevertheless, relations between employers and employees and wage determination are beset with problems that reduce productivity and, in the long run, slow the growth of earnings of employees and job creation. If they are not solved, there is a danger that wages will be kept down to encourage investment and compensate for low productivity and that the conditions that hinder productivity growth will be perpetuated. Much of the potential for growth arising from the solid basis of the education and training system will be lost. The average wage in Tunisia has barely stayed constant in real terms, whereas one of the encouraging effects of rapid export growth in East Asian economies has been to increase the hourly earnings of the bulk of the employed, as well as to generate jobs.

2.27 A major obstacle to higher productivity has been the difficulties of maintaining labour discipline. The Government modified the labour code, the basic legislation governing employment, in February 1994 to allow dismissal for certain offenses. Up to then dismissals were rare and costly to the employer. They required cumbersome procedures and decisions by labour courts, which employers claim rarely ruled in their favor, while the penalties for wrongful dismissal that could ensue were severe. Laziness and absenteeism were consequently difficult to punish by dismissal and the rate of absenteeism in Tunisia is high. According to a survey by the Foreign Investment Advisory Service of off-shore firms in 1991, absenteeism was 15-20%. The modifications to the labour code put laziness, absenteeism, and refusal to follow legitimate instructions among the grounds for dismissal. But they still rely on the decisions of the labour courts, following thorough investigation, and their effect will be decided by how the courts apply them.

2.28 Dismissal of employees as a measure to cut costs or to change the skills mix of the firm's workforce also requires authorization, which is not granted easily, and entails substantial severance payments. In effect, firms are being made to carry the cost of the lack of unemployment insurance. The cost is that firms often carry redundant employees and are prevented from restructuring to meet external competition.

2.29 Productivity growth is also impeded by the rigid wage structure, which prevents closely linking base wages and bonuses to performance. Apart from the primary effect of weakening the incentive to individuals and groups to perform their routine work well, they reduce the incentive to workers to adapt to changes, in particular to modify their skills as products and equipment change, and hence obstruct the competitivity of the enterprise. Improvements originating from the initiative of employees, both on the shopfloor and throughout the

other parts of an enterprise, raise its productivity substantially, but they depend on having a system of rewards reliably linked to results.

Restructuring

2.30 Many enterprises need to improve their products and upgrade their production lines. Such restructuring is needed not only by those that were highly protected, but also by some exporters. In an ideally functioning market the financing is available when such restructuring is economically viable, otherwise the enterprise closes. But there are several reasons why a potentially viable firm may not be obtain financing for restructuring and that make it difficult to determine whether or not the firm is indeed potentially viable.

2.31 The first is that the viability of the enterprise depends as much on the problems of entrepreneurship, management, and organisation discussed here as on the physical characteristics of the equipment and products. But the owners frequently lack the capabilities for putting together a program to solve their problems that would convince bankers -- if they had the capabilities they would most likely not be in the same difficulties. A case may be made for providing assistance to enterprises in the form of diagnostics and formulation of restructuring and training plans that could be presented to potential sources of financing, e.g. banks or investors.

2.32 Second, banks may be deterred by problems of collateral and arrears on bank loans. Land can often not be used as collateral because only a small proportion of titles are formally fully in order, although ownership may be unquestioned legally and in practice. (The issue of land titles is discussed in Chapter VI, Section D). Plant, machinery, and rolling stock can not be used as collateral (one reason that banks are setting up leasing companies). Many enterprises are in arrears on their payments to banks because of difficulties in recent years: the Gulf war and the recession that followed in Europe have been hard on a number of exporters, and some enterprises have been hurt by liberalization of imports. If banks were to finance restructuring of these enterprises they would usually need to restructure their debt as well, whereas the owners of the enterprises might not be able to put up fresh capital. The solution would normally be to issue equity, either to the banks or to potential partners. But banks have not yet acquired the staff needed to sit on the boards of enterprises, monitor the management, who are usually the owners, and ensure that they gain full access to the information. They are also likely to prefer not to add to the burdens they have with some of their present equity holdings. The alternative of ceding equity to a partner not closely linked to the owners but able to provide financing, and possibly know-how, seems to be rarely accepted and such partners may be difficult to find.

2.33 The effect of bankruptcy legislation is not clear and needs to be elucidated. The current legislation give debtors weak protection against creditors (see Chapter VI , Section C). On the face of it, bankers have a strong threat to make debtors pay and, with the removal in 1992 of the stamp duty for taking a case to court, 8% of the claimed amount, they seem to take legal action quicker. They are also under greater pressure to do so because of the new prudential regulations. Often a threat is enough; many debtors fell in arrears on their loans because the banks did not seem willing to go to court. But a banker may not have an interest in forcing a bankruptcy and yet may be unable to work out an accommodation with a debtor, especially if other creditors are involved. It is not clear how banks and enterprises behave under such circumstances.

2.34 Finally, banks need to be persuaded that a restructuring program can be implemented. A major difficulty is to lay off labour. Restructuring almost always entails reductions in employment and changes in the skills mix. Without a reasonable assurance of being able to take the actions when needed, potential financiers, even an enterprise owner with abundant own resources, will not commit money. Even then the enterprise would need to bear the cost of severance pay, in other words to bear the cost of the safety net that is missing from the social protection system.

2.35 These are issues for which enterprises and banks could probably in collaboration devise mutually acceptable remedies to implement themselves or to propose to the authorities if administrative or legislative measures are needed. Banks also do not want their clients to be in difficulties. Yet dialogue between enterprises and banks has been limited to individual borrower-lender relations. Arrangements for a dialogue to address such issues, and others that may exist, could be either a working group, comprising representatives of both sides, with a specific mandate, or a permanent joint commission for identifying and resolving issues.

P A R T 2: POLICIES FOR THE FUTURE

CHAPTER III: DEVELOPING FINANCIAL INSTITUTIONS

3.1. Extensive reforms of banking and capital markets are causing the financial sector to evolve rapidly. A sound, modern banking system is emerging from the simple, narrow system of a few years ago, while *Bourse* is becoming more active as public interest in it grows. The future development of the financial sector will hinge on the public sector transferring more of its activities to the private sector. The public sector should end its predominance in banking through progressive divestiture. It could also be the main source of equity on the market through privatizations, at least until the economy's evolution results in private firms resorting regularly to the stock market for capital. The Treasury will, for the foreseeable future, be the main issuer of bonds and needs to adopt practices that allow the secondary market to develop. Demand for such securities is growing both among private savers and on the periphery of the financial market, i.e. among the social security funds and insurance companies. The roles of these institutions will change in the coming years; to prevent unsustainable deficits and to meet the demand for a wider range of services, part of the social protection provided by the social security funds will migrate to privately managed accounts. A precondition is that the insurance industry have an up-to-date regulatory framework and that the companies be sound, which will again require removing the public sector's predominance, as well as restructuring.

A. BANKING

Reform and Evolution of the Market

3.2. Before the reforms began in 1987, the financial sector's principal function was to channel financial resources according to the priorities of the Government. The sector was correspondingly narrow: the only significant instruments for financing enterprises, apart from own resources, were bank loans and budgetary funds, and all but the smallest loans needed prior authorization. Deposit banks could lend for up to seven years and had the obligation to place up to 20% of their deposits in *Bons d'équipement*, ten year treasury bonds with low yields. Development banks did not take deposits and only lent long term. Both types of banks could hold equity. Issues of equity to the general public were limited to a handful of public sector institutions, and the stock market, the *Bourse*, was moribund. Only on the rare occasions that the Government or certain development banks issued bonds to the public did the ordinary saver have an alternative to deposits with banks or the postal savings system, which kept its deposits with the treasury. These instruments were, nevertheless, usually attractive to savers because they carried tax advantages, though the distortions that arose ensured that secondary markets in equity or bonds could not develop.

3.3. Liberalization of the supervisory framework and legislation governing banking has, among other things, removed authorization requirements for loans, controls on interest rates, and the obligation to finance the treasury. Prudential regulations were revised in 1991 to include more stringent rules for loan classification and interest suspension. The Central Bank's powers and responsibilities as the body responsible for regulating the banking sector have been made clearer and stronger; a banking council has been created for dealing with serious offenses; and the conditions and qualifications for the creation, ownership, and management of banks have been defined. The Central Bank's own capacities for supervising and inspecting banks have been reorganized and strengthened.

3.4. These measures are enabling the market to develop. In addition to the deposit banks, of which there are now twelve and which are in effect universal banks, and eight development banks, the regulations recognize investment banks, of which two or three are being established, and leasing companies, of which there are already six. Reform of the stock market and of the taxation of financial instruments have increased activity on the *Bourse* and aroused the public's interest in investing in equity and bonds. The demand for equity is being met mainly from privatizations since there is still little supply from the private sector, but flotations of bonds by private firms have been successful. Open and closed end mutual funds are relative newcomers and are proving popular.

3.5. The revised prudential regulations gave, for the first time, a reliable picture of the condition of the banking system. It roughly confirmed what had been thought, that a number of banks, notably public sector deposit banks, had major portfolio problems, but financial stability was not endangered. Almost all the private deposit banks and all but one of the development banks meet the capital adequacy ratio of 5%, which is close to the BIS recommendation of 4% for Tier 1 capital (the difference being that the Tunisian definition of capital includes general provisions). Of these, the ones that do not should have no difficulty in meeting the ratio soon through provisioning or raising equity.

The Public Sector in Banking: Preparing for Change

3.6. The public sector controls banks accounting for 70% of banking assets, a predominance inconsistent with the private sector orientation of the economy. However, reducing this predominance will take time. The public sector deposit banks have major managerial and portfolio problems, so it is unlikely that they can be privatized in the near future. Their portfolio problems are in large part classified loans to and equity in enterprises in the public sector and must be solved by privatizing, reforming, and closing these enterprises. Since many of these enterprises are not classified as public, no aggregate figure is available, and few loans have government guarantees. The management and staffing problems of these banks will also take time to overcome. All of them are implementing programs to install up-to-date internal management and control structures, as well as to retrain staff. But all of them face the problems of difficulty in laying off personnel and, in addition, they are hindered in linking pay to performance because their pay scales are determined by civil service scales.

3.7. The problem of the development banks is that, to be effective in the liberalized financial sector, they need to find new roles. Since they do not take deposits and only lend long term at fixed interest rates, they are more like funds than banks. They do not have the banker's advantage of being able to withdraw funds if dissatisfied with the management or market prospects of an enterprise. Consequently, some are not organized like banks, have insufficient expertise to evaluate investment risks or to assert themselves on the boards of enterprises, and have small staffs. Not being under the pressures of the past to invest in projects favored by the authorities, they place much of their money on the money market or in government paper at little risk and good returns. This is rational, given their constraints, but it implies that the substantial capital with which they were endowed is being invested by others.

3.8. Although the State's exit from ownership and control of banks cannot be an objective for the short term, it should be an objective for the longer term, which means that certain steps should be taken now. One step is to implement a program for reducing arrears on the debt of public enterprises to banks, notably through privatizations, including that of enterprises not officially classified as public. (The issue is discussed further in Chapter VI, Section A) A second necessary step is to provide the public sector deposit banks with fresh capital. But, unless there is a corresponding transfer of control to the private sector, the capital should not be raised from

the general public through equity issues. Otherwise the banks would be taking the risky course of creating expectations while shielded by lenient disclosure rules and before their portfolio and management problems have been overcome. If they did not become quickly profitable and competitive enough to stay profitable, they would either disappoint expectations or be forced to pay dividends while making losses. Such "fictitious" dividends have been paid by banks before, but if they were to grow they could become obstacles to the banks' future soundness. The third step is to find new roles for the development banks, which are all controlled by the State. Some of these banks are investigating new roles for themselves, but in the cases of the five bilateral banks that were set up in partnership with Arab OPEC countries, the Government needs to explore the alternatives with these partners.

3.9. Where the public sector could add to the diversity and competition in banking is in developing the postal saving system, the *Caisse d'Epargne Nationale Tunisienne*, CENT. Judging by the experience of countries as diverse as France, Germany and Japan, it could be made into a major source of financial saving and provider of services to households and small enterprises, especially in rural areas. Operating through 900 post offices around the country, its network is unrivalled; about one million people have CENT passbooks. The postal system has also the capability to effect large numbers of financial transactions: it provides the cheque clearing system of the banks and all employees of the central government and local authorities (about 300,000 persons) are paid through postal checking accounts. The CENT has been losing market share to the banks because its accounts have been subject to greater restrictions than the savings accounts of banks, because its deposits have been used exclusively to finance the Treasury, and because it has been limited to accepting deposits and does not provide other services. It has its own niche and, given greater autonomy, it could become the major financial institution for lower income households.

B. THE CAPITAL MARKETS

3.10. The equity market is still minute because largely because the private sector has been reluctant to use it to raise capital and the public sector has only once used it to privatize a firm. The demand for equity as an investment is, however, strong. Turnover of equity on the secondary market was only TD 98 million in the first half of 1994. Compared to countries classified as emerging markets by the IFC, Tunisia's ratio of capitalization to GDP is one-tenth that of the lowest figure in that group. Although all equity transactions, even between family members, must pass through the *Bourse*, only twenty companies, including ten banks and a leasing company, are listed and traded on the secondary market *(côte permanente)*.

3.11. The generally accepted view in Tunisia is that there is pent-up demand for equity, and it is supported by evidence. Recent issues to the general public of shares in public enterprises that were being privatized were highly successful; their prices even rose well above the blocks of shares that had been sold earlier to groups of investors with the aim of giving them simultaneously control over and major stakes in the enterprises. Moreover, turnover has been increasing rapidly over the last year, largely because of the popularity of the open-end mutual fund, of which there were 10 in mid-1994, with a total capital of TD240 million, whereas none existed in 1991. The average monthly trading in the first half of 1994 was roughly the same as the trading in the whold first half of 1993. Although excessive expectations may have been aroused by the spate of economic reforms in recent years, real returns on equity have been higher than on alternative financial instruments, and dividends are not taxed.

3.12. But supply has grown slowly. In both the private and the public sectors the main obstacles to the issue of equity have been the reluctance to lose control and the need for disclosure. In the case of private

firms this reflects the tendency for firms to be controlled by families and small groups. None of the equity of the private firms listed on the *Bourse* has voting rights. Similarly, the public enterprises that have issued equity remain under public sector control, although the majority of shares in some cases are held by individuals -- and widely dispersed. Such equity issues by public enterprises can be costly, since the returns to shareholders are kept high to maintain confidence, even when the enterprise paying the dividends is making losses. The reluctance of the public sector to cede control seems also to have hindered privatization from fulfilling its promise as a source of equity. Of the 43 cases of privatization up to mid-1994, only one has resulted in the issue of equity to the public.

3.13. Owners of enterprises will become more willing to raise capital through equity issues as the economy evolves, especially as they feel the need for expansion. Among the many factors that may influence the private sector's willingness to raise capital through the stock market, the outward orientation of the economy is likely to be prominent, since international competition will increase the need in some enterprises to expand and upgrade their production and products and, consequently, to rely increasingly on hired managerial and technical staff outside their controlling families and groups. A successful export performance will add to the need for capital for expansion and will probably be closely correlated with the growth of the stock market. The likely effects of recent banking reforms are ambiguous. The prudential regulations will induce banks to curtail lending to highly indebted firms, and to classify loans to those that do not have audited accounts, thus raising loan costs. But the firms most affected will normally not be successful exporters.

3.14. Certain reforms are, nonetheless, needed for the stock market to develop. Some are under preparation, including vesting supervisory responsibility in an authority separate from the *Bourse*; measures to develop brokerage outside the banks, which have little motive to encourage alternatives to themselves; and the establishment of institutions for settlements and safekeeping of securities. To encourage foreign investment in Tunisian enterprises the present requirement for Central Bank authorization should be removed, possibly by replacing it with a capital gains tax on short term investments, say less than a year, so as to favor investments intended to develop the enterprise through bringing expertise and capital, rather than short term speculative money.

3.15. An apparent paradox is that certain tax advantages for issuing and holding equity hinder the development of the market. Purchases of new equity are 50% tax deductible, while issues of fresh equity are deductible up to 35% of corporate profits. Owners of enterprises benefit without losing control by creating closed end mutual funds (SICAFs) to hold shares in their own enterprises. Since the SICAFs were first permitted in 1985, 45 have been created with a total capital of TD350 million by mid-1994 invested mainly in equity. Another device has been for enterprises to sell equity to banks with repurchase agreements, in effect obtaining bank loan with tax advantages. Both these devices are obstacles to a true equity market.

3.16. There is a justification at present for tax advantages for the issue of equity, provided it can be freely traded on the Bourse. Such tax advantages should not, therefore, be available for equity issues to related parties or associated with repurchase agreements. There is no economic justification for giving tax advantages to companies for purchasing and holding equity. It is also doubtful whether such tax advantages are justified for individuals, given the public's strong demand for equity. If it is felt that some such advantage must be given to individuals, it should be in a form that does not hinder trading on the secondary market. One such form would be "equity savings accounts" on the French model, which would be deductible from income tax up to specified limits and which would forfeit the tax advantage if the money is withdrawn before the prescribed period. Such accounts would not distinguish between purchases on the primary or secondary markets. The taxation of open-

end mutual funds (SICAVs) would remain at the present 15% of income, even though dividends are not taxed, since the bulk of their investments are in bonds.

3.17. The bond market is likely to develop more quickly than the equity market. The need for one in Tunisia is growing.

- It would establish market determined long term interest rates and a yield curve.
- It would spread risk for borrowers and lenders by diversifying the instruments and maturities.
- It would facilitate the financing of housing and infrastructure.
- Institutional investors (social security funds and insurance companies) will be seeking to invest large sums in coming years and will need liquid bond markets.

3.18. Two steps are needed to develop the bond market. One is that the Treasury develop mechanisms for issuing its paper through market mechanisms. Such mechanisms did not develop as long as the Treasury was able to oblige banks to buy its *bons d'équipement* (10 year bonds with low interest rates, most recently 8 1/4%). In 1989 the Treasury began to issue bills (maturities less than a year) through banks by a bidding process and in 1991 it stopped issuing *bons d' équipement*. It is now redeeming outstanding *bons d'équipement*, of which practically none will be left after 1996. To refinance these and meet its net borrowing requirements, it will need to issue paper of several maturities on a broader market than the banks without causing perturbations at the time of issue or later on.

3.19. The second step is to allow private borrowers to issue bonds freely. The issue of bearer bonds has been constrained both to prevent competition that would raise borrowing costs and to protect the public from uncreditworthy borrowers. These constraints matter less for nominative bonds, which can be issued freely. But for bearer bonds competition is fundamental to the creation of market and must be accepted.

3.20. A legitimate concern has been to protect the public from uncreditworthy borrowers. However, the Treasury cannot play the part of a credit rating agency, both because it cannot perform the analysis that such agencies rely on and because it would implicitly give to any issue that takes place a seal of approval that could be mistaken for a guarantee. Credit rating agencies are necessarily private sector institutions because of this and, as the market becomes active, credit rating services will be provided. The role that the Government would need to play is that of ensuring that the ownership and financial interests of providers of credit ratings are declared so as to offset any moral hazard problems. In the meantime the Government requires that bond issuers either be quoted on the *Bourse*, in which case they comply with the disclosure rules, or obtain bank guarantees -- an elegant solution for the time being.

C. THE INSTITUTIONAL INVESTORS

3.21. The institutional investors, the state owned social security funds and insurance companies, raise three major issues that concern the private sector.

- Their importance as investors in financial markets is growing rapidly. They will increasingly require a more diversified and deeper financial sector.
- The role of the private sector in providing the same or better services can be expanded.
- Social security payments could be lowered.

3.22. The social security funds have been the chief means for protecting the population against insurable risks, like sickness, injury, disability, old age, and, to a modest degree, unemployment. They cover all the formal private sector, public enterprises, government employees, students, and various minor groups, on the basis of contributions by beneficiaries and employers. The private sector is covered by the CNSS and its pension fund, the CAVIS. Public sector employees are either covered directly by the State and the pension fund, CNRPS, or by the CNSS, the exception being certain utilities, which have their own fund, the CREGT. There are 15 insurance and reinsurance companies, though their combined weight is much smaller than that of the funds. Insurance penetration is low by the standards of comparable countries, as can be seen from the ratio of premia to GDP of 1.55% in 1990, and the trend has been downward.

3.23. Both sets of institutions will be liquidating large stocks of unremunerative assets and will be seeking to invest the proceeds more remuneratively. The funds had accumulated substantial reserves, but were constrained to investing them according to government priorities. They mainly financed the Treasury through purchase of *bons d'équipement*, though they also invested in low-cost housing and, to a small extent, in the shares of enterprises. The insurance companies had greater flexibility, but were obliged to place 50% of their technical reserves in *bons d'équipement*. These investment constraints have been replaced recently by prudential guidelines that give the institutions flexibility in investing, while the Treasury's redemptions of its *bons d'équipement* removes the problem of finding a market. Initially most of the investment will be in new Treasury paper, but the institutions will be seeking a wider range of instruments to match their obligations, including high grade non-Government bonds and equity.

3.24. The funds have played a major role in ensuring the welfare of the general population, but the provision of social protection must evolve towards greater diversity and reliance on the private sector if it is not to be undermined by financial problems and public dissatisfaction. With the evolution of the economy and rise in incomes, households and enterprises seek greater diversity of products to match their specific needs. This is especially the case for life insurance and pension plans, whose development by the insurance industry has been hindered by the competition of the social security funds. The funds were established to provide social protection at a time when the insurance industry was in its infancy and alternatives were virtually unknown. Since then the insurance industry has developed and other means of meeting these needs in financially sustainable ways have been devised around the world.

The Social Security Funds[1]

3.25. The Government has made two political choices:

- that it will maintain social security programs to protect low income groups, if necessary with budgetary support; and

- that it will continue to bear part of the overall cost of health care.

3.26. The system by which health care benefits are provided is a political choice in which countries differ widely. Choices range from financing health care from the budget without contributions, as in Canada and the United Kingdom, to leaving it entirely to the individual and private insurance. The Government's choice is

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1/ The discussion of the social security funds is based on a World Bank study: "Republic of Tunisia: The Social Protection System", Report No. 11376-TUN, April 1993.

to keep the present contributory system, making its benefits available only to those with adequate records of contributions and the really needy. All others would pay the full costs. Since cost accounting is being adopted by hospitals and clinics in the public sector, the authorities will be able to determine the price and subsidy of each form of treatment.

3.27. In a contributory system of this kind the deficit to be financed by the budget depends on how effectively evasion is prevented. At present it is rife. Enterprises and employees must pay contributions to the CNSS for health insurance and retirement benefits. But the beneficiaries, the employees, often have little incentive to contribute themselves, or to ensure that their employers contribute, since free health care, their major concern, is easily available, regardless of contributions. Roughly 760,000 families, half the population, obtain health care free or for nominal charges as needy families. Preventing evasion requires both stricter monitoring of contributions and strengthening the incentive to contribute by convincing people that they will otherwise not receive them. Making the incentive credible will be a delicate task.

3.28. Retirement and disability benefits could be provided through the social security funds at basic levels that meet the needs of lower income groups, while above these levels, they would be obtained through complementary schemes. This is the option that the Government envisages. These complementary schemes could include funded company schemes, life insurance, and the individual capitalization accounts that are being adopted in several countries in various forms. Enrolment in one of these could be made mandatory.

3.29. As prerequisites for a reform of this kind of retirement benefits, existing pension schemes must be made financially sound and those that would be part of the complementary system must be moved towards becoming fully funded. The fact that the CAVIS, CNRPS, and CREGT maintained substantial reserves will help; these funds operated on a pay-as-you-go basis, but might have been close to being fully funded if the remuneration on their investments had not been kept low by past Government policies. Now they are projected to incur growing deficits unless steps are taken. Population growth is slowing and major revisions of the pension arrangements are needed. Steps that could bring benefits and contributions more in line with each other would include moving gradually towards basing pensions on a longer history of contributions, or towards actualized lifetime income; lowering accrual rates; and removing, where possible, service credits. Raising the retirement age to 65, coupled with an inducement to keep working provided by relaxing the maximum replacement rate, would also reduce pension payments for a while, though this has to be weighed against the need to provide employment.

3.30. Measures of this kind will require an appropriate regulatory and supervisory framework. It would need to cover issues such as ensuring that benefits can be carried from one institution to another, the regulation of individual capitalization accounts, and due diligence on the part of all institutions providing social protection. Such a framework would need to be harmonized with, or integrated into, the regulation and supervision of the insurance sector.

3.31. A limited unemployment insurance scheme also needs to be considered. Enterprises must adapt if they are to be competitive and one obstacle has been that the authorities have difficulty allowing workers to be laid off if there is no safety net. The Government has limited short term schemes to compensate laid off workers, though these are temporary expedients and not permanent safety nets. Otherwise enterprises have to provide severance packages, which may complicate their futures. A contributory insurance scheme providing workers unemployment benefits for a limited time would reduce the resistance to laying workers off.

Alternatively, it would yield revenue to help finance payments to laid off workers that the Government feels politically obliged to make.

3.32. There may be scope for reducing social security contributions, in which case this should be a priority to help enterprises be more competitive and encourage employment. From an economic point of view, to the extent they are considered part of the wage contract, whether these contributions are high or low is part of the question of how high the wage level is. In Tunisia they are high if compared to developing country standards, though they are in line with Europe; they are 23.75% of wages, the employer contributing 17.5%. But they include contributions for family benefits, which finance child support. This is an income transfer, not an insurable risk, and the contributions are, in economic terms, a tax and not part of the wage contract. These benefits account for 4-5% of the wage, and should be removed from the social security payments and replaced by a tax that does not raise the cost of labour.

The Insurance Companies

3.33. Reform of social protection requires that the insurance industry, which has serious problems, be made sound and competitive. A program of privatization, closures, and mergers of State controlled insurance companies should be implemented. Of the 15 resident companies, four are State-owned and account for 46% of premia, if the State owned-export insurance company and the private reinsurance company are excluded. The largest, the STAR, accounts for 34% of premia. The losses of the industry are substantial and concentrated mainly in the State-owned companies. Over the last six years the cumulative losses amounted to TD 50 million, equal to 25% of annual premia or 180% of paid up capital and reserves of the 13 companies. Moreover, the morale and efficiency of the staffs of the State-owned companies are low. Only through wage and promotion policies based on merit, extensive training, and a gradual elimination of redundant staff can these companies hope to compete if they remain independent.

3.34. To encourage competition from new entrants the minimum capital requirements of TD 3 million should be reduced and adjusted to the nature of the insurance (life, health and accident, general). The requirements need also to be enforced evenhandedly. Since the State-owned companies do not meet the minimum capital requirements, they are competing with private firms in the knowledge that the State intends to recapitalize them when budgetary resources are available. Foreign entry should also be made easier. The period when it was necessary to escape from the dominance of foreign interests and to promote Tunisian insurance companies is over, but the requirement that the majority ownership should be Tunisian still exists. By requiring that foreign institutions operate through locally established subsidiaries and by encouraging joint ventures, the risks of foreign dominance and lack of permanent commitment to the economy can be minimized.

3.35. Since solvency monitoring is now the accepted form of regulation in developed economies, the practice in the European community could be taken as a convenient model. This will entail modifying the solvency requirements of the revised code, which is 20% of gross premia and probably too high to be practicable. The EEC uses 18% of retained premia (gross premia less premia ceded to reinsurers) for the first ECU 10 million and 16% for amounts above that. The EEC also provides for a solvency margin related to the average losses over the preceding years, to prevent insurers from underpricing. In Tunisia, where insuring at an expected loss is frequent, such a regulation is needed. Both work accident and group health insurance are used as loss leaders to establish relations with clients. In both cases insurers are unable to persuade enterprises to insure their employees by name, leaving the enterprises free to under-declare the number of employees but in practice to obtain insurance for all. This appears to have been the main reason for the Government's decision in 1992 to

transfer work accident insurance to the social security funds, which have databases on employees. The insurance companies would have preferred that the law oblige enterprises to insure by name. An appropriate solvency requirement would have prevented the problem from arising. Consequently it will be desirable to introduce the requirement and return work accident insurance to insurance companies, with the supplementary measure of making insurance by name obligatory.

3.36. Now that the *bons d'équipement* are being redeemed and the requirement that 50% of technical reserves be placed in Treasury paper has been reduced to 35%, better financial and risk management are needed. A regulation setting maximum limits to investments in different types of securities would encourage firms to build up their expertise. Firms should be required to invest in securities that have well-developed secondary markets, especially mutual funds, permitting them to be sold when needed, but investments in group related securities should be discouraged. An evaluation of the assets should be regularly updated on the basis of market value. The industry also needs to develop its actuarial capabilities and compile more complete and reliable data on loss experience and mortality tables for the insured population. Technical cooperation under the aegis of the insurance association would simplify this task. The social security funds should also cooperate, since they have extensive data on experience with private and public sector firms, especially in enabling private firms to provide work accident insurance.

D. SUMMARY OF RECOMMENDATIONS

Banking

* Ending the predominance of the public sector in banking in the next three years should be a priority.

  - In the case of the deposit banks this requires that portfolio problems arising from the public sector must be overcome, primarily through privatization.

  - The development banks must find new roles in keeping with the evolution of the financial sector.

* The CENT should be given autonomy and developed into a savings bank for lower income groups.

Capital Markets

* The supply of equity on the secondary market should be increased by accelerating privatization of public enterprises.

* The present tax advantages for issuing and holding equity should be replaced by "equity savings accounts".

* The Treasury needs to develop market mechanisms for issuing its paper.

* Private borrowers should be allowed to issue bonds freely.

* Companies meeting adequate disclosure standards but not listed on the *Bourse* should not be required to have bank guarantees to issue bonds.

CHAPTER IV: SPECIAL INCENTIVES AND ECONOMIC INTEGRATION[2]

4.1. The economy developed on special incentives designed to encourage investment in various sectors, export of manufactures, and foreign direct investment. Private entrepreneurship developed under this regime and the export performance was good enough to allow high investment levels without macroeconomic problems. But some of the weaknesses of the economy have been equally due to these incentives: in particular, the lack of interaction between the off-shore and on-shore economies, the prevalence of relatively simple technology, and the almost exclusive concentration of foreign investment in the off-shore sector. These weakness will be a hindrance for an export oriented economy. Consequently the special incentives regimes have been revised to concentrate them on a few mutually compatible objectives. The next major step is to integrate the manufacture of exports more fully into the domestic economy through reforms of customs procedures and suitable adjustment of the incentives.

A. SPECIAL INCENTIVES

4.2. The sectoral investment codes were intended to encourage a nascent private sector and lost their relevance as the private sector developed. Consequently, the Government is replacing them with a unified code aimed at objectives more relevant to Tunisia's export orientation and its socio-political priorities. To the extent that their success could be measured by more investment than would have occurred without them, the sectoral codes as a whole show no indication of having had any effect since 1986. They competed among themselves to attract investment to their sectors by offering, among other things, tax exemptions or reductions, preferential credits, reductions of social security payments, and investment subsidies. The winner has been the tourist sector code, which gave direct and indirect subsidies estimated at 25% of the cost of the investment, higher than in the other sectors. Given that such investments are technically simple and yield quick returns, the more difficult investments in agriculture and manufacturing cannot compete. Tourism is, consequently, draining investment that might otherwise have gone elsewhere. Figures that cover all types of investment in tourism do not exist, but Table 7 gives an indication of the importance of tourism related investment as a whole.

4.3. The sectoral codes were ill adapted to objectives like the acquisition and assimilation of new technology. They offered too many advantages for too wide a range of investments for more difficult objectives like that to be favored. In principle incentives were available for the introduction of new technology and for protection, or even subsidy, of infant industries, but the fact that the procedures and criteria were never defined indicates an awareness of the futility of competing with the simple traditional investments.

2/ Foreign investment is taken here to exclude extraction and transport of hydrocarbons.

Table 7: Composition of Fixed Investment 1986-93					
	1986	1988	1990	1992	1993
Total Investment/GDP	24.0	19.3	22.7	22.9	23.8
Shares of Total Investment					
Agriculture	16.3	16.6	15.6	15.3	14.7
Manufacturing	17.2	15.8	17.4	14.9	14.8
Non-manufacturing Industry	17.7	14.0	12.2	13.0	17.2
Tourism related *	38.7	38.1	40.9	44.6	40.9

* Transport, tourism, housing
Source: Ministry of Planning and Regional Development

4.4. But the budgetary cost of the codes has been high. The Tunisian authorities estimated the cost in 1990 of the direct and indirect subsidies, including taxes foregone, at TD 120 million, over 1% of GDP. The scale of the tax advantages alone was so broad that, in the words of Tunisian officials, they amounted to a parallel tax system. It has been largely because of these codes that direct tax yields in Tunisia have been unusually low. In 1992 corporate tax receipts, excluding oil companies, were TD 140 million and total direct tax receipts constituted only 15% of government revenue, whereas a level of 20% would be more typical of a lower-middle income country.

4.5. A new unified code, adopted in January 1994, replaces the sectoral, "vertical", approach of the investment codes by "horizontal" criteria, notably exports, development of disadvantaged regions, and acquisition of technology. This is a major improvement, though a sectoral component giving the incentives to agricultural investments remains. In this respect Tunisia conforms to a practice in many developed and developing countries that can be justified by, among other reasons, the need to slow migration to towns. However, the application of the code is likely to have a sectoral bias since, instead of having a single body to decide on applications for the advantages under the code for all sectors, it has a number of sectoral committees. To avoid this there should be one body for according all incentives under the code, though it would consult sectoral experts.

B. THE OFF-SHORE SECTOR AND FOREIGN DIRECT INVESTMENT (FDI)

4.6. The off-shore sector originated as an expedient to enable Tunisia to pursue a policy of economic growth under high protection without encountering the problems of exporting that such policies usually cause. It had a dual function, to encourage exports and to attract FDI to the manufacture of exports, in either case without interfering with the on-shore economy.

4.7. To encourage exports enterprises that export their entire outputs are, under legislation from 1972, exempt from taxes and quantitative restrictions. The tax exemption not only applies to earnings and customs duties on imported inputs, but also allows refunds of taxes and duties on goods and services bought locally. The enterprises can also be permitted to sell up to 20% of their output locally, after payment of taxes and duties, but in practice this permission is never granted. Except for the unusual feature that an enterprise can be located anywhere in the country, the off-shore sector is a typical export processing zone. Customs surveillance is ensured by assigning a customs officer to the enterprise, which pays his salary and provides him with accommodation. Off-shore enterprises had in practice preferential access to foreign exchange in times of balance of payments difficulties, though the recent liberalization of the current account of the balance of payments has removed the importance that this policy once had.

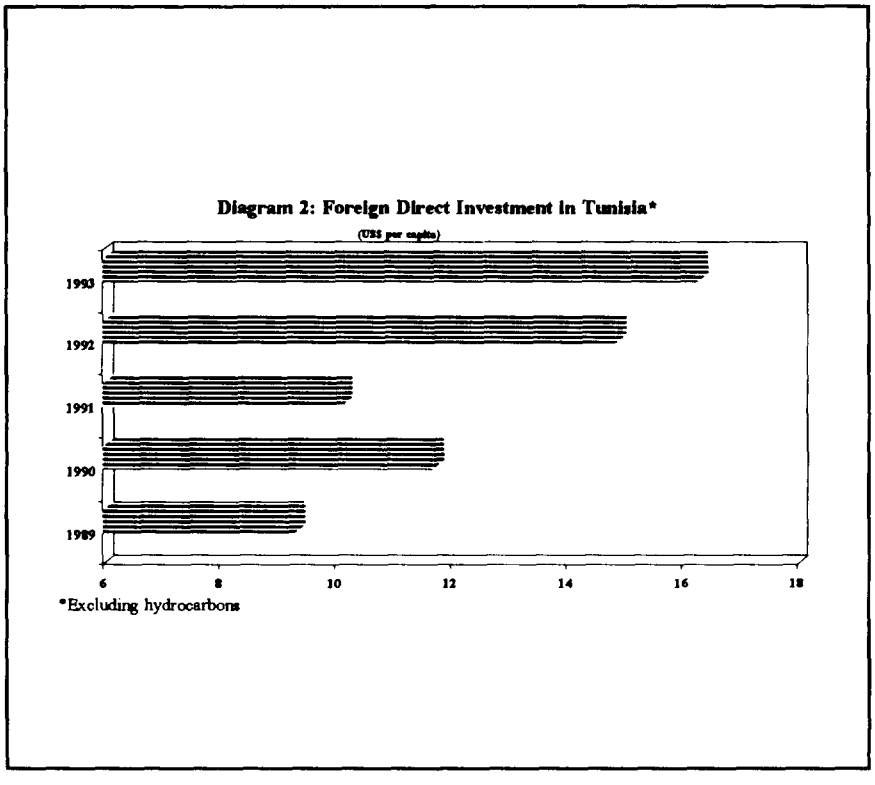
4.8. FDI has always been welcome and the main purpose of the exemption from direct taxation was originally to encourage it. Foreign investors are entitled to repatriate dividends and capital. The processing of investment applications by foreign investors has been reduced to a matter of a few days by the creation of a one-stop-shop in the Agence de Promotion de l'Industrie (API). The Government is energetic in promotional campaigns in Europe, the United States, and other countries to attract FDI.

4.9. Pains have also been taken to reassure investors regarding respect for their rights and assets by adherence to a number of international conventions. Tunisia is a member of the International Center for the Settlement of Investment Disputes (ICSID), and has ratified this association with the Multilateral Investment Guarantee Association (MIGA). It has investment agreements with a number of European, Arab, and African countries, and most recently, February 1993, with the United States. Tunisia is also a member of the World Intellectual Property Organization and a signatory of the United Nations Conference on Trade and Development (UNCTAD) agreement on protection of patents and trade-marks, which, although they do not directly affect foreign investment (and may deter certain types of foreign investors), confirm its attachment to legality and impartial adjudication of disputes. A benefit, or a symptom of its attitude, is that it has had no international investment disputes since 1984 and few before that.

4.10. These arrangements have been moderately successful in quantitative terms, but not qualitatively. Off-shore enterprises achieved the objective of earning enough foreign exchange to prevent serious balance of payments problems and were largely responsible for enabling Tunisia to overcome the loss of oil export earnings in the 1980s. Manufactured exports (excluding phosphate products) grew at an annual average of around 10% in the 1970s and 1980s, and much of the greater part of the growth came from the off-shore enterprises. By 1990 they numbered roughly 1,100 and contributed an estimated 37% of total exports of goods and non factor services. The inflow of FDI was not as striking. The great bulk of FDI has been off-shore and, as seen from the figure the volume has been moderate; per capita it was slightly higher than in Morocco and now it is slightly lower. Another measure of success is the proportion of off-shore enterprises that are foreign; in most EPZs foreign investments predominate, but in Tunisia slightly more than half the off-shore enterprises are local, 23% are wholly foreign, and 24% are joint ventures. Although it is possible that the foreign firms are larger than the Tunisian firms, there seems to be no evidence for that. Moreover, much of the foreign contribution to the joint ventures has been in the form of technology and not capital.

4.11. In qualitative terms the results have been disappointing. With few exceptions, the technology level of the off-shore sector is low. Textiles and garments preponderate and will be the most affected when the MFA is ended. The foreign investment is usually footloose and may disappear. Since little foreign investment has been on-shore, its effect in increasing the competitiveness of the on-shore economy has been negligible.

There are several reasons for this performance that indicate that it will not improve unless the distinction between off-shore and on-shore is gradually broken down.



The Economy's Dichotomy

4.12. There is a dichotomy between the off-shore and on-shore economies that prevents exporting and FDI from stimulating greater competitiveness in the on-shore enterprises. The off-shore enterprises obtain almost no inputs from the domestic economy (labor and energy aside) so that the stimulus to competitiveness normally arising from exporting is annulled. A local supplier is at a disadvantage with respect to a foreign supplier since he pays taxes and duties on his own inputs and, perhaps, obtains them from a relatively inefficient domestic supplier. No mechanisms for the domestic supply of an input into the manufacture of an export (an indirect export) exist to earn the same tax advantages as the direct export, although the principle is accepted by the authorities. With foreign off-shore enterprises there is usually even less prospect for local supplies of inputs. Most are *maquiladoras*, i.e., subsidiaries of foreign companies that supply the inputs and, after local processing or assembly, take all the output. Some of the larger and more progressive off-shore enterprises have yielded externalities usually associated with exporting, including the training of some of Tunisia's top managers and some of its skilled labor force, but bearing in mind the off-shore sector's size, this yield has been small; offsetting these enterprises have been a number of simple ventures, often no more than assemblages of sewing machines.

4.13. The dichotomy has also limited the extent to which FDI could contribute to the improved competitivity of on-shore enterprises. The Tunisian domestic market is small and does not offer the main market opportunity that a foreign investor might have seen for investing in a small economy, that of selling inputs to rapidly growing enterprises, which would necessarily be exporters. Consequently, foreign investment has been overwhelmingly in the off-shore sector and about three-fourths of on-shore foreign investments are minority shareholdings, mostly partnerships in which the foreign partner contributed technology rather than capital.

4.14. The off-shore enterprises themselves have shown only a limited gain in technology. This is most evident among foreign enterprises, among which the *maquiladoras* are common, and whose technology and management levels are manifest from the labor force, of which the overwhelming majority are unskilled, young women who leave their jobs when they marry. Turnover is high, 25 to 30% a year. Lack of concern for quality and high absenteeism are frequent complaints of employers, but they merely reflect the nature of the activity and

management. Surveys indicate that where the enterprises have recruited selectively, provided training, and given the employees a longer term interest in their jobs, the results have been higher quality and less absenteeism.

4.15. The progressive off-shore firms appear to be mainly Tunisian or joint ventures, though they constitute a minority. They are mostly cases where a Tunisian entrepreneur with appropriate specialized knowledge has been able to develop a subcontracting activity, perhaps in collaboration with a client. Such cases are limited by the supply of this type of entrepreneur. A profit maximizing entrepreneur without such an advantage would choose the easier alternatives that prevail in the off-shore sector, such as garment assembly. Nonetheless, the progressive firms indicate that subcontracting holds opportunities for exporting provided the requisite training can be arranged, especially through foreign partnerships, an avenue that the Tunisian authorities have been exploring.

Breaking Down the Dichotomy

4.16. To attain the kind of export diversification and growth that Tunisia needs, the off-shore/on-shore dichotomy must be broken down by integrating exporting into the domestic economy. Short of removing all trade barriers and tariffs, or of imposing on the off-shore sector the same regulations as for the on-shore sector, integration will consist of extending to partial and indirect exporters the same advantages as are extended to the off-shore enterprises. An enterprise that exports only part of its output should be eligible for refunds of import duties and taxes on the inputs into that part, while indirect exporters should be similarly treated for the parts of their output that are used to produce exports. Such refunds should be prompt and with a minimum of paper work.

4.17. The administration of such refunds is considerably more complex than the simple system used for wholly exporting enterprises. Consequently, although the new investment code explicitly allows incentives for partial exporters, the procedures, especially customs, are not defined and indirect exporters, who might in the long run have a greater effect of integration, are not included. But appropriate techniques have been devised in other countries and need only to be adapted to Tunisia's circumstances. This will, however, require changes in customs and port procedures and retraining of customs officials. An appropriate trade facilitation commission is being set up by the Tunisian authorities to prepare the formulation of the procedures.

A Greater Role for FDI

4.18. The modest results in attracting FDI conforms to experience around the world that the volume of such investment is determined by the assessment by potential investors of the market prospects that the country offers. Tunisia is too small to offer the kind of domestic market that has been available in Latin America and is expected in Eastern Europe and China. Hence it must offer good export prospects. Some of the East Asian economies attract huge amounts of investment, without offering special incentives, or much prospect of a domestic market, because they are successful exporters. Their export performance assures prospective investors that certain essential conditions exist for establishing a competitive enterprise.

4.19. The modest inflow of FDI can not be attributed to difficulties faced by established enterprises. Although there are a number of such difficulties, they have mostly been in the nature of irritants rather than serious problems. On the whole the managers of foreign off-shore enterprises view conditions in Tunisia favorably and the higher authorities have consistently taken pains to respond to their complaints. Recently the API has also set up a specialized unit to help the enterprises handle problems as they arise and indications are

that it is working satisfactorily. The biggest source of complaints is the difficulty of dismissing or penalizing workers for poor performance or misdemeanors. Some enterprises that closed their operations in Tunisia blamed that as the reason.

4.20. Even though it is unlikely that inflows of FDI will rise sharply in the near future, it should be sought as a means to gain technical and marketing know-how. Such know-how is acquired most effectively when the foreign investor is a partner of a local business. Hence, foreign participation in existing enterprises should be especially welcome, but in practice it faces the most difficulties. The procedures for quick clearance of foreign investments apply to new ventures. Even expansion of an existing foreign owned enterprise can take time to be authorized, while investment in existing Tunisian enterprises appear to be regarded with disfavor. If the concern is that speculative, short term investors might reap profits without benefit to the economy, the best safeguard might be a tax on short term realized capital gains. This may become particularly relevant when the stock market has developed and foreign investors can buy shares there.

4.21. Some foreign investors, on-shore and off-shore, have been disappointed by the difficulties of obtaining the clearances and infrastructure, such as telephone lines, for on-shore investments. It is still common among government employees, especially the lower ranks, to regard the private sector with suspicion, often making interaction with the administration unnecessarily difficult through arbitrary interpretations of legislation and delays. Thus when an enterprise wishes to expand through purchases of land or increases of capital, it runs into the full bureaucracy that the one-stop-shop allowed it to avoid when it initially established itself. Such disappointments must be avoided, which increases the urgency of establishing the new simplified procedures. The position has been well stated by a recent report of the Foreign Investment Advisory Service. "Governments should also consider carefully when and how they advertise their attempts to expedite approvals and provide services to investors. Advertising before true reform has occurred is likely to be counterproductive. In deciding the appropriate point at which investors should be informed of the introduction of a new service function, "better late than early" may be the appropriate rule. For an investor contemplating investment in a country, existing investors have much greater credibility than do agents of government. Thus, it is far better to have investors pleasantly surprised about the effectiveness of a country's service delivery operation, than to have them disappointed because their expectations were overly heightened by the government's marketing efforts."[3]

4.22. While welcoming foreign investment in general, there is a need to be able to check the backgrounds of investors quickly and reliably. Tunisia's convenient location for foreign investors is also convenient for investment of money of doubtful origins, and there have been suspicions regarding some foreign investments in privatized enterprises. As long as controls were pervasive it was easier to examine potential foreign investors' credentials. The authorities demonstrated their good judgment in cases like the BCCI, when they denied it permission to set up a branch in Tunisia. Now they will need to have recourse to outside sources of information, such as Interpol and national investigation agencies. But such procedures should be a system of *ex post* supervision and not part of a clearance process for foreign investment.

3/ See Foreign Investment Advisory Service, Occasional Paper 2 Facilitating Foreign Investment: Government Institutions to Screen, Monitor, and Service Investment from Abroad by Louis T. Wells, Jr. & Alvin G. Wint.

C. SUMMARY OF RECOMMENDATIONS

Special Incentives

* The application of the new investment code should be performed by a single body and not by sectoral committees.

* In the longer run, the authorities should consider abandoning an investment code in favor of a system based solely on the relevant tax law.

The Off-shore Sector and FDI

* A medium term program should be formulated to integrate the off-shore sector into the domestic economy by measures to pass on to indirect and partial exporters the same advantages and simplified customs procedures.

* The procedures for foreign investors to expand their enterprises or to enter into existing Tunisian enterprises should be as simple, quick, and certain as for new investments. To discourage short term, speculative investments a tax on short term realized capital gains should be considered.

* A quick and effective system of *ex post* background checks on potential foreign investors is needed.

CHAPTER V: SKILLS AND TECHNOLOGY

5.1. Reforming incentives is one part of making the economy grow internationally competitive in a steadily widening range of products. The other part is identifying the products in which the economy can become competitive and mastering their production. At the same time enterprises must stay abreast of technical developments around the world in activities that are well-established in the country, such as textiles and ceramics.

5.2. Identifying and mastering opportunities to become competitive on new products have been attempted in a variety of ways by different countries, the notable successes of recent decades being certain East Asian countries and the failures being spread around the world. But there is no simple East Asian model to emulate. Protection and subsidies to become competitive through learning-by-doing were successful in Japan, South Korea, and Taiwan, because these economies had domestic markets. They were not used in Hong-Kong or Singapore, and, of the first three, the smallest, Taiwan, relied the most on foreign investment and partnerships to acquire technology. Moreover, the tolerance of the developed countries in the 1960 and 1970s for some of the practices that were used to promote exports diminished in the 1980s. Now subsidies, including cross-subsidies within an enterprise, for production, or even development, of products provoke retaliation through anti-dumping measures. The rules governing international trade have become stricter and, given the pressures faced by the developed economies to protect domestic employment, they are applied readily.

5.3. Tunisia has been quick to identify the methods that are probably the best suited to it, namely sub-contracting and foreign investment. Sub-contracting has many advantages, especially in manufacturing. It can lead progressively from simple to more difficult products, e.g., through linkage. It establishes a partnership with the purchaser, who will have an incentive to invest in a transfer of technology. It reduces the risk of being confined to obsolete techniques because up-to-date techniques are proprietary. And it permits a country to establish a reputation for quality in specific products by setting standards to which it must conform.

5.4. Having identified the opportunity, Tunisia has been innovative in taking advantage of it. A "sub-contracting exchange" (*Bourse de sous-traitance*) was established by the Industrial Promotion Agency (API), which supplies foreign firms looking for sub-contractors with information on the technical capabilities and experience of possible partners. This exchange quickly became a success and has a substantial roster of potential sub-contractors. The API has also arranged training and technical partnerships analogous to apprenticeships for Tunisian enterprises with major European firms, giving a good base for the former to become sub-contractors for the latter. Private firms have also gone ahead in developing successful sub-contracting businesses without the support of public sector institutions, an indication that the Government has spotted a trend with a future.

5.5. Sub-contracting lends itself to joint ventures and technical partnerships and, hence, to foreign investment. The reasons that these latter sources of export diversification have been modest in the past have been discussed in Chapter IV. It only need be stressed here that the potential for sub-contracting and any other method of building technical capacities in Tunisia will be increased by foreign investment flows into the economy.

5.6. Firms that do not export also need to develop technologically, both to compete against imports and because it may make them direct or indirect exporters. Developed countries have devised a variety of mechanisms for helping enterprises, and some innovative mechanisms are being tried in developing countries. Often there is an element of cooperation among enterprises. Research Associations in the United Kingdom consist of groups of firms producing similar products or using similar technology. and promote research and technical

services. Only about a quarter of the costs were supported by the State. In Japan groups of small firms wishing to acquire the same foreign technology would create a joint venture of their own to acquire the technology and diffuse it among the group. In Germany groups of technical centers have established common service centers that send experts to small enterprises to diagnose their problems, which they often do better than the enterprises. The diagnoses usually stimulate the enterprises to seek advice from the technical centers, which they pay for. Various other mechanisms have been devised in developing countries, sometimes making use of expertise that can be obtained at low cost, such as retired experts and academic staff, or senior executive programs.

A. EDUCATION AND TRAINING[4]

5.7. The education and training system is well developed, but it is on the verge of major changes as it becomes more responsive to private sector demand and as the private sector also contributes more to its supply and financing. At present it is a largely public system whose breadth and relatively high standards have made it one of Tunisia's distinguishing features. However, the State's own resources can not adequately meet the ever-growing demand, nor can a purely public education and training system keep abreast of the changing and highly specific needs of enterprises. The private sector shows willingness to invest in providing education and training, but a framework is needed to prevent the public system from discouraging it.

Table 8: PUBLIC EXPENDITURES ON EDUCATION (1992)

	Primary Years 1-6	Secondary Years 7-13	Higher	Total
TD Millions	299.6	253.7	131.8	651.8
As % of GDP	2.1	1.8	0.9	4.8
As % of Budget	9.4	8.0	4.2	21.6

Source: Ministry of Education and Science

Basic Education (years 1-9)

5.8. Primary education, the first six years, has been highly selective, especially at the last year. Consequently, many children dropped out in the first four years and only 45% of all children reached upper basic education, i.e. the seventh year. The Government judged that, given the budget constraints, this was the best way to preserve standards and meet the demand for more higher education. But it has now concluded that such a loss of human potential is more than the economy can afford , since the ability of a worker without basic

4/ This section is based on work done in MN1PH.

education of nine years to acquire and upgrade skills later is low and a person who has not completed six years of primary school is likely to relapse into illiteracy.

5.9. The Government is now aiming at making nine years of basic education the norm, though roughly 30% of sixth year pupils can be still be expected to fail the entry tests for the seventh year. The target is sound and the number of dropouts from primary school is expected to decline in the near future. Better quality basic education with higher completion rates will result in a labour force better able to acquire and upgrade skills. It may also result in lower overall costs since over half the dropouts from general education receive vocational training or technical training, which cost more, or become apprentices subsidized from the budget.

Table 9: ENROLLMENT IN EDUCATION AND TRAINING (1992)

	Primary Years 1-6	Secondary Years 7-9 Years 10-13	Higher	Technical[1] Training
Public	1,432,121	342,305 225,076	87,780	28,522
Private	8,400	71,152	---	17,880
Total	1,440,521	638,533	87,780	46,402

[1] Excluding apprentices.

Source: Ministry of Education and Science
Ministry of Vocational Training and Employment

Vocational and Technical Training

5.10. The Government has also begun to reform the public vocational and technical training system. The system is large and diverse, yet much of the training it imparts is of limited use to employers. Part of the reason is that it has two objectives, an economic one of providing skill and a social one of keeping unemployed youths occupied, and the two were not sufficiently kept apart. Recent reforms, which include the creation of the Ministry of Vocational Training and Employment in 1990 and new legislation in 1993, aim to make the economic objective paramount for at least some of the institutions on which the private sector most depends.

5.11. The reforms also aim at greater private sector involvement in providing training and formulating policy, though only a beginning has been made in setting up appropriate mechanisms. One issue is how private training institutions can develop when the public system provides training at no cost to most pupils or employers. Although private training institutions train about 20,000 people, over half are in office skills and most of the rest in activities related to clothing. Technical subjects appear to be limited to electronics. A second issue is how the private sector can be given more of the responsibility of financing and managing public training institutions that respond to their training needs. Given the diversity of training institutions, an essential condition is that their economic and social objectives be separated.

Table 10: Vocational and Technical Training: Capacity and Enrolment (1992)

Ministries:	No. of Centres	Enrolment No. of Pupils	Capacity No. of Pupils
Vocational Training and Employment	85	6,457	9,298
Agriculture	37	2,596	3,878
Tourism and Handicrafts	20	2,012	2,180
Transport	1	36	60
Education and Science	40	5,311	8,000
Health	19	629	770
Planning and Regional Development	161	4,425	5,672
Social Affairs	74	1,399	2,980
Other			
National Women's Union (U.N.F.T.)	89	2,892	5,498
Private Sector	315	20,198	20,198
Total	841	45,955	58,534

Source: Ministry of Vocational Training and Employment.

5.12. The two main instruments for stimulating private training are the Taxe de Formation Professionnelle (TFP) and apprenticeships. The TFP is levied on payrolls, at 1% for industrial enterprises and 2% for services, and is reimbursed to cover part of the cost of approved training. Its influence has been modest so far, largely because, until they were reformed in 1993, the procedures were cumbersome. In 1991 TD 4 million were reimbursed to 345 enterprises, covering 42% of their eligible training costs, but 42% of this went to 13 public enterprises.

5.13. The potential of the TFP is that, with an appropriate definition of approved training, it could be the basis for the development of private sector training capacity, at least for continuing training, for which it is most suited. The basic principle should be that the TFP's use as an incentive should favor private as much as public provision of training. This means, in the first place, that training provided by the public sector under this

arrangement should be on a full cost basis. It also means that apprenticeship schemes and in-house training using outside trainers, should be eligible for reimbursement of the TFP. Among other training costs that could be envisaged as eligible would be the employment of experienced foreign technicians and foremen to work on the shopfloor on short term contracts (for which the rules governing expatriate employees need to be extended).

5.14. Apprenticeships, including a dual system of apprenticeships and formal training similar to Germany's, are widely regarded in Tunisia as effective and not costly. But they need a training and monitoring infrastructure, as well as appropriate incentives. Up to now apprenticeships have been used mainly to employ dropouts from basic education by subsidizing their wage costs from the budget. They appear to have been effective in imparting lower level skills, though there seem not to be a shortage of these. But such apprentices are unlikely to develop further; only 20% receive formal training outside the enterprises. A pilot program for a dual system is under way, but the lack of success so far in implanting it outside Germany indicates that whatever type of apprenticeship system is adopted, it must be designed for local behaviour and expectations.

5.15. The authorities are at present developing, with private sector involvement, some of the infrastructure needed for defining apprenticeship programs and monitoring their implementation, the emphasis being on higher level skills. They also need to address the issue of the incentives needed to make apprenticeships work. An enterprise needs an incentive to train apprentices if it incurs a cost and runs a risk that the person it trained is lured by a competitor. In the German dual system the cost to the enterprise is reduced because apprentices pay for much of their training by receiving low pay and often performing menial tasks. A similar arrangement, or, alternatively, a means of binding the apprentice to the enterprise for a time may be preferable to the present system of subsidizing the apprentice's pay from the budget. The TFP alone is unlikely to be enough to pay for formal training and for apprenticeships. Apprentices themselves will be willing to sacrifice present pay for future gain when their earnings are closely linked to productivity. Moreover, they are less likely to leave employers with career development and training programs. Hence, modifications of the wage structure and the labour code will be necessary for apprenticeships to become a major training method.

5.16. The large number of public institutions should not be allowed to prevent the development of private training. In principle, these institutions should charge for their training and the budget subsidy should be transferred to the pupils, who would be free to choose among approved institutions. Enterprises would also finance pupils and the development of loan financing for training should be encouraged. A further step would be for enterprises with a common activity to manage such institutions, as is the practice for smaller enterprises in Japan, though enterprises there go further and also set up the institutions. This is not incompatible with maintaining the social objective of many of the training institutions, but it means that when the authorities want to subsidies an institution for a social objective directly, rather than subsidies the pupils, they need to ensure that do not thereby discourage potential private training meeting economic needs.

From Secondary to Higher Education

5.17. The private sector can add to the needed increase in the availability of secondary education. It has already responded to the market opportunity created by the higher standards maintained by the public system and the demand for secondary education: about 12% of secondary school enrolment is in private schools. However, since the private schools, with the exception of one elite school, cater to pupils who have failed in the public system, they are regarded as a low quality institution. They consequently often lack good facilities and materials. Nonetheless, their performance is good; statistical analysis indicates that, allowing for the levels of

the pupils, the success rate of 15% passing the *baccalauréat* is comparable to the 30% pass rate of the public schools. Although the education authorities would welcome private secondary schools of high quality, the present workings of the market meet a real need and it may be efficient to help the schools catering to the weak pupils to improve the quality of their services.

5.18. The bigger flow of pupils out of primary into secondary must finally be matched by an enlarged post-secondary system. The *baccalauréat* examination at the end of thirteen years of school has always been highly selective, the pass rate being only about 30%. The stakes are high, since a pass ensures a place at the university, where the teaching costs are borne by the State. So pupils try again and again. Although reliable figures do not exist, the proportion of pupils who ultimately obtain the baccalauréat may be as high as 80%. The expansion of basic education is likely to increase the flow of pupils taking the *baccalauréat*.

5.19. Rather than throttle the flow by raising the standard of the *baccalauréat*, the Government is aiming for a larger and more diverse post-secondary system of education and training. This will reduce the waste arising from the lack of recognition of the secondary schooling of pupils who did not get the *baccalauréat* and the consequent problem of demoralized youth. The university system has been expanding at 8% a year, but the authorities' concern not to allow an imbalance in the use of budgetary resources to the detriment of basic and secondary education limits this expansion.

5.20. Several steps are being taken to allow expansion and diversification of private post-secondary education and training. Legislation is being prepared to give recognition to private institution diplomas and to prescribe the standards. This will help meet the unsatisfied market need, though the degree to which it does so will depend on the diversity allowed. The main demand is from people who have not got the *baccalauréat* and want opportunities to build on their secondary education, and most private institutions will seek to provide diplomas below university standard. This does not preclude the possibility of specialized institutions of university standard or higher, possibly financed by enterprises, foreign donors, and philanthropies. And there would be no bar on private institutions teaching and giving diplomas that are not recognized. A step being taken to help this market is to issue certificates of completion of secondary studies. This will help both school leavers and teaching institutions in making their choices, especially if the certificate includes the *baccalauréat* grades. Another step would be to give tax incentives for education institutions meeting certain criteria, for instance those whose diplomas are recognized.

5.21. A broader spread of education, especially after secondary school, would require private financing through student loans and grants by enterprises. These would supplement the State's financing. Several models of student loans exist; they can be moderately subsidized with State guarantees, as in the United States, and they can be matched by own financing in proportions determined by the family's income, as in Germany. Financing by enterprises could be encouraged by a number of methods, including tax deductions and obligations on the students to work for the enterprises for a specified period under specified conditions. Families in Tunisia value education; consequently, such devices would add to effective demand and stimulate a supply response.

B. TECHNICAL CENTERS

5.22. A number of technical centers have been promoting the acquisition and assimilation of technology in well established activities with large numbers of enterprises. On the whole entrepreneurs find their services

useful, though they criticize their efficiency and the level of expertise of the staffs. The most recent of the centers is the technical center for the textiles sector, CETTEX, set up in 1992. The others are the CNCC (for leather and shoes); the CETIME (for mechanical and electrical industries); and the CTMCCV (for construction materials, ceramics, and glass). All these provide technical advice to enterprises in their sectors. Somewhat different is the CNI, operating in information technologies and softwares. Since the pace of change and diversity in the sector make it difficult for the CNI to perform the same functions as other technical centers, it tends to compete with the enterprises in its sector rather than support them.

5.23. The economy's outward orientation requires both a broader range of services than the technical centers now provide and a strengthening of the ability of the private sector to provide technical expertise to the producing enterprises. Since the technical centers' main function at present is to provide the kind of technical services that private firms can be expected to provide, they need to balance three different objectives : providing technical expertise to the enterprises of their sectors; developing private sector capabilities for providing technical expertise, especially forms where the private firms can be expected to replace the technical centers; and performing an array of functions that private firms cannot be expected to perform, at least not in the medium term.

5.24. There are a number of functions that the centers can perform as repositories of sectoral technical expertise with mandates to promote technical development of their sectors and are not likely to be performed by private firms. One is to collect and disseminate information on technology for enterprises and the State. Enterprises in Tunisia are mostly too small to be able to stay abreast of new techniques and product designs being adopted around the world. A second is to act as the sectors' expert representatives on technical policy issues, e.g., defining standards and verification procedures. A third is to formulate training programs and to monitor their implementation. Technical training institutions would need to agree with the centers on their curricula. For apprenticeships, the centers would define the training in each specialization and would monitor the enterprises taking the apprentices. A fourth function is to assist the authorities in monitoring incentives and State assistance in their sectors, e.g., action plans undertaken by enterprises to obtain subsidies under the unified investment code for the adoption of new techniques and for technical support to small enterprises, which the centers might themselves provide. Finally, there is always the need for a body of expertise that is able to take a detached long term view of the sectors' needs and prospects.

5.25. The technical centers should aim to shift the balance between their objectives gradually to these functions, which they have regarded as secondary, from providing direct technical advice to enterprises, which has been their primary responsibility. They would then be at the middle of networks of information flows and training programs for their sectors. Where private expertise is available it should be used and developed. The CETTEX, for instance, is engaged in promoting professional training in textiles in private institutions. It is also addressing the issues of shortages of test laboratories and standard verification procedures. It performs these functions and manages to serve the largest branch of manufacturing in the private sector with only 20 staff by using private and foreign expertise. It has the advantage that there is more private expertise available in Tunisia in textiles than in some other activities, but it demonstrates how the centers can harness private firms to achieve their objectives. The extreme contrast to the CETTEX is the CNI, which competes with private firms on the basis of subsidies and has a virtual monopoly on public sector procurement, although private firms have shown they can provide better services.

5.26. To be able to serve their sectors effectively and to enable private technical advisory and consulting services to develop, the centers need to become cooperative ventures of their sectors. The basis for this exists.

The financing of the centers is a levy on turnover of enterprises in the sector, a typically cooperative form of financing, and in September 1992 the Government gave the representatives of the private sector a majority on the boards of the centers and the power to nominate the Board Chairman. But the dominance of the State persists and is likely to be an obstacle to redeployment of activities and responsiveness to enterprise needs because the staffs are bound by civil service regulations, pay and incentives. A change of the centers' present status as public utilities would free them to attract professional staff through private sector pay and incentive structures and to respond better to enterprise needs. The State would, nevertheless, need to maintain a substantial presence on the boards of these centers, both because there will be occasions when it must counteract the dominance by narrow groups and because it needs to ensure that the centers pursue long term objectives.

5.27. Such a cooperative framework allows the financing of the centers to be based largely on the principle that the beneficiaries pay the cost, though this does not rule out some Government contributions. The cooperative nature of the levy on enterprises, however, is at present offset by the way the levy is implemented; it is collected by the tax authorities and is transferred by the Government to the centers with delays, some of it often being used for unrelated purposes. The enterprises consequently regard the levy as a tax and evasion is widespread. They have an incentive to be free-riders since the Government must fill any financing gap. The evasion can be reduced if the levy is paid directly by the enterprises into special accounts to which the centers have free access, with the tax authorities' help in policing the payments. The centers would publish the names of free-riders and discriminate against them.

5.28. In time the share of the levy should diminish as full cost payments for a number of services gain in importance. Where services are provided that could be provided by private firms, even if none that could provide them exist at the time, payments would have to be on the basis of full costs, both to avoid unfair competition and to give the private sector an indication of the costs and prices. The centers would then need to adopt cost accounting, which none have yet done. One center, the CNCC, which began charging fees comparable to those of the private sector after having charged low fees before, found that demand for its services remained stable. The State should also shift to payments for services on the basis of costs, but since the centers also provide services that can be costed separately, it could contribute a levy, as do the enterprises. The centers are also cooperative ventures between the enterprises and the State.

5.29. This cooperative formula works best where enterprises do not feel that they will be strengthening rivals to their own disadvantage. Well established export activities are the most suitable, as can be seen from the ability of East Asian governments to organize collaborative ventures among exporters. Activities facing intense import competition are almost as suitable. Most of the technical centers are in one or the other. The CTMCCV is a partial exception, since part of its domain is unaffected by external competition. However, the number of firms in that part is sufficiently large for the formula to have good prospects of working. The CNI is a complete exception since it is not in a significant export activity and private Tunisian firms tend to collaborate with external partners. Given the breadth and speed of change in its field, the CNI can perform only to a modest extent the basic functions of the technical centers, such as keeping a watch on technology, or provide an expertise beyond basic training to private firms. Consequently, its purpose needs to be reviewed. In the meantime it should be withheld from public sector procurement until it has established dependable cost accounting.

C. STANDARDS, LABORATORIES, VERIFICATION

5.30. Success in exporting, especially in exporting manufactures, depends on reliability in conforming to accepted standards and quality levels. There are advantages to enterprises in cooperating among themselves and with the State in establishing a reputation for such reliability. One reason is that standards, and often quality criteria, are common property, so that costs and mistakes can be avoided by a cooperative arrangement for a specialized agency to obtain and disseminate information on them. A second reason is that, if a country acquires a reputation for reliability in supplying certain goods at specific standards and of expected quality levels, it benefits all the country's suppliers, for instance by making it easier to find new clients. Environmental standards also need to be close to European norms, since it is likely that discrimination against suppliers who do not sufficiently protect the environment will grow.

5.31. The standards and patents agency, the INNORPI, has been establishing European standards, where relevant, as Tunisian standards, and can be considered to have been successful since these standards appear to be fully accepted by Tunisian enterprises, which even take the initiative sometimes in getting them adopted. An infrastructure of testing and certification, or verification, is needed. The shortage of laboratories for testing is exemplified by the textiles sector. Over 1,600 firms have expressed an interest in the testing of textiles, but there are only eight laboratories, which only make 25% of their time available to outsiders. But rapidly setting up a public sector network of laboratories is unlikely to meet the need. First, the public sector does not have the financial resources or technical staff needed. Second, there is an advantage to performing verification, especially for exports, through private laboratories, since these will be less susceptible to political pressures, as, for example, when a major export industry is in difficulties. Moreover, when a private laboratory makes a mistake, the repercussions will be smaller than when the State laboratory makes the same mistake. Verification procedures through private laboratories are standard in Europe and the Tunisian procedures should be aligned with them. Tunisia's trading partners would monitor the verification laboratories, though the Tunisian authorities should also supervise them, both to forestall problems and to be able to act in the national interest in case of disputes. The technical centers could provide technical support to private firms in setting up the laboratories and in supervising them.

D. SUMMARY OF RECOMMENDATIONS

Education and Training

* Private education and training institutions at secondary and post-secondary levels should be encouraged through the adoption of an appropriate regulatory framework and a favorable tax regime.

* Private financing schemes, allowing an element of subsidy, should be established for study in private educational institutions.

* Incentives to firms to invest in training their employees should favor private as much as public provision of training. This should include in-house training using outside trainers and apprenticeships.

* An appropriate system of incentives, covering taxes and wages, needs to be devised for the apprenticeship scheme being envisaged by the Government to be successful.

Technical Centers

* The technical centers should aim to develop private sector capabilities for providing technical advice and expertise to firms in their sectors.

* The status of the centers should be changed to free their staff from civil service regulations.

* The levies paid by enterprises for the centers should be paid into special accounts with the Treasury but freely accessible to the centers.

* The CNI's functions should be reviewed and the feasibility of its being able to perform these functions cost-effectively should be examined. It should be withheld from public sector procurement until it has established cost accounting.

CHAPTER VI: THE STATE AND THE ENTERPRISE

A. TRANSFERRING ACTIVITIES FROM PUBLIC TO PRIVATE SECTOR

Privatization: the Need to Accelerate

6.1. The transfer of economic activities to the private sector has taken two forms. One has been the removal of restrictions on the entry of private firms into activities performed by public sector institutions. The other has been to privatize public enterprises. Up to now progress on the former has been faster than on the latter.

6.2. Privatization needs to be accelerated. Although Tunisia was an early starter, beginning in 1988, only 43 enterprises have been privatized so far. There are about 190 enterprises in which the State has direct majority shareholdings and which are officially classified as public, and a further 400 roughly in which the State and public sector institutions combined have majority shareholdings. Except where the context indicates otherwise, both types of enterprise will be treated as public enterprises in this report At the present pace of privatization, only half the enterprises will have been privatized by the year 2030. The firms divested have been mostly small; as compared to the total of all enterprises officially classified as public, the combined sales value of TD 134 of the enterprises privatized by the end of 1992 was only 1% of the total book value and their total employment only 6% of total employment.

6.3. It is likely that public enterprises will face difficulties in the near future unless privatization is accelerated. Overall their management compares well with that of many countries and has avoided the large financial losses that have undermined financial and macroeconomic stability that have been common elsewhere. But the variations are large. Some are notable for their efficiency. Others have serious management problems. But it is the losses and inefficiencies that create problems for the economy if they are substantial.

6.4. The difficulties will arise from two main sources. One is that, just like private firms, many face increasing competition from trade liberalization and new domestic firms. In most cases meeting such competition requires not only efficient management but also an enterprise strategy covering at least product design and quality, investment in new plant, training, and financial plans. Few public enterprises can expect to receive the corporate leadership from their shareholders needed for preparing and implementing such a strategy. For those officially classified as public, the leadership would have to come from their supervising ministries, which are not staffed for such functions. Of those not classified as public, some may have major shareholders capable of exercising such leadership. But most do not and often the principal shareholder faces the same problem. It is common, for instance, for public sector banks to be major shareholders in public enterprises and to be in need of restructuring themselves. Such banks would find it hard to lead major undertakings in enterprises in which they have substantial shareholdings. The task could also be complicated if the financing needs are large, as they will be in most cases, since their own portfolio considerations will limit the financing they can provide. If there are other shareholders agreement on burden sharing may then be hard to reach.

6.5. The second problem public enterprises will face is that the prudential regulations will make it increasingly difficult to finance their losses. In other words, loss making public enterprises are an obstacle to a sound banking system. Up to now the bulk of the losses of public enterprises appear to have been borne by the banks, if the phosphates sector is excluded. Only three or four public enterprises receive subsidies directly

from the budget, the phosphates sector and the railways accounting for nearly, if not quite, all. The true size of the aggregate current losses and the cumulative amount with the banks are not known since the 400 or so enterprises not officially classified as public are lost to view. They manifest themselves when loans are classified according to the prudential regulations. It appears that both private and public enterprises are responsible for large parts of the portfolio problems of the banks, the public enterprises weighing especially heavily with the public sector banks.

6.6. The phosphates sector is a special case because it presents regional social problems that are likely to deter private parties. Tunisia's phosphate ores are of low grade and the movements of world prices have made them unprofitable for a number of years. The Government has cut mining back substantially to reduce its losses, but is constrained by the lack of economic alternatives in the mining region. The associated chemicals complex is heavily indebted to the banks, accounting for nearly half the cumulative losses of the enterprises officially classified as public. It is technically efficiently run and a large part of its debt was incurred through foreign exchange losses on external borrowing. It has reasonable prospects of generating operating profits in the future and two profitable subsidiaries have recently been privatized. Although the possibility of further privatizations should be pursued, the scope is likely to be small for some time.

Privatization: Creating Goodwill

6.7. Privatization now benefits from goodwill in the public. This is a notable achievement on the part of the Government, since only a few years ago it was widely regarded with suspicion. Unlike most countries that have implemented major privatization programs, Tunisia was not trying to cope with the collapse of the old system, the choice of an electorate, or an economic crisis. The policy that led to public support consisted, first, in demonstrating the benefits in terms of better service of allowing the private sector more freedom in activities that had been wholly or partly reserved to the public sector, and, second, in building trust in privatization through consensus, transparency, and careful preparation.

6.8. This policy succeeded for several reasons. One reason was that the social costs in terms of jobs lost appeared more manageable when they were spread over numerous agencies, over time, and over different regions. In contrast, losses of jobs from divestitures threatened to be concentrated and conspicuous (although the experience so far has been better than expected). Second, it had to be manifest from the start that the best possible terms were being obtained and that the well-connected were not being favored. Third, there should not be an appearance that divestitures were an easy means for foreigners to gain control over Tunisia's capital assets. A fourth reason was that the technicalities of privatization had to be learnt, and the damage from beginners' mistakes had to be kept to the minimum. For these reasons, privatization has been cautious and slow.

6.9. The Government began to allow the private sector to take over activities from the public sector first in agriculture, which was the sector with the most activities run exclusively by the State and where the greatest progress has occurred. Agricultural inputs are now mostly delivered by the private sector, whereas few were in 1986; the State's role is largely restricted to regions where the private sector has not yet shown interest. Similarly, extensive activities of the State in mechanized agricultural operations (ploughing, harvesting, etc.), fisheries, and livestock have been transferred to the private sector. The Government is also taking steps to disengage from cold storage, milk collection, and various veterinary services. Activities like regional crop spraying, in which there are benefits from coordination, are contracted out to private firms but organized and subsidized by the State. Similar actions have occurred in transport, where passenger and freight transport by public enterprises is fast giving way to private competition, where a private company is now competing with the

State airline in providing charter services, and where three private companies have captured a share of the shipping market. The provision of public telecommunications services (pay phones, fax, telex) was recently opened to private firms, which are multiplying rapidly.

6.10. The Government is also exploring ways to place responsibility in private hands for the management of common resources and public goods, where the State had traditionally played a paternalistic role. Some of the present effort still consists of pilot programs, but the achievements so far could be models for similar initiatives in other sectors. Among the more advanced is the management of potable water resources in rural areas based on local water users' associations, of which 1,400 have sprung up and are mostly functioning satisfactorily. Organization of users' groups for irrigation water has been slower, but should accelerate as the Government implements its program to recover fully O&M costs, as compared to their present level of around 75% (excluding depreciation of local machinery, which adds 15%-25% to costs). Similarly, the Government is trying to conserve and improve natural resources through the active participation of the local populations and has devised pilot programs to transfer more responsibilities for the conservation of soils and pastures to users' groups. It has withdrawn from exploiting forests, leaving it to the private sector, and limits itself to ensuring the maintenance of the forests.

Privatization: The Lessons Learnt

6.11. Limited though this experience has been, the Tunisian authorities have drawn some lessons from it and adapted their objectives and procedures accordingly. The first lesson was that the institutional framework, having been designed primarily to ensure consensus, transparency, and careful preparation, was less effective in initiating proposals for divestiture or executing them speedily. Decisions on which firms to privatize and on what terms were made by the CAREPP,[5] set up in the Prime Minister's office and chaired by the Prime Minister himself. The membership of the commission ensured that a high degree of agreement was reached across the Government as it comprised the four ministers of the most important ministries in this context, the Governor of the Central Bank, the Secretary General of the Government, and selected senior civil servants and advisors. Consensus outside the Government was achieved through consultation with the representatives of employers (UTICA) and of labor (UGTT), as well as publicity in news media. The commission also had access to expertise within the Government and outside advisors. But its purpose was to spread responsibilities rather than to concentrate them, so that the commission was unlikely to take initiatives, let alone prepare a concrete privatization program. The initial proposal to privatize had to come from the enterprise itself or from its technical ministry - the most that the CAREPP could do as regards a program was to be the forum for the Government to formulate its principal objectives and intended scope of privatization.

6.12. The second lesson was that private entrepreneurs who judged that they could convert money-losing enterprises to profitability were usually right. No overall data for the results of divestitures so far are available, but some cases are striking and the assessment of the authorities and the public is that they indicate the rule. Almost all the privatized enterprises were loss-makers and all but a few appear now to be profitable, in some cases with increased employment. In one case the new owners rehired most of the two thirds of the work force that had been dismissed with severance packages (making them better off than those who did not lose their jobs). A large textile firm has been exporting successfully and has increased employment by adding to its shifts. More

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5/ *Commission d'Assainissement et de Restructuration des Entreprises à Participations Publiques* (commission for the restructuring and rehabilitation of enterprises with public sector shareholding).

recently, a private group has taken over a transport enterprise that had been reduced in size, with the entire remaining work force and its debts.

6.13. The third lesson has been that negotiated divestitures probably do not yield the best terms for the Government. There were no public offerings until mid-1993; of the 39 divestitures until then, all were negotiated, 11 of them being share sales through negotiated placements, and in some cases a long standing private shareholder with almost half the shares bought out the State. These methods were used because it appeared there would be little demand for the weak enterprises that were being put up for sale. Their drawback is that Tunisia is small enough for collusion between potential buyers to be easy to organize, and the CAREPP has on occasion withdrawn or postponed a divestiture because it judged that there was not enough competition. But the market for public enterprises appears to be stronger than had been thought. Apart from entrepreneurs whose preference is to gain control, there is a general public that shows demand for equity in potentially profitable enterprises and has little access to the equity of private firms. Moreover, the opposition to foreign investors appears to be less than had been feared, partly because, although these investors have shown interest, it has not been so great as to support concerns that they might dominate the economy. The authorities thus have a freer hand to create competition among potential buyers by seeking foreign investors.

6.14. A fourth lesson has been that negotiated divestitures are unsuitable for large enterprises, especially if they are profitable. When the required investment by the buyer is big, the difficulty of finding enough potential buyers to ensure competition, especially in the eyes of a watchful public, will be greater. However, the opposite extreme to negotiated divestitures, dispersing shares over a large public, has the drawback of leaving open the questions of how the management will be selected and to whom it will answer. Such cases require that control over the management not depend, at least at the start, on having a majority or near-majority of the capital, but just on having a substantial stake in the enterprise.

Privatization: New Approaches

6.15. Profiting from the experience gained and also from the development of the Bourse over the previous years, the Government tried a new procedure in early 1993. It aimed to spread ownership of equity in divested enterprises widely, while ensuring that their management was in the hands of a group or individual with substantial investments in the enterprises, and to develop the equity market by ensuring a supply of equity that could be traded. The privatization of a chemical firm was advertised in leading European business papers as well as in Tunisia; a large minority of the shares was auctioned as a block on the *Bourse* to a single bidder (in this case a group of investors); and another block was put up shortly after for subscription by the general public with limits on individual purchases. The State retains a minority holding for a transition period. The operation went smoothly, the first block bringing a somewhat higher bid than had been expected and the price of subscription shares went considerably higher than the block (the rules stipulate that the block shares cannot be sold at that time). The results indicate that future divestitures can use the same procedure.

6.16. Now that a measure of goodwill has been won and the authorities have determined their objectives and means of achieving them, privatization needs to be accelerated on the basis of an action program. Listing enterprises to be privatized over the next three years would encourage private investment by reducing uncertainty, since privatizations in a single year may cover productive capacities comparable to the total capacity in new investments and, hence, affect private investment decisions. Manufacturing investments are especially likely to be affected since most enterprises privatized will be in or related to manufacturing. There is no need for a definitive list of all the enterprises that will eventually be privatized since such a list can arouse controversy, often

over marginal cases, and thus lose goodwill. Besides, attitudes change, as they have done in Tunisia, and what was not acceptable yesterday becomes acceptable tomorrow, cement being a case in point. The Government's stated principle that any enterprise in a competitive sector is privatizable embraces enough public enterprises to fill a program for several years. However the selection process of leaving the enterprises and supervising ministries to volunteer enterprises for privatization has been too slow. Recently the responsibility for preparing a privatization program has been given to the Ministry of Planning and Regional Development. The Ministry's task may be made easier by the creation of a small body of "wise men", senior, respected, and disinterested figures from the public and private sectors, who would set up the privatization programs and thus reassure the public that the general interest was being looked after. The Ministry would provide the secretariat to this body and supervise the implementation of the program.

6.17. The learning process of the past privatization has resulted in a technically competent group of officials who are capable of advising the Government and supervising on managing details of a privatization. They may, however, need to add to their skills as privatization reaches larger firms and foreign investors increase their presence, but they will be most effective if they stay a small group and make the greatest use of the private sector in preparing financial and organizational restructuring, doing the legal work, and performing the myriad other tasks of a privatization. The banks, or some other acceptable agents, could be given the responsibility of the whole privatization of an enterprise. But officials would review the proposals and refer the decisions to the political authorities.

Infrastructure and Public Utilities

6.18. On the whole the public sector has managed these well, though certain activities need to improve. In the more efficient activities, such as power, sewage disposal, and water supply, privatization or partnerships with the private sector may not bring short term gains in productivity or efficiency. But they could release the public sector from substantial expenditures in the near future and stimulate productivity and innovation over time. Foreign partnerships and investments should be encouraged, both because of the know-how they bring and because they provide additional resources.

6.19. The Government has begun to consider partnerships with foreign private firms for the generation of electric power with the electricity and gas company, STEG. A major investment in the telecommunications system is being carried out and has resulted in a sharp improvement in the quality, diversity, and regional coverage of services. The postal system, the PTT, envisages giving the telephone system autonomy as a public utility. It could go further and attract foreign partners as shareholders by making the telephone entity a corporation and inviting investors. There might be opportunities for efficiency gains through private sector provision of solid waste disposal services and greater use of private contractors in the design, construction, and maintenance of roads.

6.20. The infrastructure problem where prompt action to bring in the private sector is needed consists of shortages of land for industrial and commercial use and poor maintenance of existing industrial estates. Poor drainage, flooding, deteriorating service roads, and inadequate enforcement of pollution regulations are cited by the UTICA as common problems among existing estates. The unsatisfied demand for industrial premises is large: the public sector agency for such land development, the AFI, which had a monopoly since 1973, has marketed no new estates for ten years and records 1,000 unsatisfied applications. Consequently, there has been considerable construction of industrial premises where not officially permitted, with the risk of misallocation of land use and pollution.

6.21. The development of industrial and commercial land needs to be transferred to be private sector with a regulatory framework to ensure suitable zoning. The AFI has been an instrument of Government policy and not responsive to the market. it was used to attract industry to remote areas by developing industrial estates there. This policy failed, but the costs weight heavily on its balance sheet. It also did not sell its land at market prices, thus failing to gain additional revenue. Part of its inability to maintain the existing estates satisfactorily stems from its financial difficulties.

6.22. The financial needs for the industrial estates alone dictate the need to transfer its development to the private sector. According to the AFI:

- rehabilitation of the existing 43 industrial estates it developed would amount to US$30 million;
- the creation of 14 new industrial estates would cost about US$80 million;
- restoring the AFI's balance sheet to equilibrium would cost US$20 million.

6.23. Transferring development of industrial and commercial lend to the private sector would necessitate several steps.

- A new regulatory framework is needed. A draft law and decree prepared by the AFI in September 1992 are a step forward, but they would constrain developers by specifying capital requirements; requiring ministerial approval based on "length of service" in the business and other qualifications; holding foreign capital to minority shares; and imposing a standard form of contract. These constraints should be removed.

- Regional planning should be conducted in consultation with the private sector. Although the AFI could provide technical support, the consultation should be across the Government. Such consultation could also address issues of simplifying and speeding up procedures.

- The AFI's design and engineering offices should be privatized.

- The legal and fiscal status of leasing as pertaining to industrial estates, should be clearly defined and should facilitate joint ownership and management of estates.

B. FACILITATING TRADE[6]

6.24. The costs and time taken for conveying merchandise through Tunisian ports and for shipping it to or from foreign ports need to be reduced. Tunisia has fallen behind many, if not most, of its competitors in this respect and must emulate economies that have instituted permanent arrangements for facilitating trade. The stakes are high. International transport costs are typically 10-20% of the total cost of the goods. They can decide whether a price is competitive or not. They are even large enough for improvements to be noticeable in the national accounts. Speed and regularity are crucial to competitiveness in markets that require quick reactions or just-in-time stock management, which concern a large part of Tunisia's exports. A competitor in Europe can usually deliver a truckload to almost anywhere in the EEC within 24 hours. Trade facilitation is also crucial to

6/ This section is mainly based on work done in MN1IN.

reducing the dichotomy between off-shore and on-shore enterprises, which is in part due to the difference between the simplified customs procedures enjoyed by off-shore enterprises and the cumbersome procedures for the rest of the economy. Indirect exporters, in particular, are at disadvantage in supplying off-shore firms, as compared to foreigners, because they must clear customs both for their own imported inputs and for delivery to their off-shore clients.

6.25. An indicator of how slow the passage of goods is through Tunisia's ports is that it is unlikely to be less than six days for a container, whereas at most a few hours would be needed in a modern port. Goods take longer to cross the port than to cross the sea. Estimates of the average length of stay of goods in Tunisian ports are 3-4 weeks, long enough to expose goods to deterioration and pilferage (though the theft rate is low). Another aspect of speed is that foreign firms, especially some multinationals, will not deal with non-standard documentation since that costs them time and money. Hence, export opportunities are being lost because of outdated procedures at home.

6.26. These procedures are one reason why passage is not faster. Passage of goods through a port consists of a series of steps accompanied by appropriate documentation, and countries that have reduced the steps to a minimum and simplified the documentation give their exporters a competitive advantage. Since the various steps usually correspond to different agencies, such as freight forwarders, customs, port authorities, cargo handlers, shipping agents, insurers, and bankers, there is a tendency for documents to multiply. 30-40 signatures may be usual for a single shipment and as many as ten copies may be needed. Since their layouts and terminology are not harmonized, transferring information from one step in the port to the next is slow and subject to frequent errors. In modern ports documentation is standardized so that a basic set serves all the different agents without superfluous information. Most of the information is handled through an integrated computer system, thus eliminating the need to transmit the same information repeatedly, and such paper copies as may be needed are obtained through printers and copiers. Such computer systems also allow transmission of information to an exporter's clients and bankers, thus expediting procedures on arrival. In all these respects practice in Tunisia is out of date.

6.27. Customs procedures particularly need to be lightened by relying on modern methods of basing inspections on the customs' knowledge of the firms and random checks. In modern ports only 5% of declarations are scrutinised and less than half of these entail physical inspection. In Tunisia physical inspection is the norm, especially for imports, which are often inspected twice. It then becomes necessary to have special procedures for certain types of goods or particular firms, such as off-shore firms, which may solve a particular problem but does so at the cost of giving advantages to some but not to others. A step forward in speeding customs procedures was taken in the mid-1980s with the introduction of computer based clearing through the SINDA software developed in Tunisia. But the momentum was not kept up and SINDA did not evolve along with changing requirements or technical possibilities. Moreover, much of its potential for reducing paperwork was wasted because the customs continued to require all the documents supporting the declarations, apart from which the SINDA did not cover the special regimes and did not have enough terminals. Since the SINDA does not conform to any internationally accepted standards, it needs to be replaced.

6.28. Inefficient cargo handling is another obstacle to quick passage through ports. On average the merchandise handled by a docker gang in Tunisian ports is about half that in Algeria. This low productivity of dockers is mainly the result of the monopoly of the cargo handling firm, the STAM (*Société Tunisienne d'Acconage et de la Manutention)*, in the ports of Tunis (La Goulette, Radés, and Tunis), where a docker gang handles 80 tons of all bag cargo in a shift. In contrast, a docker gang in Sousse handles 300 tons and in Sfax

400 tons, because there is competition. Moreover, such a gang in the Tunis ports has 16 men, whereas 10 would be ample. But, although the Tunis ports greatly lower the national average because they account for 45% of the country's trade, none of the ports compares with modern ports around the world.

6.29. The full cost to the economy of costly and slow trade cannot be measured and is not directly felt since it consists mainly of lost export opportunities, but part of it is the cost of shipping, which appears to be unusually high. For instance, it costs less to ship a container to Marseilles from New York or Hong Kong than from Tunis. Even though normal containers may not be representative of Tunisia's cargo, of which most goes on pallets or on trailers on RORO vessels, sometimes with rebates from shipping lines for regular customers, this is a valid indication of the costs since reliance on RORO vessels is often a second best due to the inadequate container facilities in Tunisia. Specific calculations by Bank staff of the costs of shipping confirm the conclusion in detail. Various reasons are given for these high costs, among them economies of scale in major ports; but the most important reason is that Tunisia's maritime trade has been dominated by a shipping conference, which, though formally dissolved at the beginning of 1993 to comply with EEC competition policy, continues to function as a cartel. A further burden on Tunisian enterprises is the requirement that they insure their freight with Tunisian companies, whose costs are high by international standards.

6.30. A precondition for facilitating trade is that ports and shipping be opened to competition. At present there are several interlocking interests that need to be separated. The port authority, OPNT (*Office des Ports Nationaux Tunisiens)*, is a major shareholder in the national shipping line, the CTN (*Compagnie Tunisienne de Navigation),* one of the lines that constituted the shipping conference. The CTN has a right of first refusal for bulk and bag cargo, which has led to frequent complaints of delays while the CTN sought to charter vessels, when it lacked the necessary capacity, to obtain the contracts itself. Enforcement of this right seems to be waning, but the CTN still enjoys the advantage of receiving rebates from the OPNT as a regular customer. In other respects the OPNT's port charges do not seem to be based on efficiency criteria; they do not, for example, differ between ports. At least part of the CTN's profitability is due to these rebates, apart from which the OPNT covers its losses on its West African routes. The private sector has not been able to break in to this market; the shipping companies set up by private entrepreneurs are either in difficulties for lack of business or are finding business as tramp lines away from Tunisia. The CTN is the majority shareholder in the STAM, which is also profitable, despite its low productivity. The main freight forwarding agent, also a leading agent for shipping, the IATA, and insurance, is a public enterprise, the SOCOTU, which recently absorbed the TTT, another public enterprise and the only Tunisian firm with TIR trucks.

6.31. The consequences have been to leave Tunisia with costly and technically backward ports and shipping and to make it heavily dependent on foreign firms for its overseas transport. It has no specialized container facilities. An apparent lack of demand for containers is usually explained by the small size of shipments and the necessity of grouping the shipments of several firms in one container, which complicates customs and handling. But the preferences of the shipping lines of the conference for bulk merchandise and RORO systems seem to have been at least as important in suppressing containerization. Yet the CTN has only two small RORO vessels itself (a total of 500m rolling deck) and its fleet is old and obsolete. The STAM relies mainly on ships' cranes, while its shore-based handling equipment is provided mostly by the OPNT. Tunisia has no private TIR trucks for hauling trailers to RORO vessels and then to destination because the effect of protecting the domestic truck assembly enterprise is to make trucks too costly for Tunisian haulers to be competitive with Europeans. The TIR trucks of the SOCOTU do not cross the sea. Much of the legislation is out of date as well; that governing dock labour was influenced by French legislation of 1947 and is unsuited to present day technology,

while there are many pieces of legislation governing the other operators in the ports (freight forwarders, ships' chandlers, etc.) that are often ill harmonized or outdated.

6.32. The CTN's right of first refusal should be eliminated. This poses the question of the future of the enterprise, which should be addressed as a public enterprise issue but not allowed to hamper Tunisia's external trade. The various pricing and other barriers to competition should be eliminated to enable the private sector to enter. The CTN should also be replaced as a shareholder in the STAM with the aim of full privatization in the near future. Other measures could be to broaden the representation of enterprises, especially private enterprises, on the boards of agencies such as the OPNT, where representation has been so far closely linked to firms operating in the ports; and to allow insurance for exports to be opened to international competition.

6.33. The customs need to establish a two-way channel of communication with institutions representing the private sector, in place of the present one-way channel of a public relations office. The probity of the customs is acknowledged to be of an unusually high standard, but the price has been an aloofness that often disregards the rights of importers and exporters and prevents the customs from appreciating fully the costs their actions may entail for firms. Maintaining and reinforcing the customs' probity and yet being responsive to the needs of enterprises can only be achieved through an institutionalized means of communication and an impartial official procedure for settling disputes promptly before they are taken to courts. Thus decisions by the customs,such as the suspension of procedures for importing duty-free replacements of items that did not conform to original specifications or were defective, would be subject to review to determine the justification and, if necessary, the most appropriate means of tackling the problems that arise. Similarly, the causes for the delays in refunding duties collected erroneously, or in completing certain procedures for which enterprises need to put up bank guarantees, could be eliminated. At present the obstacles are such that enterprises often abandon any effort to recover payments, and guarantees accumulate needlessly, whereas such problems should not arise or should be solved immediately.

6.34. A trade facilitation program should follow three principles. The first is that customs, port procedures, cargo-handling, and shipping should be considered services to exporters and importers, whose requirements are paramount. The second principle is that facilitating trade never ends; changes in the economy, in regulations affecting economic transactions, in products, and in transport techniques all need to be taken continuously into account. The third is that importers must be treated on a par with exporters; that is to say obstacles to trade should not be used to protect domestic producers. Such obstacles cannot discriminate between imports needed for producing exports and those needed for other purposes and, hence, handicap the activities with the most promise for the future.

6.35. Trade facilitation is technically complicated, involves many parties, and needs to be a permanent process. The most effective way of devising and carrying-out a program would be to divide it into two stages. In the first stage a working group representative of the principal concerned groups would be given the responsibility of proposing a detailed program that the authorities could implement. The second stage would be to create a permanent trade facilitation commission based on continuous consultation between the main concerned parties. The working group could comprise representatives of enterprises, probably the Chamber of Commerce, of the labor movement (the UGTT), and of the government departments governing ports, customs, external trade, and external payments. Technical sub-commissions could include representatives of other bodies as needed, e.g., the Ministries of Defence and of State Properties, and the shipping lines. The permanent commission's composition would be similar. Although Tunisia has considerable professional expertise in most aspects of trade,

a prerequisite for devising a trade facilitation program would be a study of the methods adopted in other countries.

6.36. All these institutions provide important services to enterprises and, in the interest of efficiency and responsiveness to needs, should publish regular reports. The OPNT could provide an annual report detailing its costs and revenues by port using cost accounting; the CTN needs to publish its accounts and corporate policy; and the STAM needs to provide details of its performance and finances. For the customs regular publication of changes in regulations and procedures would not only help enterprises, but would remove one source of complaints, namely that customs officials, themselves, are often out of date in their knowledge of current procedures. Such openness will go far to provide the means for continually improving Tunisia's ability to compete internationally.

C. REMOVING GAPS IN THE LEGAL SYSTEM

6.37. The legal system governing economic activities is modern, as it is in most areas, though it has fallen behind the evolution of business practices around the world in certain respects. The legislation and practices of other countries should be consulted for removing the deficiencies discussed here. There is no lack of legal expertise, so that the most effective way of formulating the legislation needed would be to entrust the task to one or more commissions comprising, in addition to members of the legal profession, representatives of the private sector, workers, and government. Given the outward orientation of the economy and its openness to foreign investment, this should be a regular or continuous practice.

6.38. The rights and legal principles necessary to the private sector are recognized, including property rights, the basic principles of contract, a judicial body under the exclusive authority of the law, and remedies to enforce obligations and judgments. Tunisia adheres to major international treaties regarding investments and intellectual property rights, among other things, and international treaties take precedence over national law.

Company Law

6.39. One respect in which Tunisian legislation has fallen behind international practice is a gap in company law regarding holding companies and corporate groups. The law does not recognize these types of relations between companies and is consequently ill placed to regulate accounting and reporting, liability of parent companies for the actions of their subsidiaries, contracts between parents and subsidiaries (tie-in clauses, transfer pricing), bankruptcy of corporate groups, and protection of minority shareholders. An issue that will grow in importance is the protection of Tunisians who invest with foreign partners. A second gap is the absence of the unipersonal company. This is especially important for small enterprises and people offering specialized services, but it also leads to perverse effects, notably forcing foreign companies establishing local branches to take on straw partners. A third gap is the absence of mechanisms and procedures for restructuring private companies, although legislation for public enterprises exists. Practice has followed French principles, but legislation is needed for the rights and obligations of partners and shareholders, the companies that emerge, and creditors.

Contract Law

6.40. There are similar gaps in contract law, where new forms of contract are not explicitly regulated. These include leasing, lease-backs, factoring, and franchising. Some of these have become common, but there

is a need to ensure that they do not lead to conflicts between practice and legislation in their regulation and settlement of disputes.

Bankruptcy

6.41. Bankruptcy legislation reflects the traditional stigma attached to bankruptcy rather than the modern causes and needs. This is illustrated by the reference in the legislation to merchants rather than to companies. The penalties are harsh and include the loss of certain civil rights, such as the rights to vote or to hold certain offices. Consequently legal bankruptcies are infrequent, ranging from seven to eleven a year, while many enterprises close and settlements are reached out of court.

6.42. Although some social disapproval of bankruptcy is desirable, it needs to be balanced with a reasonable effort to keep a going concern going. Hence a need for early measures to forestall bankruptcy by allowing debtors to compose with creditors. The only means available at present, the *concordat préventif,* is too little too late; it allows the debtor, before cessation of payments, to request the courts to allow him to seek agreement with creditors to pay 75% of unsecured debt within two years or 50% within one year. If the court denies the request, bankruptcy is declared, but even if the request is granted the effect may be marginal since secured debts are unaffected. It would be preferable to give greater flexibility in composing with creditors, secured and unsecured, and to recognize that bankruptcies may occur despite honest and competent efforts to avoid it and, therefore, to modify the penalties.

Lengthiness of Cases

6.43. A common criticism of the legal system is that the courts move slowly. But it is difficult to find a satisfactory explanation as to why this should be so since even the facts are in dispute. According to the official statistics, the average case takes 3.7 months, but managers of enterprises agree that cases usually drag on for years. One acknowledged problem is the lack of expertise in economic cases. To some extent this may be a temporary phenomenon, since the *Institut Supérieur de la Magistrature,* which trains present and future judges, produced its first graduates in 1989. Nevertheless, it would be desirable to assess the need for more training of judges in economic cases. It would also help accelerate cases if government lawyers were more solidly grounded in economic legislation and could bring points of law to the attention of judges during the case.

D. LAND AND HOUSING

6.44. The development and sale of land and housing have long been subject to cumbersome and confused regulations, public sector monopolies, and distorted incentives. Consequently the markets function poorly. By the standards of countries whose property markets function well, the share of available land that comes on the market is small. One consequence is that the price of housing has been rising faster than household incomes, threatening to undermine the unusually high standard of housing that Tunisia has achieved for most of the population. The administrative problems also prevent the widespread use of mortgage financing and thus block a method of financing housing and businesses that has been basic to many economies.

6.45. Because of the cumbersome nature of the regulations governing land titles, only about 3% of properties are estimated to have titles that are fully in order. Property rights are based on the Torrens system,

in which all rights are entered in a Land Register. In this system transactions must be carefully verified before they are recorded and when, as in Tunisia, the procedures and institutions concerned do not function smoothly, backlogs can develop. A backlog was created early, in Tunisia's case, when it was decided in the mid-1960s that the Torrens system, which had been introduced in the 19th century for the properties of European settlers, should be extended to the whole country. By 1990 only 15% of properties had been registered and the traditional system of registering property rights (*titres arabes*) continues to function and to be recognized for most purposes, excluding mortgages.

6.46. For the backlog to be removed over the long term the process of registering land and property titles needs to be modified and the institutions administering the process need to become more efficient and to coordinate better. In Tunisia, as in few other countries, registration is a judicial act. Hence it involves the Land Tribunal, as well as the Office of Topography and Cartography (OTC), and the Land Registry (*Conservation de la Propriété Foncière*), each under a different ministry. These agencies function at different levels of decentralization and their coordination varies widely. The Registry rejects most of the requests it receives to record changes in property rights because the documentation is faulty, but the lack of a good information system that can be used by all the agencies prevents the authorities from detecting unrecorded transactions. Since the penalties for not recording are light, registration and recording property rights are, in effect, voluntary. Until 1987 the registration fee, with a base rate of 14.6% was a deterrent and, given the cost and difficulty, people often avoided registration. Since then the costs of registration have been lowered. But a result of these problems has been that the sequence of ownership of a property that may have been duly registered in the past can often not be reconstructed.

6.47. Legislation adopted in 1992, and to come into effect in 1995, aims at bringing records up to date by only recognizing property rights that have been duly recorded. This puts pressure on owners of property to record their titles. To avoid the problem of faulty documentation in the future, the same legislation requires that property transactions be drafted by people with the requisite expertise (notaries, lawyers, personnel of the Land Registry). But the legislation will be difficult to implement unless the administrative obstacles to registration and to recording property rights are overcome. To make it work a number of measures need to be taken. The registration of land should not be a judicial act and the Land Tribunals should be limited to resolving land disputes. More generally, the procedures for registering and recording should be simplified. The OTC has begun to use private surveyors, but since it employs most of the surveyors in Tunisia, it should encourage them to set up as private professionals. All the agencies involved need to have access to a better data system.

6.48. To function well, property markets require that incentives not be distorted and that the market be competitive. The existing taxes on property -- a capital gains tax and a tax on rental values -- yield little and have been difficult to apply. As a consequence, they are levied unevenly and distort the market. Local authorities can levy a tax on the value of undeveloped land, but only 20% have chosen to do so since the tax raises several problems, such as assessing the value of the land when the market is limited. An overhaul of the taxation of property is needed and is being studied by the authorities, a possible objective being to replace present taxes by a tax on the value of property. A good information system is also needed for a property market, as well as for taxation and registration purposes. Market forces should also be allowed to operate in the development of hitherto undeveloped land, subject to a regulatory framework for zoning and environmental protection. This means the *de facto* public sector monopolies in this activity (for industry: AFI; for housing: AFH -- *Agence foncière de l'habitat*; for tourism: AFT --*Agence foncière du tourisme*) should be removed and the activity opened to the private sector.

E. IMPROVING ECONOMIC DATA

6.49. The ability of the authorities and entrepreneurs to discern and analyze trends in the economy is limited by a lack of good data. This report's description of the private sector has been limited by gaps in the available data. Data collection and processing for national accounts purposes and for analyzing household consumption have been relatively good, though in these areas too there have been shortfalls, notably collecting more data than can be processed while they are still useful.

6.50. Improvements need to be made both in the collection and processing of data with the objectives of making them available to users before they are outdated. The INS conducts annual surveys of production that aim at comprehensiveness and are, consequently, attempts at censuses. Only a fraction of the enterprises respond, leaving the National Institute of Statistics, INS, with a sample it had not chosen, whose bias it cannot reliably estimate. Such surveys are costly, but their usefulness is reduced by the delays in processing the data, partly because follow-up on responses is costly as well and partly because the mass of data is too great. Reliable information on production could be obtained at less cost and while still useful by frequent surveys using appropriate samples and follow-ups. Alternative sources of data should also be used more: registration lists of enterprises; electricity, gas, and water connections; lists of bank clients; and social security enrollment are examples.

6.51. A consultative process needs to be established with the private sector, the Government, and public sector institutions that also provide information services to the private sector, such as the API. Such a process should define what data should be made available to the various users and the time limits. At present the public sector agencies, notably the INS, view themselves as being agencies serving the Government. Most tasks for the Government take precedence over others (at present the INS is taking a census of the population). These tasks are essential, but they should not preclude routine provision of information. The private sector and the authorities have specific needs for up-to-date information and the competitiveness of Tunisian enterprises and management of the economy will be improved by meeting these needs.

F. EXTENDING PARTNERSHIP TO POLICY MAKING

6.52. One far-reaching aspect of the development of the private sector is making the sector share the responsibility of formulating and implementing reforms. The Tunisian authorities have an established practice of consulting representatives of affected parties when preparing reforms, and their consultations with private sector leaders have made it easier for them to carry out some difficult measures. But consultation does not transfer responsibility to those most concerned for reaching an agreed outcome, nor for implementing the agreement. Consultation elicits a point of view which those consulted formulate to further their own interests, while assuming that others will do the same.

6.53. The practice of entrusting the formulation and implementation of reforms to councils or committees consisting of representatives of the principal concerned groups has been one reason East Asian economies have been able to carry out complicated policies smoothly. It places the burden of finding solutions to problems on those who have an interest in having the problems solved, instead of passing the burden to the authorities. The role of the authorities is to ensure the compatibility of the solutions with other priorities and constraints, including the interests of groups who may be indirectly affected. They may also need to ensure that the process moves ahead without excessive friction.

6.54. To be effective such councils need to be charged with the responsibility of finding solutions to the problems of a clearly defined area, but should be left to formulate the problems and to discuss them freely. Private sector organizations have access to a wealth of expertise--the preparation of this report has made abundant use of analyses prepared for the UTICA--which should be used in collaboration with other concerned groups, including the concerned government authorities, to move from analyses and advocacy to the preparation of concrete measures.

6.55. A number of areas where such councils could be effective can be identified. One, already mentioned, is trade facilitation, which is technically complicated and involves several parties, but where the desire for improvement on the part of the private sector and the Government is strong. Other areas that lend themselves to this approach include reform of judicial procedures affecting business and the formulation of technical training and apprenticeship programs.

G. SUMMARY OF RECOMMENDATIONS

Reducing the State's Direct Economic Activities

* Privatization of public enterprises needs to be accelerated. A three year privatization program could be drawn up by a small body of "wise men".

* Private sector expertise should be used in the preparation of individual privatizations.

* Consideration should be given to privatization of utilities or partnerships with private firms in their management. Similarly consideration should be given to obtaining private capital for infrastructure and utility projects, particularly foreign private capital.

* The provision and maintenance of industrial and commercial estates should be privatized, with the State providing a regulatory framework.

Facilitating Trade

* A trade facilitation program needs to be formulated for the entire processes of importing and exporting. This should be done through the creation of a permanent trade facilitation commission with representation from the main concerned groups. The program should aim at simplifying documentation and harmonizing it with documentation used by major trading partners.

* The interlocking interests of OPNT, CTN, and STAM should be broken up.

* Competition in port services and shipping should be encouraged, especially in cargo handling in the Tunis ports. The CTN's right of first refusal should be abolished and its cartel arrangement should be dropped.

* The high import duties on trucks that prevent Tunisian TIR firms from being competitive should be lowered.

* Exporters and importers should not be limited to Tunisian companies for insurance.

* The customs should establish a two-way channel of communication with institutions representing the private sector.

* Customs procedures should be modernized and the SINDA should be replaced by an up-to-date system.

Legal Constraints

* Company and contract law need to be brought up-to-date with developments around the world.

* Insolvency proceedings should be reformed to conform more to practice in Europe.

* Judicial procedures need to be adapted to modern business needs and a consistent jurisprudence needs to be established.

Data

* The availability of data on enterprises, employment, and supplies and uses of goods, services and land needs to be improved.