

A vibrant street scene in Tunisia, featuring ornate, light-colored buildings with blue accents. A market stall in the foreground displays various clothing items. People are walking along the street, and a black lamppost stands in the middle ground. The sky is clear and blue.

Tunisia Diagnostic paper: Assessing Progress and Challenges in Unlocking the Private Sector's Potential and Developing a Sustainable Market Economy

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Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank's strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in the country.

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The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (**BEEPS**) and the Life in Transition Survey (**LITS**), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and OECD. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD's Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

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Tunisia Diagnostic
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Executive summary

Tunisia's private sector is characterised by the 'missing middle'; the public sector and often inefficient large state-owned enterprises (SOEs) dominate the economy, while small firms, representing 90 per cent of the total number of firms, are unable to grow and create jobs. Five main obstacles impair firm performance and private sector development:

- A complex set of policies **distorting domestic competition** hold back Tunisia's private sector development. SOEs prevalence extends to non-strategic sectors and pervasive price controls impede the functioning of market forces and hinder competition, given weak regulators and potential for market capture from state-controlled incumbents. Important regulatory barriers to entry are embedded in the dual onshore-offshore structure of the economy, which makes a distinction between export-oriented companies and those aimed at the domestic market in terms of regulations and incentives. Competitiveness deteriorated in the first four years after the revolution in the absence of significant reform efforts, but reform momentum has picked up since 2015, as demonstrated by the approval of the Competition and Investment Laws and the design of performance contracts for public sector managers to improve **governance**. Meanwhile, a coherent and comprehensive strategy to liberalise and properly regulate markets is still lacking.
- In the renewable energy sector, which is emerging both in the region and globally as a sound investment for environmental and economic reasons, the state-owned Tunisian Company of Electricity and Gas (STEG) exerts significant influence over project development, hampering private sector participation in the production of **green** energy. There is a lack of transparency concerning important technical and operational issues directly affecting private renewable energy projects, as well as the prevalence of subsidised pricing, which negatively affects the viability and sustainability of renewable projects on a commercial basis. Tunisia's Nationally Determined Contributions (NDC targets), announced by the government in 2016, will require large private sector investment as well as removal of regulatory barriers in the renewable energy sector.
- Low participation of women in the labour force continues to represent a major challenge to the inclusiveness of the Tunisian economy, and skills mismatch presents a major bottleneck for the private sector. Factors influencing skills mismatch include shortcomings in the quality of public education, rigidity of entry-routes to vocational training and from vocational training to employment, sticky wages, informality, discrimination, lack of competencies among university graduates, low private sector capacity to drive skills demand, and an under-utilisation of women's skills. This gives rise to a significant loss of human capital potential for Tunisia's economy, limits **inclusion**, and contributes to a vast misallocation of resources.
- The banking sector, largely dominated by public banks, faces significant challenges, negatively affecting its financial **resilience** and limiting access to finance in the absence of alternative financing instruments. The intensity of the problem varies across different segments of the economy. Non-performing loans (NPLs) in Tunisia are the largest among the Southern and Eastern Mediterranean (SEMED) countries, the result of hasty lending to certain sectors such as tourism, and have been an ongoing problem for the last two decades, posing a significant burden to access to finance, growth, and banks' balance sheets, especially public banks, where they are disproportionately concentrated. Moreover, resolving NPLs faces legal impediments, delayed by lengthy bankruptcy and court proceedings, lack of amicable settlements, and limited out-of-court restructuring.

■ The logistics sector plays an integral role in Tunisia's economy, and the country has traditionally prioritised, in the national development strategy, the **integration** into the global economy through the attraction of foreign direct investment (FDI) and the progressive liberalisation of the trade regime. Yet, the sector suffers from a lack of a coherent policy, and companies offering logistical services face certain administrative and regulatory obstacles. In addition, Tunisia is facing increasing competition from countries that have improved their infrastructure and logistics chains, while those in Tunisia have deteriorated. Coordination amongst various stakeholders is one of the most important policy recommendations related to developing the logistics sector.

Since 2011, growth has been subdued, averaging only 1.5 per cent per year, compared to 4.5 per cent on average in the decade before. Economic activity was held back by instability and dire security conditions, which led to contractions in tourism, oil and gas extraction, logistics, and mining, and a slowdown in the manufacturing industries and services. More recently, macroeconomic vulnerabilities increased; the current account deficit in per cent of GDP reached double digits for the first time; foreign reserves fell to critical levels, covering less than three months of imports; the dinar depreciated by more than 20 per cent; and inflation reached its highest level in over 26 years driven by the currency depreciation, energy price increases, and wage inflation. Meanwhile, in 2017, there has been some enhancement in economic activity, driven by the sustained improvements in security, tourism, and phosphate production; a recovery in services; and a good agricultural season, but growth remained sluggish at 1.9 per cent.

Since 2011, Tunisia completed a comparatively smooth political transition, steps were taken to simplify and streamline administration, and the government has embarked on a campaign to combat corruption. Meanwhile, challenges continue to exist in the political landscape, which the parliament and government have tried to address. However, some elements within the bureaucracy, still present since pre-2011, remain averse to reforms, and the presence of concentrations of economic power centres continues. There is a need to strengthen institutional capacity, such as the ability to design and implement reforms, improve and enforce laws, and deliver services to citizens and businesses. There is also a need for a strong modernisation programme, and for measures to reduce regional disparities.

This diagnostic document consists of the following sections: 1) political economy; 2) private sector performance; 3) key obstacles to private sector development; and 4) qualities of a sustainable market economy. The diagnostic exercise presented in the paper draws from the recently adopted EBRD methodology for measuring transition, which is based on six desirable qualities of a sustainable market economy: *competitive, well governed, green, inclusive, resilient, and integrated*.

1. Political Economy

Since 2011, Tunisia completed a relatively smooth political transition. An elected Constituent Assembly drafted a progressive constitution, and the country held parliamentary and presidential elections, which most observers described as free, fair, and inclusive. The government represents parliamentary majority, and the legislative assertively exercises its right to monitor and review government operations. Compared to many other countries in the region, the Tunisian political economy landscape is diverse and not dominated by few power centres. This is, arguably, one of the key successes of the political transition since 2011. Tunisia enjoys an active, free, and diverse media scene. Civil society organisations have a large membership base and regularly engage in key political and socio-economic issues, often exerting influence and leverage that exceed those of other powerful political actors.

However, four challenges exist in Tunisia's political landscape. First, the two leading political groupings – the original Nidaa-Tunis party, and Ennahda party – are undergoing transitions in the ideologies they represent and in their leadership cadres. While this demonstrates renewal and dynamism, it has diluted their abilities to play clear and leading roles in some of the most important debates in Tunisia. Second, the large labour unions, which boast relatively major memberships and illustrious heritage in Tunisia's efforts at securing its political independence in the 1950s, advocate economic positions that, often, are not congruent with aspects of the free market. Third, though Tunisia's political transition in the past seven years has been largely successful, power centres from the regime that reigned before 2011 remain influential, with some elements within the bureaucracy being averse to reforms. This reveals the deeper issue of the existence of a major division in Tunisia regarding whether or not these old power centres are to be included in the economy. Finally, the war in neighbouring Libya has imposed several risks and challenges on Tunisia. A rise in militancy and attacks against foreigners has acutely damaged the tourism industry for most of the past seven

years. The consequences for the entire economy have been serious.

The parliament and government have been trying to address some of these issues, but challenges remain. Interactions with labour unions are becoming more productive than before. The legal framework surrounding a 'Reconciliation Bill' to deal with power centres from the regime of pre-2011, although stirring major controversy, has been passed. Crucially, the IMF programme, signed in 2016, is a key guide to reform efforts. Some of the political economy challenges highlighted above cast their shadow on the programme; a number of reforms were not undertaken in time, which led to postponement in disbursement. Nevertheless, the steps to address these challenges are starting to bear fruit, and further discussions surrounding key reform steps are progressing. Still, the four challenges remain. In particular, the transition within the largest political groupings is important, for it has the potential to give rise to new disturbances. This is particularly important in the period after President Essebsi's time in office ends. Moreover, the government continues to face difficulties when seeking to implement austerity measures, as shown by the demonstrations that erupted in January 2018 in response to the announcement of increases in the price of subsidised petrol and tax rises on cars, phone calls, internet usage, and other items, as part of the 2018 budget.

Against this context-specific political economy landscape, the capacity of the Tunisian state to pass reforms and concretely implement them, enforce the law, and deliver services to citizens and businesses needs to be tangibly improved. While numerous key legislative initiatives have been passed, the presence of a number of influential social and economic actors dictates that economic reforms go through a consensus-seeking process, with compromise often seen as the sub-optimal outcome, yet the only one possible. This weakens the institutional, policy, administrative, and legal environments in which entrepreneurs and businesses operate. The pace, scope, and sequencing of such a consensus-building process could be facilitated

and accelerated by a structured, transparent, and inclusive platform for dialogue between the main political and private sector stakeholders to achieve consensus on economic reforms. A similar exercise conducted in other countries, with the support of EBRD and other International Financial Institutions (**IFIs**), has proven of notable effectiveness to progress on key reforms. The Strategic Council, led by the Tunisia Investment Authority and comprising the main business associations, assumes this function. This platform discusses obstacles to the business environment and recommends common policy solutions to the High Investment Council, a cabinet group of relevant ministers chaired by the Prime Minister. It will be important that the Strategic Council delivers substantial output and that the authorities follow-up its recommendations.

Since late 2016, the government has started a campaign to stamp out power centres that the government claims have been implicated in corruption, but much remains to be done. Anti-corruption steps included: passing the Access to Information Law, one of the most progressive laws in the region; adopting a national Anti-Corruption Strategy; and approving a Financial Court Law, which allows the court to investigate ‘grand corruption cases’. Now the Anti-Corruption Agency has to be empowered with more resources to perform its function, gain trust of the population and enhance the confidence of the international community in the extent of the country’s efforts. Laws on conflict of interests, particularly in the cases of politically-influential individuals, and illicit enrichment policies need to be introduced.

Despite the government’s anti-corruption campaign, corruption remains one of the most problematic factors for doing business in Tunisia, and concentrations of economic power centres still exist. Cronyism and predation remain prevalent in highly regulated sectors, including those dominated by imports, in which decision-making has been influenced by different power centres. The consequence is weakening competition in certain sectors, and the blocking of some businesses, particularly from peripheral regions, from entering the market. Resorting to bribery seems to remain a recurring practice in various interactions with the administrative bureaucracy. According to the EBRD-EIB-WB MENA Enterprise Survey (**MENA ES**), conducted in 2013, firms reported paying on average 2.7 per cent of total annual revenue in informal payments or gifts to public officials to “get things done” with regard to customs, taxes, licences, and regulations.

Tunisia has taken steps to introduce simplification of administrative processes, including through the ‘regulatory guillotine’. At the same time, there is a need to simplify further bureaucratic procedures handled by the state administration, with which firms have to comply. This has a disproportionate effect on small and medium enterprises (**SMEs**) by diverting scarce resources to compliance with regulations and administrative procedures. Moreover, the Central Bank of Tunisia (**BCT**) needs to simplify access to foreign currency and gradually liberalise the foreign exchange market, as this is one of the major regulatory barriers to the private sector.

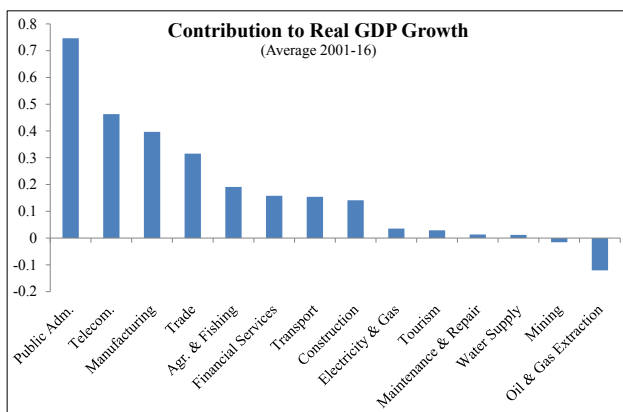
There is a need for a strong modernisation programme. This is particularly true for those entities that interface with, and deliver services to, the private sector, which should be more efficient and transparent. Despite some efforts – supported by IFIs – to accelerate the delivery of public projects through strengthening key units within the state administration, there is a need for wider efforts to enhance inter-ministerial coordination, including with local entities. Similar to the best practice in other countries, there is a need to introduce e-governance service tools to make it easier, more transparent, and more cost-effective for businesses to pay taxes as well as to provide the authorities with instruments to identify those who do not comply.

These weaknesses are also causes for the disparity among coastal regions and peripheries. While the government has started a political decentralisation process, the regions' local administrations suffer from a lack of skilled and empowered staff, able to manage projects and the large budgets received from the central administration – including through donor support. Moreover, unclear land tenure and property rights, inefficient public service delivery, and a degraded rule of law environment limit the attractiveness of these regions to businesses. Reducing disparities among the regions is one of the crucial developmental challenges of Tunisia, and indeed of most of North Africa, particularly for potential implications for stability.

2. Private sector performance

Historically, the public sector and sectors dominated by SOEs have mainly driven growth.

In the period 2001–16, public administration was the leading driver of growth, contributing by 0.75 percentage points to growth that was 3.27 per cent on average. It was followed by telecommunications (0.46 percentage points), manufacturing (0.4 percentage points), trade (0.32 percentage points), mechanical and electricity industries (0.22 percentage points), agriculture and fishing (0.19 percentage points), financial services (0.16 percentage points), and transportation (0.15 percentage points). Furthermore, an analysis of GDP decomposition at the sectoral level highlights that monopolistic profits and rents in these sectors, from barriers to entry, inflate the contribution of the transport, fixed-line telecommunications, and trade sectors.



Tunisia's private sector is skewed in number toward small firms.

The distribution of private sector firms by employment size highlights that one-person firms (self-employment) account for 86 per cent of Tunisian firms. Only 0.4 per cent of firms employ more than 100 workers. Nevertheless, large firms account for more than a third of all jobs, more than all one-person firms combined. The analysis of the dynamics of firms' jobs creation by size in the period 1997–2010 conducted by Rijkers et al. in 2013¹ confirms this observation, showing that, all else being equal, large firms create more jobs than do small firms. Therefore, the scarcity of medium

and large firms appears to be a key explanation for the low level of job creation in Tunisia. The study also analysed the dynamics of firms' jobs creation by age, showing that the greatest net employment creation was in young firms of one to two years of age. Therefore, promoting firm growth – for small firms – and removing barriers to entry to the market – for new firms – would result in more job opportunities in both the short run – from new entrants – and the medium run, since young firms grow faster than older firms do. Moreover, promoting entry of large firms, including through FDI, would be more beneficial, as large firms have superior dynamic performance and job creation from the beginning and over time.

The private sector lacks dynamism and is concentrated in low productivity sectors.

Entry rates, other than self-employment, are very low compared to international peers, but better than regional peers, with only one newly registered firm on average for each 1000 working age people, compared to five in Norway, the best performer, but less than one on average in Morocco, Jordan, and Egypt. Meanwhile, Tunisia is much more restrictive and protective of professional privileges compared to peers. Typically, regulations are in place to ensure a certain standard of service quality. However, in Tunisia, regulatory limitations impose restrictions on market variables such as prices and the number of service providers. The number of exclusive rights is eleven for accountants compared to five on average in OECD and nine for architects and engineers compared to an OECD average of four. More than 60 per cent of OECD and European Union (EU) countries do not have any regulations of prices in these professions. Moreover, firm exit rates are low, a manifestation of limited competitive pressure and cumbersome bankruptcy procedures. Productivity growth has been low, as firms remain primarily active in low-productivity sectors and upward mobility is limited. It is estimated that 77 per cent of workers are in sectors with below-average levels of productivity, which reflect the existence of

¹ Rijkers, Bob, Hassen Arrouri, Caroline Freund, and Antonio Nucifora. 2013. "Structural Stagnation: Firm-Level Evidence on Job Creation in Tunisia." 8th IZA/World Bank Conference on Employment and Development, January 2013.

barriers to entry and to competition. Between 2000 and 2010, the reallocation of labour from low-productivity to high-productivity sectors contributed only 0.4 per cent to the change in real GDP per capita per year, while the productivity growth within sectors contributed 2.2 per cent. Moreover, high-productivity sectors face a higher level of shortage in high-skilled labour supply, which adversely affect their growth potential.

The onshore-offshore duality impairs firms' performance. Tunisia has an offshore system, in which export-oriented companies enjoy incentives such as tax breaks, and an onshore system for industries aimed at the domestic market. This duality creates two sets of problems. First, the dual system establishes significant barriers to foreign entry for the domestic onshore market where companies are heavily protected from competition, also because several industries in the onshore sector are heavily regulated. As a result, they are characterised by low productivity and survive largely thanks to privileges and rents extraction arising from barriers to entry for competitors, despite the presence of several high-productivity segments which are operating under competitive rules. On the other hand, the offshore sector, able to attract FDI, has performed better as an engine of job creation and exports growth. The onshore-offshore segmentation is manifested by differences in the firm-size distribution, average productivity, efficiency, and export performance, among other aspects. Second, the offshore firms have limited links to the domestic economy, as the low quality of services and intermediate goods produced in the onshore sector – often not priced in a competitive way – harm the firms operating in the offshore sector, resulting in the need for importing most of the inputs needed and the focus mainly on low value-added assembly activities. The dichotomy contributes to keeping both sides of the economy trapped in low productivity, despite recent efforts to bridge the gap between the two regimes and lessen the difference in taxation that have yielded some positive results.

Five main obstacles impair firm performance and private sector development. In the following section, we first look at how the dominance of SOEs in the economy hinders private sector activity and limits its growth potential. We then look at the role the logistics sector plays in the Tunisia economy, and the effects of its recent decline on private sector competitiveness and the integration into domestic and global value chains (**GVCs**). Then, we study how gender inequalities and skills mismatch hinder private sector development; contribute to high unemployment rates, especially among youth, women, and graduates; and raise pressures for public employment. Next, we study Tunisia's financial sector challenges and legacy high exposure to the tourism sector, which increased financial vulnerabilities and NPLs ratios, and contributed to limited access finance, posing a challenge to the private sector. Finally, we explore ways in which the current regulatory environment could be more encouraging for private sector participation in renewable energy production.

3. Key obstacles to private sector development

3.1. Limited domestic competition hampers private sector development

A complex set of policies distorting competition hold back Tunisia's private sector development. The strong presence of the state in the economy and the lack of a level playing field where public and private operators can co-exist restrict competition. Moreover regulatory barriers to entry limit the number of operators in several markets within the domestic (onshore) sector, including through severe restrictions to FDI. Prior to the 2011 revolution, more than 50 per cent of the Tunisian economy was either closed or subject to heavy entry restrictions for private sector participation, reducing the scope for achieving efficiency, often associated with the presence of competition. Additionally, a pervasive system of price controls restricts the free operation of market forces, and weak enforcement capabilities and the unclear attribution of enforcement powers between sector regulators and the Competition Council exacerbate the issue in various sectors.

SOEs dominate the Tunisian economy, and their prevalence extends to non-strategic sectors. There are 104 SOEs operating in Tunisia, across 17 sectors – compared to an OECD average of 13 sectors – and accounting to approximately 13 per cent of GDP. Some SOEs benefit from legal or *de facto* monopolies in certain sectors; they hold the monopoly in the production, importation, and distribution of cereals, meat, sugar, and the tobacco supply chain; they hold between 50 and 100 per cent market share in gas, electricity, railroad and air transport, and fixed-line telecommunication services; and they are active in the import of tea, coffee, vegetable oils, iron, and pharmaceuticals. Even when SOEs operate alongside private sector operators, the absence of a competitive neutrality framework leads to significant distortions. Moreover, SOEs' role extends well beyond the provision of key public

goods to the most vulnerable, in contrast to international experience and best practices. For example, there are currently a number of SOEs operating hotels and restaurants, twelve offering real estate services, and three running golf facilities. Al Karama Holding, which manages confiscated assets, holds several of these assets, which are up for privatisation.

SOEs receive a large amount of state aid through subsidies, capital injections, and tax incentives, representing a major obstacle to promoting private sector participation. As part of the obligations under the Association Agreement (**AA**) with the EU, which entered into force in 1998 and created a Free Trade Area between the EU and Tunisia, the latter is required to implement a state aid framework. However, the scrutiny of state aid, grants, and subsidies is not consolidated currently under a specific law or centralised authority. Presently, each ministry can approve their own state aid, granted through various instruments and objectives, on an *ad hoc* basis and without planning, through a sectoral commission established at the respective ministries, which the Ministry of Finance attends.

Regulatory barriers to entry affect economic activity, including through FDI restrictions embedded in the dual onshore-offshore structure of the economy. Barriers to market entry and contestability, rooted in national legislation and sectoral regulation, are notably strong in health, education, professional services, and some segments of the telecommunications sector. These restrictions stifle economic growth by hampering private initiative and discouraging innovation and productivity. Barriers to entry affect directly firms operating in the domestic sector (onshore), but also have a negative impact on the performance of firms operating in the export-oriented sector (offshore), which suffer from low quality services and the uncompetitive pricing of intermediate goods produced in the onshore sector. Significant barriers to FDI were enshrined in the pre-revolution investment regime, especially

through the 1993 investment code, which consolidated the duality between the onshore and offshore sectors, and the distinction disappeared in the Investment Law of 2016 and the Fiscal Incentives Law issued in February 2017. Legal limits to the stake that foreign entities could own are indeed ubiquitous in Tunisia, with investment in 49 sectors subject to authorisation if foreign ownership exceeds 50 per cent, while the law prohibits foreign participation in other sectors, such as wholesale trade. In addition, the legislation does not provide for legal guarantees to foreign investors, while the strict control of capital account, which applies even for non-resident (offshore) firms for which retransfer of funds and capital income were subject to authorisation, constitute a heavy constraint for companies investing in Tunisia. In the new laws of 2016 and 2017, there has only been a lessening of the difference in the taxation of onshore and offshore investments, and there is talk about aligning the taxation of both regimes in the future, but this alignment has not happened yet.

Pervasive price controls represent another major impediment to the functioning of market forces. Regulated tariffs, favourable to SOEs, limit the ability of the private sector to operate in a profitable way, even where there are no legal restrictions, thereby removing incentives for efficiency and innovation improvements. Both the Competition Laws of 1991 and 2015 establish that competition on free markets sets prices. However, the laws introduce significant exceptions to this principle for ‘essential’ goods subsidised by the state, services provided under state monopolies, and activities characterised by lack of competition because of a law or regulation. The laws also provide for exceptional temporary price controls up to six months in situations of crisis or natural disaster or if the market situation was obviously abnormal in a particular sector. The World Trade Organisation’s (WTO) Trade Policy Review of 2016 indicates that Decree No. 95-1142 of June 1995 still sets the products and services for which price competition is not free, and the list is strikingly extensive. It includes 18 categories of products that are subject to a controlled price regime at all stages (production and distribution), nine

categories of products that are subject to price authorisation at the production stage in sectors with insufficient competition, and 36 categories of products that are subject to self-authorisation at the distribution stage and controls of distributor’s margins. To implement price control mechanisms, a General Compensation Fund (CGC) was set up in 1970, whose expenditures have risen from 2010 onwards. In addition, since 1994, Tunisia has had an annual programme subsidising the import of ‘popular-selling’ cars from European and Asian manufacturers, with a fixed profit margin for local dealers.

Promoting competition is particularly challenging in the regulated sectors, given weak regulators and potential for capture from state-controlled incumbents. Corruption and cronyism tend to be present more in sectors with heavy state involvement, which adversely affect private sector companies present in those sectors. The telecommunication sector exemplifies the problem, where, in spite of signs of increased competition over the years, especially in the mobile segment, significant challenges remain. The inability to enforce the approved local loop unbundling and bit stream offer limits fixed broadband expansion, because of the lack of *de facto* independence of the telecom regulator, Instance Nationale des Télécommunications (INT), from the incumbent fixed line operator, Tunisie Telecom (TT). A recent auction to issue a new infrastructure license in 2017, awarded to a consortium led by Agence Tunisienne d’Internet (ATI) (40 per cent) – whose main shareholder is TT – cast additional doubts on the possibility to further increase competition in the provision of broadband services. This is because the high price of the license led this consortium to be the lone bidder, and resulted in the main competitor of TT becoming ATI, its subsidiary, rather than an independent firm. Moreover, an unclear attribution of enforcement powers between INT and the Competition Council, an unnecessarily restricting licensing regime, and the absence of clear strategies and policies to promote infrastructure-sharing compound regulatory problems. The latter policies could be done through mandatory requirements to share

infrastructure in the case of the nascent 4G networks and a clear regulatory framework to define the rights and obligations of each operator.

In the first four years after the revolution, no significant reforms were introduced, resulting in a significant deterioration in competitiveness.

Tunisia's successful political transition led, in the first few years after the revolution, to a dilution in the power of the executive and heightened the need for securing the buy-in of large social segments. This meant that the political conditions for major economic reforms affecting the competitive landscape were not present until 2015. The political situation, compounded by the pressures exerted by powerful stakeholders with vested interests opposed to major economic reforms, and the lack of a clearly articulated economic vision, led to a significant deterioration in the business environment, as evidenced in the 2016–2017 World Economic Forum's (WEF) Global Competitiveness Report (GCR), published in September 2016. In this report, Tunisia slipped to 95th position in the overall rank out of 138 economies (from 83rd in the 2013–2014 report and 32nd before the revolution), with negative trends observed in all areas related to the intensity of competitive pressure; from the extent of dominance and perceived price competition to the overall quality of the regulatory environment.

Since 2015, positive reform steps have been taken, but a coherent and comprehensive strategy to liberalise and properly regulate markets is still lacking.

The new Competition Law of 2015, replacing the 1991 law that was among the first introduced in the SEMED region, increases the powers of the Competition Council to enforce the revamped legislation. It strengthens the prerogatives of the Competition Council vis-à-vis the government, doubles administrative sanctions for anticompetitive practices (compared to the previous regime) to reach a maximum of 10 per cent of the turnover of the violating firm, and enhances the transparency of the bodies in charge of applying the Competition Law. Another main reform of the investment regime took place in 2016 with the

adoption of the Investment Law, repealing the 1993 Investment Code. The new legal framework includes a number of provisions that enshrine the principle of freedom of investment, including guaranteeing equality of treatment for foreign and local investors; establishing the principles of free acquisition, rental, and exploitation of non-agricultural land by investors; and allowing foreign investors to transfer their funds abroad freely. Moreover, it removes several sector-specific authorisations, in particular for market access, and includes provisions on dispute settlements allowing the possibility of international mediation and arbitration in case of a dispute between the state and an investor. Finally, the new law reduced barriers to entry significantly especially for foreign firms, together with the new Fiscal Incentives Law of 2017, which reduced the discrepancy in the tax treatments of onshore versus offshore sectors.

The approvals of the Competition and Investment Laws in 2015 and 2016 were a step in the right direction, but the laws are still not fully in line with international best practices.

The Competition Law solves only in part the problems of the previous regime. First, the law preserves the government's prerogative to exempt a large number of sectors from Competition Law enforcement. Second, the government retains an unnecessary role in merger control, which is particularly problematic given the state's direct involvement in the economy through SOEs. Third, the law does not sufficiently protect the Competition Council's independence. Finally, a significant source of concern derives from the lack of a coherent system for the scrutiny of state aid as each ministry can approve their own state aid. With regard to the Investment Law, critical issues persist. It is clear that the Investment and Fiscal Incentives Laws were moves in the right direction to address the dual economy issue in the country. However, more needs to be done to address obstacles for the development of a level playing field for private sector operators, and the current outlook does not indicate the willingness to engage in comprehensive reforms aimed at privatisation, competitive neutrality, and the removal of pervasive controls to the structure of

market and to the free determination of prices. Social tensions, and a still-prevailing culture that favours a public-led economic development model, appear to be the main obstacles to an ambitious competition-oriented agenda. Moreover, the new Investment Law did not cover several important sectors of the economy, including mining, energy, domestic commerce, and the financial sector, for political and strategic reasons. In addition, more sectors may be off-limits for foreign investors, given that, in 2018, a decree will establish an exhaustive list of all activities that will require prior approval. Finally, the BCT imposes restrictions on hard currency financing for mergers and acquisitions, which is a key impediment for international expansion of Tunisian companies.

Efforts have been taken to design performance contracts for managers and linking transfers with performance, but a clear strategy to create a level playing field and increase private sector participation has yet to emerge. While streamlining supervision and targeting improvements in the operational performance of some major SOEs are welcome steps, the intervention falls short of purposely seeking to increase competition across sectors and to address structural issues including through privatisation, a unified system for state aid control, and the phasing out of subsidies and price controls. The government is currently working on the categorisation of SOEs across two dimensions – strategic versus non-strategic, and operating in (potentially) competitive versus non-competitive sectors. Eventually, this would lead to the liberalisation of competitive sectors and the privatisation of non-strategic companies. Nonetheless, there is currently no objective criterion for this distinction, as it is still unclear whether the distinction will be made based on the SOE’s financial, social, and regional importance, or something else. This will leave substantial room for discretion, and it is expected to be a high-level political decision. A key implementation risk is the expected opposition from the powerful labour unions and the parliament, in addition to relative public distrust of private sector provision in ‘sensitive’ sectors.

There is a need for comprehensive and wide-ranging reforms to gradually allow more competition, liberalise, and properly regulate markets in Tunisia. There is a need to reform SOEs by establishing and implementing a competitive neutrality framework to ensure fair competition with the private sector and subject SOEs to stricter oversight by independent bodies rather than by their own line ministries. Meanwhile, steps to create a level playing field should accompany improving the governance of SOEs. In both the energy and telecommunications sectors, there is a need for a well-governed regulator and a manager of the infrastructure, independent of STEG and TT respectively; the revision of the 2015 Electricity Law and the Telecommunications Code; and the elimination of the monopoly of STEG and TT to enable private sector participation and competition, and lower costs and prices. More broadly, there is a need to implement reforms in the labour market to avoid the use of public jobs as a means of social appeasement and reduce the gap between permanent and temporary contracts. It will also be important to amend the Competition Law to enhance the coordination between sectoral regulators and the Competition Council and ensure its independence and effectiveness, and distinguish clearly between its investigation and the adjudication functions.

3.2. Regulatory barriers impede greater private sector participation in Renewable Energy

Renewable energy generation is emerging globally as a sound investment on both environmental and economic grounds. Deployment of renewable energy generation capacities is growing fast with 2016 seeing global incremental wind and solar capacity exceed that of coal and gas for the first time in history. This trend will continue and accelerate as nations commit to ambitious climate targets, such as the 2015 Paris Climate Agreement, and the cost of renewables and relevant system integration solutions – such as electricity storage – continues to drop and rivals conventional generation. The adaptation of energy systems to high penetration rates of decentralised and

intermittent renewable sources will require technological and a regulatory viewpoint. Private sector involvement in this framework will be essential as it will facilitate the mobilisation of private capital and innovation in the sector.

In 2016, Tunisia announced ambitious targets in the energy sector that will require large investment from the private sector.

Specifically, in accordance with the 2015 Paris Climate Agreement, Tunisia adopted a new Energy Strategy in November 2016 that primarily focuses on reducing energy intensity through a cross-sectoral investment programme for energy efficiency. Moreover, there is a plan to increase the share of renewables in Tunisia's overall energy mix from its current very low base of approximately 3 per cent to 12 per cent by 2020 and as much as 30 per cent by 2030. However, meeting these targets requires additional capacities, and private sector participation is necessary. It is expected that an additional 1,000 MW will be necessary in the first phase 2017–2020, and a further 1,250 MW in the second phase (2021–2030). Two thirds of the incremental renewable capacity by 2020 and potentially significantly beyond that is expected to be developed by the private sector. Some early positive signs from both the government and private developers are welcome. Private developers have more appetite to invest in renewables, as demonstrated by the 69 offers received by the Ministry of Energy for a first round of requests for proposal (RfPs). Nevertheless, several barriers impede greater private sector participation.

The state-owned Tunisian Company of Electricity and Gas (STEG) exerts significant influence over renewable project development by the private sector.

A conflict of interest exists and affects private investors' confidence and participation. STEG is the sole authorised off-taker of electricity produced by private projects for local consumption, and of up to 30 per cent surplus from auto-production. Moreover, STEG is a member of the commission tasked with granting authorisations for renewable projects for local consumption and auto-generation. Finally, STEG is the grid operator responsible for ensuring overall efficiency and reliability in

Tunisia's grid. There are other more specific issues to resolve within certain renewable categories, for example auto-generation. Auto-generation requires more clarity and improvements on issues such as whether aggregation is permissible and under which conditions. There is a need to address the currently envisaged obligatory inclusion of auto-generation renewable project in the respective sponsor's balance sheet, and the conditions, including pricing, for selling any surplus electricity to STEG.

There is lack of transparency concerning important technical and operational issues that have direct impact on private renewable energy projects.

This includes the technical availability of transmission capacity in certain areas and the way in which this capacity is allocated to specific renewable projects. It also includes the connection charges applied by STEG to private renewable projects that may differ from the actual cost of the project's connection to the transmission network, and resolving balancing issues and clarifying the role and obligations of renewable projects.

Stability and political will could improve more.

The year 2017 witnessed two different Ministers of Energy and the government is yet to show clear and strong willingness to develop the renewables sector and support it with concrete progress on secondary legislation. The Renewable Energy Law of 2015 was an important milestone and necessary first step to private sector participation. Nevertheless, there is a need to complement it by proper secondary legislation and actions, which have so far been delayed or considered unsatisfactory by international and local standards, like the secondary legislation for auto-production and authorisation regimes. For instance, the template power purchase agreement (PPA), proposed by the Ministry of Energy under the authorisation regime, is deemed non-bankable in its current version. The inability of Tunisia's National Agency for Energy Conservation (ANME) to be a strong and independent regulator further aggravate institutional concerns undermining investors' confidence. The existence of a regulator with sufficient powers is imperative to

regulate pricing, monitor compliance with the laws, and ensure the presence of a predictable level playing field for investors.

Broader issues in the Tunisian energy market such as subsidised pricing are negatively affecting the viability and sustainability of renewable projects on a commercial basis. Low

electricity prices increase risks for renewable projects developed for local consumption, and can undermine altogether the rationale for projects under auto-generation. This is because there is little commercial incentive for implementing them if their levelled cost is higher than the electricity tariff paid by its sponsor, because the latter option imposes no upfront costs or risks on this potential project sponsor.

Tunisia intends to create a regulatory environment that will be conducive for renewable investment from the private sector.

The Renewable Energy Law of 2015 accordingly envisages three potential options for project development from the private sector: (a) export projects, (b) auto-generation projects; and (c) local consumption projects (falling under an ‘authorisation’ regime for smaller projects, and the ‘concession regime’ for larger ones). For the latter category, STEG would be the sole local off-taker of the electricity produced by the private producer in independent power plant (IPP) projects. The law does not mandate local content as such, but nonetheless establishes local content as one of the parameters for assessing applications for local consumption. The uncertainty concerning the specificities of how local content provisions will be implemented is problematic in itself for private investors, as would be the actual application of local content provisions. Tunisia’s renewable capacity is still relatively low and forcing investors to source products or services from the local market could therefore result in cost increases. The latter would in turn either be passed on to consumers, or lead to a reduction in the number of projects that will be seen as commercially viable and supported by the private sector. Immediate needs include amending PPAs for the various renewable development options, which will be suitable and support project bankability. Getting the PPA

terms ‘right’ with an appropriate allocation of risks, aligning it with the international best practices, and improving its bankability is essential, as is timing.

3.3. Gender inequalities and labour skills mismatch undermine competitiveness and inclusion

Despite being highly qualified, women lag behind in economic participation, and gender gaps in the labour market continue to be significant. In line with other SEMED countries, female labour force participation in Tunisia is one of the lowest in EBRD countries of operations. While 43 per cent of women, (compared to 26 per cent of men), pursue tertiary education, only 25 per cent (compared to 71 per cent of men) make it to the labour market. Social norms and perceptions about the role of women in society continue to hinder women’s participation in the labour force. Despite being one of the most progressive laws in the region, the Tunisian Code du Statut Personnel identifies men as the primary breadwinners, and labour code provisions continue to ban women from accessing a number of tasks and jobs in various sectors. Overall, 71 per cent of respondents to the World Values Survey agreed that when jobs are scarce, men should have more right to a job than women in Tunisia. Generally, women are largely responsible for care responsibilities in Tunisia (5.3 hours spent on care responsibilities for women compared to 0.7 hours for men), only 0.4 per cent of children under two were enrolled in childcare facilities in 2006, and, when joining the work force, women are expected to continue undertaking most of the household care. Women entrepreneurship is also low with only 10 per cent of women being own-account workers in 2012, lower than Egypt (13 per cent), and the EBRD’s Countries of Operations’s (CoOs) average (14 per cent), and Morocco (17 per cent). For men, the percentage in Tunisia (20 per cent) was higher than Egypt (12 per cent) and lower than Morocco (34 per cent), but comparable to the EBRD’s average of 21 per cent. The large pool of qualified women who do not enter the labour market represents an

inefficient use of resources for the private sector and the economy as a whole. Gender discrimination is widespread in recruitment and employment and across sectors, in addition to discrimination against ethnic minorities and undocumented migrants. The labour markets also exhibit large horizontal and vertical segregation with women concentrated in services and agriculture and less than 9 per cent of Tunisian firms employing women as top managers (**MENA ES**). Sexual harassment in public spaces is unusually high, with 91 per cent of women in a large-scale survey reporting having been assaulted physically by a man in public transportation. Policies to promote better care infrastructure and a supportive environment for female entrepreneurship will contribute to a more competitive and inclusive economy.

Skills mismatch hinders private sector development, contributes to high unemployment rates, especially among youth, women, and graduates, and raises pressures for public employment. In 2016, the unemployment rate was 15.5 per cent, but over 30 per cent among university graduates. While unemployment is almost ten percentage points higher among women than among men, the disparity is even greater among university graduates, where 41 per cent of women are unemployed compared to only 21 per cent of men. Two factors have driven most graduates into the public sector, which now employ 60 per cent of them. First, the private sector failed to create enough graduate-level jobs to meet the requirements of the highly literate labour force of approximately 4 million. Second, there is a mismatch between the graduates' skills and the needs of the labour market both in terms of quality and in terms of technical focus. This is a problem for both the private sector, which ends up employing inadequately educated labour in low-skilled and low-paid activities in construction, trade, manufacturing, and tourism, and for the public sector, given the mounting fiscal pressures. Moreover, the government faces opposition, including from the powerful trade unions, when trying to reform wage policies and dismissal procedures to remove barriers to faster private-sector growth and

realign the skills of the labour force. We estimate that the economy needs to grow at about 6 per cent per year over a sustained period, driven by the private sector, in order to absorb the 90,000 new entrants to the jobs market each year. However, growth averaged only 4.5 per cent per year in the decade before the revolution and fewer than 2 per cent since. In addition, Tunisia has been one of the major sources of recruits for radical combatants, despite the country's relatively small population.

Various intertwined characteristics of the Tunisian economy contribute to the skills mismatch. First, there is an oversupply of university graduates, who are highly skilled, but often lack basic competencies, partly due to the poor quality of primary and secondary education, and to significantly outdated curricula at higher educational institutions and business schools, not matching the needs of the labour market today. Second, vocational training lacks the societal acceptance it enjoys in other countries, and only poorly performing students at schools, who have failed to progress otherwise, engage in vocational training, while higher performing students have no appetite to participate in such training. As a result, programmes often have unfilled spaces, creating a shortage of trained labour with relevant skills for employers and international investors, such as sales and marketing engineers, logistics engineers and technicians, web managers, and e-commerce managers, which is an issue observed across the SEMED region. In Tunisia in specific, unfilled vacancies made up 7.3 per cent of the positions in the food and beverages manufacturing sector; 9 per cent in ICT services; 11.9 per cent in textiles and clothing manufacturing; 16 per cent in professional, scientific, and technical services; and 24.3 per cent in commerce. Third, highly educated graduates, unable to find an adequate job domestically, often emigrate, resulting in a brain drain. Fourth, Tunisia is a transit country for Sub-Saharan migrants, most of which are unregistered and at heightened risk of discrimination in terms of working conditions as well as labour exploitation. Labour-intensive activities including construction, manufacturing, agribusiness, and primary agriculture, often

employ migrant workers informally, and through subcontractors.

Twenty-nine per cent of the enterprises surveyed in the 2013 MENA ES have identified an inadequately trained workforce as a major business constraint.

Graduates from both university and vocational training programmes fail to meet private sector employers' needs around transferrable and technical skills. At the same time, there is a low demand for high-skilled workers graduating from universities, because private sector firms remain primarily active in low-productivity and low-competitiveness sectors. A large proportion of the productive resources are concentrated in relatively unproductive small-scale activities, decreasing the number and quality of jobs created. As a result, the private sector has a low capacity to drive skills demand and absorb the number of university graduates entering the work force annually, also due to the slow pace of job creation in the formal economy, and sticky wages. Furthermore, inadequate recruitment practices limit the private sector's ability to identify and retain talent with the most appropriate skills. This gives rise to a significant loss of human capital potential for Tunisia's economy, limits inclusion, and contributes to a vast misallocation of resources.

The presence of informality and the lack of support for SMEs further exacerbate the problem.

Informal businesses and employment are prominent features of Tunisia's labour market, and hinder a smooth match between the supply and demand of skills. Estimates show that only half of Tunisia's youth have formal employment, and only half of the youth formally employed have permanent contracts. This is partly due to the sectoral collective agreements in Tunisia, some of which set starter rates at significantly higher levels than the statutory minimum wage.

The presence of strong regional disparities underpins the inequality of access to labour markets and education across regions.

Regional disparities span poverty and illiteracy (exceeding 32 per cent among those aged 10 and over in some regions compared to the

national average of 18.8 per cent). They also extend to overall unemployment (exceeding 25 per cent in some areas); youth unemployment (exceeding 55 per cent in the south); inactivity (exceeding 60 per cent in certain parts); investment and business opportunities in agricultural as well as non-agricultural sectors; and limited access to healthcare and reliable municipal services. The opportunities to develop and productively deploy market-relevant skills vary widely across regions. While youth inactivity is increasing in the south resulting in outward migration to the urban centres, Tunisia's most developed governorates have the highest share of enterprises reporting business constraints from an inadequately trained workforce. Gender-related gaps further exacerbate these disparities.

Labour markets are plagued with social issues.

The law imposes significant restrictions on trade union rights, and there are reports of employers using anti-union tactics, including the use of temporary workers, to undercut unionisation. Moreover, there are no provisions in national law on workplace mechanisms to resolve individual grievances and there is limited understanding and application of workplace grievance procedures in practice. Compliance with minimum wages and provisions on hours is an issue, especially in the informal sector, and subject to uneven enforcement, with workers hired through subcontractors or on a casual basis being particularly vulnerable. Meanwhile, union campaigns have recently improved their conditions, as subcontracting agencies are now banned in the public sector. This is particularly relevant to the construction sector, where the use of contractors and temporary workforces is very common.

Low-quality jobs and high unemployment have been met with explicit policies to increase employment within the public sector, especially after 2011.

Total employment in public administration increased substantially due to a general amnesty for civil servants fired for political reasons, direct job-offers for individuals injured in the uprising (or those who lost family members), and the regularisation of employment for temporary and contract workers

in the public sector. The government is also implementing a number of active labour market programmes, such as the SMART initiative, the vocational education and training (VET) reform programme and National Qualification Framework (NQF) development, the new employment strategy. This is in addition to programmes operated by l'Agence Nationale pour l'Emploi et le Travail Indépendant (ANETI) that place around 130,000 individuals in employment annually, such as the Stages d'Initiation à la Vie Professionnelle (SIVP), the Contrat d'Adaptation et d'Insertion Professionnelle (CAIP); the Programme d'Accompagnement des Promoteurs des Petites Entreprises (PAPPE); and the Programme du Service Civil Volontaire (SCV). Moreover, the government is at the forefront of initiatives to place more workers in employment abroad, usually linked to commitments to return to Tunisia in the medium-to-long term. These steps, although beneficial, may be partially contributing to the diversion of skills and talent away from potential employers in the private sector. Moreover, employment in SOEs, which accelerated after the 2011 revolution, crowds out private sector employment.

To improve skills mismatch, there is a need to prioritize development of market-relevant skills to increase inclusive growth and competitiveness. Policy interventions should support greater collaboration between public and private sector stakeholders in improving local skills supply. There is a need for a general drive towards improved and revived curricula – at all levels – that respond to the requirements of the labour market. It will be crucial to improve the policy and institutional framework whereby the development of technical and vocational, market-relevant skills and competences becomes a positive choice, supported by the state and society. Developing more effective human resources management practices would contribute to rebalancing workers' perceptions of private sector employment, and lead to higher staff retention and the development of the right skills for business. Ensuring fairness in the recruitment and employment of women would help bridge the gap between genders in labour force participation and in unemployment rates.

In addition, there is a need for policy interventions to support equal opportunities for women and men in the workplace, and sponsor policy dialogue to support a regulatory environment that enables women's economic participation. Finally, it would be recommended to involve the private sector in developing educational curricula to bridge the skills mismatch gap, and in performing skills mapping across various regions and sectors.

3.4. Banking sector challenges and legal impediments limit access to finance and hinder the resolution of non-performing loans

The banking sector in Tunisia faces significant challenges, and these challenges impact the private sector. Banks suffer from deteriorating solvency and profitability, poor asset quality, weak loan underwriting practices, inadequate collateral valuations, and low loan-loss absorption capacity. Moreover, banks often have difficulty to abide by prudential standards, and the regulatory forbearance, the weak supervision, and the lack of information on repayment capacity of bank customers further exacerbate their challenges. Besides, banks are significantly reliant on collateralised central bank funding, bringing more refinancing risk given the weak government finances and leading to balance sheet maturity mismatch. Coupled with the absence of alternative financing instruments, such as private equity and venture capital, banking sector challenges limit access to finance.

Access to finance is a major limitation to the private sector, and notably amongst certain groups. The share of credit to GDP averaged 67 per cent throughout the past decade, below OECD countries (143 per cent of GDP), Jordan (79 per cent of GDP), and Lebanon (78 per cent of GDP). Overall, only 34 per cent of men and 21 per cent of women held a bank account at a financial institution in 2014. Access to finance was indicated as a major constraint by 23.9 per cent of Tunisian firms, comparable to Egypt (23.4 per cent), but better than Morocco (27.7 per cent), the MENA average (35.1 per cent),

Lebanon (41.5 per cent), and Jordan (42.8 per cent) (**MENA ES**). The intensity of the problem varies across regions, gender, firm age, and firm size. The problem is more pronounced in interior regions (52.7 per cent), and the North-Eastern regions (31.9 per cent), compared to Tunis and Sfax (18.2 and 10.6 per cent respectively), while the percentage of firms identifying access to finance as a major constraint in the South Coast and West region was comparable to the national average (22.1 per cent). While women have equal access to micro-credit opportunities, in general terms, there is a perceived lack of specialised programmes catering to their particular needs, and female entrepreneurs and women-led businesses are particularly affected given their limited access to collateral. In rural parts of Tunisia in particular, women account for only 26 per cent of micro-credit recipients. Young and innovative SMEs and individuals often have difficulty accessing bank capital, and they are often cut off from external financing sources even if they have a sound business model.

The cap on lending interest rates, which the BCT imposes to protect borrowers from possible abuse, exacerbates the problem.²

Banks are unable to value credit according to maturity, because they must price longer-term maturities more or less like shorter-term ones. Moreover, they are also unable to price credit according to the level of risk of the clients, and must exclude many companies from their clientele, such as start-ups or businesses with insufficient guarantees and collateral such as SMEs, restricting access to finance. As a result, banks compete only for the limited pool of clients with low risk and high collateral, and are averse to higher-risk profitable projects. Meanwhile, capped interest rates do not prevent banks from placing conditions on loans, such as high collateral requirements, resulting in higher costs incurred by borrowers.

The government runs several key programmes to support access to finance for entrepreneurs.

Examples include the PAPPE, which is administered by ANETI, the Tunisian Solidarity Bank (**BTS**), and the Small and Medium

Enterprises Investment Bank (**BFPME**). PAPPE provides targeted support for young graduates and non-graduates starting in self-employment, through a range of financing options for starting up new businesses including business micro-loans. PAPPE also provides a monthly stipend for university non-graduates and for graduates for up to 12 months. Beyond financing entrepreneurship, the programme provides training and internship opportunities, bespoke coaching on business planning, and practical information on operating a formal business. As for BTS, which was established to manage financing programmes for individual entrepreneurs and micro-enterprises, it offers small concessional loans to entrepreneurs, and it targets small-scale entrepreneurs unable to access commercial bank guarantees. Finally, BFPME, which has over 20 regional offices, facilitates access to finance for the creation and expansion of SMEs as well as assisting existing SMEs throughout their life cycle.

NPLs in Tunisia are the largest among the SEMED countries, and have been an ongoing problem for the last two decades, holding back private sector development and further reducing the availability of capital to be extended to private firms.

Several factors have led to the consistently high NPLs ratio. In the early 1980s, the government deeply engaged the public banks in subsidising the expansion of the collateral-based tourism sector, which has historically played a significant role in the economy, as measured by its contribution to growth and employment. Subsidies included provision of looser credit requirements, loan guarantees and preferential interest rates, as well as the directed support of the public banks, resulting in the latter being the largest providers of credit to the tourism sector, and having a comparatively disproportionate high exposure to the sector. When the tourism sector went into a severe recession following the 2011 turmoil amid political instability and security concerns, the authorities relaxed loan classification rules, and NPLs started to gradually increase. Other reasons include the legacy of connected lending with allies close to the previous regime enjoying

² Law 1999-64 mandates that any conventional loan should be granted at an aggregate effective interest rate that does not exceed the average effective rate

charged in the preceding six-month period by the banks and financial institutions for similar operations by more than one-fifth.

easy access to finance at convenient rates and with very low or no collateral or guarantees, which continued throughout the 1990s and the 2000s, as the government continued to subsidise less qualified investors. Finally, credit has been growing significantly faster than economic growth; in 2016, credit growth was 10 per cent y-o-y, compared to a GDP growth of a mere 1 per cent y-o-y. Between 2011 and 2016, credit went primarily to the tertiary sector (43 per cent), followed by the secondary sector (26 per cent). Meanwhile, retail loans accounted for 28 per cent, up from 20 per cent in 2002–10.

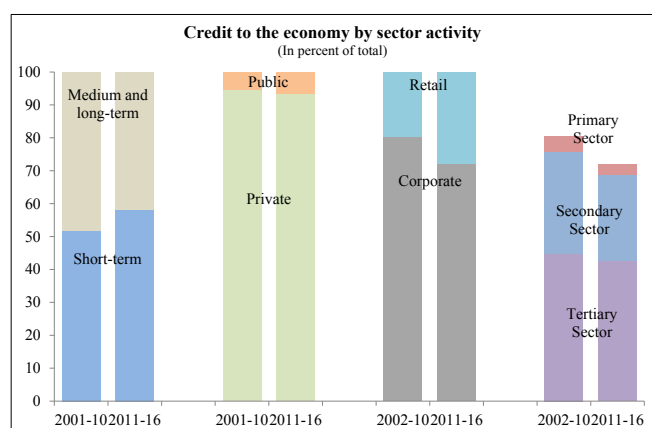


Fig. 10: Non-Performing Loans

Source: National authorities.

Since 2000, NPLs performance has been uneven. Problems in the services sector, mainly tourism and trade, led to a high and rising NPLs ratio up to 2005. The ratio was above 20 per cent between 2001 and 2005, before the authorities succeeded in decreasing it to 13.2 per cent by 2009 through strengthening the legal framework for corporate restructuring. This included: strengthening creditor rights by simplifying the procedures of debt collection and the use of real estate collateral; an improved tax treatment of provisions and write-offs; and the

creation of asset recovery companies within banking groups. As of the end of 2010, the outstanding credit to the tourism sector amounted to 6 per cent of GDP, and total tourism sector NPLs amounted to approximately 2.5 per cent of GDP. Following the 2011 turmoil, and notably following the terrorist attacks in 2015, the NPLs ratio to total loans crept up to a high of 16.6 per cent in 2015, also because the tourism loan forbearance measures imposed by a BCT circular allowed for under-provisioning. At end-2016, NPLs average of 15.6 per cent for the banking sector as a whole, and was higher for public sector banks (at 22.1 per cent), compared with 10.4 per cent for private banks, with most NPLs concentrated in the tourism industry.

Legal impediments to resolving NPLs and a poor recovery environment hamper the banking sector’s ability to decrease the NPLs volume. Public banks face legal discrimination in managing NPLs portfolios, which represents a significant constraint to growth and access to finance. Insolvent businesses are required to go through lengthy judicial settlements, and inadequate and prolonged bankruptcy proceedings, with no coordination between the Bankruptcy and Reorganisation Laws when it comes to dealing with creditors. This limits amicable settlements and pre-insolvency proceedings, and delays the process of NPLs resolution. Out-of-court restructuring is hardly resorted to, and re-organisation is limited to debt rollover. The 2014 EBRD Insolvency Office Holders (IOH) Assessment highlighted the lack of effective regulation of the profession and recommended that consideration be given to the creation of a dedicated regulatory body for IOHs. It made a number of other key recommendations, including introduction of specific entry exams for the profession, mandatory relevant practical insolvency work experience with a practising IOH for prospective IOHs, as well as regular continuing educational training.

Tunisia does not have a distressed debt and NPLs market, and the debt collection agencies prefer informal operations. Around half of the debt collection market is informal, and debt collection companies do not abide by the Debt

Collection Law. Debt collection companies are unable to directly contact their debtors and write off NPLs, increasing the time it takes for NPLs to be transferred to them. A new Collective Proceeding Law to speed up the process has been passed, but is yet to be applied in practice. Moreover, progress on creating an asset management company to deal with toxic assets, envisaged under the previous IMF programme in 2013–15, has been limited, and authorities opted out from such plans in 2016, preferring instead to establish dedicated internal structures within banks.

Recent measures were taken to reduce NPLs and prop up the banking sector. A new Banking Law passed and included a proper banking resolution framework and a deposit guarantee scheme, in line with international standards. A new Central Bank Law was passed granting the BCT more independence and outlining the lender of last resort framework. The top three public banks were capitalised in 2015–2016 and dedicated internal structures were established in 2016 to deal with NPLs and improve debt recovery. Banks were required to increase their provisioning by implementing conservative haircuts on collateral value, and were allowed to reschedule loans that were due from companies affected by the 2011 turmoil. Moreover, a decision in 2015 to freeze loan classifications of the tourism sector led temporarily some banks, which made use of the option to freeze, to have an artificially low NPLs ratio, lower provisioning, and an increased capacity to tap more liquidity injections by the BCT, using non-classified loans as collateral. Finally, asset recovery and debt collection companies were created. In response to vulnerabilities in certain banks' loan portfolios, the authorities might also consider the 'good bank-bad bank model' for individual banks, in which NPLs, mainly relating to the badly-hit tourism and property development sectors, are separated from the healthy and performing businesses by the parent bank into a newly established bad bank. With the technical assistance of the EBRD, the authorities are working to amend the law to improve the efficiency of debt collection companies, to enable the companies to contact their debtors and write off NPLs. Meanwhile, there is a need

for more legislative reforms to bring NPLs to sustainable levels gradually. There is a need for a legal amendment to make it possible for public banks to abandon claims on credits, like their private peers.

Despite the adoption of a new Bankruptcy Law to simplify bankruptcy proceedings and strengthen the role of creditors and debtors, it does not address all the recommendations jointly made by the EBRD and the IFC. First, the

law does not provide for a wider access to the amicable settlement procedure, as it should include not only solvent debtors but also debtors in the early stages of insolvency (cessation of payments). Second, it does not grant creditors the right to vote directly on a reorganisation plan ratified by the court in the judicial reorganisation procedure. Third, cram-down mechanisms – where a court imposes a reorganisation plan despite the objection of certain classes of creditors – have not been included in the voting mechanisms to enable approval by majority creditors of a reorganisation plan. Fourth, some creditors, such as the state, benefit from unlimited preferential treatment and creditors' priority are not clearly defined. Finally, personal guarantors are not able to benefit from any moratorium or stay on the debtor's activity, given the widespread practice of creditors obtaining personal guarantees from managers of the debtor. In the World Bank's 2018 Doing Business Report, Tunisia ranked 63rd in resolving bankruptcy, a five-place decline compared to 2017, proving that the reform was more cosmetic than substantive. While Tunisia performs better on a number of indicators, its rank for protecting investors dropped to 119.

3.5. Loss of comparative advantage and administrative and regulatory obstacles contribute to logistics underperformance and lower integration in Global Value Chains (GVCs)

Over the last decades, one of the major focuses of Tunisia's national development strategy was on its integration into the global economy. This was done through a strong and consistent industrial policy to anchor Tunisia into specific GVCs, in particular automotive and aeronautics; the attraction of FDI by incentivising fully exporting firms; and the progressive liberalisation of its trade regime through the creation of free trade areas. This strategy has been successful, notably in the textile, electronics, tourism, and IT sectors; Tunisian exports and imports have doubled since 1995 and have evolved in their economic structure, particularly with the considerable increase in the share of trade in components and other intermediate goods. Some sectors are already actively involved in GVCs, using foreign inputs for their exports while shipping their products abroad, including electrical machinery and appliances, and electronic products.

As a result, the logistics sector plays a key role in the economy. While the sector shows relatively little contribution to local economic activity, it mobilises more than 13 per cent of total investment in Tunisia and contributes to more than 17 per cent of the value added of the services sector, placing it just behind the trade sector. In addition, the transport sector generates foreign exchange earnings and directly employs nearly 140,000 people (around 3.5 per cent of total labour force), including 40,000 employees in the 28 SOEs in the sector. Tunisia enjoys competitive advantages from its proximity to the European market, representing an opportunity for the development of logistics activities and qualifying Tunisia to become a logistics hub in the southern Mediterranean.

However, Tunisia has been facing increasing competition from neighbouring countries in recent years. While other countries have improved their infrastructure and logistics chains, those in Tunisia have deteriorated. In Tunisia, container traffic increased by 43 per cent between 2008 and 2014, while it tripled in Morocco during the same period. Tunisia has emphasized its proximity to the European market but neglected its proximity to sub-Saharan Africa. This last argument has not escaped Morocco, which has made it its main asset attracting FDI in recent years. The Tunisian port infrastructure has not been able to modernize in the face of a significant increase in freight traffic and new trends in maritime transport over the last two decades. Tunisian ports are becoming increasingly saturated and suffer from a lack of adequate equipment and infrastructure, as well as a deterioration of support services. Port infrastructure and services are increasingly a bottleneck for the Tunisian economy and hinder the participation of local businesses in GVCs. Tunisia suffers from a lack of storage areas and the lack of adaptation of its port infrastructure, to containerised goods traffic, particularly in the port of Rades which concentrates more than 70% of the goods transport in Tunisia. The massification³ of shipments and the containerisation of goods require logistics areas near ports that allow for more complex logistics, including: warehousing, distribution, unloading, potting, sorting, and reshipment of goods. The connectivity of Tunisian ports to the world's regular transport network has not improved in recent years compared to other coastal countries, including those in the Mediterranean. In Africa, Morocco has the highest maritime connectivity index due to its geographical location at the end of the continent. Tunisia's Liner Shipping Connectivity Index⁴ (**LSCI**) is the lowest among all Mediterranean countries (6.6), compared to Morocco (67.0), Egypt (54.6), and Lebanon (44.5), and is close to the level of Algeria (7.3), Syria (11.9), and Libya (14.6). Logistics costs are around 20 per cent of GDP in Tunisia, above those of emerging countries (15 per cent),

³ Massification is a strategy that some luxury companies use in order to attain growth in the sales of product. Some luxury brands have taken and used the concept of massification to allow their brands to grow to accommodate a broader market.

⁴ This index maps the level of integration of a country into the existing global maritime transport network.

adversely affecting the competitiveness of key sectors such as industry, retail distribution and trade, agriculture, and construction. In most OECD countries, services account for 37 per cent of manufacturing exports; in Tunisia, they account for 33 per cent, out of which a quarter is commercial and transport services. Transport services are identified formally in the national accounts, whereas logistics are not. The sector accounted for 6.6 per cent of GDP in 2014, compared to 12 per cent for countries with similar economies. The sector's growth was 4 per cent over 2007–10, but just 0.6 per cent over 2010–14. Moreover, infrastructure and logistics services have not adapted well to the new global trends and have remained relatively uncompetitive, in particular maritime freight transport. As a result, Tunisia was ranked 110th out of 160 countries in the World Bank's 2016 Logistics Performance (international) Index (**LPI**), compared to 61st (out of 155 countries) in the 2010 LPI.

The logistics sector also suffers from lack of a coherent policy. The implementation of reforms to unlock the development potential of the sector has lagged, in particular due to the large number of stakeholders involved. This lack of vision and coordination hindered the timely adoption of a regulatory framework governing new supply chain businesses and the development of logistics platforms and global optimisation practices in the freight chain. These challenges attest to the complexity of integrating logistics into public policies. At the same time, sectors such as agriculture and agro-food could benefit from a more active participation in international trade. Furthermore, Tunisia has not succeeded in developing sufficiently high value-added activities to meet the demand for employment, especially for youth, for which it is crucial to deploy an efficient global logistics chain capable of linking Tunisian sectors to the global economy.

Companies offering logistical services face administrative and regulatory obstacles.

Domestic and foreign companies suffer from customs formalities and binding regulations that hamper the speed of trade and create high transaction costs. The law is rather restrictive for warehousing and logistics operations; for instance, it does not authorise the deposit and importation of goods without declaration of final recipient. There are also restrictions on freight forwarders; while foreign forwarders, mostly European, have the right to charge in Tunisia and Europe, a Tunisian forwarder cannot take an order in Europe and, in case of delivery of a cargo coming from Tunisia, must leave empty. In return, foreign forwarders do not have the right to operate in Tunisia without a Tunisian shareholder partner, and generally cannot serve local distribution channels.

The 2016–2020 quinquennial Development Plan for the Transport and Logistics sector prioritises the establishment of an institutional framework for the coordination of the sector.

The implementation of this framework should accompany the implementation of infrastructure projects, in particular the realisation of the network of logistical zones that the development plan foresees. Fostering a broader dialogue between public and private sectors will help identify and engage reforms in a structured, participatory, and proactive manner. The framework should adopt the principles of good governance such as separation of planning, control, and enforcement roles, and ensure a cross-sectoral approach. It should also cover several functions in order to ensure the control of the process of formulation, implementation, and evaluation of public policies in the area of logistics. The strengthening of the Tunisian logistics system could support the strategy of upgrading locally sourced sectors and give them a competitive advantage. So far, there have been delays in bringing key pieces of infrastructure under public private partnerships (**PPPs**) such as ports and roads, and there has been resorting to sovereign finance. Only a few PPPs were executed, such as the Rades independent power plant (**IPP**), while others, such as Enfidha-Hammamet Airport, are under arbitration after a collapse in traffic.

International experience shows that the coordination amongst various stakeholders is one of the most important policy issues related to logistics, reflecting the complexity of the sector.

The experiences of Dubai, Panama, Morocco, and Colombia reveal that logistics policies tend to focus on trade facilitation, private sector participation in infrastructure, and logistical zones. In the area of trade facilitation, countries have implemented a number of single-window systems, usually in the context of PPPs, given the large number of public and private actors involved. Similarly, these countries have implemented a port reform in which private actors have conceded the operation of the terminals, which has greatly improved connectivity. These countries have all developed logistical zones with the strategic goal of capturing the benefits of outsourcing and offshore outsourcing. Finally, improving the performance of basic services, such as transport and logistics, would be necessary to enhance the participation of private sector firms in Tunisia in GVCs, and resolve the limitations of the logistics sector that hinder the full potential of global trade integration.

4. Qualities of a sustainable market economy

Tunisia ranks 31 out of 37 countries of operations in the EBRD's Assessment Transition Quality (ATQ) scores. This index is based on a simple average of scores for the six transition qualities: competitive, well governed, integrated, inclusive, resilient, and green. Low scores drag down the country's ranking in competitiveness and governance in particular, despite being higher than the SEMED average in competitiveness (Fig.1). ATQ ratings are measured relative to other EBRD Countries of Operation.

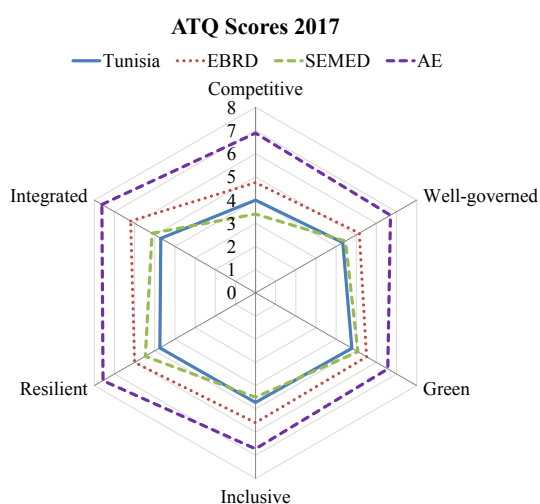


Fig. 1. Tunisia – average transition qualities. The level of development within each of the qualities is measured from 1 to 10, with 1 meaning little or no progress and 10 representing the frontier. From EBRD calculations.

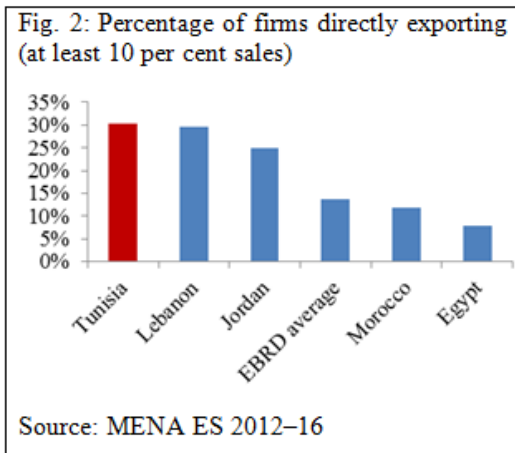
The following sections provide brief snapshots of each quality.

Competitive [ATQ = 4.00]

Tunisia's Distance to Frontier (DTF) score is in line with the SEMED average. The key gaps in Tunisia's competitiveness relate to inefficiencies in the goods and labour markets and weak innovation, mostly driven by poor institutions.

Market structures and institutions for competition

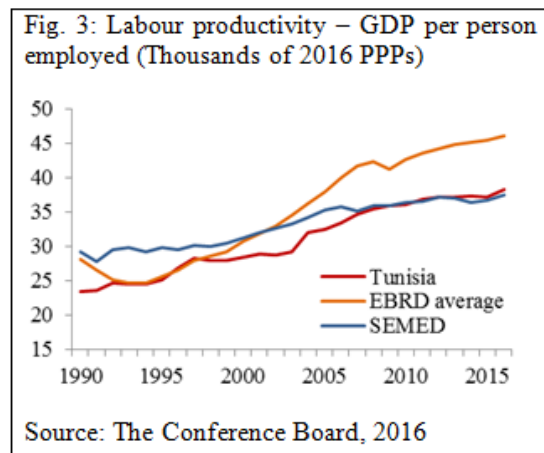
- **Barriers to competition** include high levels of state ownership and, in some cases, state capture (such as in the telecommunications sector); the prohibition of investment in certain sectors; abuse of market power; and high barriers to entry in the form of burdensome procedures for starting a business. In 2017, the World Bank's Doing Business Report ranked Tunisia 88th out of 190 countries. The 2015 Competition Law strengthens the independence of the Competition Council and reduces barriers to entry and discretionary application of regulation, but it has yet to be fully implemented.
- On the positive front, **export capacity** is relatively well developed. It takes three days to clear direct exports through customs, under half the MENA average. Moreover, the percentage of firms identifying customs and trade regulations as a major constraint is under 10 per cent, compared to over 20 per cent in MENA and 16 per cent on average across all countries. As a result, 30.2 per cent of firms are directly engaged in exporting, well over the EBRD average (**MENA ES**). Tunisia's main export markets are France (32 per cent), Italy (17 per cent), and Germany (11 per cent), and the main exports categories are machinery and electrical equipment (32 per cent), textile and clothing (19 per cent), chemicals (7 per cent), and vegetables (7 per cent).



Capacity to generate value added

- There is significant room for improvement on **innovation**. Tunisia ranks 31st out of 37 EBRD CoOs in the Knowledge Economy Index, below the EBRD average in particular in the institution and education components, despite devoting a relatively large amount of resources to innovation and spending on research and development and being clustered as a medium-stage country. A higher percentage of Tunisian firms are engaged in innovation than in the MENA region on average, and the proportion of firms undertaking process innovation is particularly high, at almost a quarter of all firms, partially related to the knowledge transfer from the GVC partners (**MENA ES**). As a result, Tunisia has been ranked 43rd in the 2018 Bloomberg Innovation Index, and is the first innovative economy in Africa and the Arab world.

- Economic complexity – reflecting the product range Tunisia produces competitively – has increased significantly, although it still lags behind other upper-middle-income peers. A stronger shift away from low- towards high-productivity sectors could further reinforce growth in **labour productivity**, which is also held back by rigid labour market regulations. Median labour productivity in Tunisia is higher than in peer economies, but median total factor productivity is lower, which means that physical capital is present, but is not used efficiently (**MENA ES**). In 2016, labour productivity per person employed was in line with the SEMED average and lower than the EBRD CoOs' average. Key issues include hiring and firing practices, rigid wage determination that does not match productivity, low female labour market participation, and poor labour-employer relations.



Well governed [ATQ = 4.33]

80th in the quality of institutions among 137 countries (WEF)

58th in property rights protection, **78th** in intellectual property protection, **70th** in judicial independence among 137 countries (WEF)

103rd in the burden of government regulation, **79th** in the transparency of government policymaking (WEF)

88th in irregular payments and bribes (WEF)

119th in the strength of investor protection among 190 countries (WB Doing Business)

A number of assessments, indicators, and firm-level surveys point to chronic structural weaknesses in economic governance standards in Tunisia. According to the WEF GCR, the top three most problematic factors for doing business relate to weak governance and are **an inefficient government bureaucracy, corruption, and policy instability**. Tunisia's Worldwide Governance Indicators (**WGI**) rankings worsened or failed to improve substantially on a number of dimensions between 2000 and 2016; political stability and absence of violence/terrorism worsened from the 60th to the 13th percentile, government effectiveness worsened from 71st to 45th and dealing with corruption ranking improved marginally to 54th percentile from 48th.

- While a wide array of policymakers in Tunisia have changed since the revolution, *policy implementers* and the **bureaucracy** have not changed significantly and remain deeply averse to change. The Tunisian public administration needs to provide the private sector with an environment that encourages firms to start and invest. To achieve this, it needs a strong modernisation programme. In

particular, those entities that interface with, and deliver services to, the private sector should be more efficient and transparent. At the same time, there is a need to simplify the number of bureaucratic procedures they handle, and with which firms have to comply. The World Bank estimates that the state's bureaucracy represents a significant tax on businesses, with close to 13 per cent of firm annual sales spent dealing with regulations, resulting from the cumulative cost of interaction with the administration (direct and indirect costs, including compliance time).

- **Corruption, particularly when dealing with customs and tax administration**, is one of the top four obstacles for business (**MENA ES**), and resorting to bribery seems to remain a recurring practice in various interactions with the administrative bureaucracy, with firms reporting paying on average 2.7 per cent of total annual revenue in informal payments or gifts to public officials to 'get things done', above SEMED and EBRD region averages. Cronyism and corruption go hand in hand in Tunisia with restrictions to market access. The findings of a WB qualitative survey indicate that cronyism and predation are most prevalent in certain areas. First, highly regulated sectors in which cronies could abuse their influence and privileged access to the decision-making spheres (including air transport and maritime transport, telecommunications, fishing, banking, commerce and distribution, real estate, hotels and restaurants). Second, business relying on imports (e.g. clothing trade, car imports, and electronic equipment). Finally, purchase of state-owned assets at nonmarket conditions or subsidies (e.g. land for real estate projects).

■ **SOEs underperformance** in Tunisia highlights that in general SOEs suffer from problems **related to their internal and external governance**. Many also incur financial losses despite protection from competition and significant government support. Perhaps most important, it is not unusual in Tunisia for SOEs to receive special treatment in various forms, and as such a level playing field is not guaranteed among all market players, resulting in distortions and economic losses.

Green [ATQ = 4.78]

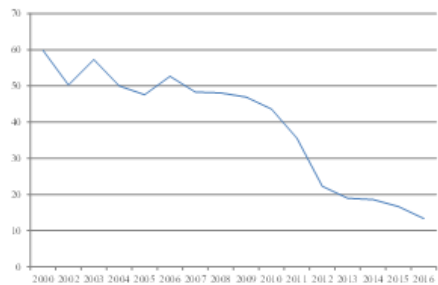
76th in CO2 emissions among 143 countries

70th in carbon intensity (CO2/GDP at PPP) among 138 countries

106th in energy intensity (primary energy consumption/GDP) among 196 countries

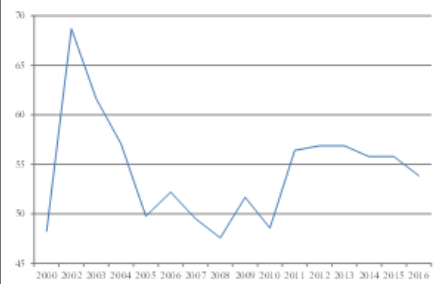
Seventeen per cent losses in the transmission and distribution networks

Fig. 4: Political Stability and Absence of Violence/Terrorism: Percentile Rank



Source: World Bank's Worldwide Governance Indicators.

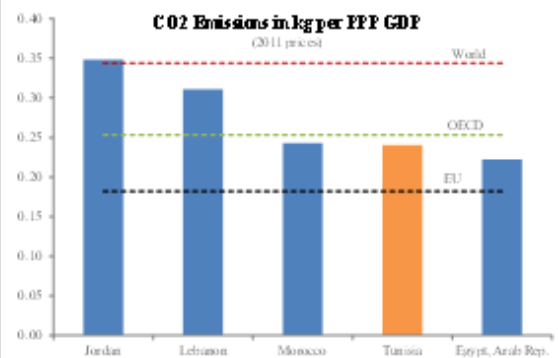
Fig. 5: Control of Corruption: Percentile Rank



Source: World Bank's Worldwide Governance Indicators.

Tunisia's green economy transition will need to focus on securing sustainable energy sources, addressing climate threats, and dealing with other rising issues such as air quality and waste management. Projections of energy demand and current supply sources anticipate a shortage of primary energy around 2020 due to population growth and depleting gas resources. Tunisia has made visible efforts to support the deployment of renewable energy (**RE**) and energy efficiency (**EE**) projects to secure the energy future. Relevant legislations are in place but often lack institutional capacity and dedicated entities monitoring the effective enactment.

Fig. 6: CO2 emissions per GDP at PPP



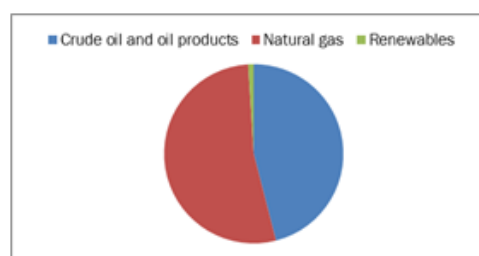
Source: International Energy Agency

There is a large potential for RE generation and EE measures to meet future energy needs.

For the past twenty years, energy and carbon intensity (CO₂/TPES) has been slowly decreasing, largely attributed to a fuel-switch from oil to natural gas in energy production, but energy consumption has more than doubled between 1994 and 2015. While comprehensive RE and EE regulatory frameworks have been set up, lack of access to finance, limited awareness, low technical capacity, and effective enforcement will need to be addressed.

- The potential for RE generation capacity is particularly large in solar and wind, which remains largely untapped and RE shares in the total primary energy supply stand at 1.6 per cent⁵. However, there has been limited progress and low private investments to date. Regulatory and policy frameworks to support RE integration have been established, including a specific law⁶ to cover RE project development.
- There are considerable technical and commercial energy losses in the transmission and distribution system, in the excess of 16 per cent⁷. The third national EE programme aims at reducing primary energy consumption by 17 per cent in 2020 and 34 per cent in 2030⁸. Nevertheless, enforcement is challenging.

Fig. 7: Primary energy consumption, 2014



Source: Bureau des statistiques, Ministère de l'Industrie

Tunisia is subject to irregular rainfall patterns, highly exposed to climate threats, and defined as chronically water scarce.

Water resources are not efficiently used with inadequate supply, maintenance, and repair in the irrigation sector. Thus, an integrated water resources management plan is needed to increase efficiency and reduce water loss, including wastewater treatment, reuse, and the use of non-conventional sources (desalination), mostly in agriculture. Agriculture uses 84 per cent of water supply, mostly for crop production, including those with high water requirements (olives).

The legislative framework for waste management is in place, but requires a clear national strategy.

Municipal solid waste (MSW) collection is covered at 80 per cent in urban and 10 per cent in rural areas. 70 per cent of the MSW ends up in landfills and only 4 per cent is recycled⁹. There is a need for a national strategy for the management of household and assimilated waste, and mobilisation of the legal and financial resources for implementation.

Air and marine pollution from chemical plants in Gabes are a pressing concern, and air quality needs updated legislation. Produced phosphate and by-products are stored unprotected close to the seaports, and hazardous substances are gradually washed into the sea and dispersed in the air by winds. PM 2.5 level is the fourth highest in the EBRD region, largely attributable to the close proximity of the Sahara, low precipitation, and the dry climate. Air pollution is regulated¹⁰ but a more rigorous and integrated air quality policy is needed.

⁵ IEA (2015)

⁶ Law N° 2015-12 of August 2016

⁷ EU average is 6 per cent, SEMED average is 12 per cent (IEA 2015)

⁸ ANME

⁹ EU recycling average is 26 per cent

¹⁰ Air Pollution and Noise Emissions Law of 2007

Inclusive [ATQ = 4.72]

One in four young people are not in employment, education or training (NEET).

Seventy per cent of men are economically active, compared to only 26 per cent of women

Twenty nine per cent of firms identify an inadequately educated workforce as a major constraint on doing business, compared to 20 per cent in the MENA region.

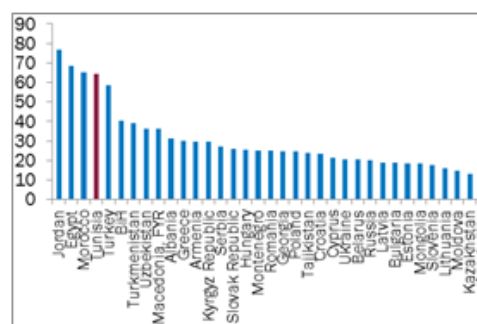
Expanding economic inclusion is critical to transitioning towards a sustainable market economy. Tunisia has one of the lowest levels of women's labour force participation in EBRD countries and has a significant way to go to expand economic opportunities for women, youth, and under-privileged regions further.

- **Youth** unemployment and youth inactivity are serious issues, with the youth unemployment rate reaching 31.8 per cent. Tunisia experiences one of the highest rates in SEMED of youth that are not in education, employment or training (NEET), estimated at approximately 33 per cent. In rural Tunisia, this category represents 58 per cent of young men and 85 per cent of young women. Highly educated youth, although still suffering exclusion, are less likely to become NEET compared to those with less education. Unemployed youth who are no longer attending any school or training programme spend on average more than three years searching before finding a job. For employed youth, it is estimated that half of them are employed in the informal sector or in low-skilled jobs, with little employment security. Financial inclusion of youth is another driver of the youth gap. Young entrepreneurs struggle to access external financing sources and are held back by the lack of (start-up)

financing instruments to support business growth such as private equity and venture capital in the general ecosystem.

- **Gender gaps** in Tunisia are smaller than elsewhere in the SEMED region, but significant nonetheless. The labour market participation rate is only 25 per cent for women, compared to 71 per cent for men. In particular, gender gaps are small in the areas of health services and labour policy. Tunisia ranks 58th (out of 188 countries) in the United Nations Development Programme's (UNDP) 2015 Gender Inequality Index¹¹. It also ranks 117th (out of 144 countries) in the World Economic Forum's 2017 Global Gender Gap Report¹².

Fig. 8: Female: Male Labour Force Participation Ratio



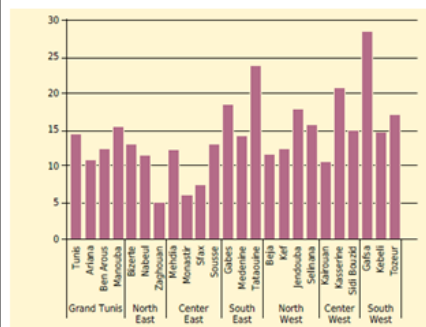
Source: International Labour Organisation

- **Regional disparities** are striking in Tunisia not only in economic outcomes, such as income and employment, but also in access to basic services, such as water and wastewater infrastructure, health, education, and transport. Distortive economic policies (such as the investment code and agricultural policy) have amplified regional imbalances. The agricultural sector remains the primary source of income and employment in Southern Tunisia, a mostly rural region affected by high poverty and unemployment rates (both around 10 percentage points higher than national average), particularly for youth.

¹¹ This index aggregates indicators across the health, empowerment, education, and labour market dimensions

¹² This report combines measures of economic participation and opportunity, educational attainment, health and survival, and political empowerment

Fig. 9: Unemployment rates by province, region



Source: Calculations based on INS 2013 Labour Force Survey

Resilient [ATQ = 4.75]

110th in financial sector development among 137 countries in WEF's Global Competitiveness Index

10th largest share of NPLs in EBRD region

Twenty one per cent in market capitalisation, below a MENA average of 59 per cent

Three per cent of its grid capacity is sourced from renewable sources

Financial sector stability remains a particular challenge in the context of the country's resilience. According to the WEF's GCR, the financial sector is relatively underdeveloped, ranking 110th among 137 countries.

While some progress has been made in the reform agenda of the **banking sector**, vulnerabilities remain. The audit and recapitalisation of the three major public banks were completed in 2015–2016 and followed by the appointment of new management. However, the operational and financial restructuring of the public banks is yet to be performed, toxic assets remain an issue with the withdrawal of the asset management company, and some dimensions of the Central Bank Law fall short of best practices. Despite some progress in resolving NPLs, they are still high at 15.6 per cent of total loans as of the end of 2016.

Capital markets are underdeveloped. The fixed-income market is relatively small, dominated by government debt securities, and activity is confined to the primary market. The corporate bond market remains underdeveloped with major impediments including the historic role that banks play in financing corporates; the lack of a secondary market; and the absence of a meaningful yield curve. On the latter issue, the EBRD supported the modelling of a dynamic sovereign benchmark yield curve reflecting market activity, to align the local bond market

with international standards and allow transparent pricing of sovereign and corporate bonds. Stock market capitalisation of 21 per cent of GDP is well below a MENA average of 58 per cent and trading values are concentrated in a small number of large companies.

As an alternative source of financing, there is a sizable presence and level of activity around **microfinance**, especially as several problems weigh down banks and impair their ability to lend to smaller clients. Underserved formal enterprises are estimated to range between 245 and 425 thousand, whereas the estimate for underserved individuals, including informal businesses, is in the range of 2.5–3.5 million, which translates into a financial inclusion rate of just 36 per cent. Historically, there were state-supported Associations de Micro Crédit (**AMC**), which were very small in size, not very sophisticated, and with default rates of over 30 per cent, while currently, there are several private players in this sector, which have fared differently. The estimates of formal and informal businesses and individuals in need of financial inclusion mean that there is a large potential for a development market for micro loans, which requires more private sector participation.

Tunisia's reliance on imports has been increasing for both oil and gas, with the coverage ratio of domestic gas production dropping by 13 percentage points between 1H2012 and 1H2016, amid also increasing concerns regarding transit of Algerian gas to Italy. However, the country has not yet taken sufficient steps to mitigate these risks by putting in place a suitable regulatory framework that incentivises procurement of energy from a resilient portfolio, including by private-sector supply and renewables. Energy subsidies and constraints to third-party access remain key issues in this framework.

Food security policy is an impediment to the development of the agricultural sector. Agricultural policies are prioritising food security in cereals, beef, and milk in which Tunisia is not competitive (produced in coastal northern regions) while distorting agricultural production away from labour-intensive products in which interior regions are competitive, such as Mediterranean products (durum wheat, olive oil, fruit, vegetables, and fisheries). The total cost of agricultural support in Tunisia is high.

Integrated [ATQ = 4.70]

Trade as a share of GDP: 87.7 per cent, compared to OECD average of 75.3 per cent.

FDI inflows as a share of GDP: 2.6 per cent, compared to OECD average of 4.1 per cent.

Portfolio inflows as a share of GDP: 0.1 per cent, compared to OECD average of 3.8 per cent.

Quality of infrastructure: ranked 86th out of 140 countries (WEF GCR, 2017)

Logistics performance (international) index: ranked 110th out of 160 countries (WB, LPI database, 2016)

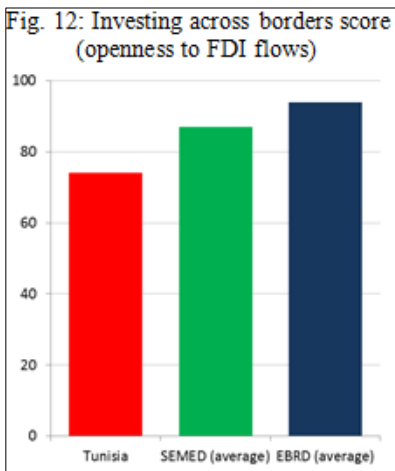
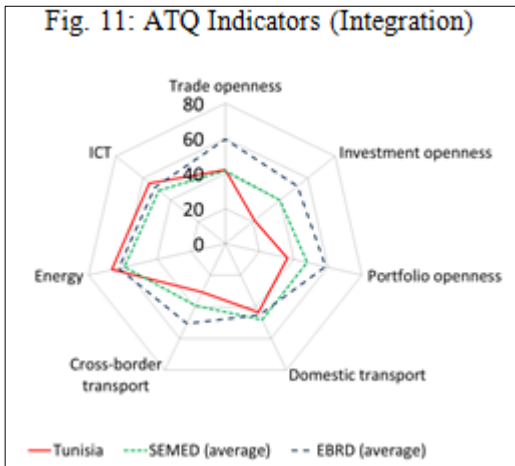
Tunisia is among the worst performers both in the SEMED and in the overall EBRD region in terms of integration, and faces challenges especially regarding its external integration, where it reaches the lowest score among all EBRD countries.

EBRD's Transition Report 2017–18 forecasts that Tunisia would need to spend 23.8 per cent of its annual GDP over 2018–22 on infrastructure to catch-up with advanced economies, and more to maintain the infrastructure stock and build new infrastructure. The infrastructure needs surpass those of the SEMED and the EBRD countries and appear mostly in the transport and the energy sector.

External integration

While Tunisia performs relatively better in terms of trade, its performance compared to OECD average and regional averages is worse in terms of FDI and portfolio inflows, explained partially by institutional inefficiencies.

- **Trade environment:** Tunisia's trade integration has been assembling and re-exporting products for France and Italy, including high-value products, in particular automotive, aerospace, and financial services. Tunisia is one of the few non-energy-producing countries with a positive trade balance with the EU, demonstrating the competitiveness of its exports. Trade policies have a high level of unpredictability (the binding overhang ratio is the highest among all EBRD countries at 42.4 per cent compared to OECD average of 3.8 per cent).
- **Investment environment:** Tunisia's openness to FDI flows is the lowest among significantly lagging behind all EBRD countries. The country is part of 42 bilateral investment agreements, compared to the averages of SEMED (59), EBRD (63) and OECD countries (95). The Investment Law of 2016 did not eliminate the distinction between the onshore and offshore sectors and did not cover several important sectors of the economy, including mining, energy, domestic commerce, and the financial sector, for political and strategic reasons. Moreover, more sectors may be off-limits for foreign investors through the exhaustive list of all activities that will require prior approval, expected in 2018.
- **Non-FDI environment:** Tunisia's capital account openness is low, lagging behind SEMED, EBRD and OECD countries averages, constraining further development of capital markets.



Internal integration

- Domestic transport:** Tunisia performs poorly in terms of quality of infrastructure, especially regarding the quality of railways. The quality of roads is comparable to the overall SEMED and EBRD countries levels. Low competence and quality of logistics services impair the situation.
- Cross-border integration:** Tunisia's logistic performance ranking plummeted from 61st in 2010 to 110th in 2016, below its SEMED peers. More specifically, Tunisia ranks poorly across a number of logistic quality indicators; 147th in customs and border efficiency, 93rd in trade and transport infrastructure, and 133rd in ease of arranging shipments.
- Energy and ICT:** The quality of electricity in Tunisia is good, in line with the EBRD and OECD averages and losses due to electrical outages are below the SEMED and EBRD levels. Only around half of the Tunisian population have access to broadband (compared to 82.8 per cent in OECD countries, a SEMED average of 57.4 per cent, and an EBRD average of 64.1 per cent).



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