MCC Advisory Council Briefing Memorandum: Tunisia Compact

MCC seeks the Advisory Council's advice on the design of a compact to generate growth and investment by alleviating constraints related to excessive market controls, rigid labor market regulations and water scarcity. The reforms identified in the program should liberalize markets in the longer term without exaggerating political instability or inequality in the shorter term.

Background

Tunisia is a lower-middle income country of 11.4 million people with GDP of $10,752 USD, PPP. The country covers land area of 63,170 mi^2 and has a semi-arid Mediterranean climate in the northern coastal areas, which transitions to arid in the middle region and then desert climate in the southern areas that border the Sahara desert. Tunisia's population is primarily urban and coastal, with 60% of the population living in an urban area, and 85% of the population living within 100km of a coastline. Sixty-nine percent of the population is working age (15-64); 32.6% are between the ages of 15-34.2 In 2011, a peaceful revolution overthrew the regime of Ben-Ali in events that initiated the "Arab Spring" throughout the Middle East and North Africa (MENA).

Tunisia is the only country to emerge from the Arab Spring with a successful democratic transition. In 2014, Tunisia ratified a new Constitution and successfully held presidential elections with a peaceful transition of political power. To ensure that this transition offers opportunities to all Tunisians, the Government of Tunisia (GoT) is planning concrete measures to address the perceived long-standing inequalities and disparities between the developed northern and central coastal areas and the historically neglected eastern interior and south. To this end, the GoT has prioritized the installation of accountable governance mechanisms (including decentralization efforts), promoting increased investment in interior regions, and generating employment for youth to address these historical inequalities and decrease social unrest.

Tunisia's economic growth was strong in the years prior to the 2011 revolution, with an average annual GDP per capita growth rate of 3.27% in the 10 years prior to 2011; it has since lagged at 0.52 since 2011%, likely due to instability and uncertainty (Exhibits 1 and 2). Services make up the largest share of value-added (60%) and employ 51% of the population. The highest-value-added services are in tourism, which directly contributes 6.6% of GDP and employs 6% of the working population. Manufacturing and industry account for 28% of GDP and 33% of employment. Agriculture and agro-processing make up 12% to 16% of GDP and employ approximately 20% of the workforce, and 30% of the workforce in the four interior regions.

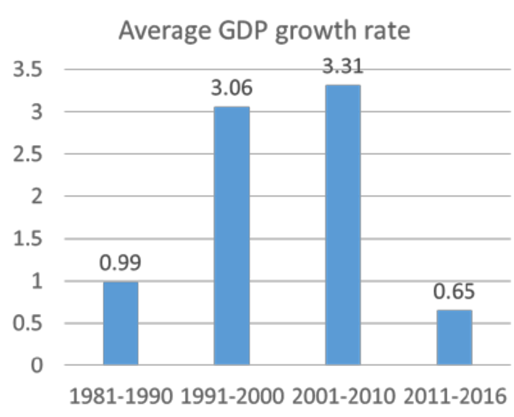

Exhibit 1: Tunisia Average GDP Growth Rate 1981-2016

Tunisia's growth has been characterized by a dual economy with an offshore (export-oriented) sector supported by generous tax-incentives and a light regulatory regime and an onshore (domestic-oriented) sector which is heavily protected. Incentives in the offshore economy has led to low-cost, low-value-added production for export. Even Tunisia's production in relatively higher value added segments, such as electronics and electrical equipment, is primarily focused on labor-intensive assembly. Further, the onshore segment is made up of primarily low-productivity firms which benefit from significant protections that contribute to lower quality or higher priced goods which limit their ability to support the offshore segment that is exposed to competition. This dualism contributes to the trend wherein jobs and economic opportunity remain concentrated in coastal, urban areas where proximity to European and Mediterranean export markets is favorable. The result has been unequal growth and job creation skewed towards the urban coastal areas, and unemployment in interior regions is significantly higher than in the two coastal regions.

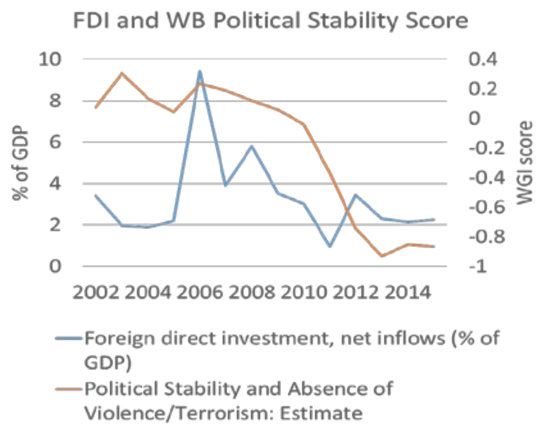

Exhibit 2: Tunisia Foreign Direct Investment and Political Stability, World Bank, 2002-2014

The poverty rate in Tunisia is 15.2% at the national poverty line, and 2.9% at the extreme poverty line. This rate has diminished substantially since 2005, and marks impressive achievements in welfare improvement and economic development for Tunisians across the board. However, relative rates of poverty have been increasing in three of the four interior regions, meaning that progress on poverty reduction has been slower in these regions, even though progress has been made, highlighting an uneven achievement.

The country has made substantial progress in closing gender gaps in education and health. Women in Tunisia have generally more education, notably at the tertiary level, than men. However, this progress has not translated into higher rates of female participation in economic life.[1] Although among the highest in the MENA region, the women's labor force participation rate in Tunisia is among the lowest in the world, at 25%, in comparison to the 75% male labor participation rate.

The Government of Tunisia's current plan for economic development is laid out in the 2016 – 2020 Development Plan, a product of national and regional consultations. The plan aims to achieve an average annual GDP growth rate of 4% per year through 2020. It also includes a focus on inclusive growth benefitting all regions of the country and segments of the population. The plan is based on five pillars, including:

- Pillar 1: Good governance, public administration reforms and anticorruption measures
- Pillar 2: Transition from a low-cost country to an economic hub
- Pillar 3: Human development and social inclusion
- Pillar 4: Realizing regional ambitions

[1] Tunisia ranks 126 out of 144 countries on the World Economic Forum's Gender Gap Index, and even lower (126) in the economic participation and opportunity sub-index.

- Pillar 5: The Green Economy, a pillar of sustainable development

MCC Engagement with Tunisia

MCC selected Tunisia for a compact in December 2016. The compact is in the early stages of development process (estimated to take between 2-3 years) having just recently completed the first milestone that is the identification of "binding constraints" and a "root cause analysis". A team mission was undertaken September 25 - October 6 for the purposes of delving deeper in to the root causes of Tunisia's economic constraints and prepare the GoT to submit concept notes. The next milestone is the development of "Concept Notes", expected in November 2017, which among other things, will elaborate upon a conceptual program and program logic that links the proposed investments to the expected outcomes. The MCC team will review and assess the viability of the conceptual program and present an "Opportunity Memo" to the IMC before proceeding to detailed program design and development.

MCC and the GoT have consulted with foreign and domestic businesses in Tunisia throughout the compact development process. Meetings with companies have taken place individually, as well as in groups as part of the Root Cause Analysis and the Constraints Analysis consultations and validation sessions. Private sector associations have played a prominent role in consultations and include, for example, the Tunisian Confederation for Industry, Trade and Handicrafts (UTICA) and the Tunisian Chamber of Commerce and Industry (CCIT). Individual companies, ranging from SMEs to larger, established companies, have been consulted in a range of sectors, such as financial services, information communication technology, manufacturing, agribusiness and tourism. To date, input from these consultations has been incorporated into the constraints and root cause analyses, which are used to identify the concepts. As the concepts are further developed, more targeted meetings will be held with private companies and associations to ensure that they are being designed in a way that addresses constraints identified in our analysis and the practical barriers to investment that companies are facing in Tunisia.

Binding Constraints

A Constraints Analysis was conducted jointly by the MCC and Tunisian teams from March through August 2017. On August 28th, the MCC Investment Management Committee (IMC) approved three binding constraints to private investment and entrepreneurship identified by the Constraints Analysis:

- *Excessive market controls of goods and services:* In Tunisia, extreme levels of state intervention and bureaucracy in goods and services markets create unreasonable regulatory requirements and compliance costs to firms, which unduly prohibit certain actors from entering and exiting, and reduce firms' competitiveness.
- *Restrictive labor market regulations:* Inflexibility of wage determination, high social charges, and employment protection mechanisms reduce productivity by discouraging formality, the attainment of efficient firm size, and increasing youth and non-urban unemployment while depressing economic participation of the working age population, particularly women.
- *Water scarcity, as a constraint to regional equity and sustainability:* Inadequate and variable supply of water inhibits medium and long term private investment in interior regions and reduces the sustainability of those investments, primarily in agriculture.

Additional information on these constraints may be found in Annex A.

Problem Statements

As a starting point for the root cause analysis, the MCC and Tunisian teams used the material from the constraints analysis to agree on the following problem statements to guide the logic of a conceptual compact program.

Market Controls:

- Excessive regulations, cumbersome procedures and uneven governance are part of an ineffective system of international trade in Tunisia that leads to informality in the economy and declines in foreign direct investment
- Excessive state intervention, in the form of price-fixing, licensing and subsidies, creates inefficiencies in the markets for goods and services and reduces the competitiveness of domestic firms
- Regional development policies are not adapted to the needs of investors, particularly for agriculture, as the dominant sector in the rural economy

Restrictive Labor Market Regulations:

- Rigidities in the legal and organizational framework governing the labor market and industrial relations inhibit firm competitiveness
- High social charges are expensive for firms, while also have limited benefit for workers

Water Scarcity: Insufficient and variable supply, as well as poor management and distribution of water resources hamper investment and cause social unrest, particularly in interior regions

Questions for the Advisory Council

MCC seeks the Advisory Council's feedback to **inform the focus of the compact**, with the following specific questions.

General

- How do you support investments in areas that have security concerns, water scarcity, or infrastructure constraints?
- How can Tunisia capitalize on their proximity to European and Sub-Saharan African markets and what is its comparative advantage versus peer countries? Are there specific companies that may want to invest?
- How might we become aware of and exploit technology to achieve our compact objectives (ie: labor market data collection, customs systems, e-government, etc.)?
- Who else should we be talking to about Tunisia? Are there companies, funds, local or international businesses, associations, think tanks, etc. that should be in our outreach plan?

Market Reforms

- How might we select and prioritize reforms that will attract private investment, maximize job growth, and impact poorer interior regions and communities?
- How might we better engage the local private sector in the reform agenda? US businesses?

- By loosening controls/subsidies, we may hurt businesses and employment in the short term; how should we sequence and mitigate this?

Water

- How might we incentivize the private sector to conserve water, particularly given that both water and power are subsidized?
- What types of investments could allow us to attract businesses to the interior regions while also conserving water?

Labor

- What reforms are feasible given the strength of Tunisia's labor unions?
- How does MCC remove labor protections without exacerbating near term unemployment and political instability?

Annex A: Additional Information on Tunisia Binding Constraints

1. *Excessive market controls of goods and services:* In Tunisia, extreme levels of state intervention and bureaucracy in goods and services markets create unreasonable regulatory requirements and compliance costs to firms, which unduly prohibit certain actors from entering and exiting, and reduce firms' competitiveness. Specific data and examples in support of this constraint include:
    - Excessive bureaucratic requirements drain firms' management resources, add administrative costs and time and privilege market access for connected firms. Managers spend over 45% of their time dealing with government requirements, compared to a global average of 13% (Exhibit 3).

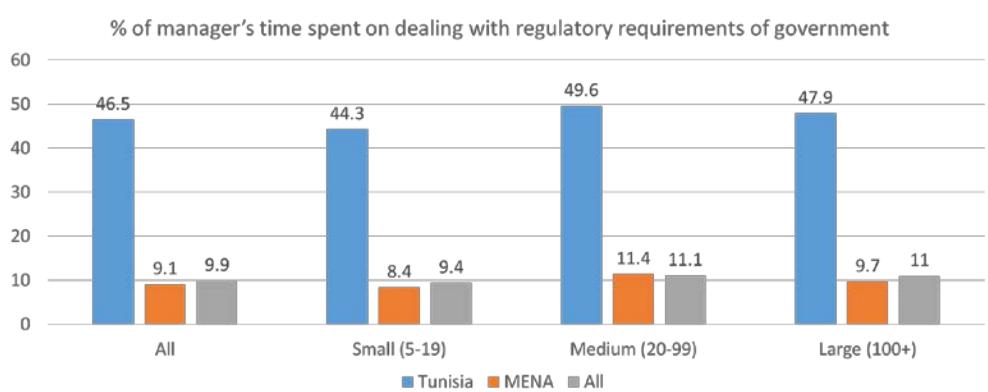

Exhibit 3: Managerial Time Spent on Government Regulatory Requirements, World Bank Enterprise Survey, 2013

    - A number of government price controls, subsidies and trade measures contribute further to market distortions in goods and services, especially in agriculture. For example, the cost of cereals in Tunisia is approximately 30% higher than the world price, encouraging cereals production over other, higher-value items such as horticulture.[2] Though there are general compensation funds to

2 https://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Brochure%20note%20politique%20agriculture%20Anglais.pdf

subsidize the consumption of staple goods, only 22% of food subsidies go to the poor, meaning that poor consumers are partly subsidizing local producers.

- Price controls and subsidies also incentivize the unproductive allocation of resources in the economy and diminish prospects for new opportunities. Energy and water consumption are subsidized, which diminishes incentives to invest and contributes to unsustainable usage. The large distinction made between onshore and offshore firms creates a useful contrast to consider a Tunisian economy with reduced bureaucracy and regulation.
- Poorly governed state-owned enterprises (SOEs) exercise significant market control, with the effect of distorting markets and reducing competitiveness of the economy overall. One-hundred nineteen SOEs currently operate in 19 sectors in Tunisia. The high level of SOE involvement, protection and state regulation of the economy creates an uncompetitive environment wherein some companies, many state-owned, enjoy privileged positions, regulations that favor incumbents or monopolies, and privileged access to decision-makers.
- The effects of uncompetitive distortions are so severe that a World Bank 2014 study estimates that a 5% decrease in the price-cost margin of incumbent firms, resulting from increased competitive pressure, would increase labor productivity by 5%, and translate to GDP growth rates of 5.5% annually.

2. *Restrictive labor market regulations:* Inflexibility of wage determination, high social charges, and employment protection mechanisms reduce productivity by discouraging formality, the attainment of efficient firm size, and increasing youth and non-urban unemployment while depressing economic participation of the working age population, particularly women. Specific data and examples in support of this constraint include:

- Restrictive labor market regulations, a constraint linked with the market controls on goods and services, affects the distribution and allocation of labor resources in the economy.
- Tunisia ranks 133 out of 138 on the labor market regulations indicator for the World Economic Forum's Global Competitiveness Index for 2016. A review of employment protection legislations (EPL) shows that stricter EPL reduces formal employment, increases the size of the informal sector, reduces value-added, reduces firm size, and reduces output. Tunisia ranks similarly in specific rankings for flexibility of wage determination, cooperation in labor-employee relations and pay and productivity (Exhibit 4).
- Dismissal procedures are cumbersome and inhibit entry, expansion and exit of firms and Tunisia is among the most restrictive countries in the world to dismiss permanent workers,
- High labor and social charges also discourage hiring and encourage informality. Tunisia has a relatively low minimum wage relative to average labor productivity, social charges and tax contributions are the highest among comparators and the quality of social services received is low, reducing incentives for employers and employees to enter into formal contracts.

- Unions are strong in Tunisia with major political and socioeconomic force, and have a major impact on wages and agreements through collective bargaining.[3][4] Unionization is more prevalent in the public sector, at 60% of workers compared to 15% in the private sector, creating a preference for public sector employment, especially among women.[5]
- Tunisian law permits hiring workers on fixed contracts for up to 4 years which can be terminated more simply than open-ended contracts, and firms have an average of 4.13 more temporary full-time workers than comparators, showing a circumvention of labor protections.
- Labor market restrictions exclude youth and women, and very likely reduce formal employment in interior regions. According to the World Economic Forum women make about 65% of what men make in comparable positions and the IMF has estimated that Tunisia could gain a 30% one-off increase in GDP growth if gender gaps were removed.[6]
- While the legal minimum wage in Tunisia is competitive, there is evidence that it is still depressing employment and growth (in the absence of a minimum wage, the youth unemployment rate could be reduced by 6%, and formal employment could increase by 6%.
- Collective agreements are bargained centrally, and apply evenly across the country, without adjustment for regional differences in productivity. Minimum wages are not linked or informed by changes in productivity. In areas with poorer business environments, labor market regulations are likely to be more constraining for firms that follow them, and exacerbate the divide between those that are protected by them and those that are not.

Figure 4: Tunisia Labor Market Efficiency Rankings, World Economic Forum, 2016-2017

[3] http://foreignpolicy.com/2016/07/20/tunisias-celebrated-labor-union-is-holding-the-country-back/
[4] There is a high degree of interaction between labor market regulations / union power to SOE inefficiencies. E.g., it was suggested that the cause for the drastic decline in the Logistics Performance Index since 2011 was due to union workers at the national freight company slowing down processes in order to extract increased benefits.
[5] Hanmer, Lucia et al. Gender and Labor Markets in Tunisia's Lagging Regions. April 2017. World Bank.
[6] IMF. 2017. Women, Work, and Economic Growth: Leveling the Playing Field.

3. *Water scarcity, as a constraint to regional equity and sustainability:* Inadequate and variable supply of water inhibits medium and long term private investment in interior regions and reduces the sustainability of those investments, primarily in agriculture. Specific data and examples in support of this constraint include:
   - Coupled with inefficiencies in the capture and mobilization of existing water resources in the northern region, the scarcity and unreliable supply of adequate water raises the costs and risks of medium- and long-term investment in interior regions, particularly for agricultural and agro-processing firms, which are the main forms of employment in those regions.
   - Limited surface and renewable groundwater resources in Tunisia are almost completely appropriated and future demand for water is expected to increase due to population growth, urbanization, and growth in industry and tourism and is predicted to surpass supply by 2030 without the implementation of more efficient water conservation strategies (Exhibit 5). [7] [8]

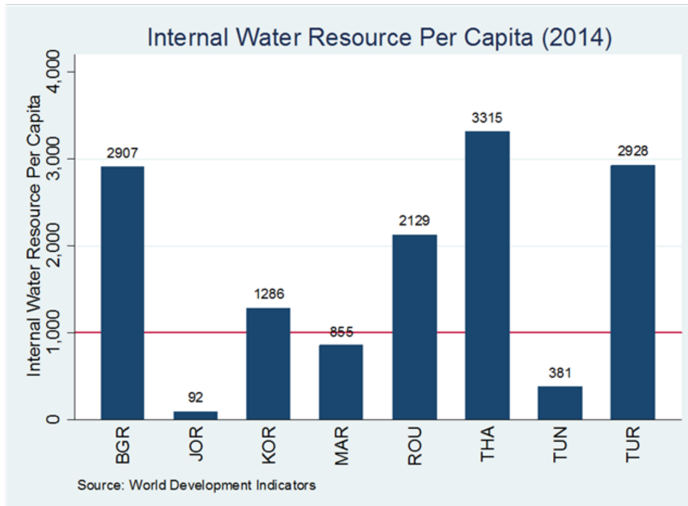

Exhibit 5: Supply of Internal Water Resources in Tunisia vs. peers, World Development Indicators, 2014

   - Agriculture consumes 80% of Tunisia's total water resources, and is also a significant share of informal, subsistence based employment and income in rural areas, in particular for women. Additionally, agricultural development projects are a key element of the GOT's Tunisia 2020 plan and contribute strongly to the "green economy" pillar of the plan. A study on the potential impact of IFC investments estimates that agriculture and food processing investments have the potential to drive the highest direct and indirect economic returns.[9]
   - Despite its scarcity, potential exists to realize substantial water use efficiencies to support increase in growth and sustainability of employment in the more water-stressed interior regions. For example, as much as 40% of water may be lost in the current distribution systems, suggesting that basic improvements could improve water distribution and reduce losses.[10] [11] In addition, the overall reduction in reservoir capacity is estimated at 40% due to sedimentation – the result of poor watershed management.

[7] USAID, 2017. Groundwater governance in Tunisia.
[8] UNFCCC, 2013. Republic of Tunisia, Second National Communication of Tunisia to the United Nations Framework Convention on Climate Change.
[9] IFC, 2012. Modeling the Socio-Economic Impact of Potential IFC Investments in Tunisia.
[10] Pers com with Ministry of Agriculture; EPA generally considers maximum acceptable loss at 10%.
[11] Surface water in the north is mobilized by dams and reservoirs and is transferred through a system of pipes to greater Tunis and coastal areas. This system is Tunisia's 'water distribution' and is where the 40% loss comes from. This 'captured' water is used for hydroelectricity, drinking water, industry, and agriculture.

- Water shortages have led to protests and social unrest, and farmers and firms alike are using various means to fight the scarcity—not all sustainable. Water supply cuts are becoming more regular (not just during droughts)[12] and interior areas are suffering long water supply cuts, reservoirs are running dry, and farmers are seeing losses, adding to social tensions.
- Farmers have been circumventing this constraint by drilling their own deep wells, a practice which is costly and illegal. Between 2010 and 2015, over 10,000 illegal wells were created leading to high illegal exploitation of water from the country's deep aquifers (see Exhibit 6).[13] Farmers also respond to a lack of rain and shutoffs in irrigation by taking fields out of production.
- Fruits and vegetables, being largely irrigated, are more insulated from water availability shocks, although even these farms were being water-rationed in recent years. Investors noted that they were reluctant to put land into use due to water availability concerns.
- In a survey of 942 manufacturing and services firms in 2015, approximately 18% of firms operating in the interior regions cited access to/cost of water as a moderate or major obstacle to the firm's current operations. Some firms are coping by building desalination plants.

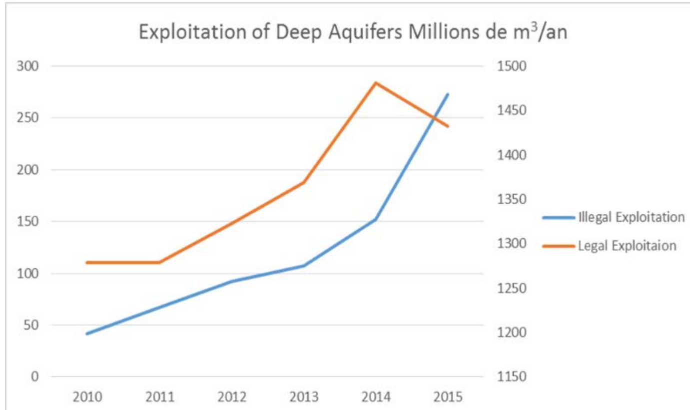

Exhibit 6: Exploitation of Deep Aquifers in Tunisia 2010 – 2015, Direction Generale Des Ressources en Eau (DGRE), Annuaire De L'exploitation Des Nappes Profondes, 2015

[12] The Ministry of Agriculture is the federal entity that has responsibility for managing water in Tunisia, not only water for agriculture.

[13] Ministry of Agriculture. 2010 and 2015. Annuire De L'Exploitation Des Nappes Profondes.