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TUNISIA ECONOMIC POLICY REVIEW TEAM:

Preliminary Executive Summary*

Brief Background to Recommendations

Tunisia is entering the post-hydrocarbon era and major transformation of the economy is required. No significant new discoveries of oil reserves are likely and the terms of trade are worsening. With local consumption rising rapidly, the country will be a net oil importer by 1990. Moreover, little stimulus can be expected from the country's mining sector (phosphates). Unless something is done the economy will, in the team's view, deteriorate slowly, creating anew the potential for serious political and social instability. The replication of last year's riots, induced by the 100 percent increase in the price of bread, needs to be avoided.

That significant increases in output are unlikely to be generated in the oil and mining sectors implies that Tunisia should look to its other productive sectors -- manufacturing, tourism and agriculture. For instance, potential exists in manufacturing, which the IBRD sees as the primary engine of growth for the 1990s. So far, however, the performance of the country's manufacturing, tourism and agricultural sectors has been relatively disappointing. A major contributing factor has been the country's economic policy environment. In spite of some significant liberalization, the economy still has a strong statist orientation, in part a product of its relationship with its former metropole France.

In light of the relatively unpromising economic environment, the scope of the Economic Policy Review Team's work in Tunisia was to identify those economic policy changes that would increase the efficiency of the economic system and stimulate increased investment, real growth, and employment. Such an analysis should assist the U.S. Government to better plan and coordinate the levels and kinds of U.S. economic assistance and support and reinforce Tunisia's efforts to achieve its development goals.

During the visit of March 20-April 6, the team, composed of PPC's Emily Leonard, Don Harrison from NE/DP/PL and Georgia State Professor Jorge Vasquez-Martinez, had the opportunity to talk to members of the U.S. Country Team, a number of Tunisian government officials at the highest ranks, and individuals in the private sector and labor, among others, about the economic goals, objectives and directions for Tunisia in both the short and long term. Generally speaking, cooperation was excellent. In almost every case we were greeted with "open arms." We also were assisted by the large volumes of studies and reports prepared by the GOT and several multilateral organizations, especially the IMF and IBRD. In some instances, preconceived notions of team members were confirmed. In other cases, we made important changes in our assessments. The field visit also facilitated placement of the economic policy environment within the Tunisian political and social context.

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* The report and recommendations of the Economic Policy Review Team are being reviewed by USAID/Tunis.

As an outgrowth of the trip, we now have a much better understanding of the Tunisian economy. This has permitted us to identify a number of major economic policy issues.

The recommendations set forth below represent the team's best professional judgements. They reflect the team's consensus of policy changes that are needed to stimulate increased and balanced growth into an otherwise stagnating economy. The team feels that the recommendations are in a sufficiently advanced state to form the core of any economic policy dialogue between the USG and the GOT, although, in some instances, further study is required for clarification. The IBRD and the IMF have targeted many of these same issues. The two organizations are working on or have completed a number of studies, including (a) mid-term assessment of the country's development plan, (b) financial sector, (c) employment, and (d) industrial sector. These studies, which touch on many of the team's recommendations, will be used as the base for policy dialogue discussion between the two organizations and the GOT. The team's report, in addition to having a life of its own, will support and complement any IBRD and IMF policy dialogue with the GOT.

Outline of Various Policy Recommendations

1. The GOT should strive for the elimination of price controls and prices should be allowed to fluctuate freely. The strong socialist tradition of the GOT, however, precludes immediate or short-term abolition of price controls altogether. As an alternative, therefore, the GOT should do away with "autohomologation," one of its various price control regimes, and allow prices to be set freely. Under "autohomologation" which applies to most industrial products entrepreneurs were to be allowed to set their own prices subject to minimal GOT oversight. In recent months, however, the GOT has been exercising oversight in a manner that has delayed considerably implementation of price hikes. Abolition of "autohomologation" would be a bold step forward and would have a substantial positive effect on private sector activity.

2. While some liberalization has taken place, import controls -- a major barrier to productive sector activity in Tunisia -- require significant reform. Import license reduction targets should be established; annual import authorizations should be granted liberally; certificates of imports for exporter production inputs should be furnished on an unlimited basis; and GOT procedures in the area of import controls should be streamlined.

3. While foreign exchange controls should be modified, such an action may be difficult to implement in the near term. In the interim, bureaucratic procedures should be revised considerably; they constitute a significant burden on the private entrepreneur. Perhaps AID could finance a seminar dealing with the impact on economic activity of GOT regulations such as foreign exchange, import, and price controls, etc.

4. Tunisia's protection system for "infant industries" requires review. Domestic enterprises, protected by import barriers and price controls, have had little incentive to hold down costs; hence they are not competitive on international markets. To assist in the review of these and other issues, an effective protection study should be conducted. Such a study already has been undertaken for Morocco.

5. The operations of parastatal enterprises need to be rationalized. The GOT should consider selling off selected enterprises. For those the GOT wishes to retain, needed management/financial controls should be adopted and/or private management contracts let. This may be an area for AID technical assistance.

6. Fiscal management requires some strengthening. The GOT must devote a greater percent of its resources to renovation and maintenance of existing infrastructure; AID may want to consider program support with local currency proceeds programmed for maintenance. In addition, in implementing its ongoing tax reform, the GOT should secure technical assistance for personnel training in programming, auditing, and indirect assessment techniques. Also, the 20 percent commercial bank government paper requirement, through which the GOT procures resources for funding its expenditures, should be lowered and curbs placed on external borrowing. A lowering of the 20 percent requirement would influence private sector activity positively by increasing credit availability.

7. To assist in the rationalization of GOT subsidies, a study of the distributional impact of subsidies on the populace should be undertaken. Based on the results of the study, a strategy would be developed for gradual elimination of the subsidies and the identification of alternative GOT means of income maintenance for the poor.

8. The GOT should consider an upward adjustment in interest rates, an adjustment that could be implemented in stages. Higher rates would promote labor-using rather than capital-intensive technologies in addition to encouraging savings and discouraging consumption.

9. The operation of the discount window through which commercial banks borrow money from the Central Bank is in dire need of reform. The many preferential discount rate schemes that have been established impose significant administrative costs on banks. Also, it is unclear whether the many preferential discount rate schemes are in fact consistent with GOT social and economic priorities.

10. Wage rates should be allowed to play their role as a pricing signal in the economy. They should reflect productivity. GOT insistence on a wage-productivity link is a step forward. Minimum wage legislation also should be reviewed; such legislation affects employment negatively.

11. The GOT should review the exchange rate. The exchange rate may be "overvalued" (or conceivably, undervalued). An "overvalued" exchange rate puts export sectors at a competitive disadvantage and encourages excessive domestic consumption of imports, thereby creating balance of payments difficulties.

12. While significant progress has been made (on a weighted basis, domestic prices are at least 80 percent of comparable global levels), the GOT should continue to strive to align domestic energy prices with global levels, thereby providing further encouragement to enery conservation. All other GOT energy policies that discourage energy conservation as well as those that affect employment negatively should be placed under review.

13. Investment incentives should be continuously reviewed to insure that the investment climate is as favorable as possible. For instance, investors find GOT laws extremely complex and burdensome.

Alternative Policy Dialogue Strategies

The USAID policy review team feels that implementation of these reforms would lay the foundations for the development of free enterprise and a strong private sector and promote growth with equity. The list of recommendations, however, is long and exhaustive. Political realities in Tunisia suggest that the GOT is unlikely to make significant headway in addressing all or many of these recommendations, especially in light of its longstanding socialist orientation. This is not to say that the GOT is incapable of undertaking any reforms. Some rather significant reforms indeed have been implemented in recent years. What this does suggest, however, is that USG assistance to the country will have to be targeted carefully to those areas of GOT policy-making where change is politically feasible and will have the most significant impact. We also must recognize that the relatively small size of the USAID program in Tunisia gives us limited leverage.

One solution to this dilemma is a carefully targeted sector program. Under this option, either the industrial or agricultural sector should be the primary focus of U.S. activities and the GOT should be encouraged to adopt reforms that will have the most significant impact on activity in that sector, e.g., restructuring of the investment incentives, land tenure reforms, etc. A second option would be to concentrate on one or two institutional bottlenecks, e.g. import controls, etc., that are major impediments to growth. Business concerns devote significant resources, attempting (in many cases succesfully) to evade such controls. Under a third option, the policy dialogue would concentrate on a more broad-based and far-reaching objective, addressing a substantial number of reforms. This would mandate a restructuring of the current project-oriented program to ESF cash transfer program assistance. Such a reformulation would recognize that political costs will attend implementation of reforms and, as such, significant leverage (substantial U.S. financial assistance) is required.

It is the team's perception that the third option is not viable. The current political situation in the country suggests that any expectations for significant adjustment over the short-term are unrealistic. As for the other two alternatives, the sector program option would require discussions in many areas simultaneously -- price controls, foreign exchange regulations, interest rate policies, etc. GOT economic policies in all these areas constitute impediments to increases in sector output. While movement by the GOT in all of these areas would definitely represent a step forward in terms of overall economic welfare, across the board movement would be difficult to accomplish; scarce policy dialogue resources would have to be spread thinly. On the other hand, the one or two institutional bottlenecks that would be emphasized under the second option would permit a more defined and better focused policy dialogue effort. From the perspective of the economy as a whole, it is unclear whether elimination of one or two institutional bottlenecks would definitely promote enhanced economic welfare, given the plethora of other impediments that would remain. Nonetheless, the team favors this option. USAID/Tunis has followed such a strategy vis-a-vis the expatriate tax issue, meeting with some success. The strategy provides a sound and firm basis for moving into more complex and difficult policy reform areas over time. It also provides both parties to the dialogue (the GOT and the USG) with time to develop additional information and understanding of the functioning of the Tunisian economic system and the impact of change in the policy framework.

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OVERVIEW*

It was our intention in drafting this report to identify explicitly certain areas in which we believe that existing public economic policy constitutes an actual or potential obstacle to achievement of what we understand to be Tunisian development goals. We have also suggested specific actions that could be taken with little or no delay. Others require longer-term action or serial actions. This document, therefore, is not one whose purpose has been served once it has been read. Rather, it is our hope, and our respectful suggestion, that it serve as an agenda of issues for a continuing process of discussion, study, action, and cooperations between our two governments.

The gains that the GOT has made in transforming the economy to one that is more market and free enterprise oriented are indeed impressive. Nonetheless, the economic system is peforming below its productive potential. Among the palpable symptoms of this malaise is a chronically high rate of involuntary unemployment, relatively low per capita incomes, disappointingly slow growth of productive sector activity, and serious fiscal and external imbalances. To turn the economy around and boost national production, investment in directly productive activity is required. Without increases in productive activity, unemployment, which was high even in the hey-day of the oil boom in the 1970s, will remain an acute problem with severe adverse economic, political and social dimensions. Therefore, the economic policy that must be found, if Tunisian economic development is to solve these core problems, is a set that will unambiguously reward the efficient use of resources, that will accelerate the rate at which investment decisions are made and implemented and that will lead to a structure and pace of economic activity that will produce higher living standards for the Tunisian people policy.

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* In drafting up this overview section, Grenada Economic Policy Memorandum, prepared by Samuel Skogstad, Bruce Bouchard, Roy Bahl, Don Harrison, and Dennis Wood, was used extensively as a reference.

Since independece in 1956, Tunisia's economy has been characterized by differing degrees of government intervention. At the height of Tunisia's socialist experiment, for instance, nearly 86 percent of agricultural land was collectivized and nearly all industry was controlled to various degrees by the public sector. The Government of Tunisia (GTO) used central planning mechanisms and direct government control throughout the economy. Results in every area, however, fell far short of expectations, especially in agriculture, where production fell sharply. Moreover, the socialist experience was completely at odds with the traditional private sector orientation of the populace which especially resented the cooperative movement. In a pragmatic response to this situation, the GOT, with support of the IBRD consultative group, reversed its policy at the end of the sixties and announced a series of policy reforms designed to promote the use of market signals and development of private enterprise in agriculture and other sectors. A number of impressive economic reforms were undertaken and continue to be implemented. However, still more needs to be done; economic signals such as prices, interest rates, and exchange rates must be permitted to function.

Tunisia, however, appears to be marking time at present, unwilling to adopt significant new economic reforms. While the populace admittedly had much distate for many of the measures introduced during the socialists experiment, it also greeted with alarm the flaunting of wealth and piccadillos that attended the capitalistics economic revival of the 1970s. The Tunisian people also are awaiting resolution of the country's political situation; the current head of the country -- Bourguiba -- is old and in poor health.

As for the Tunisian government itself, it believes that "le gouvernement est le roi" (the government is the king). According to the government, Tunisia is a small country whose people must be protected. The private sector, thus, is depicted as a villain who is out to "rape ~~rope~~ the poor urban consumer."
Consequently, the GOT maintains the "status quo" in the guise of not wanting to disrupt social unity. This kind of thinking has led to a number of perverse outcomes. One, the GOT has doled out largesse (e.g., subsidies) to the public, rekindling expectations that will be difficult to extinguish. Two, development projects have been decided on the basis of politics rather than economic viability. Three, large scale development projects have been funded without any provisions for maintenance. Four, banks have an obligation to fund economic development in Tunisia; therefore, they are required to purchase government paper as well as provide funds to GOT-sponsored development projects that they know will be money losers. Five, civil servant rolls have taken on excessive proportions; especially harmful are the large numbers employed in parastatal enterprise. To this we must add the problem of centralization. Areas outside of the capital city of Tunis continue to be neglected.

The country, thus, is at an important juncture in its history. With the resolution of the political situation, the country will be presented with a unique opportunity. It can seize the opportunity and adopt a bold structural adjustment program that will move the economy on a dynamic, free-enterprise, private sector oriented path. Or it can let the economy continue to drift downward slowly, risking political and social instability of major proportions. In any event, significant potential exists for successful implementation of a structural adjustment program; the country's well trained bureaucracy is among the best of any in the third world, and already is acutely aware of the country's economic ills. While well thought-out plans have been developed to address these ills, implementation has lagged. Any structural adjustment program will have to recognize that tradition dies very hard in Tunisia.

The structural adjustment program will have to address to a number of issues. In many areas of the economy, an anti-market bias still persists. One, significant productive sector activity remains in the hands of the GOT. Two, control of agricultural lands, marketing, inputs, and outputs is excessive. Three, an array of price controls is in effect and subsidies are significant. Four, interest rates are fixed at less than market clearing levels, a policy that encourages use of capital-intensive rather than labor-using technologies. Five, import controls, including licensing, are in use and the GOT administers a foreign exchange control system. Six, the foreign exchange rate conceivably may be "overvalued," an issue that requires further study. Seven and last, other impediments to foreign investment exist, including uncertainty vis-a-vis tax laws and bureaucratic procedures.

Cooperation between the public and private sectors will clearly be required if Tunisia's development goals are to be achieved.

Nonetheless, it is important to assess realistically the distribution of decision-making authority that will best support the nation's long-term development goals. In this regard, it is evident that the responsibilities now imposed on government officials have taxed them beyond the limit of those that can be executed thoroughly and efficiently with the resources at their disposal. It is not realistic, in our judgement, to expect that the existing government structure has the resources that would be required to take on responsibility for determining the specific kinds of goods and services the production of which should rise or fall; the technologies that should be employed in producing them; the best combination of labor and capital for each sector and industry; the prices that should be paid for inputs and charged for outputs; and so on. Yet all of these details and many more reflect decisions that are important determinants of the degree of success that can be realized in solving the core problems by achieving a high rate and quality of real economic growth.

It is our judgement that a public sector-dominant solution cannot be realized. Supervision of the manpower and activities associated with a major development drive would have to fall on the existing executive structure, which, though able and dedicated, is already over-taxed. The resources that are currently being channeled to the public sector have been drawn away from the directly productive activities of the private sector. There is no obvious basis for a presumption that this approach would yield increased real ouptput with which to pay the real cost it implies. Thus, we feel that efficiency would be served and national output advanced by a redistribution of authority over decisions in favor of the private sector. We believe the national development thrust from here on should be led by the private sector, subject to clear and explicit rules set forth by the public sector to protect the clear public interest. We turn now to those areas of public economic policy that require reform. Through reform, we believe opportunities exist to increase economic efficiency and promote an acceleration of the growth of production and employment.

FISCAL POLICY

Expenditure Policies: GOT Budget

The budget is the most important instrument to achieve GOT economic and political objectives. Besides performing the traditional roles of providing for public goods and redistributing income, GOT budget has played a crucial role in the overall level of activity and growth of the Tunisian economy. General revenues have reached in the last few years one third of GDP, and around 30 percent of these revenues have been used for capital investments. Not only does the GOT operate the conventional natural monopolies and public services, but also it is practically involved in every sector of the economy through ownership and management of a large number of enterprises.

GOT policy objectives for 1982-86 are contained in the VIth plan. Among others, the plan lists as overall targets for the period the liberalization of the economy, and limiting the role of government. The growth of GOT budget and its overall deficit between 1982 and 1985 have worked so far opposite these objectives.

1. MAIN TRENDS IN GOT BUDGET

A summary of central budget from 1982 and 1985 is contained in Table 1. The central budget is the most important component, around 80 percent, of GOT consolidated expenditure accounts. Besides the central government budget, the Treasury accounts include Special Accounts, such as the Price Stabilization Fund, Annexed Budgets, for example the post office or radio and TV, and some minor Special Assistance Funds. The Social Security System is administered independently as are certain types of extra budgetary investments financed with external assistance. We were not able to collect and consolidate data for all public accounts in our visit, so our focus will be on the central government budget, although when appropriate, we make reference to other government activities.

TABLE 1

Central Government Budget, 1982 - 1985 (1)
(In millions of dinars)

	1982	1983	1984(2)	1983(3)
(1) TOTAL REVENUES	1308	1462.2	1923.0	1930.0
Tax Revenues	(887.3)	(1063.9)	(1209.3)	(1379.0)
Non fiscal Revenues	(420.7)	(398.2)	(617.0)	(551.0)
(2) CURRENT EXPENDITURES	843.0	950.1	1180.5	1289.0
Salaries and Goods& Services	(718.6)	(845.1)	(952.5)	(1050.0)
Debt Interest	(87.4)	(105.0)	(130.0)	(156.0)
Food Subsidy Transfers	(37.0)	(0.0)	(98.0)	(83.0)
(3) CAPITAL EXPENDITURES	664.4	785.2	1075.0	1126.0
Direct Investment	(301.4)	(346.0)	(484.4)	(501.0)
Financial Operations (4)	(232.0)	(268.2)	(364.6)	(355.0)
Repayment of Debt Principal	(131.0)	(171.0)	(226.0)	(270.0)
(4) TOTAL EXPENDITURES	1507.4	1735.3	2255.5	2415.0
(5) DEFICIT (-)	.199.4	273.2	437.2	485.0
(6) FINANCING:				
External Borrowing	61.5	86.9	196.0	230.0
Domestic Borrowing	147.0	187.0	307.0	255.0
(7) DEFICIT AS PERCENT OF GDP	4.1	4.9	7.0	6.9

Source: Data provided by the Tunisian authorities.

1) It excludes the social security schemes and specialized treasury accounts.
2) Revised figures.
3) Projected figures.
4) Include capital transfer, net loans, and participations in public enterprises.

TABLE 2

Budgetary Support to Public Enterprises*
(In millions of dinars)

	1981	1982	1983**	1984***
TOTAL SUPPORT	154.8	198.4	223.4	308.9
Current Transfers to Public Enterprises	13.1	31.4	35.5	145.0
Capital Transfer to Public Enterprises	95.4	109.2	123.1	102.0
Net Loans to Public Enterprises	38.7	40.2	48.2	50.7
Participations to Public Enterprises	7.6	17.6	16.6	11.2

Source: International Monetary Fund

* Gross support; the central government also borrows from some public enterprises.

** Provisional.

*** Projected.

1.1 EVOLUTION OF REVENUES

The revenue performance in Table 2 closely reflects ecomic developments over the last four years. While tax revenues did not do well in 1982 as a consequence of the slowdown in the rate of growth of GNP caused by the international economic recession, drought, etc, non fiscal revenues, including revenues from petroleum products allowed total revenues to grow at 24 percent over 1981. The much lower rate of growth of revenues in 1983 was caused in turn by a decline in revenues from petroleum products and a reduction in the rate of growth of direct tax collections. This latter was induced by the lowering of marginal tax rates in some of the schedular income taxes as a part of the ongoing tax reform. The main contributors to the growth in tax revenues in 1983 were import taxes, after a shift in imports in that year from investment to consumption goods which carry a higher tariff, and indirect taxes.

In 1984 most direct and indirect and custom taxes yielded increases between 11 and 14 percent. The major increase,however, came from non-tax revenues, a D120 million capital gain from the reevaluation of the Central Bank holdings of foreign currency reserves.

Tax revenues are expected to grow at 14 percent in 1985. With the rate of growth of GDP at current prices projected at 11 percent, this implies a perhaps optimistic revenue elasticity of 1.21. Because some of the non-fiscal revenue increases in 1984 were a onetime event, total non-fiscal revenues will decrease in 1985 and total central government revenues will increase only slightly with respect to 1984.

In summary, the central government revenue structure over the period has been characterized by an increasingly diminishing role of revenues from petroleum, a growing importance of import and indirect taxes, and the use of non-recurrent sources of revenue. It is likely that revenues from petroleum products will continue to decline in the future given international oil market conditions and Tunisian declining reserves. Finally it will become more difficult for GOT in the future to make use of exceptional sources of non-tax revenue simply because of lack of availability.

1.2 EXPENDITURE PATTERNS

Government expenditures, both central government alone and total consolidated expenditures, have grown in the 1982-84 period at an average annual rate of around 20 percent. This is higher than the average annual rate of growth for GDP at market prices for the same period of 14.8 percent. For 1985 however, central government expenditures are projected to grow at 7 percent while GDP at market prices is forecasted to grow at 11.5 percent.

The rapid increase in current expenditures in 1982 and 1983 was to a great extent due to a strong expansion in wages and salaries. Wages went up 18 percent in 1982, 10.5 percent in 1983, and the number of government employees increased to 29,000 between 1982 and 1983 alone. Although there is no freeze on government jobs, GOT intends to relate future wage raises to productivity increases.

Transfers to public enterprises and subsidies to consumers became the main engines of government expenditure growth in 1984 and will remain so in 1985. Table 2 presents the different levels of support given by the central government to public enterprises. These data were extracted from the IMF, Tunisia Recent Economic Developments, 1984, Table 13. Total support has increased at an average annual rate of over 25 percent between 1981 and 1984, and in 1984 alone the increase was on the order of 38 percent. A considerable portion of the current transfer to public enterprises in 1984 was a special compensation for foreign currency losses due to the strong appreciation of the dollar. No similar assistance, however, was given to private firms.

Consumer subsidies have grown rapidly. After the ill advised attempt to eliminate budgetary transfers to the Price Compensation Fund in 1984 by doubling the price of bread, the government response that year was to increase revenues by temporary tax measures and let the deficit grow. Too little effort was made to cut down other expenditures. The decrease in food subsidy transfer in 1985 is misleading since the Price Compensation Fund will have unfunded expenditures of D60 million, which likely will be eventually paid by the central government.

The cost of servicing the debt has increased continuously throughout the period, practically doubling between 1982 and 1985, mainly due to the strong dollar but also to the accumulation of deficits. Direct government investments have remained on average above the targets in the VIth plan, adding to the overall government deficit. In the 1985 budget direct central government investments will increase only at 3.4 percent.

A different pattern, however, of too little maintenance expenditure on government capital projects appears to have developed over the years. Some of the government officials we talked to expressed the opinion that some capital investments are wasted because of the lack of maintenance. The phenomenon of a low maintenance expenditures is the product of political bias and inadequate budgeting procedures. It is always politically more attractive to build a new school or hospital than to repair and upkeep those already in place. In comparison to other budget categories (wages and salaries, consumer subsidies, transfers to public enterprises, etc.), maintenance expenditures do not have a well defined and belligerent constituency. If expenditures have to be contained, it has been expedient to sacrifice maintenance expenditures.

Present budgeting procedures have also helped to keep down maintenance expenditures. The Development Plan contains the list of all capital investment projects to be undertaken by the public sector during the five year period. Each one of these capital investments in principle, although not always in practice, is decided upon by the Ministry of Plan after a cost-benefit analysis of the project. The selected capital investments enter directly the budget which is implemented by the Ministry of Finance. The problem is that the Ministry of Plan does not seem to attach to each capital project an estimate of the annual recurrent capital expenditures implied for the next three or five years. This could easily be done since the Ministry of Plan has to take recurrent expenditures into account in the cost-benefit analysis. The recurrent costs could then be entered automatically in the annual budget requests of the relevant ministry or agency using the capital project.

1.3 THE EVOLUTION OF THE DEFICIT

The central government deficit has gone from D199.4 million in 1982 to a projected D485 million in 1985. As a ratio of GDP, the central government deficit has increased steadily, rising from 4.1 percent of GDP in 1982 to 7.0 percent in 1984. If the budget projections are realized, the 1985 deficit-GDP ratio will be the same as in 1984. The consolidated central government deficits including all Treasury accounts and the Social Security system generally exceed the central government deficit. Using IMF figures, the ratios of the consolidated deficits to GDP were 5.1 for 1982 and 5.5 for 1983, which are higher than the ratio in Table 1 with only central government figures.

We have seen that from the expenditure side the main driving forces behind the deficits have been current expenditure increases in wages and salaries in 1982 and 1983 and for 1984 and 1985 transfers to public enterprises and households together with the increasing cost of servicing the debt. From the revenue side, revenues from petroleum products will continue to play a decreasing role but tax revenues have remained reasonably buoyant in spite of the lower rates in direct schedular taxes.

Given the already high level of fiscal pressure in the country which puts the Tunisian share of government revenues in GDP around the mean of the OECD countries but relatively high in comparision to other less developed countries, the deficit will have to be controlled by restraining the rate of growth of government expenditures, in particular current expenditures. The biggest threat is continuous uncontrollable increases in transfers to public enterprises and consumer subsidies. To be able to close the deficit gap in the future, GOT has to change radically present pricing policies. Some improvements have already been made in this direction. Public enterprises, where possible, have to charge a price equal to the opportunity cost of the product. Subsidized prices should be continuously raised by formula, and in some cases subsidies entirely removed.

The negative financial side effects of the deficits have become increasingly important. On the one hand, the deficits have been absorbing increasing amounts of domestic savings, with 1985 the exception. GOT forces the banking system to hold more government debt at low interest rates than they would voluntarily hold. The rest of the domestic funds to finance the deficit comes from borrowings from the Social Security system, the postal cheque system and some profitable public enterprises. In all these cases the GOT crowds out investment by the private sector, which, in all likelihood, would make a more efficient use of the national savings. A considerable portion of the deficit has been financed by external borrowing, some of it at non-concessional terms. This adds to debt servicing difficulties in the future and should be controlled.

2. PROPOSALS

GOT official seem aware of almost all the problems reviewed above. This awareness and some willingness to take corrective measures are reflected in the 1985 budget. The rate of growth in expenditures has been considerably reduced and the relative size of the deficit has been contained.

From conversations with Tunisian officials, however, there is less awareness about the serious threat that transfers to public enterprises pose to future budget stability. A lot of hope has been put on new development banks as a way to rationalize and streamline public enterprises. But the new banks may only be another layer of bureaucracy with very little impact on the enterprises' long-run viability. If GOT is serious about liberalizing the economy and avoiding increasing deficits in the future, it should put in place a plan to divest many more public enterprises than it now appears ready to do so.

AID should consider specialized budget support for renovation and maintenance of public sector plant and equipment. The rate of return per dollar invested in this activity is probably higher than the rate of return from new capital projects. GOT should be encouraged to study in detail its maintenance and repair needs. GOT should also be encouraged to introduce budgeting procedures that would make it more difficult to displace maintenance expenditures by other items in the budget.

GOT seems more aware of the threat to budget stability presented by subsidies to consumer goods than that of transfers to parastatal enterprise. Some corrective policy measures, e.g., moderate price increases, have already been put in place.

GOT could also follow more evenly paced wage and salary policies. The last increase was in 1983. The morale and even quality of the civil service may be hurt by this approach without any actual savings over a period of a few years.

Finally, the GOT should agree to the placement of curbs on (a) external borrowing undertaken on non-concessional terms and (b) domestic borrowing, including borrowing from banks. Such curbs, though restricting available sources of financing, would enforce a measure of discipline on all GOT expenditure categories.

TAXATION

1. Present Tax System

The Tunisian tax system, a complex legacy from colonial times, can be categorized for expositional purposes into a set of direct taxes on income and profits and another group of indirect taxes falling on the production and sale of goods and services. Imported goods pay custom duties according to the tariff as well as indirect taxes. There are also export duties on selected commodities. Some taxes and surtaxes are earmarked to certain types of expenditure such as the Price Stabilization Fund. Local government financing relies on a series of small property and sales taxes and/or transfers and grants from the central government.

1.1. Direct Taxes

Individual income is subject to a system of schedular taxes, a schedule for each different source of income, and total household income regardless its source is subject to a highly progressive surtax (Contribution Personnelle d'Etat). There are in total five schedular taxes falling on (i) income from wages and salaries, (ii) income from professional and self-employed activities, (iii) interest and dividend income, (iv) agricultural output and income and (v) profits from industrial and commercial activities. In this last case rates change with the nature of the activity. Corporations are only subject to the last schedule which taxes profits from industrial and commercial activities.

Although officially not considered a tax in Tunisia, there is also a payroll tax with contributions by both employers and employees. The schedular tax on agricultural output is the closest thing in the Tunisian tax structure to a property or wealthy tax. However, wealth transfers either at death or inter vivos are taxable. The inheritence tax is highly progressive, although it provides generous exemptions for close relatives. The family home is excluded from the inheritance tax when occupied by the descendents.

1.1.a. Schedular Taxes

(i) Schedular tax on income from wages and salaries.

The tax base for residents includes labor income received worldwide. Non-residents in principle are taxed only on income made in Tunisia. All wages and salary income is withheld at source according to a pay as you earn (PAYE) system. This system leaves little room for tax avoidance. In-kind payments (e.g. housing, automobiles, etc) are by law fully taxable, but harder to detect than ordinary wage income. Payments in-kind have been growing in importance through time. The law does not contain any provisions for income averaging but it allows a fixed deduction for each tax payer of D200 and a proportional deduction of 10 percent. The rate structure is progressive, starting at 5 percent for incomes of up to D2.500 and reaching 8.9 percent for incomes over D6,000. The law does not contain any provision to correct for automatic increases in tax burdens induced by inflation. Because of the progressivity of the rate structure, as nominal incomes rise to keep up with inflation, taxpayers find themselves paying tax at higher rates even though real income may have decreased.

(ii) Schedular Tax on Professional Income.

Professionals, other self-employed and partnerships involved in economic activities other than industry and commerce are subject to a proportional of tax at a flat rate of 20 percent. On top of that, they are also supposed to pay 10 percent of gross revenues, or an additional 0.5 percent on net income. Deductions for business expenses have pre-established ceilings. Some professions have been granted lower rates temporarily.

There appears to be considerable tax evasion in this group of taxpayers. The Ministry of Finance does not have the adequate resources for the inspection and the field audits necessary to control tax evasion in these traditionally hard to tax sectors. Because the self-assessment system is not working, the income tax department assesses incomes of professionals, etc. from available third party information. For example, lawyers in the private sector are assessed an income similar to their counterparts in the public sector. This is an area where tax enforcement could be considerably improved by, for example, establishing updated tax assessment norms, and retraining inspectors in direct and indirect auditing techniques, and in some cases, accounting. Complete evasion by professionals is unlikely, however, because of indirect controls techniques such as having to show proof of paid taxes to have a phone installed or to get a passport.

(iii) Schedular Tax on Dividends and Interest.

Income from capital in the form of dividends and interest are taxed at different rates. Rental payments from real estate are excluded from the tax base and are taxed only lightly at the local level. More importantly, most capital gains are excluded from the schedular tax and they are not taxed elsewhere in the tax structure. However, realized capital gains from the sale of buildings that have been owned for less than 6 years are taxable, and so are capital gains from the sale of land for construction regardless of the duration of ownership.

Interest income from deposits of all sorts pays tax at a rate of 11.5 percent and the tax is withheld by the financial institution at source. Dividends received by individuals are taxed at 16.7 percent, while intercompany distributions are taxed at 19.5 percent. In both cases taxes are also withheld by the distributing company.

(iv) Schedular Tax on Agricultural Output and Income.

This tax is basically a producer tax levied on the gross value of different farm outputs. Most agricultural outputs are taxed at a rate of 3 percent. Certain agricultural products with large crops such as wine, olives, or fibers are specially assessed and their rates have varied from 3 percent to 11 percent. Some of the rates for these specially assessed products are changed annually reflecting crop and price conditions. The rate for all of them has been set at 3 percent for 1985. Livestock is taxed on a per head basis, with the excise rate varying for the different types of livestock. Very small farmers escape the tax completely. As an alternative to the taxes an agricultural output and excises on livestock, farmers that keep adequate records can opt to be taxed on a net income basis at a rate of 15 percent. Only very small farmers who grow cash crops appear to escape the tax net completely.

(v) Schedular Tax on Profits from Industrial and Commercial Activities.

Profits of all individual enterprises, partnerships, and corporations are subject to this schedular tax called the patente. The patente has two parts, a standard operating fee or minimum tax, and a proportional component. The operating fee is levied as a function of total gross sevarence at a rate of D80 for less than D15,000 of revenues, to D 300 for revenues beyond D 300,000.

The proportional component of the tax is levied on accounting profits. Beginning in 1985, the first D 1,000 of profits will be taxed at 10 percent. The rate for corporations engaged on commercial activities will be 25 percent. Those engaged in industrial, handicraft, transport, and tourism pay at the lower of rate of 20 percent. Mining corporations pay still a lower rate. Tax rates for individual enterprises and partnerships used to be lower than those for corporations and mildly progressive. Beginning January 1985, individuals and unincorporated businesses will pay the same rate as corporations. Individual and unincorporated enterprises pay the tax annually, but corporations are required to make quarterly advanced payments based on the tax paid the previous year. In 1984 GOT required on acceleration in advanced payment from various corporate sectors to cover unanticipated transfers to the Price Stabilization Fund.

The proportional tax on commercial and industrial profits suffer from common structural problems of corporate income taxes in other countries. For example, real assets can be depreciated only at original or purchase cost and on a straight line basis, although slightly faster depreciation is allowed for multiple shifts. Inventory accounting of stock-held in trade is done on a first-in first-out basis rather than on a last-in first-out basis. During inflationary periods, the replacement cost of capital will generally exceed original prices, hence depreciating at original cost basis artificially inflates profits. A similar phenomenon takes place with inventory valuation in a first-in first-out basis. In both cases taxes are increased with no counterpart increase in real profits. The present policy of allowing carry-forward of losses for a maximum period of three years is also more restrictive than the policies followed in most countries.

1.1.b. The Comprehensive and Progressive Personal Income Tax (Contribution Personnelle d'Etat).

On top of the schedular taxes, individual income in its entirety (irrespective of source) is subject to a highly progressive tax. Since 1984 husband and wife can file separately. Separate returns can also be filed for dependents with earnings. Prior to 1984, the entire family income was added into a single tax base, but half of the spouse's income was exempt. There is also a child allowance of TD 45 of up to four children and a minimum exempt of TD 100. To arrive at taxable income, everybody can deduct ten percent of wage and salary income. Some interest income is also deductible, as well as some miscellaneous sources such as life insurance premimums. No credits are given, however, for any of the schedular taxes paid. The problems cited under the schedular tax on wage and salary income such as lack of inflation adjustment or lack of income averaging, are still present under the progressive tax, but with much more deleterious effects because of the steeper progressivity of the tax rate schedule.

The rates range from zero for taxable incomes of less than D 900 to 80 percent for taxable incomes of D 100,000. The average tax rate cannot, in any case, exceed 55 percent of tax of taxable income, however.

1-1-c Payroll Taxes

Although Tunisian authorities like to think of the present social security contribution as insurance premiums, they are really payroll taxes. There is no strict correspondence between individual contributions and retirement benefits as there would be in a strict insurance scheme. In particular, there is a ceiling for benefits, but not for contributions. Both employers and employees legally contribute to the social security system, although the incidence of the tax likely falls entirely on employees The statutory contribution of employees is 6.25 percent and of employers 20 percent of basic salary plus year end bonus. Pension benefits cannot exceed 90 percent of the retirement base, and they cannot be less than two-thirds of what a worker would make at minimum wages.

Social security and other mandatory contributions for employers have added considerably to the cost of labor services vis-à-vis capital services and other inputs of production. For example, employers are also required to contribute 2 percent for worker's health insurance, and 2.5 percent for job-related accident insurance. When other labor-related costs such as group health insurance are added to mandatory contributions based on wages, the Budget Economique 1985 estimates that a 40 percent premium is added to basic labor costs. This anti-labor bias combined with very low and even negative real interest rates has not helped GOT objectives of employment promotion. GOT is planning to study in 1985 ways to redress the imbalance of relative input prices. The Budget Economique 1985 mentions the possibility of earmarking a surtax on business profits to the social security system in order to reduce the present employer social security contribution.

2. Indirect Taxes

2.1 Sales Taxes

Three types of indirect sales taxes have been in operation in Tunisia since 1955: (a) a manufacturer tax on production, (b) a sales tax on consumption and (c) a sales tax on services. In 1983, GOT began a sector by sector introduction of a value added tax. The taxes on production and consumption are levied at the factory gate or for imports at the port of entry. In this sense, the sales tax on consumption is actually a surtax on the production tax rather than a consumption sales tax on its own. The sales tax on service is levied at the time the service is performed. For all three taxes, depending on the sector, the seller of the commodity can deduct the taxes paid previously on all inputs of production including plant and equipment.

The production tax is levied on the total value of goods computed at wholesale prices for domestic goods and at a price that includes freight and insurance for imported goods. The coverage is very general but a few subsidized commodities such as cereals or milk are exempt. The general rate for the production tax is 14.4 percent but lower rates apply for some preferential goods or subsidized inputs, e.g., fertilizers or electricity. Hotels pay tax at a rate of 10 percent on all their gross receipts including meals.

The main difference between the production tax and the so-called consumption tax is that the latter is levied much more selectively than the former. The consumption tax is levied otherwise on the same basis as the production tax. The consumption duty rate on luxury goods, automobiles and household appliances is 23 percent. The rates on other taxed goods such as wine and beer have been set at 16 percent. Goods with a larger "social content" component are taxed still at the lower rate of 8 percent.

The sales tax on services falls on all final economic activities that do not involve sales of goods. Life and general insurance companies, which are the most conspicuous exemption from the tax base, pay only an ad valorem tax on premium income. The general rate for services is 8.5 percent but again there is a lower rate, 4.5 percent, for selected activities, e.g., services rendered by self-employed professionals or railroad transportation.

As part of the tax reform, GOT started in 1983 a sector by sector introduction of a limited value-added tax (VAT). The VAT uses the "invoice method" whereby the firm at each stage of production computes it gross tax on the basis of total sales, but thentakes a credit equal to the tax already paid by the suppliers of its intermediate and capital goods. Because each taxpayer has to show proof of the taxes paid by its supplier to claim the credit, the invoice method carries an important self-enforcing component. The Tunisian VAT is limited because not all previously paid taxes are creditable. Also, once in place the Tunisian VAT will not directly tax retailers in many sectors because they are frequently too many and more importantly, they are too small to keep records. In these cases GOT intends to tax the sales to these retailers rather the sales by them, but nothing of this sort has been designed yet. So far the limited VAT has been introduced in construction and supporting services for the public sector, hotels, electricity and import sectors. Scheduled extension of the VAT to other sectors during 1984 such as transport and wholesaling have not taken place.

2.2 Other indirect taxes and customs duties

There are some other indirect taxes in Tunisia such as the motor vehicle tax and excises on particular commodities. The motor vehicle tax is a function of horsepower and ranges for automobiles from D 10 to D 1000 per annum. Excise duties at various ad valorem and specific rates are levied on traditional commodities such as tobacco, alcoholic beverages, tires, and petroleum products. Coffee, tea and soap are also subject to excise taxes in Tunisia.

The Tunisian tariff follows the old Brussels nomenclature rules and methods of classification and valuation. According to the Director of Customs, Tunisia has started the change to the GATT system of classification and valuation (so far two of the twenty-nine chapters of the tariff have been converted) and the full conversion is to be finished in 1986. The tariff provides a high to moderate degree of protection to domestic producers from imports. Rates for individual commodities go from zero to 300 percent. The high degree of protection granted to consumer goods seems to have encouraged domestic production of this type of goods at the cost of manufacturing goods. Besides the tariff, all imports pay a special customs processing fee of 5 percent on the total value of imports. Since the processing fee revenues typically exceed customs operation costs, 40 percent of the revenue reverts to the

Treasury to fund GOT expenditures. Although like in many other countries there is fraud in Tunisian customs, computerization of the tariff and the entire import process has made it harder to abuse the system. Contraband does not appear to be a serious problem either. In 1983 Tunisia introduced a reimbursement system for the domestic and customs taxes prepaid on exported commodities to support export activities. The introduction of the VAT will facilitate significantly this reimbursement policy. There are still export taxes on some selected agricultural products, all earmarked to the Price Stabilization Fund. There is also a minimum 1.5 percent fee on the value of all exports.

2-3 Local Public Finances

About one fourth of local government receipts come from different types of property taxes on houses, vacant lots, and commercial and industrial establishments. Property valuation techniques are crude, but fortunately tax rates are quite low. Between 15 and 20 percent of local revenues come from an assortment of different fees and excises on shows, produce sold in local market, etc. The bulk of local financing comes from a common fund administered by the central government. The resources are raised through either surtaxes or sharing in a number of central government taxes.

3. Revenue Yields

Revenue from direct taxes in 1985 is projected to reach D 291.5 million or 15 percent of total recurrent revenue for the year. The most important contribution will come from indirect taxes, D 697.5 million, which combined with import duties of D 344 million, will amount to 55 percent of total central government revenues. Although they have played a decreasing role over the last few years, profits from oil and other public activities are anticipated to bring in D400 million or 23 percent of total revenue. The balance or 7 percent of revenues will come from fees and miscellaneous sources.

The most important characteristic of the revenue structure for 1985, shared by previous year budgets, is the predominant role played by indirect and customs taxes. This characteristic, common to all developing countries, is the result of the much easier administration of customs and indirect taxes in general.

The importance of indirect and custom taxes has been enhanced in the last three or four years by decreases in profits from the exploitation of oil resources. Cuts in some income tax rates over the last two years, which are part of the tax reform we will discuss below, have also contributed to a slight decline of the relative importance of direct taxes.

4. Tax Reform in Tunisia

There is ample awareness among Tunisian high-ranking officials that the present tax system is unduly complex, at times vague, and that very high marginal rates have produced disincentives to work effort, saving, investment and risk-taking behavior. It is also commonly admitted that high rates have discouraged taxpayer voluntary compliance. Concomitantly, GOT authorities acknowledge that rates are high and, therefore, have been unwilling to administer the system tightly. A certain amount of "cheating" has been tolerated. The cascade of multiple schedular taxes has created distortion in the organization of production. Higher tax evasion has led in a vicious circle to higher tax rates. Because of the different ability of groups of taxpayers to escape taxes, e.g., the self-employed and professionals vis-à-vis employees subject to withholding, the system has produced serious horizontal and vertical inequities and a general feeling of unfairness in the distribution of tax burdens. The excessive reliance on indirect taxes and custom taxes adds significantly to the overall regressivity of the tax system.

Because the tax on services is not generally deductible from the tax on production or vice versa, and the consumption tax is not deductible from the production or service tax either, goods have been taxed differently depending on the number of transactions involved from manufacturing to final consumption. The cascading of taxes has caused inequities among consumers with different tastes as well as distortions in production and distribution. The proliferation of special regimes and exemptions for indirect taxes has compounded the difficulties.

Tax administration has been hampered not only by the lack of voluntary compliance and GOT tolerance of "cheating" but also by double sets of book accounts and lack of enough qualified personnel to carry out proper auditing of company and individual returns. There is also a lack of adequate facilities and equipment to control fraud. As a result, only a too small fraction of individual or company cases get reviewed each year.

For all the reasons above, GOT started a fiscal reform in 1983 with the main objectives of improving overall efficiency and equity. The means to achieve these targets were first, a simplification of direct taxes by moving toward a global income tax and lowering average tax rates for individuals and firms; and second, the introduction and gradual substitution of indirect taxes with a comprehensive value-added tax. The GOT hoped that loss in revenue from lower income tax rates could be offset through administrative and enforcement reforms.

The global personal income tax envisioned will not discriminate among the different sources of income and will permit differentiated treatment of different abilities to pay. The schedular taxes will have their role diminished by lowering their tax rates and will eventually be eliminated, while the present Contribution Personnelle d'Etat is transformed in the global income tax. For corporations the reform seeks a transformation of the present schedular tax on profits (the patente), into a standard corporate income tax with special encouragement to private subscription of equity capital.

While some progress has been made in the reform of direct taxes -- some rates of the schedular taxes have been lowered, it is unlikely that the main goal of the reform, the introduction of a single comprehensive income tax, will be achieved in the near future at the present pace. The reform documents, mainly the VIth Plan, were explicitly vague about timing under the logic that GOT needed flexibility to control the losses in revenue that would result from the tax changes. Even though there is some merit to this argument, the lack of a binding time schedule has allowed the reform to lose momentum.

The pace of the reform has been a little faster with indirect taxes. But as we indicated above even some of the few sectors that were scheduled to come under the VAT have not been accomplished and it is not known when the changes will take place. Again, this aspect of the reform has been hurt because of the lack of a binding time schedule.

The tax reform documents also mention some plans for strengthening general tax administration and enforcement. On the administrative side, it is hoped that through improvements in equipment, computerization of tax information, and recruitment and training of new personnel, the number of cases audited will increase over 50 percent toward the end of the VIth Plan. The experiment with computers, however, does not seem to be bearing fruit mainly due to the lack of programs and lack of a comprehensive design of how to integrate the new equipment with the changes in tax legislation. New personnel has been contracted as planned, and these people are receiving training at the moment in auditing, accounting, etc. It is too early, therefore, to tell what the benefits of this measure will be. There is little doubt, however, that more and better trained and paid personnel are necessary conditions for a successful tax reform in Tunisia.

At the level of enforcement, some important steps have been planned. For example it was planned to make certain forms of fiscal evasion a criminal offense and have them publicized. Tax offenders would also be denied public privileges such as access to credit. There are plans to accelerate court procedures, and also make fines and assessment effective even when they are appealed.

The measures actually introduced, however, have lacked full vigor. A penalty of up to 40 percent on tax evasion, and a 1 percent monthly rate of interest for taxes overdue are still too low to significantly increase compliance. Tax enforcement is a politically delicate area, but also one with potentially powerful announcement or exemplary effects. If the attitude of the average taxpayer toward tax compliance is to change in the future, he has to see not only that public resources are put to good use, and not diverted to special interest groups, but also that the tax administration is willing to prosecute and punish high income tax evaders.

5. PROPOSALS

The level of competence among GOT budget officials is high. GOT has a very good idea of the main problems of the Tunisian taxation system and has planned a tax reform with which we agree in general terms. There are particular areas in which the tax reform could be carried further, e.g. elimination of export taxes, lowering the effective protection of some sectors and simplifying the tariff, strengthening the role of property taxation, etc. The main failing of the tax reform, however, has been the lack of a detailed study of the alternatives open to GOT, a forecast of the revenue consequences of the different actions, and a timetable establishing a detailed outline of the steps to be taken. The subdued and evolutionary approach to the reform was obviously a political choice, but in our opinion, it has diminished considerably its effectiveness and destroyed any positive announcement effect it may have had on taxpayers. There is still time to do it right, but it is doubtful that AID would have enough leverage to induce a change in the overall approach.

AID can offer technical assistance for personnel training in programming, auditing, and indirect assessment techniques. ~~I~~ We think GOT would be very receptive to these offers. GOT does not seem to need much aid in terms of structural or analytical support. ~~I~~ We do not think either that they would be receptive to proposals for an all outside team of experts. GOT, however, could probably benefit from different views and perspectives.

Some temporary budget support could be made conditional on accelerated progress of the initiated tax reform. But prior to this GOT has to study what revenue will be forthcoming once the new taxes are in place. High levels of expenditures and large deficits are probably the main reason for the present slow pace of the tax reform. Tax reform and lower tax burdens are key components for private sector and export led higher rates of growth in Tunisia.

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PRICE SUBSIDIES!

- ~~TAXATION~~

Tunisia has for many years followed an ambitious redistributional agenda. This agenda has been carried out in the form of income and wage policies, investment in infrastructure, and provision of public services, and pricing and subsidy policies, among others. Pricing and subsidy policies in particular have been closely interwoven. In the case of some key basic foods, their fixed low prices have been subsidized by government mainly through the Price Compensation Fund. In the case of public services, prices have been kept well below unit cost of production or the goods even supplied free, thanks to a collection of direct and indirect financial supports from government. This report studies the first group of subsidized commodities, those under the tutelage of the Price Compensation Fund.

Subsidies to key staple goods have grown in importance year after year since the 1970s, and they are budgeted to reach D312 million in 1985. This figure represents a 20 percent increase over the amount spent in 1984 and approximately 13 percent of the central government expenditures.

It is important to realize that the main objective behind this large sum of money should be to redistribute purchasing power in favor of low income groups. That is, if every household in Tunisia had approximately the same income level, it would make little sense to spend expensively collected tax revenues to make the basic staples available to everyone at reduced prices. Taxpayers themselves could have bought the goods, if they so desired, without incurring the transaction and administration costs caused by the subsidy schemes.

The key policy question is therefore whether or not food subsidies redistribute income in favor of the poor. But even if food subsidies redistribute income in favor of the poor two other questions should be asked. Is there a more cost efficient way to do it? Are they politically and administratively viable? To answer the question on distribution appropriately,it would be necessary to look at both the distribution by income group of the costs (taxes, etc.) of the funds used by the Price Compensation Fund and the distribution of benefits.

Even though a considerable portion of the Fund revenues are proceeds from earmarked taxes, it would be very hard, if meaningful at all, to find their distribution by income groups. The cost side of the distributional equation, even when we can say little about it, should be kept in mind, however, because low income groups may indeed be paying in taxes a good portion of the cost of the subsidies. The taxes earmarked to the Fund are mostly indirect and custom taxes which are suspect of having a regressive or anti-poor incidence. Reliance on indirect and custom taxes is also a characteristic of the entire Tunisian tax structure, and transfers from the central government to the Fund have been substantial. More to the point, some Tunisians seem to look at price subsidies as a way to compensate for the regressivity of the indirect tax system.

It is generally easier to establish the distribution across income groups of gross benefits from price subsidies. Below we make a rudimentary attempt, given the time and data available, to determine that distribution for Tunisian subsidies. If the distribution of benefits from (some) subsidies were found to be markedly skewed toward high income groups, those subsidies would be clearly difficult to justify. Unfortunately, there does not seem to exist any study that has looked in detail at the incidence of price subsidies in Tunisia.

Even when some price subsidies may benefit high income groups disproportionately, they may still improve the purchasing power of low income groups. The logical policy answer in these cases would be to devise a way to target the poor and exclude middle and high income groups from the subsidy. However, there are no easy alternatives to the current situation.

A lot of the attention paid to the price subsidy scheme in Tunisia in the last few years has been caused by the visibility of large budgetary transfers to the Price Compensation Fund. Although politically it may make a difference, the opportunity cost to the Tunisian economy of one dollar spent on price subsidies is the same whether it comes from the central government's budget or from the conventionally separated revenues of the Price Compensation Fund.

2. Operation and Magnitude of the Price Subsidies

The implementation of the price subsidy program by the Price Compensation Fund appears to be uncomplicated and more importantly, non distortionary to production activities. Typically a national monopoly buys from domestic producers and is also in charge of imports. Domestic producer prices, which are generally kept at international levels but have been losing ground with respect to other domestic prices, are set by government experts to at least cover the average total cost of production. The purchasing monopoly then sells the domestic and imported outputs at subsidized prices to manufacturers and wholesalers. The Price Compensation Fund pays the national monopoly for the difference between the price they buy from producers and the price they charge wholesalers. Strict price controls insure that the price subsidy is passed on to consumers by the final retailers. Some of the commodities subsidized by the Price Compensation Fund are actually inputs of production for farmers, in particular fertilizers and animal feed. In this case the subsidies would eventually be passed on to consumer, only (a) if the price paid by the national buying monopolies to farmers reflect the cost advantage of the subsidized inputs and (b) if farmers do not consume the cost advantage with poor management or in other ways. For these reasons, it is doubtful that a significant part of the input subsidy is passed on to consumers. A large part of the subsidy probably goes to efficient farmers. The purchase price paid by the national monopoly probably covers the costs of operation of the least efficient or marginal farmers.

Table 1 contains a list of the most important subsidized commodities by the Fund and the amounts spent on each one of them from 1981 on and the projected figures for 1985. By large the most important group of commodities are cereals, which in 1985 represent over 63 percent of the Fund's total expenditures. As the last column of Table 1 shows, the growth in subsidies to cereals and its derivatives will continue to grow at the hefty rate of 20 percent in 1985. Only D36.1 million of the total of D197 million projected expenditures on cereals for 1985 will be on animal feed. Edible oil (a mix of olive and soybean oils) subsidies are second in importance representing 13 percent of the 1985 budget of the Fund. Expenditures went from D6 million in 1983 to D38.3 million in 1984. The oil subsidy is very sensitive to domestic crop and export prospects of olive oil and the international price of soybeans. The subsidy to sugar, still relatively small, is the fastest growing one for 1985 and can be attributed mainly to the high operating costs of a new Tunisian sugar refining plant. In the category of other for 1985, there are for example D2.2 million for tea due to the increase in the international price of tea. Tea had not received a subsidy in 1984.

The last row in Table 1 presents the sum of budgetary transfers plus transfers from special Treasury funds to the Price Compensation Fund. The decrease from D106 million in central government transfers in 1984 to D90 million in 1985 is misleading, however, because (as it stands now) there are D60 million of unfunded expenditures by the Fund for 1985 which very likely the central government will absorb eventually. That would put the total central government transfer for 1985 at D150 million. The Price Compensation Fund has accumulated unfunded liabilities amounting to D89 million over the past several years on top of the D60 million for 1985.

Apart from central government support, the Price Compensation Fund own revenues for 1985 come in descending order of importance from (a) earmarked taxes on petroleum products, (b) earmarked custom taxes, (c) earmarked production and consumption taxes, and (d) taxes on alcoholic beverages. Total revenue from taxes are projected to grow 12 percent in 1985. This falls short of the 20 percent increase in price support expenditures. To help close the susidy bill, some prices of subsidized goods were raised during 1984. The price of cereals were increased 10 millimes per kilogram, milk 40 millimes per liter, and some meats 300 millimes per kilogram. These modests increases have hardly made a dent into the continously growing deficit of the Price Compensation Fund. We do not know what subsidized food prices will be hiked or the extent to which they will be raised during 1985.

3. The Distributional Impact of Subsidies

The first question that has to be asked is whether all segments of the population have the opportunity of benefit from price subsidies. This may not be the case if some rural population are not able to buy the food either because of geographic isolation or because they live in a non-cash environment. It seems, however, that only a very small portion of the Tunisian population may fall in this category.

TABLE 1

The Price Stabilization Fund:
Subsidies Furnished in 1981-85
(In Millions of Dinars)

	1981	1982	1983*	1984*	1985**	Percent Rate of Change 84-85
TOTAL	231.2	165.0	149.3	260	312	20
Cereals	160.9	119.3	103.5	164	197.1	20
Olive Oil	17.0	9.0	6.0	38.3	40.2	5
Sugar	19.5	-	-	12.3	18.3	49
Meat	10.1	7.0	10.4	7.5	7.9	5
Milk	3.7	3.8	5.5	8.3	10.0	20
Ferti-lizers	13.8	13.6	11.5	15.6	19.3	24
Other	6.2	12.3	12.4	14.0	18.7	33
Budget Subsidies plus Transfer from Treasury	135	45.0		106	90	-15

Source: Ministry of Finance

*: provisional figures
**: projected figures

In order to get an idea of how benefits from subsidies are distributed among income classes, first it is necessary to be able to measure individual benefits. When the price of the commodity is reduced for example to 50 percent of its market cost as is now the case of bread and oil in Tunisia, more of the commodity is purchased (a) because it is now relatively cheaper and therefore more attractive than other goods and (b)because lowering the price has in fact increased the purchasing power of individuals.

When the demand for the good is elastic as may be the case for individuals, the price subsidy induces the individual to spend a larger share of his budget on the good. This emphasizes the negative effect that future price increases will have on the individual's welfare. But even when individual demands are inelastic, price subsidies can result in high consumption levels. It is not surprising, given the approximately 50 percent subsidy for wheat products, that consumption of wheat per capita in Tunisia has grown twice as fast as the consumption per capita in comparable countries.

A relatively easy to compute measure of individual benefits is given by the income transfer necessary to allow the individual to buy the after subsidy bundle of goods at market prices (i.e., without subsidies). This "income equivalent" measure can be computed as the product of the quantity purchased times the difference between the actual unit cost and the sale price.

The "income equivalent" measure generally overstates the benefit from the subsidy to the individual. That is, if outright income transfers were feasible and allowed, it will take much less money than the "income equivalent" to make the individual as well off. This difference is due to the well known inefficiency of specific-good and in kind redistributional programs vis-a-vis direct income transfers.

We face important data limitations in the actual quantification of the redistributional impact of food subsidies in Tunisia. For example, the best source of data, the 1980 Household Consumption Survey by the National Institute of Statistics, is at least five years old. We make the (not unreasonable) assumption that the relative distribution of consumption patterns among income groups has not changed much in the last five years. But because of this and other data compromises, our findings should be taken only as a first step. A more rigorous research effort is clearly needed. The 1985 Household Consumption Survey soon to be initiated by GOT brings an excellent opportunity to undertake a rigorous study of the distributional impact of subsidies. We feel, however, that future research is unlikely to change the basic direction of our findings.

Table 2 presents individual levels of consumption for the most important products subsidized by the Price Compensation Fund. The table distinguishes among seven expenditure categories of individuals. Expenditure figures were used in lieu of income in the entire 1980 Household Consumption Survey. This may introduce some biases, in particular, for higher income groups which save a larger proportion of their incomes. Table 3 gives an idea of the population distribution among the different expenditure categories in Table 2, i.e., the relative importance of each group. Although the expenditure categories in Tables 2 and 3 do not coincide exactly, they are close enough for our purposes. To quantify benefits per capita for each of the subsidized goods it is necessary to multiply the physical consumption levels in Table 2 by the respective subsidy per unit (the difference between unit cost and sale price).

For cereals, actual consumption (see row 1 of Table 2) decreases with income indicating that cereals, as a group, are an inferior good. With the only exception of the very poor (less than D70 of annual expenditure), the absolute benefits from the cereal subsidy therefore becomes smaller as income goes up. Since cereals represent almost two thirds of the total budget of the Price Compensation Fund, total subsidy expenditures would seem to redistribute income toward the poor. This conclusion is however offset, at least partially, by the distribution of benefits received from all other groups of commodities. From Table 2, it is clear that subsidies to milk products and meat benefit the rich much more than the poor. Even though these two categories combined do not represent more than 6 percent of the Fund budget, milk subsidies are budgeted to grow at 20 percent and meat subsidies at 5 percent in 1985. The pro-poor impact of subsidies for cereals tends also to be offset, although less markedly, by the subisides to edible oils and sugar. The consumption of these commodities rises mildly with income.

To be able to state categorically what the net impact on the poor of cereal subsidies versus the remainder of the goods subsidized, we need detailed information on subsidy rates. It seems that, as a whole, food subsidies provide an equal per capita benefit across the board or perhaps slightly larger benefits to lower income groups. The very poor, those with less than D60 of annual expenditures in 1980--many of them living in rural areas, receive probably smaller benefits than other income groups.

What these findings mean is that with the exception of the very poor, the change in the distribution of income in Tunisia as measured by Gini coefficients etc. before and after food subsidies would be mildly progressive or pro-poor. It is important to remember that we have been analyzing the distribution of gross benefits from food subsidies alone i.e., our statement ignores the distributional impact of tax revenues that finance the Price Compensation Fund. If the distributional impact of taxes is somewhat regressive as suspected, then the net impact of the Price Compensation Fund on income distribution may be even less pro-poor than stated above.

Table 2
Individual Food Consumption in Different
Per Capita Expenditure Groups
(Annual Figures in Kilograms for 1980)

Product	Less Than D70	D70 to D100	D100 to D130	D130 to D200	D200 to D300	D300 to D500	D500 & over
Cereals	189.8	201.1	199.0	195.2	192.3	188.0	184.7
Edible Oils	11.1	13.3	15.3	15.3	17.0	18.2	19.4
Sugar	9.2	11.5	13.0	14.0	16.0	17.0	17.7
Milk Products	17.2	39.3	37.7	51.3	69.0	89.1	125.3
Meats	2.3	5.4	8.1	14.6	20.5	27.5	38.5
Tea	1.0	1.1	1.3	1.3	1.4	1.3	1.4

Source: 1980 Household Consumption Survey

Table 3
Distribution of the Tunisian Population
According to Per Capita Expenditure Categories

Annual Per Capita Expenditures */	Percent of Total Population	Cumulative Percentage
Less than D60	7.5	7.5
60 to 120	21.8	29.3
120 to 200	26.6	55.9
200 to 300	19.8	75.7
300 to 500	15.4	91.1
over D 500	8.9	100.0

Source: 1980 Household Consumption Survey

*/ In dinars

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GOT current subsidy schemes benefit the "poor" and rich alike. Subsidies also run counter to any consumption restraints and are a drain on the GOT budget.

A considerable amount of money can obviously be saved by cutting food subsidies to the middle and higher income groups. Targeting food subsidies to the lower income groups alone would require, however, some sort of rationing card or food coupons, and it is not clear that any of these systems are feasible in Tunisia at the present time. An income cash transfer program could also be used as an alternative. We have heard in our visit contradictory viewpoints from Tunisian officials on the administrative feasibility and even political advisability of a system that targets the poor exclusively. Ration cards or coupons, for example, were deemed inadvisable because they would create or enhance social class separations. There was awareness, however, that if black markets for coupons were to develop that would not be necessarily bad for the poor. The coupons could be sold and the proceeds could be used in the manner desired by the seller of the coupons. Some other officials were optimistic about implementing a cash transfer program for low income households. In particular, it was suggested that the national identity card and neighborhood committees of Solidarité Social could be used to identify the poor and police the program.

At any rate, entire elimination of food subsidies, as has been advised in the recent past, would clearly hurt a large segment of the population which through time has become dependent on some of the subsidized goods, in particular cereal products.

GOT should follow the recent policy of continued small increases to control the cost of the price subsidies to cereals and perhaps oil, if no satisfactory way is found to target the poor exclusively. The gradual elimination of meat, milk products, and sugar subsidies through continuous moderate price increases would hurt everyone but the rich probably more that the poor.

AID should, if necessary, cooperate with GOT on an in-depth study of the distributional impact of food subsidies, research feasible alternatives to target the poor exclusively, and make the results widely available to the public. AID should also encourage GOT to follow the IMF and World Bank advice on the use of price formulas for subsidized goods which would allow all prices in an almost automatic way to reflect changes in production and import costs, thereby helping to eliminate possible excess GOT subsidies.

This report has not dealt with many other subsidies in the Tunisian economy mainly because of the lack of time and data. But subsidies through below cost pricing for (a) many public services and (b) products sold by public enterprises have the same opportunity cost for the Tunisian economy and perhaps even a more regressive distributional impact than direct food subsidies. GOT has been taking the right steps in the area ofenergy prices subsidized by the Tunisian Petroleum Company.

The in-depths study recommended above should cover all types of subsidies in the Tunisian economy. The focus on food subsidies in the recent past has been mainly due to their high visibility in the Tunisian economy.

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Parastatal Enterprise

The following points merit highlight:

- In Tunisia, the continued high costs to the economy in terms of GOT financial support of inefficient public enterprises outweighs the social, political, and perceived economic benefits.
- The Government of Tunisia has both recognized and accepted the need for change and has embarked on a reform program.
- The reform program should, if carried out as planned, result in a positive first step in reversing the negative economic effect of the parastatals, i.e., economic inefficiency.
- While market competition is the intended ultimate goal, the reform plans are silent on government policies affecting market decisions in general (price controls, protectionism, interest rates, etc.)
- AID can play a positive role in supporting reform.

The public enterprise sector has been seen by the GOT as an important tool in shaping the development of the country. Start-up of the enterprise accelerated concomitantly with Tunisia's socialist experiment in the 1960s. Primary rationale for the establishment of parastatals include (a) their strategic nature and GOT wish to take over the "commanding heights" of the economy (mainly public utilities and transportation), (b) the need for a significant amount of investment beyond the capacity of the private sector (such as iron and steel, hydrocarbons, and mining), (c) the desire on the part of the GOT to commence new activities (such as textiles and tourism in the 1970s), or (d) assurance of a regular supply of basic commodities at reasonable rates (cereals).

Over 500 parastatal enterprises have been established. However, this is somewhat misleading. A number of the enterprises are programs, projects or activities of a particular ministry, e.g., hospitals, export and investment protection agencies, etc. and thus can not be considered "productive." In others, the percentage of capital owned by the GOT is quite small, e.g., in roughly 200, GOT equity interest is less than 33 percent.

Nonetheless, significant economic activity, including productive sector, is in the hands of the GOT. The parastatals account for at least 24 percent of Tunisia's GDP and 40 percent of investment. A large contributor is energy, which includes the state oil company -- Tunisian Petroleum Company. Other important activities are mechanical and electrical products, mining, construction materials and chemicals. As a group, the parastatals provide employment for 24 percent of the population working outside agriculture and pay 38 percent of total salaries. Parastatal enterprises also contribute significant amounts of exports, accounting for at least three-fourths of total, although their imports represent but 45 percent of total.

Of all the enterprises, industry accounts for 31 percent followed by services (28 percent), tourism (20), building and construction (9), agriculture and fishing (7), and mining and energy (5). The GOT (a) controls over 50 percent of dairy production, (b) owns two of the four major supermarket chains, (c) exercises command over most fish production through the establishment of a national fish company, and (d) has established the state slaughterhouse company. Over 50 percent of productive capacity in textiles rests with the GOT. In handicrafts, the GOT controls one-third of production, a small percentage of domestic sales, and nearly all export sales. It has command over heavy manufacturing and the extractive industries, consisting of oil, phosphates, iron, lead and zinc. In addition, the

GOT (a) is responsible for the importation of foodstuffs at the wholesale level, (b) owns the two largest commercial banks, (c) controls transportation other than a commuter airline and inter- and intra-city taxi service, (d) dominates health care, education and training, and (e) has all basic utility services.

The parastatal enterprises are a drain on the budget. The GOT supports the parastatals through (a) budgetary support, (b) capital transfers, (c) loans, and (d) equity participations. In 1984, total support reached almost $310 million Tunisian Dinars, up 38 percent over 1983. Support had totaled 198 million Tunisian Dinars in ~~1981.~~ 1982 and 155 million Tunisian Dinars in 1977. Primarily responsible for the 1984 increase is a substantial hike in budget support which represented almost 50 percent of total support in that year. Capital transfers in 1984 were actually lower than in 1982 while the other two components, although rising modestly, account for a relatively small portion of total support -- together roughly 20 percent in 1984. The increase in budgetary transfers is attributable mainly to a deterioration in profitability of the enterprises. According to data relating to a 46 enterprise sample, profitability has deteriorated since 1979, from a $15 million profit in 1979 to a $60 million loss in 1983 -- equivalent to almost 1 percent of GDP. (These data exclude the National Petroleum Company which traditionally reports profits.) Moreover, these data may understate problems by masking true difficulties. Undoubtedly, numerous hidden subsidies are furnished by the GOT which do not appear in the financial statements. For instance, the GOT has been known to tax competing products produced by the private sector, allowing the parastatal product tax-free status. The parastatal financial difficulties can be attributed to lackluster management, overemployment ("featherbedding"), and GOT tariff and price policies which do not permit the enterprises to charge appropriate prices. The main activities recording losses have been transportation, mining (mainly phosphates), and food and agricultural processing, whereas relatively favorable results have been recorded for electricity, gas and water, services, and construction materials.

While providing monies to the parastatals, the GOT is simultaneously tapping them for funds. Such borrowing, which amounted to as much as $145 million in 1984, promises to affect adversely the financial operations of the parastatals from which the monies are borrowed. For instance, robbed of resources, they may be unable to undertake requisite maintenance. In effect, the GOT appears to be taking monies away from profitable, productive activities and subsidizing unproductive, money-losing enterprises.

Owing to the important contributions of the parastatals to investment, growth and employment, the GOT is undertaking reforms considered necessary to improve the sector's efficiency. The VIth Plan clearly recognizes that (a) public enterprises are inefficient and (b) operation of the enterprises in the current mode is having a negative impact on Tunisia's economic performance. Generally speaking, the GOT will be seeking to cut in half the number of enterprises; those that compete directly with the private sector will be sold off. These competitive enterprises, for the most part, are small and have GOT equity interest of under 34 percent. On the other hand, those enterprises that do not compete with the private sector will be kept, including public services -- transport, electricity, gas, railroads, etc. The GOT also will retain concerns (a) exploiting natural resources such as cement, chemicals, metallurgy -- iron and steel, phosphate, and oil and (b) requiring large capital investment, e.g., those concerns with productive assets of over 100 million dinars. In addition, the GOT will undertake activities where new technologies are needed, which redress regional imbalances, and which can be described as strategic. We are concerned over the large number of enterprises to be retained especially since it is likely that government control is the primary reason in many cases, for the lack of private sector competition. The private sector conceivably could run the enterprises better than the GOT. according to one local businessman, the private sector could "run circles" around the GOT.

For the enterprises that will not be retained, the Country's VII Development plan states that the ~~State~~ GOT must withdraw from its direct role in running the enterprises and let private sector entities take control. The State would still have a say in operations but only through its representatives on enterprise boards. This will require that the laws governing State participation be changed to limit GOT involvement in the day to day affairs of running the enterprises to a much more restricted role. The plan notes that as a first step in the process, internal reorganization of the Economic Ministries will be necessary. Rather than having responsibilities for various aspects of management and planning scattered throughout the bureaucracy, which results in duplication and is often used as an excuse for bad performance by the enterprises, a single unit attached to each minister's office will be created to interact with the enterprises and act as a central point for the diverse actions of the various administrative concerns such as budget, social affairs, price controls, etc. The ultimate goal is to turn a profit; for those parastatals where this may not be possible, e.g., health and housing, the aim is to operate as efficiently as possible.

These Ministry units will develop multi-year plans with the individual enterprises with agreed upon targets and measurable performance indicators. After negotiation with the enterprise management, a performance contract will be drawn up which also commits the government to specific revenue and budgetary actions. The Ministries will then remove themselves from day to day involvement in management and will rely on regular reports from the enterprises containing basic performance indicators (balance sheets, production levels, etc.) to gauge progress toward the plan.

Within the enterprises, the governing boards (Conseils d'Administration), which had become simple rubber stamps in many cases, will become responsible for most key management decisions affecting the enterprises. The plan notes that care must be taken to make sure that any government representatives on these boards be competent. For some enterprises, either because of size or major problems, full-time permanent board members may have to be appointed. Day to day management decisions will be the responsibility of the Director General supported by an advisory committee composed of the key management staff.

For the reform program to be implemented successfully, introduction of modern management techniques, particularly in the realm of financial control and audits, is required. To this end a major national effort needs to be made for training e.g. is to train adminsitrative advisors at the Ecole Nationale d'Administration (ENA) and financial comptrollers at the Hautes Etudes Commerciales (HEC). Better communications between management and workers is also considered vital.

Following the Prime Minister's speech of 29 March 1984 announcing reforms in the public sector, a system similar to that envisioned in the plan was put into motion. In each of the Economic Ministries a task force (Cellule de Charges de Missions) has been established directly under the Minister and has the responsibilities described in the VIth Plan. At present they are focusing their efforts on ailing enterprises, either to improve efficiency, in order to reduce the budget drain or to improve operations to a level where profitability will permit divestiture. A method that could be used for divestiture would be to place the enterprises' shares on the stock exchange for purchase by private investors. However, a company cannot be traded on the stock market until it records profits in three successive years.

These task forces submit the plans for improving the enterprises and the proposed contracts to a National Commission on the reform of public enterprises which screens the plan and submits them to an Interministerial Commitee which is composed of 3 or 4 of the concerned Ministers. When the enterprises are back on their feet this structure is supposed to be dissolved. Instructions for taking the intended measures to improve public sector management and increase competitivity have been issued.

In meetings with the Ministry of National Economy, the task force appeared to be functioning. They are focusing on 16 enterprises which have been decreed to be in need of improvement out of the 126 which are the Ministry's resonsibility.

In the Ministry of Plan, modern computer data runs cover operaing and performance data for the 101 organizations in which the GOT's participation level is 34% or more and are productive enterprises. These data are aggregated and reported to the Minister regularly. Of these, 48 have been selected for individual attention because of their size and impact on the economy (together the 48 account fo 20 percent of the value added in the domestic product and 55% of the total exports of goods). While exogenous factors such as the value of the Tunisian Dinar have clearly affected profitability negatively (e.g. U.S. dollar denominated debt increases), the computer data suggests that a major problem is excessive salaries, suggesting this be an area of GOT focus.

Students are being trained, as planned, at ENA and HEC but the first group will not have completed the three year cycle until next year. Until that time, any reforms in internal financial administration will be difficult to achieve.

In sum, the GOT is examining means to improve the efficiency of the public enterprises and reduce their dependence on budgetary transfers, including (a) norms to be used in deciding which public enterprises would remain under direct control of the Government and what the Government's equity share would be, (b) the transfer to enterprises of control over their own affiliates (presently assumed by the Government), (c) the clarification of relations between the Government and the public enterprises within a conceptual framework, (d) an increase of the responsibility of the boards of directors of the enterprises and the implementation of internal and external auditing systems, (e) an improvement in GOT's financial and technical control, and (f) the systematic recourse to competitive bidding in public contracts and the standardization of contracting procedures.

In addition, a financial rescue scheme totalling $120 million has been implemented for 1984 that will finance accumulated past debt-service payments. Sixty percent of the transfers would be received by enterprises engaged in transportation, mainly the railway company, and enterprises in the mining and water supply sector would also receive important contributions.

Some "privatization" of parastatal enterprise is taking place. The GOT (a) is passing control of automative assembly, previously monopolized by the public sector, to the private sector through the creation of four (4) new joint ventures, (b) has opened refrigerator assembly, another former government monopoly, to private competition, (c) has ceded most tourist activity, an area where the GOT once played the major role, to the private sector and (d) will reduce through capital augmentation GOT shareholding in the large parastatal textile company SOGITEX from 100 percent to 34 percent under a process which will divide the company into 5 separate smaller companies. A major problem, though, with ~~the~~ any divestment is the GOT requirement that mandates new owners to agree to maintain current management and employment practices, almost ensuring the units' continued unprofitability. Also, while other parastatal enterprises, in addition to those cited above, have been sold off, they have been sold to other state enterprises.

The GOT is currently applying a more flexible pricing policy in the private enterprises sector. Public transporation tariffs were increased in December 1982 and more recently in August 1983. Increases in tariffs for water and electricity have been decided upon; however, these increases will not affect the low-income segments of the population.

In addition to the Tunisia Economic Development Bank, National Tourist Development Bank, and National Agricultural Development Bank, a number of development banks have recently been started as commercial ventures between the GOT and Arab-oil surplus states (see table). A primary aim of the banks is to mobilize external capital. A secondary purpose is ostensibly to assist in restructuring existing public enterprises. According to some observers, Arab states will not want to see their monies wasted. The creation of these development banks causes us some concern. Conceivably, their functions could be undertaken more effectively by the private sector. Moreover, they will not reduce the administrative burden on a GOT bureaucracy already stretched to the limit. The GOT bureaucracy will have to exercise oversight of the development banks as it was required to do so in the case of the parastatal enterprises.

Tunisia: Arab-Sponsored Development Banks

Name	Start-up Dates	Capital	Activities
Saudi Arabia-Tunisia Investment Society	1981	TD 50 million each	Light industry, tourism, infrastructur
Tunisia-Kuwaiti Development Bank*	1981	TD 50 million each	Infrastructure and heavy industry
Tunisia-Qatar Bank	1982	TD 35 million	N.A.**
United Arab Emirates (U.A.E.) Bank	1982	TD 50 million total	N.A.
Maghreb Arab (Algerian) Bank	1982	TD 40 million total	Heavy industry
Joint Investment Company (Saudi Arabian)	1983	$50 million total	N.A.
Tunisian-Libyan Investment Bank	1984	TD 100 million total	N.A.
Saudi-Tunisia Society for Investment in Development	1984	TD 30 million total	Tourism

*Associated directly with the Kuwaiti Fund for Arab Economic Development
**Not available

Proposals

The parastatals provide not inconsequential amounts of employment. Therefore, any action taken by the GOT that results in a loss of jobs has important political implications. As an alternative arrangement to the employees, cost effectiveness of individual concerns could be enhanced by reduction of wages. However, this will be difficult to accomplish; in Tunisia wages are negotiated nationally (see section on exchange rate) rather than between management and workers in an individual concern. The GOT will have to carefully balance off financial savings of any reforms with any loss in employment.

Nonetheless, the parastatals can be divided into three major categories: (i) enterprises which are (appear to be or could be) profitable and for which no reason exists for government retention; (ii) enterprises which are of questionable profitability (at best) and for which no reason exists for government retention; and (iii) public utilities, etc., for which reasons may exist for GOT retention, such reasons to include economies of scale and externalities, among others.

Ideally, for selected enterprises in category (i), an investment bank or business appraiser should be contracted to value assets and establish a fair price, and a sale negotiated with interested investors. Theoretically, interested investors should exist since the enterprises are defined as those that are or could be profitable. As for enterprises in category (ii), an investment bank or business appraiser should be contracted to value assets and establish a fair price. If no investor interest exists, assets should be auctioned off. However, prior to any sale to investors or auction of assets ~~making any moves~~, the GOT will have to address interrelated issues of monopoly power, tariff protection, price controls, wage policies, and employment. Resolution of these issues is critical to successful divestiture. For instance, even if an enterprise is profitable, no investor may purchase the enterprise if imposition of price controls could eliminate the profits. If asked, USAID should be willing to fund whatever studies are required to address these issues.

In any event, for every enterprise in category (iii), the operations should be appraised, making recommendations about needed management improvements/financial controls. In the case of utilities, a private management contract should be let if not already operated by a private entrepreneur.

Tunisia: Financial Operations of Public Enterprises, 1979-83

(TD Millions)

	1979	1980	1981	1982	1983 (Prov.)
Including Petroleum companies					
Total Receipts	1,106	1,347	1,607	1,783	2,091
Total Expenses	1,073	1,286	1,564	1,762	2,054
Net Profits	33	61	43	21	37
(As percent of total receipts)	(3.0)	(4.5)	(2.7)	(1.2)	(1.8)
Excluding Petroleum Companies					
Total Receipts	1,091	1,207	1,423	1,538	1,807
Total Expenses	1,013	1,204	1,440	1,590	1,848
Net Profits or losses	6	3	-17	-52	-41
(As percent of total receipts)	(0.6)	(0.2)	(-1.2)	(-3.3)	(-2.3)
Food & agricultural processing	-5	-13	-20	-9	-12
Services	4	5	5	9	4
Construction materials	4	5	4	-2	3
Transportation	3	-4	-16	-35	-27
Textiles and Paper	-3	-2	--	-1	-1
Steel and chemicals	6	6	1	-4	--
Mining	-15	-7	-2	-22	-24
Electricity, gas, water and tourism	12	13	11	12	17

SOURCES: Data provided by the Tunisian authorities and IMF staff calculations.

MONETARY POLICY

Tunisia's monetary system, consisting of the Central Bank of Tunisia, ten (10) commercial banks, eight (8) investment or development banks, two (2) specialized savings institutions, the postal cheque system, offshore banks, foreign bank representative offices, a stock and bond exchange, and eight (8) portfolio management companies, is extremely complex. Patterned after that of its former metropole France, instruments include (a) several required liquidity and reserve ratios, (b) limitations on bank borrowing from the Central Bank, (c) a complex structure of interest rates, and (d) an extensive system of rediscount facilities, together with selective and quantitative credit controls.

In recent years, money supply growth has been relatively rapid, increasing 17.3 percent in 1981, 23.6 percent in 1982 and 19.7 percent in 1983. This accomodative monetary policy has helped the GOT to cover its financial requirements. Funding of GOT financial requirements also has been facilitated by a 20 percent government paper requirement on bank demand and time deposits. In addition, the commercial banks must channel resources equivalent to eighteen (18) percent of deposits in medium-term credit to the private sector and for the purposes of this requirement the private sector includes parastatal enterprise. Failure to maintain the 18 percent requirement mandates that banks place non-interest bearing deposits at the Central Bank equivalent to the amount by which such bank lending is lagging behind the required ratio. There is also a five (5) percent requirement in National Home Savings Company bonds for the banks. This requirement, however, is not being rigidly enforced; allocations currently stand at but 0.3 percent.

A number of other bank ratios have been established including (a) a minimum liquidity ratio between liquid and other negotiable assets and short-term liabilities, (b) a minimum solvency ratio between capital and reserves and deposit liabilities, (c) non-liquid ratio between non-liquid assets (mostly long-term credit) and liabilities, (d) a reserve ratio between interest-free deposit accounts with the Central Bank and demand and time deposits with maturity of less than one year, and (e) maximum borrowing ratio between borrowing from the Central Bank and the money market and demand, time, and savings deposits. For the most part, however, these ratios either are not enforced or are set at zero, e.g., the reserve ratio is currently set at zero.

The pace of bank credit expansion has been brisk, rising 22.6 percent in 1980, 25.0 percent in 1981, 24.7 percent in 1982, and 18.7 percent in 1983. Most bank credit, of which sixty percent is short-term, goes to the industrial sector (50.9 percent of total in 1984) followed by services --

sector, the most favored subsectors are mechanical and electrical, chemicals, food processing, construction and public works, mining, and textiles. A breakdown of credit allocation between the public and private sectors is unavailable; GOT authorities include credit to parastatals in their data for credit to the private sector. In any case, credit provided to the GOT is significant.

Tunisia's very detailed structure of interest rates is prescribed by the Central Bank. Different GOT discount rates exist according to the (a) sector (industry, agriculture, housing, tourism, etc.), (b) purpose (construction, seasonal credit, loans for medium and small-size industry, loans for under-developed regions of the country, exports, etc.), and (c) maturities (short, medium and long-term). Interest rates on a bank loan are fixed depending on (a) the permissibility of discounting the loan, (b) the maturity of the loan, and (c) the sector and the purpose. Interest rates on deposits (demand, time and savings) are also fixed by the Central Bank; rates vary according to maturity (i.e. longer maturities having higher rates), the nature of the saver (individual or corporation), the size of the deposit (small savers have special rates), and purpose (e.g., savings for housing).

Rediscounting, together with selective and quantitative credit controls, is perhaps the Central Bank's most important policy instrument. A number of preferential discount schemes have been established. Under these schemes, the Central Bank furnishes monies up to certain limits to the commercial banks when presented with eligible paper. All the various discount rates are negative or, at best, marginally positive in real terms. The system of rediscount facilities is employed to direct credit to priority areas and, as such, is a form of selective credit controls. In contrast to discount rate schemes in other countries, in the case of client default, the commercial bank and not the Central Bank is liable. Interest rates charged the banks are liberal, generally below the Central Bank's discount rate of 9.25 percent.

Borrowings outside these limits require Central Bank prior approval; generally speaking, the Central Bank is quite liberal in granting such requests. Central Bank prior approval is required for a number of other transactions. All medium-term credit in the productive sectors -- agriculture, industry, and tourism -- irrespective of the amount, requires prior approval. The exception is new projects for which the Agence de Promotion d'Industrie (API), the country's industrial promotion agency, has affixed a guarantee. Prior approval, however, is required if the amount specified in the agreement with API is broached. Medium-term credit for residential construction, office buildings, commerce and consumer goods not permitted altogether. Other transactions which require the Central Bank to provide approval prior to banks providing credit consist of (a) all short-term credit in excess of Tunisian Dinar (TD) 1,000,000 accumulated across all banks,* (b) any overdraft in excess of TD 1,000,000, and (c) all loans furnished to the agriculture, mining and industrial sectors valued at more than TD 1,000,000. Prior approval is required for securing discounts on (a) all short-term credit in excess of TD 1,000,000 and (b) any seasonal agricultural or cultural credit exceeding TD 100,000.

Essentially three types of paper are rediscountable, including (a) commercial, (b) inventory, and (c) pre-financing of public sector activities.
The Central Bank furnishes each commercial bank a certain allocation for each area. No limitations, on the other hand, exist for credit for export operations or public sector activities once they are underway. The Central Bank also makes allocations to the banks for seasonal agricultural credit. This relates primarily to cereals, olive oil, and wine, and allocations depend on the economic circumstances at harvest in a given year.

The monetary system as it functions today introduces a number of constraints on the commercial banking system and economic distortions.

All the various ratios imposed by the Central Bank on the commercial bank operations places a significant constraint on their activity. While some of the ratios are required to insure safety in the banking system, the existence of these requirements makes banking more difficult than need be. The government paper requirement which mandates that banks set aside 20 percent of their resources for government equipment bonds is especially onerous. The GOT pays scant interest -- 5.5 percent -- on paper with maturities of 10 years. Moreover, the existence of the requirement means that the private sector gets less credit than otherwise would be the case.

* For instance, if a customer requests a loan of TD 800,000 from one bank and a loan of TD 300,000 from another, Central Bank prior approval must be secured.

Commercial bankers also would like to see the 18 percent medium-term credit to private sector requirement eliminated. Commercial banks incur significant administrative costs in lending medium term. They argue that the requirement is no longer necessary in light of the recent establishment of the various development banks. The development banks were set up explicitly to provide medium and long-term credit. The bankers, though, recognize that the development banks will face financial constraints in the future that must be overcome. When the capital that has been furnished to them has been used up, the development banks will have to resort to borrowing abroad at very high international rates. A possible alternative--accepting deposits--is forbidden by statute. With lending rates fixed by the Central Bank at relatively low levels, however, borrowing abroad on the part of the development banks is not a financially viable alternative. Therefore, the bankers suggest that either (a) prevailing lending rates in the economy be freed or (b) commercial banks be required to subscribe to the capital of the development banks. Commercial banks would be more than willing to provide capital if the 18 percent requirement were dropped. That would eliminate the high administrative costs associated with the medium-term lending.

The lending rates prescribed by the Central Bank are affixed as both maximums and minimums. For instance, the maximum lending rates for discountable commercial operations is 8.5 percent, the minimum 8.0 percent. The problem is that the spread is not wide enough, ranging from a quarter to a half of a percent. This does not permit sufficient margin to reflect the creditworthiness of customers. According to economic theory and good banking practice, "poor" credit risks should pay more. Hence, the banks have no incentive to differentiate between "poor" and "good" credit risks.

While banks would like to provide more credit to the private sector, the current credit system promotes credit to the public sector. Risks attached to public sector lending are much lower since such lending is guaranteed by the GOT. On the other hand, the GOT claims that some banks do not like to lend to public sector enterprises.

The current monetary system also discourages any new lending that is conducted outside the province of the preferential discount rate schemes. Resources with which to make new loans are difficult to come by. Artificially maintained low deposit rates discourage deposits. In the absence of deposits, an alternative source of resources to banks is the Central Bank's discount window. However, borrowings from the Central Bank outside the preferential discount scheme take place at the "normal" discount rate of

9.25 percent. The "normal" discount rate rises to 12 percent -- taux d'enfer (hell rate) -- if bank borrowings from the Central Bank exceed 15 percent of their deposits and still higher to 15 percent -- taux d'enfer super (super hell rate) -- if bank borrowings from the Central Bank rise above 17.5 percent of deposits. With maximum lending rates of 10.5 and attendant administrative costs, the banks lose money if they borrow from the Central Bank to finance the loan request. Thus, if the prospective client is a new one, the loan request is denied. In the case of an old client, the bank accepts the fact that it will take a loss on the transaction.

Interest rate formulation also is producing economic inefficiency. Interest rates that are negative in real terms encourage capital intensive production, thereby affecting employment negatively. The GOT has been hiking interest rates. Nonetheless, they are still negative or at best marginally positive in real terms. Demand deposits (checking accounts) pay one percent to corporations and two percent to individuals while savings deposit rates range from 3.5 to 8.5 percent for corporations and 4.5 to 9.0 percent for individuals. As for lending rates, they vary from 7.0 to 10.5 percent. According to both the IMF and domestic banking officials, interest rates on both loans and deposits should be increased at least three (3) percentage points.

The overall impact of all this government regulation is to limit competition among banks. All interest rates are predetermined by the Central Bank. Any competition that does take place is through services rather than interest rate adjustments. In the absence of government regulation, there would be more credit extended and many more different types of credit furnished. For instance, all new forms of credit must be authorized by the Central Bank. The weight of government regulation is such that banks feel compelled to lend money for development projects undertaken by the GOT even if they know the projects will be money losers.

As noted above, there are a number of preferential discount rate schemes. While these preferential rediscount schemes are intended to direct credit to certain areas, it is unclear whether at this time these areas are, in fact, those that the GOT wishes to encourage. In addition, the preferential discount rate schemes impose significant administrative costs on banks. According to the IMF, the GOT should simplify the system, limiting any preferential discount rate schemes to those areas which it would like to explicitly promote. Any move to reform the system, however, will be made more difficult by the credit promotion fund for small and medium size concerns and the soon to be implemented foreign exchange guarantee fund. Currently, to finance the promotion fund for small and medium size concerns, banks must allocate .625 percent of loans extended. Moreover, the soon-to-be implemented foreign exchange guarantee fund will be financed similarly. These two funds will have to be explicitly taken into account under any overall reform of the credit system.

The GOT also pays subsidies of 3.5 percent on agricultural loans and 3.0 percent on tourism transactions. The GOT must recognize that the impact of the subsidies is not only to lower the cost of credit in the two areas but also to direct a greater portion of total credit for the two sectors. For instance, does the GOT want credit to be diverted from say the industrial sector to agriculture and tourism.

The GOT authorities recognize that the current monetary system requires significant reform. In this regard, rationalization of the various rediscount schemes assumes utmost importance. They also acknowledge that the interest rate has been tasked to achieve numerous social ends, many of which conflict. In the end, none of the social objectives are achieved satisfactorily. In addition, according to the authorities any move to reform the credit system must be taken in tandem with reforms in other areas of the economy such as price controls, a position that has some merit.

Proposals

The main thrust of any reform of the monetary system should be to improve the (a) efficiency of the financial intermediation process and (b) domestic resource mobilization and allocation.

A. The GOT should at this time consider an upward adjustment in the interest rate. In addition to checking the large amount of funds currently going into the real estate market, a higher level of domestic interest rates would prevent any "capital flight" which so far has been minimal at least ~~among~~ private sector entities and would promote savings and discourage consumption. The Central Bank, indeed, is actively considering the matter and some upward adjustment is likely this year. Any adjustments will be in the neighborhood of 1 to 2 percentage points. According to the Central Bank, interest rates would have been hiked last year if it were not for the extreme complexity of the current monetary system which has mandated significant discussion. Discussion must be held prior to adjustment of each interest rate with critical assessments made.

Ideally, given the fluctuation in the inflation rate and real liquidity, interest rates should move according to market forces, providing needed flexibility. The Central Bank could determine the overall supply of credit, and, through competition among prospective borrowers for the available supply of credit, the interest rate would be determined. While the GOT is thinking of establishing credit ceilings, they would not be imposed on an overall basis rather they would be levied on each borrower. We do not feel that this is a particularly good idea. In addition to imposing excessive administrative costs on the Central Bank through the introduction of additional complexity to an already complex credit system, the individual credit ceilings might direct funds from high yielding to low yielding activities.

B. The overly complex operations of the Central Bank's discount window should be simplified and harmonized. The large number of preferential discount schemes should be reduced based on GOT social and economic priorities. Ideally, no more than two or three would operate; good candidates would be export and agriculture. The GOT, in the interest rate reforms to be introduced this year, appears to be moving in this direction. While most interest rates will be hiked between 1 and 2 percentage points, little if any increases are to be introduced in those preferential rediscount schemes dealing with (a) agriculture, (b) exports, and (c) small industry.

C. The GOT should reduce the 20 percent commercial bank government paper requirement. This would limit the burden imposed on the commercial banks of having to channel funds to the GOT at excessively low interest rates. In addition, it would free up funds for lending to private sector activities.

PRICE CONTROLS

In relation to most less developed countries, Tunisia has an extensive price control system, although perhaps not in comparison to other French metropole countries. Price controls have been affixed on the vast majority of all goods. The apparent social motive behind these controls is to protect real incomes of low income households. The cost of the policy, however, is distortion of relative prices and costs, resulting in disincentives to domestic production of the items, less efficient marketing and ultimately a lower GDP. For instance, a quality product usually cannot be sold for more than a very basic one. In addition, the impact of price controls on the domestic housing stock has been especially harmful; the placement of a lid on rental prices has affected the supply of new housing negatively and requisite maintenance has not been undertaken. Consequently, the quality of the housing stock has gone down. While some liberalization has taken place in recent years, the price control system still imposes a significant burden on domestic business activity and undoubtedly constitutes a drag on economic activity.

Price controls are administered by the Direction du Prix de Contrôles d'Economie Directorate in the Ministry of National Economy. Almost 100 people work in Tunis with roughly the same number toiling in the 14 regional offices for a total staff of almost 200. For the purposes of administering price controls, five separate price control schemes operate in Tunisia, including (a) the taxation regime, (b) homologation, (c) autohomologation, (d) liberté contrôlée (controled liberty), and (e) libertée totale (total liberty or free).

The taxation regime covers necessities. The GOT fixes by fiat the prices of fertilizers, sugar, bread, flour, olive and soybean oil, milk and other dairy products, tea, coffee, rice, cement, meat and other foods, petroleum products, public utilities, social services e.g. hospital care, transport, and school supplies, among other items. For those agricultural products covered under this regime, generally speaking subsidies are provided through the Price Stabilization Fund (For a description of these subsidies and operations of the Fund, consult the subsidies section of the overall report). Within the taxation regime, some liberalization is taking place. Energy prices on an overall weighted basis are not far from world levels and utilities prices are close to cost recovery. In addition, while the GOT did have to rescind the January 1984 100 percent increase in bread prices, the Price Stabilization Fund is hiking some prices. On the other hand, little so far has been done with respect to social services prices. The GOT has given little attention to user fees. Items subsumed under the taxation regime, by far, have the largest weight in price indices.

The regime--Liberté Contrôlée--covers all services, except those explicitly defined to come under the taxation regime. Examples include television repairs, gas stations, car wash establishments, etc. As a proportion of total articles in the economy and respective weights in price indices, coverage of this regime is quite limited. The regime is slightly more liberal than homologation but less so than autohomologation; the GOT has 15 days to respond to a price proposal by an entrepreneur.

Under "homologation," the GOT sets the price providing a fixed margin to the producer based on costs of production. Under this system, price increases for products are granted when needed with careful attention paid to cost structure analysis. Nevertheless, definition of costs is extremely difficult. At one time subsuming almost all industrial productsin the economy, coverage is now limited to certain sensitive products such as salt and razor blades. These products make up but a small portion of the weights in price indices. Under this regime, the GOT has up to 60 days to respond to a price proposal. However, the GOT can rescind a price change put into effect by a concern even if the 60 day time period has elapsed. Typically, under "homologation" the concern will submit a price proposal to the authorities who generally already have reviewed the issue. If the price is rejected, the concern is asked to come up with another.

In an effort to liberalize somewhat the pricing of industrial products, the GOT introduced autohomologation in 1982. This scheme now covers most industrial products; many industrial items previously covered by homologation were placed under this regime. Through introduction of autohomologation, the GOT also was seeking to simplify the price control system and make its job easier. Under autohomologation, the entrepreneur determines the price. If the entrepreneur wanted to hike prices, he would inform the GOT. The GOT would have 48 hours to respond; failing to do so, the price increase would go into effect. Over the past year, this system in practice has operated similarly to homologation. Informed by a producer of his desire to increase prices, the GOT has told producers of its need to have more time to consider the matter and then it would proceed not to follow up. The GOT claims that this price control regime is in its evolutionary and "neophyte" stage and hence the GOT must proceed cautiously. Consequently, some producers are now increasing prices without telling the GOT. While autohomologation covers a large number of items, the weights are relatively small in price indices.

Finally, some prices of products (believe it or not) are freely determined. These products include selected items in the agricultural sector, fisheries, artisans, handicrafts, candy, and small printing concerns. These products make up a small percent of weight in price indices. Even under this regime, however, prices are not freely determined. The GOT on occasion has used moral suasion to limit prices; for example, during certain periods of the year, the GOT talks down the price of lamb.

The entire set of price controls is further complicated by the possibility that an item may be subject to one price control scheme at the farm gate or factory gate level and another at the wholesale or retail level.

The trend had been to progressively liberalize the price control system.

In a move intended at the time to liberalize considerably price controls, the law of 27 January, 1982 was put into effect. The law classified all goods into categories and introduced autohomologation. The intent of the law was (a) to introduce some flexibility in the price control system and (b) through permitting concerns under "autohomologation" to set their own prices to encourage competition. In drafting the law, considerable discussions took place between the GOT and industrialist. Moreover, the law was coordinated through the National Price Commission which consists of national organizations, administrative bodies, employers, consumers, workers, and the National Women's Union, among others.

The law of 27 January 1982 placed all goods not specifically categorized in the residual category--"autohomologation." At the time, this amounted to a significant reduction in price controls on a large number of industrial products (notably some food products and some plastic and chemical products) and less rigid control on a number of other products. In addition, any monitoring of those products subject to autohomologation would be minimal; only random samples of enterprises on an "ex post" basis would be used.

Some backsliding, however, has occurred recently. Price developments led to increased usage in late 1982 of price controls which had been liberalized earlier in the year. Persuasion was used by price inspectors to encourage producers and sellers to reduce prices by a range of five (5) to fifteen (15) percent. In response to a nationwide call in the elections, price controls were tightened further in 1983. In addition to "voluntary" decreases in several producer and consumer prices, a consultative group for agricultural products among producers, merchants and central and local administration was introduced to stabilize prices in the wholesale market. In addition, the GOT will excercise quality control on those items for which prices are freely determined, and it would consider placing price controls on those items whose prices had gone up dramatically, e.g., maintenance and repairs. Finally, monitoring of those prices set under autohomologation has been tightened. Since introduction of the law of 1982, the only move toward liberalization has been the freeing up of the price of chicken.

As for the immediate future, no specific measures to liberalize the price controls system are envisioned by the GOT at this time.

Nevertheless, the general philosophy of the GOT is to make the price control system more flexible and efficient.

In spite of the virtual ban on imports of many items, we doubt that the price control system has restrained prices. Some manufacturers make very high profits under the current system. While the gross profit margins are too low -- only 15 to 24 percent,businesses cheat by selling without invoices for cash to build up factory costs and the range of allowable costs is wide. In addition, while the controls were in the form of price "ceilings," they also acted as price "floors" and this has contributed to higher prices in some sectors than would otherwise be the case. In spite of the fact that many firms are operating below capacity, a general reluctance exists to building up sales by charging less than the amounts permitted. Reasons include (a) fear that one will subsequently be subjected to control at the reduced price level, (b) a feeling that one can never reap the full benefits of price cutting since the Government will take steps to keep inefficient competitors in business, and (c) the general ambience of no price competition which the price control system encourages. By keeping some prices high, price controls, therefore, have become an important element of the country's protection system for "infant" industries.

Proposals

Many of these problems stem, at least in part, from the difficulty in finding sufficient qualified staff to administer the price control system, a problem that has been encountered by all states using price controls. This also means that many manufacturers get away with misleading information and make far larger real profits than appears. For this reason alone, a case exists for trying to limit price controls to what it is possible to control efficiently. Even the most advanced industrial countries, where there is an ample supply of trained accountants, have found it impracticable to try and control more than a small minority of key product prices. In Tunisia, the problems are especially acute. A staff of less than 200 control more than 4,000 different prices. Generally speaking, restrictions should be eliminated and prices allowed to fluctuate freely. Under such an environment, prices might well end up lower than manufacturers now find it possible to get away with. For key products, where there are no imports and local suppliers are in a monopolistic position, price controls may constitute a legitimate public sector initiative. Price controls also may be retained on a temporary basis for those "infant industries" with real potential. Nevertheless, in terms of a policy program designed to impose on government no more analytical, regulatory, and monitoring responsibility than is clearly beneficial, our preference would be to do away with price controls altogether.

We recognize, however, that the strong socialist tradition of the GOT precludes abolition of price controls altogether, especially on those sensitive products whose prices are fixed by fiat by the GOT. The GOT feels that some price form of controls are necessary from the vantage points of both producers and consumers. Producer needs to have a thorough understanding of their costs. From the vantage point of the consumer, price controls are necessary to insure social cohesion; Tunisia is a small country and with limited competition the consumer could be victimized. Therefore, as an alternative solution we suggest that the GOT do away with "autohomologation" and free up the prices, facilitating more efficient resource allocation. This would represent a bold move by the GOT and would have a significant positive impact on economic activity in the country, especially over the medium and longer term. One reason for adoption of "autohomologation" was to lessen the administrative burden on the GOT's thin staff. Yet a cursory examination suggests that system, to the contrary, has heightened the burden. The GOT also should assess critically the possibility of introducing and/or increasing user fees, starting with hospitals and higher education. As for other prices, the GOT should consider gradual liberalization over time, especially for those products under the province of the Price Compensation Fund.

EXCHANGE RATE

A concern exists that Tunisia's currency -- the Tunisian dinar -- is overvalued. An "overvalued" exchange rate discourages economic activity in those sectors relying on external markets by placing domestic producers at a disadvantage. Moreover, an "overvalued" exchange rate contributes to excessive domestic consumption of imports. The resulting impact on exports and imports creates balance of payments difficulties.

Any current exchange rate difficulties are attributable to (a) the sharp appreciation of the U.S. dollar and (b) the substantial run-up in wages in the early 1980s. Initially, the Tunisian dinar which has never been convertible* was pegged to the French franc. In 1974, that link was severed and rates were fixed daily by the Central Bank taking into consideration the value of the franc and the West German mark. On April 25, 1978, the U.S. dollar was added to the basket with weights assigned to reflect the relative importance of Tunisian foreign exchange outflows and receipts. To compensate for the recent appreciation of the U.S. dollar, the GOT has been gradually restructuring the basket. In March 1981, the Italian lira was added to the basket and currency weights were revised. More recently, according to the IMF an additional four currencies were included in the basket. The currencies in the basket are now those of countries which weigh heavily in Tunisia's foreign trade. According to the Governor of the Central Bank, the currencies and their respective weights are kept secret to avoid speculation.

Normally, to examine whether an exchange rate is overvalued or undervalued, one looks at price indices, either retail or wholesale. In the case of Tunisia, however, price indices mean very little because of the pervasive system of price controls. As an alternative, therefore, one should look at wages.

Since 1977, wages have been set in Tunisia on the basis of the "social contract." Two sets of negotiations take place. On the private sector side, the General Union of Tunisia -- the Tunisian equivalent to the U.S. A.F.L. or C.I.O. -- bargains with the Employers' Federation -- UTICA -- in some forty separate subsectors, covering 80 percent of the privately employed labor force. The GOT plays the role of an observer and, in some instances, that of an arbitrator. Negotiations arrive at increases in minimum wages with management free to pay increases in excess of the prescribed increases. For the government sector, the Union of Public Sector Employees

* "Convertibility" implies that the exchange rate is determined by market demand and supply forces.

negotiates directly with the GOT, and the General Union of Tunisia provides guidance. Generally speaking, public sector wage hikes have been larger than those in the private sector. Some sectors are not covered under either convention such as banking. The banking sector recently gave wage increases considered by the GOT to be excessive. As a result, the GOT instructed the banks to roll back the increases.

Negotiations between the General Union of Tunisia and UTICA center on the national minimum wage and minimum guaranteed agriculture wage. These minimum wages have an important impact on other wages; other wages in both the union and non-union sector, excepting small concerns, go up automatically with increases in the minimum wages. Under the pact, wage increases, theoretically, are granted on the basis of cost-of-living hikes and enhanced labor productivity. Because of the absence of productivity indicators, however, wages are adjusted mainly on the basis of cost-of-living changes, with adjustments, generally speaking, coming six months after an increase in the consumer price index of more than five (5) percent. To prevent the entire transmission of foreign price increases on the minimum wage, the agreed upon cost-of-living index excludes imported final goods. In recent times, some disagreement had arisen over which cost-of-living index to use.

The national minimum wage and the minimum guaranteed agriculture wage went up rapidly in the early 1980s. The national minimum wage was increased 18.3 percent in April 1981, 31.5 percent in February 1982, and 11.2 percent in March 1983, while the increases for the minimum guaranteed agricultural wage were 22.6 percent, 20 percent, and 11.7 percent respectively. In large part because of these increases, the average annual wage in the economy grew 13.4, 23.1 and 16.2 percent, respectively, in 1981, 1982 and 1983. When deflated for price increases, the increases were still on the order of 4.0, 8.4, and 6.6 percent in respectively 1981, 1982 and 1983.

These wage increases together with the appreciation of the U.S. dollar mean that the real effective exchange rate based on relative unit labor costs is estimated to have risen roughly fifteen (15) percent over 1980-83. According to these data, unit labor costs for manufacturing in Tunisia have increased more rapidly over the period than in competitor countries and this has not been offset by a nominal effective depreciation of the dinar. Moreover, these data understate the loss of competitiveness. For instance, the last agreement negotiated between the Union of Public Sector Employees and the GOT called for significant increases in fringe benefits. In the private sector, substantial social contributions were made by employers in addition to other levies on worker wages; in fact, taxes and the social contributions increase wages by as much as forty percent or more. These factors, which augment significantly real wages, are not reflected in the above data. As a consequence, the Chief of Cabinet in the Ministry of Social Services claims that Tunisia is no longer competitive. For example, it is said that wages are twenty percent higher in Tunisia than in the neighboring North African state of Morocco. That Moroccan workers also are more productive exacerbates Tunisia's lack of competitiveness vis-a-vis Morocco. However, comparing Tunisia to Morocco may be like comparing apples to pears; Tunisia is significantly more developed than Morocco.

The last wage agreements in both the public and private sectors were negotiated in 1983 and were to be effective over a three-year period. This year is, thus, a discussion year. In a development that appears to be a significant departure from past practice, the GOT is insisting that future wage hikes and fringe benefit increases be linked to productivity gains. According to the GOT, wage increases unrelated to productivity gains will exacerbate inflation, reduce exports and increase imports, and create balance or payments difficulties. Any business concern, however, that is able to demonstrate increases in real output will be permitted to hike wages. In addition to claiming it cannot afford any increases, the GOT also contends that inflation has still not caught up with the wage increases granted in the early 1980s. The unions, however, are unlikely to be acquiescent to the GOT proposal. Ten percent of the enterprises in UTICA came up with productivity norms that were rejected outright by the unions. Unions also claim that the large increases granted in the early 1980s made up for past and not future inflation and that productivity is difficult to measure. In addition, unions feel that the GOT reneged on a promise to furnish some wage relief this year; as noted above, increases were not scheduled to take place until next year. In any event, an agreement for a productivity-wage link, no matter how minimal, would represent a sharp advance, auguring well for Tunisia's future competitiveness.

This discussion on wage rates suggests that the Tunisian Dinar may indeed by "overvalued." When queried, Central Bank officials volunteered that the Dinar may be overvalued by as much as five (5) percent. The Governor also cited the real possibility of "perverse elasticities" through which a devaluation contributes to a weakened rather than strengthened balance of a payments situation. Under the "perverse elasticity" case, the combination of (a) marketing constraints and (b) inability to increase production because of technological limitations together with (a) inflation that the devaluation produces (import costs rise) and (b) the willingness of middle men to pocket rather than pass on the gains from the devaluation limits export increases, while the populace continues to absorb the same amount of imports in spite of their higher cost. Moreover, a devaluation would have a negative impact on the GOT budget; the U.S. dollar debt for the public enterprises is significant. Instead of resorting to a devaluation, the GOT would rather impose stricter price controls. In any case, a devaluation to be effective must be implemented in combination with a number of other policies.

While we agree that a devaluation must be implemented as part of an overall package of reforms, we remain unconvinced that the size of the current overvaluation is only in the order of five percent (the overvaluation could be higher or the currency conceivably could be undervalued) and that perverse elasticities do, in fact, exist in Tunisia. Perverse elasticities can indeed exist but they only seem operative in quite small economies. Tunisia's economy, however, is relatively sizable. In any event, the matter is an empirical question that must be studied.

Proposal

The Tunisian dinar may need to be realigned if the country is to be competitive on overseas markets. We suggest that the GOT determine through study the extent of any depreciation required and implement the change.

The GOT also may want to consider additional amendments in the manner in which the foreign exchange rate is determined with an eye toward reducing in the future any possibilities of the exchange rate becoming excessively "over or undervalued." In this regard, the GOT may want to consider full convertibility. Under full convertibility, the exchange rate would be determined by market forces with the currency freely tradeable in foreign exchange markets. Such a move is unlikely. The Central Bank is quite hesitant to opt for full convertibility, arguing that the market for dinars would be "thin."* Therefore, the exchange rate could vary significantly on a day-to-day basis and this could affect foreign trade negatively.

* If a market is "thin", few items are traded at one time. Therefore any significant excesses or deficiencies in demand and supply can have a substantial impact on prices.

FOREIGN EXCHANGE CONTROLS

Tunisia, like so many other less developed countries (LDCs), has a complex foreign exchange control system. Under the system which is administered by The Central Bank, all hard currency must pass through The Central Bank. In spite of some modest liberalization, the system continues burdensome and is a detriment to private sector investment. The difficulty with exchange controls is the overwhelming volume of information that is required in order for government control to better serve the national interest than would be the case in the absence of controls. There is no reason to presume that the Government knows how to utilize hard foreign currency better than say an entity in the private sector.

According to Tunisian authorities, the primary goal of the foreign exchange central system is to maintain balance of payments equilibrium. In recent years, Tunisia has encountered balance of payments difficulties arising primarily from external developments. In light of these difficulties, hard foreign currency, thus, has become a scarce resource that must be allocated efficiently among various possible uses, uses that must be consistent with Tunisian national development policy. The end result is that imports are controlled on the basis of foreign exchange availability with such availability determined by developments in the export sector. In sum, the objectives of Tunisia's foreign exchange control system are (a) to contain the outflow of hard foreign currency and preclude "capital flight," (b) to assure the availability of foreign currency in order to assist the Tunisian business concern to carry out its transactions, (c) to help direct foreign exchange into those areas that will yield the most developmental benefits for the Tunisian economy, and (d) to help train the Tunisian business concern regarding the appropriateness of the various uses of foreign exchange.

Clearly, this discussion suggests that the GOT feels that it has a comparative advantage in allocating scarce foreign exchange reserves. The GOT does not feel that the private entrepreneur will use foreign exchange efficiently. Thus, according to the GOT, foreign exchange controls will produce greater gains for the Tunisian economy than allowing free use of foreign exchange.

A distinguishing feature of Tunisia's current foreign exchange control system is the differentiation between residents and non-residents. The system, as presently constituted, discriminates heavily against residents. They may not open foreign accounts in convertible foreign currencies. In addition, all export proceeds must be repatriated and surrendered, normally within ten (10) days from the date payment is due if no credit is extended or, unless special authorization from the

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* Invisibles relate to transactions such as port services, warehouses, commissions, royalties, taxes, trademarks, and interest rather than actual goods.

Central Bank is obtained, within 100 days after shipment if the goods are sold on credit. Residents must repatriate and surrender all proceeds from invisibles.* The foreign exchange control system also fixes maximum foreign exchange allocations for residents for (a) travel abroad as tourists, (b) exporters and hotel owners for foreign business travel, (c) educational expenses abroad, (d) certain salary remittances, (c) subscriptions to journals and periodicals, (f) dues to scientific, cultural, and sports associations, and (g) certain other transfers of dividends due nonresidents.

On the other hand, regulations are far more lax for nonresidents. Foreign accounts in convertible dinars may be opened without authorization in the names of nonresident foreign nationals and of Tunisia's workers abroad, and, with authorization, in the names of other Tunisian nonresidents. These accounts may be credited freely with dinar proceeds (a) from sales to the Central Bank of convertible currencies, (b) with interest on balances in these accounts, and (c) with transfers from other foreign accounts in convertible dinars. They may be debited freely (a) for payments of any kind in Tunisia, (b) for transfers to other foreign accounts in convertible dinars, and (c) for the purchase of any foreign currency from the Central Bank. Foreign accounts in convertible foreign currencies may be established by nonresidents without authorization; regulations governing the use of these accounts are as liberal as those for foreign accounts in convertible dinars. Capital accounts may be opened in the name of a resident of any foreign country. They may be credited without prior approval of the Central Bank with the proceeds of (a) sales on the stock exchange and of Tunisian securities, (b) real estate or rights to real estate, and (c) capital accounts held by other nonresidents. Subject to limits, capital accounts may be debited freely for (a) living expenses, (b) foreign exchange imported in relation to a trip to Tunisia, (c) expenses incurred in the management of Tunisian securities, and (d) real estate transactions, among others. Nonresident manufacturing enterprises, whose capital is held by nonresidents and has been constituted to the extent of at least 66 percent through the import of convertible currencies, are exempt from the requirement of repatriation and surrender of export proceeds. The nonresident enterprises also may open special dinar accounts to cover their expenses in Tunisia. While required to obtain prior approval, nonresidents are guaranteed the right to repatriate capital invested in foreign currency or the net proceeds or sale of liquidation even if this amount exceeds the amount initially invested in foreign currency plus the earnings on that capital.

Moreover, "suspense accounts" have been established for nonresidents and use of such accounts is liberal. Suspense accounts are used for crediting all proceeds accruing in Tunisia to nonresidents where such proceeds are awaiting (a) utilization in Tunisia for specified purposes or (b) Central Bank approval for transfer abroad or transfer to other nonresident accounts. Nonresidents may maintain foreign currency savings accounts in the Postal Cheque System, and these accounts can be debited and credited freely. Finally, restrictions on nonresident invisible transactions are minimal.

While the foreign exchange system is complex and cumbersome, it is not as onerous as it appears, especially as it impacts on residents. Special accounts -- Exportation Frais Accessoire (EFAC) -- are available to resident exporters and hotel owners for credit of their export proceeds. Limits on these accounts which are denominated in convertible dinars are four (4) percent of total proceeds for exporters if export proceeds are repatriated more than 30 days after shipment of the merchandise and six (6) percent if repatriation occurs within 30 days following shipment. Hotel owners may credit to such accounts up to four (4) percent of their foreign exchange proceeds. In February 1984, eligibility for the opening of such accounts was extended to travel agencies and all providers of services abroad. These accounts also can be used for business travel abroad. The annual ceiling on payments for travel expenditures that can be made by debiting the account has been raised from D2,000 to D4,000. Similar accounts -- Business Travel Accounts in Convertible Dinars -- are available to resident manufacturing enterprises that produce exclusively for exports and are approved under the terms of Law # 72-38; they may arrange to credit two (2) percent of export proceeds.

In addition to the EFAC accounts, other aspects make the system less onerous. The Central Bank approves freely payments for (a) international merchandise, (b) processing, repair, assembly, royalties, patents, and trademarks, (c) taxes, fines, and court expenses, and (d) interest and amortization due nonresidents. The Central Bank has delegated authority to deposit banks for issuance of authorization for (a) certain transfers by resident export manufacturing, (b) dividends payable to nonresident shareholders by resident export manufacturers, (c) certain balances held by exporters on EFAC accounts, and, up to specified limits, EFAC balances held by exporters and hotel owners for business travel abroad, (d) bank charges and interest owed by the banks to their correspondents abroad, (e) interest and redemption proceeds due on government bonds purchased by the nonresidents with balances held in nonresident capital accounts, and (f) up to certain limits, the use by resident firms for employee business travel of balances held by them in accounts in convertible dinars. Also, the Central Bank will be setting aside, on a case-by-case basis, funds for travel abroad of those industrialists and merchants who are not deemed eligible for EFAC accounts. The monthly allowance for studying abroad was raised in March 1981 from D100 to D140 and in 1982 to D200 and also in 1982 the annual travel allowance was doubled to D200 for travellers to Morocco.

Further liberalization of the system is underway. Foreign Exchange Notification No. 7, passed in 1984, permits the business concern earning foreign currency to keep a portion of those receipts. The foreign currency retained is to be used by the concern to assist in the conduct of business. For instance, the foreign currency could be used for trips abroad to locate new markets, contact suppliers, etc. The aim of the law is to make the Tunisian concern more mature, in addition to reducing time spent securing foreign exchange allocations from he Central Bank. For 1985, the GOT is giving strong consideration to amending the foreign exchange control system in order to facilitate the procurement of technical assistance from abroad on an emergency basis. The aim is to have guidelines in place that will provide needed flexibility in order to save time for the business concern. The GOT presumption is that domestic entrepreneurs are not well educated in this area. According to the GOT, any significant liberalization of foreign exchange control system, however, will await substantial improvement in the balance of payments. Nonetheless, in spite of liberalization, some, albeit not significant, capital has fled the country. Most Tunisian businessmen have modest sized accounts abroad whose use is reserved for vacations, purchase of spare parts, etc. Even larger accounts may be held abroad by GOT officials.

the GOT fears "capital flight."

Proposals

We do not feel that the GOT has a comparative advantage in allocating foreign exchange. In the absence of GOT control, private market mechanisms would develop to allocate the foreign exchange efficiently. The manner in which the current system operates continues to impose significant costs on doing business in Tunisia and is a detriment to economic activity (see Annex). Alternative arrangements that would represent a sharp departure from the present system range from discarding the foreign exchange control system altogether to permitting residents, both individuals and business concerns, to keep up to 100 percent of their documented foreign exchange earnings in foreign exchange accounts that are not subject to interest rate ceilings with free withdrawals.

Either of the above solutions, however, is untenable at this time. While liberalization of the foreign exchange control system would have a positive impact on the business climate, some capital outflows are possible in the near term. Capital flows, generally speaking, are related to perceptions regarding fiscal management and GOT fiscal management has not been strong. Moreover, according to GOT officials, a previous effort to significantly open up the foreign exchange control system resulted in "capital flight." Over the medium and long-term, however, an easing of foreign exchange controls would induce capital inflows if requisite fiscal reforms were adopted.

In sum, we do not anticipate significant liberalization of the foreign exchange control system in the near future. Nonetheless, the GOT should be encouraged to continue its policy of slow liberalization. In this regard, any bureaucratic procedures that unnecessarily delay processing of requests for foreign exchange should be streamlined. Additional study also is required to determine precisely those amendations of the present foreign exchange control system that would have the most positive impact on domestic business activity. Perhaps AID should fund a private sector seminar to discuss this and other issues that currently affect private sector activity negatively. Finally, some of the foreign exchange allocations for residents in areas, such as travel abroad, appear unnecessarily restrictive; some of these allocations should be liberalized.

ANNEX
PRACTICE AS OPPOSED TO THEORY

Conversation with a Tunisian businessman in the private sector-tourism. He heads a travel agency and a car rental service. His last trip abroad on business was 10 days ago, thus the information is quite fresh.

He had heard of the proposed changes in foreign exchange controls, i.e. Foreign Exchange Notification No.7 of 1984, but as far as he was concerned, he had noticed no changes in practice. For his quite recent trip abroad, for instance, he had to go through an exhaustive number of procedures to obtain 300 dinars' worth of hard currency for business travel expenses. Each time he goes on a business trip:

1. He has to fill out 6 copies of a form requesting the 300 dinars in hard currency. He has to detail the purposes of the business trip plus how long it will last.

2. Step number two: he sends this form to the Federation of Travel Agencies which must give its approval for the trip.

3. He takes the form from the Federation of Travel Agencies, if it has approved the trip, and takes it to his local commercial bank.

4. The local bank sends the form to its head office.

5. The head office then sends the form to the Central bank.

6. The form will sit there for one or two weeks, if no one is applying pressure anywhere. If the Central Bank agrees, it sends the form back to the head office of the local bank in question.

7. The head office sends the form to its local branch.

8. The local branch calls the businessman to tell him that he may come and pick up the 300 dinars in hard currency. (300 Dinars is the maximum ever given, no matter how long the proposed trip).

The shortest time conceivable between making the initial request and actually receiving the money is 3 to 4 days--with a great deal of follow-up.

The Central Bank is perceived as one big bottleneck.

The person in question travels abroad in order to encourage tourism to Tunisia. For one recent trip, the Central Bank had denied him any hard currency. He was obliged to phone his contact in Europe to ask if he would pay all his expenses during his trip. The amount would be deducted from the eventual profits from the tourism package, if indeed the deal went through.

IMPORT AND EXPORT CONTROLS

Import and export control is administered by the Directorate of Trade and Licenses of the Ministry of National Economy. A staff of 60 individuals works full time on administration. The Directorate, in consultation with the Central Bank, determines the imports and exports that are to be prohibited or liberalized, as well as the imports that are to be subject to quotas. The Directorate also is responsible for issuance of import and export licenses.

Import Controls

The GOT makes extensive use of import controls, although not inconsequential amounts of liberalization is taking place. In Tunisia, quantitative restrictions are imposed through prohibition of imports and discretionary licensing, in addition to payments restrictions. Import controls prevent domestic consumers from securing an item at the lowest possible price and creates an additional cost on doing business. It also imposes an administrative burden on the government.

Separate paragraph to be inserted here

Tunisia's import controls may be broadly classified into four regimes: (a) import licenses, (b) annual authorizations, (c) certificate of imports and (d) temporary admissions.

Import licenses, covering roughly 43 percent of total imports, is the most controlled of all the regimes. Licenses must be secured for imports of all items otherwise prohibited and this relates primarily to commercial transactions. In order to procure a license, an individual fills out a license form and hands it to his commercial bank who transmits the application to the Directorate of Trade and Licenses of the Ministry of National Economy. The Directorate determines if the application is appropriate. If its response is in the affirmative, the application is sent on to the Central Bank's Directorate of Foreign Commercial Transactions. The Central Bank determines whether sufficient foreign is available to finance the transaction. Making an affirmative determination, the application is returned to the commercial bank. Of total applications, only three (3) or four (4) percent are rejected. That the rejection rate is so small reflects, in part, that people know what will be rejected. In some cases, licenses are issued on the basis of domestic need. In others, they are issued to protect domestic industries especially textiles.

The second regime, annual authorizations, relates primarily to industrialists and factory owners and accounts for 25 percent of all imports. Generally speaking, the regime can be described as liberal. Under the regime, the industrialist, factory owner, etc. negotiates with the Directorate of Trade and Licenses of the

Ministry of National Economy for an authorization that will cover all the year's import needs. Negotiations center around whether the import needs are as high as the applicant claims. Once agreement has been reached, the application as in the case of licenses, is sent to the Central Bank for final approval with documentation then transferred to the importer's commercial bank. To facilitate operations of this regime, importers are asked to submit their needs three months prior to the year for which the application is being made. In a new development, authorizations not used in a given year can be carried forward; this sought to minimize the significant importation that used to take place at the end of each year as importers sought to use up all of their allocation. An importer also is free to ask for a supplemental allocation in any given year.

The third and by far the most liberal regime is the Certificate of Import. This relates to needs of exporters and is covered in Annex I of the Notice to Importers and Exporters in Official Gazette No. 75 of November 27, 1981. Goods covered include raw materials, semi-finished goods, spare parts, imports by industry and hotel trade, machinery, and capital goods. Imports coming in under Certificate of Imports are covered by agreement negotiated by the investor with the Agence de Promotion d'Investment (API) -- the country's industrial promotion agency. While the agreement stipulates a maximum value of imports that the investor can bring in, it does not stipulate any import mix. The investor, however, should not bring in goods that can be produced locally. If import needs turn out to be greater than anticipated, the importer must reapply to API for an additional allocation. Once API approval is secured, documentation is delivered to the concern's commercial bank; the Directorate of Trade and Licenses of the Ministry of the National Economy and the Central Bank need not be consulted at all. Roughly 25 percent of total imports come in under Certificates of Import.

The final regime--temporary admissions--account for 7 percent of all imports. This regime relates to re-exports, primarily for sulfur imports employed in the country's chemical industry to make fertilizer.

Generally speaking, foreign currency may be purchased from the Central Bank for all payments that have received proper and prior authorization.

The GOT has been liberalizing the import control system. In 1981, authorized banks were allowed to acquire import licenses and receive payments authorization from the Ministry of National Economy and Central Bank. A revised list of liberalized products was published in early 1982. The import procedure was significantly simplified through annual authorizations issued to industrialists in export-oriented industries, large-scale traders, retail merchants, and agencies responsible for supplying certain essential goods for domestic and industrial use. In addition, at the end of 1982, the procedures for requesting import certificates had been geographically decentralized, thereby speeding up the process.

In 1983 the process of relaxation of the trade system was interrupted out of concern for the deterioration of the balance of payments. At the beginning of the year, the 1983 import programfor wholesalers and retailers was limited to 1982 levels and the annual import authorizations that are issued to industrialists were limited to 80 percent of the 1982 level; an additional 20 percent of the previous year levels was released in the second half of the year. The volume of imports subject to quotas and to the annual import programs was significantly reduced from the 1982 level, a move designed to contain imports of nonessential consumer goods. For 1983, the share of liberalized imports declined slightly, 21 percent of total imports in 1983 versus 22 percent in 1982.

The current philosophy of the GOT regarding import controls can definitely be characterized as a move toward further liberalization. Developments in 1983 were simply a temporary setback. The stated philosophy is to liberalize all imports required to promote Tunisian economic development, in addition to facilitating imports required to satisfy agricultural consumer goods needs. At the same time, in light of the relative scarcity of foreign exchange, luxury goods imports will be limited.

The general tendency will be to liberalize all imports required by the exporter to produce his product. Thus, all imports of raw materials, semi-finished products, and spare parts will be liberalized in an effort to promote the production of exports. Exports also will be promoted through permitting the exporter to import items fulfilling personal needs, e.g., a car, that would otherwise be prohibited to persons not exporting. A commission has been set up explicitly to liberalize imports, especially spare parts. The commission whose first full month of operation was in March represent a serious and determined effort by the GOT to introduce significant reforms in the area of import controls. The proportion of imports which are licensed already has come down from

50 percent in 1984 to 43 percent this year. On the other hand, reflecting limited foreign exchange availability, import controls relating to luxury goods imports which make up roughly one to two percent of total imports are being tightened. Strict limits also are being applied to automobile imports; three automobile plants-General Motors, Opel, and Peugeot/Citroen--operate in Tunisia. According to local business, nobody is getting licenses, especially for luxury goods.

In spite of ongoing liberalization, importers still complain that they cannot secure desired imports in the appropriate amount in a timely fashion. Tunisian businessmen continue to encounter difficulties in securing spare parts. Nonetheless, the populace is "managing" in spite of the system. Import licensing is especially serious. Import licensing is ad hoc; each time an importer needs an item he must make a formal request to the appropriate authorities and this is very time consuming. This highlights the advantages offered under the annual authorization and certificates of imports regimes. Generally speaking, the Tunisian populace feels a need to import; foreign imports are considered to be of higher quality than their Tunisian counterparts.

Proposals

The current GOT efforts to liberalize import controls are to be lauded. Theoretically, we would like to see all import controls lifted on those goods imported but not produced locally. As for those items which are controlled to protect domestic producers--the "infant industry agreement", some criteria should be developed for gradual easing of controls. For instance, at the time the local industry reached maturity, controls would be discarded altogether. However, in light of current foreign exchange difficulties and the protection mentality of the GOT, such reforms are unlikely to be adopted. Therefore, we urge the GOT strongly to continue to liberalize import controls. In this regard, several actions would be beneficial. One, GOT should set license reduction targets; e.g. by the end of 1986 no more than 35 percent of all imports would be subject to licenses, in contrast to 43 percent at present. Two, the GOT should be as liberal as possible in furnishing annual authorizations. Any request for additional allocations in a given year should be pro forma. Three, certificates of imports should be unlimited for all exporter production inputs. Four, in administering import licenses and the annual authorization regimes, the functions currently performed by the Directorate of Trade and Licenses of the Ministry of National Economy and the Central Bank should be combined, thereby eliminating a step for the importer.

Export Controls

In addition to discouraging re-export, the rationale for export controls in Tunisia is to prevent the export of products needed domestically. However, if the imposition of export licenses produce a reduction in exports or the potential for reduction in exports, the licenses shrink the available market for the commodity produced, thereby discouraging production by domestic producers. Thus, the efficiency loss in income to producers may not be compensated by corresponding gains for consumers.

Export controls take two forms in Tunisia: (a) export licenses and (b) repatriation commitments.

In the case of export licenses, procedures parallel those for import controls subject to licenses and annual authorization. The exporter vets his request with his commercial bank who transmits the application to (a) the Directorate of Trade and Licenses of the Ministry of National Economy, (b) then to the Central Bank, and (c) back to the commercial bank. Export licenses, which are required on 50 percent of all exports, relate primarily to products needed domestically such as livestock products, grains, etc. At one time considered a major restraint, the export license system can now be described as relatively liberal. Licenses are now considered a mere formality. They are intended to provide information to the GOT rather than to be used by the GOT as a restrictive device. The GOT now almost never refuses a request for a license. The guiding principle is to allow the export, and if a need later develops in the economy for the good that was exported the item can them be imported. To assist in liberalizng the system, a commission was established in 1984. Exporters find the current system moderately burdensome. It takes a week to get a license. Thus, the small possibility exists that a lucrative overseas market will be lost.

The remainder of exports are subject to the "engagement de rapatriation"--repatriation agreement. Under this system, the exporter simply promises to surrender export proceeds to the Central Bank. Exports that are licensed also are subject to the repatriation agreement.

Proposals

Ideally, export licensing should be discontinued. However, failing that, the GOT should set targets for reductions in export licenses. For instance, the GOT could agree to reduce the proportion of exports that are licensed to say 40 or 45 percent by the end of next year from current levels of 50 percent. The problem with export license is the time required to secure the license; allowing the functions currently performed by the Directorate of Trade and Licenses of the Ministry of National Economy and the Central Bank to be performed in one office conceivably could reduce processing time.

Import Tariffs

Import tariffs are widespread and, in some instances, quite high. They have been used to protect domestic producers -- the "infant industry" argument. More importantly, however, they have been an important source of revenue, accounting for 30 percent of GOT proceeds. Unlike other sources of revenue, tariffs are easily collectible; the recent computerization program, which is a model for not only other less developed countries, but developed countries as well such as France and Italy, is helping in this regard.

A five (5) percent tax has been levied across the board on all imports. This tax has two elements. Sixty (60) percent of proceeds go to customs to cover administrative costs such as working overtime to clear shipments. The remainder goes directly to the Treasury to assist in financing GOT expenditures.

In addition to the across the board import tariff, tariffs are imposed with rates ranging from 7.5 percent at the low end to a whopping 300 percent at the high end. A special regime exists for some exporters which exempts them from payment of duties. The extremely high tariff rates are reserved for luxury goods imports such as cars. While 300 percent is indeed high, few goods are taxed at that rate. In fact, little, if any, items draw rates above 200 percent.

A major function for the tariffs is to provide protection to domestic concerns -- the "infant industry" argument. Protection is not substantial according to the Tunisian Director General of Customs. He claimed that the average overall effective rate of protection is but ten (10) percent. Moreover, generally speaking, protection is reviewed each year, albeit informally.

If indeed the overall effective protection rate is as low as ten (10) percent, it is to be lauded. While the team did not have a chance to thoroughly review the matter, a cursory calculation using data on import taxes and value of imports on a CIF basis suggests that average effective overall protection is well above ten (10) percent, approaching 20-25 percent. With the newly installed computer equipment in place, the rate should have been easy enough to calculate. Moreover, selected items may be receiving significant protection. In addition, no formal review of overall protection has taken or is to take place in the near future. In sharp contrast, such a review has been undertaken in the neighboring North African State of Morocco.

We also were concerned over the possibility that imports of raw materials and intermediate goods were subject to higher tariffs than the final product for which the inputs were used to produce. For instance, at one time the costs of input imports to produce a pulverizer were greater than the price of importing the product from abroad. The difficulty always crops up when an item can be considered both a production input and a consumer article. This problem appears to be diminishing in importance. Since 1983, exporters get rebates on taxes paid on imported inputs.

Proposal

We recognize the need for GOT to raise revenues, especially in light of the country's current fiscal difficulties. However, we also recognize the desirability of limiting protection in the economy; protection -- be it import tariffs and licenses and/or price controls -- provides little incentive for domestic producers to hold down costs, producing domestic firms which are uncompetitive on overseas markets. The GOT must lower protection to domestic producers through reduction in tariffs and licenses on competing overseas products. Through furnishing little incentives to economize on costs, the protection has rendered the domestic producers uncompetitive on oversease markets. While a move to lower protection will undoubtedly fire much political controversy, it is vitally necessary to promote production of exports, which are critical to the economy's future economic viability. Political realities, however, suggest that a move across the board is unfeasible. The GOT should move to reduce protection on a select few product lines which are not now competitive on overseas markets but with minimal improvements in operational efficiency could be competitive. Therefore, the team recommends that an effective protection study be undertaken to assist in the determination of these select few product lines.

UNEMPLOYMENT

Unemployment remains a serious problem in Tunisia. Even in the heyday of the "oil boom" in the 1970s, the unemployment problem loomed large. According to 1980 data, some 12-13 percent of the labor force is unemployed, and an equal number is substantially underemployed. Those that are employed are concentrated in agriculture (33 percent) and manufacturing (between 15 and 25 percent). Unemployment is especially severe among youths and in the rural sector. The unemployed were a primary force in the riots in early 1984 that followed in the wake of the GOT's decision to double the price of bread, a decision that was later rescinded. GOT efforts to decrease unemployment through a decrease in birth rates have been more than offset by low mortality rates and higher labor participation rates, particularly among women. Moreover, emigration of Tunisians has been curbed by restrictive measures taken in Western Europe and, more recently, the neighboring state of Libya.

A number of GOT policies have contributed to the unemployment problem. One, GOT wage policies have had an especially negative impact; the sharp increases in social contributions by employees and the demonstration effect of high public sector wages have produced high labor costs, thereby discouraging use of labor. For instance, over 1971-81, the minimum wage increased at an annual rate of 5.7 percent in real terms. Two, by keeping interest rates artificially low, interest policies have stimulated the use of capital. Three, past incentive laws did little to encourage employment. As an example, enterprises with less than ten (10) employees were excluded from any benefits under the incentive system even though they are particularly labor-intensive. Four, producer prices for agricultural products were maintained at low levels, discouraging rural production which is labor intensive. Five, energy has been sold at highly subsidized prices to domestic industry, thereby stimulating energy-intensive industries, which also tend to be capital-intensive. At the same time that domestic industry has been subsidized, private consumers have paid prices at or above world levels. Sixth and last, the comprehensive protection system affected employment adversely; the system gave excessive protection to industries serving the domestic market and discouraged export industries; the manufacturing industries serving the domestic market tend to be capital intensive while the export industries generally speaking are labor using.

The GOT has taken some major steps to rectify the situation. Interest rates have been hiked; the incentive law has been structured somewhat to give additional encouragement to employment; producer prices for agricultural prices have been raised to levels approaching world price levels; energy prices were raised; and the GOT hopes to relate future wage increases to productivity. Notwithstanding these moves, much more needs to be done. For instance, in spite of some liberalization, interest rates remain negative in real terms or at best marginally positive.

Proposal

With the exception of the minimum wage legislation, the issues raised here cut across many areas including investment climate, monetary policy, import tariffs, agriculture and energy, among others, and the proposal sections for these other areas should be consulted. Minimum wages, if effective, have probably been detrimental to employment, production costs, export capability, etc. That wages in the past were raised across the board prevented them from reflecting labor scarcity and productivity, denying wage rates their role as an economic signal. The GOT decision to relate wage increases in the future to productivity may be an important first step in rectifying this difficulty.

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INVESTMENT CLIMATE

Over the past decade or so, the Government of Tunisia has instituted laws and policies which offer impressive incentives for both domestic and international investment in Tunisia . As a result, investment activity over the same period of time has increased. Nonetheless, several disincentives to the private sector investor, need to be addressed in order to expand investment opportunities.

Introduction

In the late sixties and early seventies the Tunisian Government began to adopt investment incentive laws and create investment and export support structures. Over the last decade, activities designed to increase funds in private sector investment have met with some success (see Table IV below).

TABLE 1

INVESTMENT PROJECTS*
(1973-81)

Sector	Number of Projects	Investment (Millions TD)	Employment
Miscellaneous	3,030	329.6	55,991
Agriculture	3,491	638.3	66,582
Construction materials, Ceramics & Glass Industries	1,976	820.9	55,489
Mechanical & Electical Ind.	1,972	623.7	64,797
Chemical and Rubber Ind.	489	538.8	13,288
Textiles	3,343	397.8	129,096
TOTAL	14,301	3,349.1	383,243

* Under laws 72-38, 74-74, and 81-56.

Similar figures for 1982, 1983 and the first ten months of 1984 were reported.

TABLE II

	1982	1983	1984 (10 mos.)
No. of Projects	2,154	1,762	1,556
Investment Value (Millions TD)	672.9	657.4	513.7

In 1984 investments were spread among sectors as follows:

TABLE III

Sector	Number of Projects	Investment (Millions TD)	Employment
Miscellaneous	299	45.3	3,231
Agriculture	266	80.4	3,724
Construction Materials, Ceramics, & Glass Industries	269	127.6	4,299
Mechanical & Electrical Ind.	193	90.1	3,837
Chemical & Rubber Industries	48	59.6	890
Textiles	481	110.7	9,236
TOTAL	1.556	513.7	25,217

Since 1977, the steady increase of private investment realized under the new legislation was broken only in 1978 and 1981. 1978 was a year of major disputes between the labor movement and the government.

U.S. interest and involvement in Tunisian investment was extremely limited until 1984 when approximately 10 companies under the Entrepôt/TDP project came to Tunisia. In May 1984 20 more U.S. companies attended a conference on investment in Tunisia. This May USAID is assisting General Motors hold a similar conference in Detroit co-sponsored by API (the Tunisian Agency for Investment Promotion).

The Legislative Framework of Incentives

The laws consist principally of:

1. Law No. 69-35 (the first Investment Code, entitling approved projects to certain tax reductions and repatriation guarantees);

2. Law No. 72-38 (to encourage export projects, which are required to be at least two-thirds owned by non-residents in order to receive the full benefits of the foreign currency guarantees of the law);

3. Law No. 81-56 (industrial projects for decentralization and employment); and

4. Law No. 82-67 (promoting investment in agricultural projects).

With the adoption of Law No. 82-67 of August 6, 1982, relating to investment in agricultural projects, Tunisia has taken an additional step in its policy of seeking increased economic development by significant reliance on private sector investment activity. This policy, while having its conceptual origin in Tunisia's first investment law adopted in 1969, has been more aggressively applied since 1972 through the promulgation of a series of investment promotion laws intended to encourage both foreign and domestic private investment. The 1972 law (Law No. 72-38) provided for the creation of API and is primarily intended to encourage foreign companies to establish Tunisian operations that will produce for export, increase the country's industrial base, and generate employment and foreign exchange. While the law was originally utilized more by wholly foreign-owned enterprises, it is also applicable to Tunisian-owned enterprises. At present, approximately half of the companies operating under the law are Tunisian-owned, one quarter are wholly foreign-owned and the remaining quarter have varying proportions of foreign and Tunisian ownership.

Another investment law, adopted in 1974, (Law No. 74-74), was intended to increase both Tunisian and foreign investment in industrial projects that would produce principally for the domestic market. This law has now been replaced by the more generous Law No. 81-56 of 1981. While the primary focus of the 1981 law remains production for the domestic market, it expands the incentives of the 1974 law by: (1) increasing the tax exemption period, (2) granting investment subsidies for job creation, and (3) providing for certain governmental assistance with the implementation of necessary infrastructure. The incentives will vary according to the number of employment positions created by the project, its fulfillment of the decentralization policy by its location and the project's level of technology.

Copies of the Law No. 72-38 and Law No. 81-56 laws are attached as Annex A.

Institutional Assistance

The Institutional Apparatus

A. API

The principal institution responsible for encouraging and approving industrial projects in Tunisia is "l'Agence de Promotion des Investissements" (the Investment Promotion Agency or "API"). This organization, created pursuant to the 1972 export investment law, is staffed by relatively sophisticated professionals and is very close to being a "one-stop" center for investors. API is governed by a Board of Directors whose membership includes representatives of ministries and governmental agencies whose activities directly affect the investor: e.g. Ministries of Planning, Finance, National Economy, and the Central Bank. Together with the President of API (the GOT's operational investment coordinator), these representatives are able to be responsive to a broad spectrum of investor needs and concerns. The ability of the API Board of Directors (1) to coordinate the policies of various governmental regulatory bodies, (2) to develop joint regulations and, (3) to provide guidance for consistent interpretation of provisions of the investment laws, offers an important mechanism for avoiding bureaucratic delays and investor frustrutions.

Currently, a proposal submitted by an investor can be expected to be acted upon by API within six weeks of its submission. API is required by statute to respond within a month. Improperly drawn up paper work, however, can delay the process up to an additional two weeks.

B. APIA

The Agricultural Promotion Agency (APIA) began operations in 1983. It regulates both large and small scale investment in agriculture in a manner similar to that of API. Since inception, APIA has approved 188 projects involving a total investment of approximately 100 million TD.

C. AFI

The "Agence Foncière Industrielle" (AFI) was established in 1973 to acquire land, install infrastructure and either sell or lease land and buildings to industrial enterprises. AFI's principal purpose is thus to assist API-regulated companies with their site requirements. In an effort to encourage investment in the less developed areas of Tunisia, AFI has made significant investment in roads and lands. However, this investment has not been sufficient to offset other problems facing potential investors such as the lack of reliable telephone and telex services in the rural areas. Therefore, investment in rural areas continues to lag.

D. SCAT-ONTT

The organization with responsibility for regulating tourism-oriented projects is the "Sous-Commission des Agrements Touristique" ("SCAT"). Although tourism-oriented activities account for a substantial percentage of Tunisia's foreign exchange earnings, investments in these activities are regulated by an early Foreign Investment Code (Law No. 69-35 of 1969) and are not beneficiaries of the more streamlined institutional mechanism of API. Instead, tourism proposals are reviewed independently by SCAT as well as the "Office National du Tourisme" ("ONTT") and their land requirements are reviewed by the "Agence Foncière Touristique."

E. The National Investments Commission

The highest Tunisian governmental body dealing with private investment is the National Investments Commission, whose members include the Ministers of Planning, National Economy, Finance, Agriculture, Public Works of Housing as well as the Governor of the Central Bank. The Commission, created pursuant to the original 1969 Investment Code (Law No. 69-35) and by Decree No 73-19 of 1973, is chaired by the Prime Minister and does not meet on a regular basis. It has the authority, however, to settle disputes among various governmental bodies concerning investment policy. It is also authorized to delegate its powers relating to industrial matters to API and to SCAT for tourism matters.

F. CEPEX

The Center for the Promotion of Exports was created in 1973 to facilitate the marketing of exports. It surveys foreign markets, advises and directs Tunisian exporters, assists foreign imports, disseminates commercial information, and contributes to the formulation of policy relating to foreign trade. Through contacts with Tunisian commercial attachés it identifies overseas market possibilities.

G. COTUNACE

The "Compagnie Tunisienne d'Assurance Commercial d'Exportation" is the first export insurance company to be organized by the GOT. COTUNACE is planned to be operational by year end 1985. Though specific operational guidelines have not yet been fully developed, once in operation it is planned that all exports, except those of commodities such as petrolium, olive oil and phosphates, will be required to have export insurance coverage in order to have access to preferential export financing.

H. Post-Approval Institutional Assistance

The assistance offered to investors by the above institutions has resulted in an impressive number of realized projects. The promotional aspects of API's activities, for example, are equal in most respects to comparable institutions in industrial countries. Also, API's coordination efforts have facilitated the entry of major foreign investment projects into Tunisia. An additional attraction for investment in Tunisia is the existence of a subdivision within API's promotion department that provides continued assistance after the approval stage of a project to the investor who may lack familiarity with other Tunisian procedures and regulations. In this regard, 23 branch offices have been established.

Incentives, Privileges and Exemptions

A. Percentage of Foreign Ownership Allowed

1. Under the 1972 law, companies producing for export may be 100 percent owned by "non-residents." If at least 66 percent of the company is not owned by non-residents, certain of the exchange control exceptions and incentives provided by the law are unavailable to the company itself, with

any non-resident minority shareholder remaining entitled to repatriation rights. Accordingly , if a foreign investor's strategy is to use Tunisia for an export production base (which may, depending on the amount of local value added, entitle the product to a Tunisian certificate of origin and associated international trade preferences) Law No. 72-38 provides complete flexibility as to ownership.

2. Under the 1981 Law (as well as its 1974 predecessor) no specific reference is made to the allowable percentage of foreign ownership. While a general rule of thumb appears to be to allow foreign owernship in a percentage equal to that percentage of projected export production, this is a matter that may be negotiated on a case-by-case basis with API. Greater foreign ownership, even exceeding a majority position, may be permitted depending upon, e.g. number of jobs created, location, and level of technology.

3. There has been as yet no experience under the 1982 agricultural investment law sufficient to indicate what attitude will be taken by the recently created APIA (Agricultural Investment Promotion Agency) regarding permissible foreign ownership in agricultural projects.

B. Foreign Exchange Availability

1. Under the 1972 law, export companies generate their own foreign exchange to be held either abroad or in accounts with "off-shore" banks (created under Tunisia's Law No. 76-63). As long as the company is owned at least 66 percent by "non-residents", the law provides maximum flexibility with respect to foreign exchange.

2. Law No. 81-56 companies are guaranteed sufficient foreign exchange both to meet import requirements and to permit repatriation of the profits of any non-resident shareholder or partner. The guarantee is set forth in the API-sponsored approval and must be negotiated on a project-by-project basis.

C. Fiscal Incentives

Investments made under Law No. 72-38 (export industries), Law No. 91-56 (industrial projects for domestic production), Law No. 82-67 (agricultural projects) or in tourism projects (under the older Law No. 59-35) are entitled to fiscal incentives of two general types (1) exemption from certain specified taxes and (2) exemption from certain customs duties. The exemptions are available regardless of the nationality of the owner of the project, and they are available to certain expansions of existing enterprises as well as to new projects.

The team was concerned that similarly placed investors might receive different incentives packages because some investors were better bargainers than others. We were assured, however, that API guidelines furnish little discretion; all incentives are codified. In rare instances, nonetheless, an especially large investor can negotiate a better deal directly with the GOT rather than going through API.

The most significant of the potential tax exemptions are the following:

1. Tourism Projects (Law No. 69-35)

a. Three to five year (can be extended for an additional five years) exemption from the Corporate Income Tax ("La Patente").

b. Fixed incorporation fees or registration charges on basic legal transactions (e.g., deeds of partnerships, deeds to increase capital).

c. Reduced customs charges on imported capital goods.

2. Export-Oriented Projects (Law No. 72-33)

a. Ten-year exemption from corporate income tax (with liability for such tax at a reduced rate of 10 percent for an additional ten-year period).

b. Exemption from the tax on rental value ("Taxes sur la valeur locative").

c. Twenty-year exemption from the tax on income from securities.

d. Exemption from (or reimbursement for) customs duties and turnover taxes otherwise payable upon import of capital goods, equipment spare parts, raw materials and semi finished products required for production. Notice 119 issued by the Minister of Finance on January 16, 1973, limits the definition of the term "products required for production" to "capital equipment, spare parts, and raw materials and all products necessary for the manufacture of products exported").

e. Reduction of the tax on distributed profits to a rate of 6 percent on profits distributed to either holders of registered shares or partners and 8 percent for profits distributed to holders of bearer shares.

3. Industrial Projects for Domestic Production (Law No. 81-56)

a. Exemption, which is set according to location of the project, number of jobs created, and level of technology, from the corporate income tax (La Patente) for five to ten years and at the rate of between 40 percent to 90 percent of the amount otherwise due. (All fiscal incentives afforded by Law No. 81-56 may be expanded if the project offers a high level of technology, water or energy savings, or is otherwise of a particular interest to the national economy).

b. Fixed incorporation fees or registration charges on basic legal transactions (e.g., deeds of partnership, deeds to increase capital).

c. Exemption from (or reimbursement for) customs duties and turnover taxes otherwise payable on imported capital goods necessary for the project's production.

d. Exemption from the business license fee.

e. Tax rebate on (re)invested income or profits within five years from the incorporation date to a maximum of:

- 30 percent of the overall annual income for natural persons subject to the Personal Income Tax ("Contribution Personnelle d'Etat") and

- 50 percent of the annual profits of legal entities subject to the tax on profits from trade and manufacture or the tax on profits from non-commercial professions

f. Reduction of the distributed profits tax (Impôt sur le Revenu des Valeurs Mobilières) on profits distributed to shareholdersm of an amount not to exceed 6 percent of the nominal value of the shares.

g. Exemption from the Vocational Training Tax.

D. Repatriation of Profits and Capital

The Investment Code of 1969 (articles 16-18 of Law No. 69-35), and the 1981 law (articles 18-20 of Law No. 81-56) make specific provision for the repatriation of both capital and profits by non-resident investors. The controlling instrument for such rights of repartiation is the formal approval document issued by the relevant regulatory institution (*e.g.* API, in the case of industrial projects). Both laws also specifically provide that repatriation of capital is guaranteed even where the actual net proceeds from the sale on liquidation exceed the amount initially invested.

Law No. 72-38, which makes specific reference to the repatriation rights of profits of export-oriented companies, does not contain a provision dealing with the repatriation of capital. Presumably (although this should be clarified), such a repatriation right would be set forth in the API approval and could then fall within the broader coverage of the 1969 Investment Code.

E. Investment Guarantees

The Tunisian Constitution of 1959, in its preamble and first seventeen articles, guarantees certain fundamental rights and freedoms. In its ennumeration of such rights, the constitution generally restricts itself to political rights and makes little reference to those of a social or economic nature.

The 1969 Investment Code and Law No. 81-56 (and its predecessor Law No. 74-74) set forth a range of guarantees to the investor that provide for:

1. Non-discrimination and equality of treatment for foreign investors (Article 6, Law No. 69-35; Article 3, Law No. 81-56.
2. Stability of preexisting rights (Article 3, Law No. 69-35; Article 26, Law No. 81-56).

No such provisions are specifically set forth in Law No.72-38.

F. Dispute Resolution

Both the 1969 Investment Code and Law No. 81-56 provide for procedures for the settlement of disputes between investors and the government. The procedures are as follows:

1. According to any existing bilateral agreement concerning investment protection between Tunisia and the investor's home country.

2. According to the Convention for the establishment of an Arab investment guarantee organization (ratified by Law No. 72-4, October 17, 1972).

3. According to the International Convention for the Settlement of Investment Disputes between States and Nationals of Other States (ratified by Law No. 66-33, May 3, 1966).

No such provisions are specifically set forth in Law No. 72-38.

International Trade Preferences

Tunisia is a party to bilateral trade agreements with the governments of at least thirteen different Arab countries. The trade preferences vary from those setting forth most-favored nation guarantees (e.g., Egypt, Sudan) to those establishing duty-free treatment of specified manufactured products (e.g., Morocco, Bahrain) assuming a certain minimum percentage of Tunisian labor or components in the exported product. Moreover, as Tunisia is an associate member of the European Community, products with a Tunisian certificate of origin are entitled to certain trade preferences when exported to member countries of the Community. As such, trade agreements may provide a significant incentive to investment. A more detailed review of the agreements and their effect should be done at the earliest possible opportunity.

The entry of Spain and Portugal into the EEC threatens Tunisia's export preferences to the EEC, particularly for olive oil. The GOT hopes to negotiate maintenance of its current quota of 50,000 metric tonnes per year.

Comparative Advantage

The June 29, 1983 IBRD Review of the VIth Development Plan used a coherent set of necessary product characteristics to arrive at the following list of exports for which Tunisia should have a distinct competitive advantage edge over existing suppliers to European markets:

1. Phosphate and related chemicals
2. High fashion, quality garments
3. High fashion, quality shoes priced between Italian shoe prices and, Far Eastern and Brazilian ones.
4. Engineering products, particularly electrical and electronic machinery, equipment, etc.
5. Fertilizers
6. Flowers

While the GOT seems in general agreement with these findings, investors do not seem to have the same set of priorities. The GOT is currently considering revising the 1981 law to liberalize certain investment incentives retaining requirements only in the area of employment and to adopt policies to encourage industry specific investment. The construction of three or four privately managed, fully developed industrial parks in the underdeveloped high priority regions of Tunisia is an idea under preliminary consideration by API. These parks would be focused on attracting both foreign and domestic owned companies of varying size. The parks would not, as presently conceived, be "free trade zones" though companies could engage in "bonded-for-export" production.

Disincentives

While the GOT has made significant strides in promoting investment, a number of concerns exist. CEPEX, from an institutional standpoint, is not particularly effective. Generally speaking, CEPEX has a bureaucracy that is not dealing with export promotion. While the organization has had missions to Bahrain and Jordan, no market surveys have yet to be financed. Too much desk research is being undertaken. CEPEX needs to work directly with companies; hands-on approach is required. On the other hand, the newly appointed General Manager is quite able and should provide much needed direction for a bureaucracy comprising between 40 and 50 persons.

The rudiments of an Export Credit Insurance program have been established but operations have yet to commence. Such a program is a must and should have been put into operation several years ago. Valuable time has been lost in the effort to promote exports. The Central Bank has claimed that such a program was not needed. The Export Credit Insurance program will be coordinated with CEPEX and API activities.

The impact of Tunisia's tax laws on private investment, despite the exemptions and incentives provided by the investment laws, may be viewed as being inconsistent with the government's general encouragement of investment. Tax laws are complex and vague; no single compilation of the tax regulations exists; and reference must be made to the Ministry of Finance as specific problems arise. As U.S. investors, especially medium-sized companies, may perceive the requirement of individual negotiation of their tax position with a foreign government as too great an unknown to proceed with pre-investment activity. Moreover, Tunisia's policy of taxation of worldwide income of individuals working with the country, whether for export projects or projects for domestic production, may be a significant obstacle to a project's economic viability. As this tax burden will normally be at least partially assumed by the project itself, rather than the individual employee, the Tunisian personal income tax is in effect a tax on the producer, substantially increasing operating costs. This is a disincentive to those investors who might be considering Tunisia as one among several investment locations. When Tunisia's investment incentives are compared to those in Malta, Morocco, Spain, Portugal, Egypt, and Ireland, they are comparable or even better, except with respect to the expatriate tax issue. The Tunisian government is aware of the negative effect that such a taxation policy has especially on U.S. investment in Tunisia. Several proposed tax reforms measures are presently at various stages of study and develoment with the Government. The reform closest to adoption would alter the calculation of this tax for U.S. employees of petroleum exploration companies and off-shore banks. Tax reform proposals for other industries are at more preliminary stages.

Another relative unknown is future Tunisian wage and fringe benefits levels. Any company operating in Tunisia with ten or more employees is subject to the contractual agreements reached between the owners' and labor unions. In the past there had been no GOT pressure on these negotiations to link wage and fringe benefit increases with gains in productivity. It will be of interest to see how effective the GOT's recent pronouncements favoring wage/productivity ties will be on current contract negotiations.

While the climate for exporting and importing has improved with recently implemented streamlined procedures for gaining GOT authorization, the remaining bureaucratic complexities and paperwork required for exporting and importing can still result in costly delays in production and lost export sales. Generally speaking, customs does attempt to be responsive to investor needs. However, problems of communications do arise. In that event, the investor should go to one of the 23 branch offices established by API, which were set up to deal with these kinds of issues.

Greater incentives are furnished to investors settling away from Tunis. While no tax exemptions are provided for settlement in Tunis, 90 percent tax exemptions for ten years may be provided for concerns settling in the more remote areas of the country. The problem with this policy is that it has not been especially successful and it has been a significant drain on the public coffers.

Other disincentives exit.

- Every investment, irrespective of size or character, needs some form of approval for benefits from incentives.

- In the past, maintenance had been neglected because of a lack of incentives. However, starting this year maintenance expenditures will receive the same incentives as new construction for all export operations and for domestic enterprises during the first year of their operations. Nonetheless, after the first year for domestic enterprises, maintenance investments will not be as attractive as new investment.

- Although exports need to be promoted to generate needed foreign exchange, incentives are not as generous for pure home market operations.

- The GOT does not encourage domestic enterprises to establish linkages with foreign firms. This may have a negative impact on technology transfers from abroad. On the other hand, incentives are furnished to foreign firms to establish join ventures with local firms.

- A concern needs to secure approval from the Central Bank prior to establishing sales operations abroad.

- Difficulties have been encountered in getting rebates of customs duties paid on imports when goods are subsequently exported. The exception is those goods imported under the "temporary admissions" import regime.

- Problems do exist with respect to country of origin certificates for the assembly in Tunisia of semi-finished products of EEC origin prior to export to EFTA countries, in spite of the convention that does exist between the EEC and Maghreb states, including Tunisia.

- While the GOT does provide for sufficient "handholding" of investors after the approval stage, sometimes companies do run into problems; they have not consulted the branch offices established by API.

- Foreign exchanges controls are indeed a problem.

- Incentives increase with increases in prospective employment up to 150 jobs. Above 150 jobs, incentives do not vary. The problem, however, is that the system as constituted, discriminates against the small concern. Enterprises with under 10 employees were excluded from benefits. Generally speaking, small concerns are especially labor-intensive. This problem is magnified by the significant unemployment in the country.

- Investment incentives should be made more generous for concerns providing greater domestic value added. Incentives do not increase with increases in value added. On the other hand, for a concern to receive incentives, domestic value added must be at least 40 percent. This is a relatively steep requirement at least by Caribbean standards.

Finally, in spite of the efforts the GOT has made in encouraging investment, the French philosophy of government as it existed during the first part of this century has had and continues to have a large influence on the Tunisian perception of the role of government ~~with~~ the country's economy. Frequently, there is a knee-jerk reaction of the GOT to become involved in what should be a strictly private sector activity. The willingness to reduce its control and involvement over many areas of economic activity which could better be handled by the private sector is often difficult for the GOT to do.

Areas of Potential USAID Intervention

There are three specific areas where USAID intervention can assist in the continued development of the private sector in Tunisia. First, the continued improvement of the investment climate in Tunisia should be the target of intense, well-aimed policy dialogue and the strengthening of related Tunisian institutions. Second, development and enhancement of Tunisian management and operational skills can be accomplished through programs of technology transfer and assistance. Finally, there is a continued need to expose and educate American business to the benefits which may be realized by investment in Tunisia. USAID in conjunction with the Agency for Investment Promotion (API) should expand their investment promotion activities aimed at attracting U.S. companies. The Mission is presently planning an evaluation of its ongoing private sector promotion activity in mid-1985 which will identify specific areas of future involvement and sub project design.

Conclusion

The Tunisian Government has a real interest in developing its private sector and is interested in diversifying its traditional trade relations with Europe by attracting more American business enterprises to Tunisia. Over the years, European manufacturers in substantial numbers have realized the advantages of moving labor intensive operations to Tunisia. The same advantages, including the fact that Tunisia is an Associate Member of the European Community, are now being actively presented to American businessmen. Moreover, Tunisia's access to Arab markets is greatly facilitated by the presence, with its diplomatic connections throughout the Arab world, of the Arab League Headquarters in Tunis. This combined with the fact that Tunisia is a member of various political and economic groupings in the Mediterranean region heightens the desirability of the country as a site for commercial and manufacturing activity.

Proposals

A. Based on the results of a soon-to-be-released IBRD study on the country's industrial investment incentives and incorporating the concerns noted above, rework the incentive system.

B. Remove any GOT impediments, including bureaucratic procedures, that frustrate investment.

AGRICULTURE

In relation to other sectors of the economy, agriculture has been declining. Agriculture is now contributing a smaller portion of GDP and providing proportionately less employment opportunities. Nonetheless, agriculture still contributes about 16 percent of GDP and provides employment for almost 33 percent of the "economically active" work force.

The GOT "socialist experiment" in the 1960s had an especially adverse impact on the sector. The GOT pursued systematically a course of transforming private farms into cooperatives and collectives. At the height of the experiment, almost 90 percent of arable lands were either collectivized or controlled by the GOT. This policy resulted in a decline in production of most basic commodities during the 1960s. Total value added by agriculture dropped by 30% between 1965 and 1969. After the abandonment of this policy in 1969, production began to recover. (The GOT today only controls 10 percent of arable lands.) Overall, value added increased by 91 percent between 1969 and 1972, but progress thereafter has been slow. By 1972, grain production was about 2.5 times the average of the late 1960s, but in the early 1980s was still at the early 1970s level. Growth during the Fifth Plan Period (1977 - 1981) was virtually nil. Growth in the first two years of the Sixth Plan period was also poor--actually down 10 percent in 1982/3 due to drought--but up almost 12 percent in 1983/84 despite poor weather for cereal crops.

Major products consist of cereals--hard wheat, soft wheat, and barley; fruits and vegetables--citrus fruit, dates, tomatoes, red peppers, potatoes, melons and watermelons, and almonds; grapes--table and wine; olive oil; and other--meat, sugar beets, milk and fish. Agricultural exports totaled 147 million Tunisian Dinars in 1984. The most important are olive oil, fish, dates, citrus, wine and almonds. Imports far exceed exports, with foodstuffs imports totaling 290 million Tunisian Dinars in 1984. Major imports include hard wheat, soft wheat, sugar, soybean oil, maize, milk and tea.

Tunisia has 5 million hectares of land cropped regularly or intermittently. However, yields are limited sharply by low rainfall, low soil fertility and poor cultural practices. The Southern region, 60 percent of total land area, is sparsely populated, primarily by nomadic herders, with some grain and tree crops. Grain yields are extremely low, averaging 1-3 Qx/ha. In the Central region, which has between 200 and 400mm average annual rainfall, cereals are more important but yields are still very low and livestock, is a major source of income. Annually, most of the cereal is grown in the Northern region, which has 400 to 1300 mm of rainfall, but here too yields are low, typically only about 15-18 Qx/ha. This region, with 20 percent of total land areas, produces 70 percent of the cereals, about half the livestock, milk and vegetables, and almost all the grapes and citrus. In a typical year, cereals occupy about 1.5 million hectares, olives 1.4 million hectares, and other tree crops 300,000 hectares.

Farm size as well as income distribution is sharply skewed. Livestock tends to be concentrated on very small farms. Illustratively, in 1975, 60 percent of the cattle and sheep were reported to be owned by farmers with 10 hectares or less who together had about 18 percent of the land.

Table I: DISTRIBUTION OF FARM LANDS

Farm ~~Land~~ Size Hectares	Percentage of Farmers	Percent of Agr. Land
0-2	21.50	1.6
2-5	23.10	5.9
5-50	51.48	57.9
50-200	3.60	24.1
200+	0.42	10.5

A number of obstacles are impending agricultural production, including (a) marketing and input supply, (b) credit, (c) land tenure, (d) irrigation and (e) selected crop specific issues. Although no longer a major issue, in the past price controls have been a significant problem.

Agricultural marketing and input supply is not well organized and hampers rural development. Public marketing and input supply enterprises exist for cereals, pulses, olives, wine, meat, fertilizer, seed and farm machinery, and several public development authorities participate in the collection of milk, fruit and vegetables. They tend to be slow in responding to market signals and in distriubting farm inputs. Farm inputs are usually not available in the quantities required at the time required. These problems are partly caused by lack of efficiency and partly by GOT price policy which does not permit these enterprises to generate sufficient financial surpluses to finance their own investments. Thus, they must solicit government budget transfers which are often not furnished on a timely basis. These problems are also caused by conflicting objectives given to public marketing and input supply enterprises, including GOT policies to (a) subsidize consumption of basic foodstuffs and farm inputs, (b) assure supply of food to consumers while promoting exports, and

(c) collect crops from farmers and supply them with inputs without an adequate budget.

Private marketing and input supply enterprises had not been permitted to legally compete with public enterprises for certain commodities (the marketing of cereal and olive oil, and the distribution of high-yield cereal seed). However, a parallel private market for these commodities had been tolerated on which small scale trading operations had occurred. Official price margins between purchase and resale of fertilizers and cereal seed were not increased between 1970 and 1982 and became sufficiently narrow that they forced private distributors out of this activity. More recently, the GOT has been working to stimulate better fertilizer distribution (encouraged by A.I.D's PL 480 self-help provisions). Private dealers and cooperatives are now receiving greater incentives, through increased margins, to establish outlets.

The GOT also is establishing an Agricultural Promotion Institute whose objectives are to increase efficiency of GOT-owned marketing and processing enterprises, to promote investments by the private sector, and to develop marketing cooperatives. An especially important area requiring reform is farm mechanization and the GOT is also moving ahead in this area. The existing subsidy and tax structure for farm machinery will be reformed; access to credit for farm machinery will be facilitated; and the services of the public farm machinery enterprises will be improved.

The agricultural credit system has major drawbacks. One, several lending programs with different appraisal criteria, lending terms, and lending procedures co-exist. Perhaps the most significant drawback, this creates confusion and discrimination and produces needlessly high administrative costs. Two, only about 15 percent of farmers are now receiving funds, although as many as 90 percent have loans outstanding. Three, credit is often inefficiently used due to low interest rates, encouraging the use of credit for non-productive purposes including consumption. Large farmers were recently denied access to the subsidized credit schemes forcing them to turn to commercial banks where lending rates range as high as 10.5 percent. The high lending rates encountered by large farmers, however, are being offset, at least partially, by GOT subsidization to the extent of 3.5 percent of the interest owed to banks. In any even, we expect to see little furthe r rationalization of interest rates; the GOT sees agriculture as a high risk and low profitability occupation. Any upward adjustments will be very gradual. Four, loan recoveries are low (30 to 60 percent depending on default risk borne by the credit institutions). Loan recovery rates, however, should be going up in the future; the GOT now has at its disposal increased ability to for e close and seize lands.

Tunisia's land tenure system constrains the development of agriculture. Most farms are extremely small (68 percent have less than 10 hectares) and fragmented (70 percent have 2 or more separate parcels). Much of the farm land is owned by absentee landlords and cooperatives both of which often utilize the land poorly and inefficiently. Few farmers have land titles and no legal protection for tenant farmers exists, discouraging investment in the land. All these problems inhibit the introduction of new technologies. In response, the GOT has started taking measures (a) to impose maximum and minimum farm sizes, (b) to consolidate land in irrigation perimeters, (c) to issue land titles and certificates of possession, and (d) to distribute lands that were collectivized to private farmers. So far, however, most action has been confined to the public irrigation perimeters where land consolidation has begun.

While irrigation has contributed significantly to rapid growth of Tunisian agriculture, existing irrigation systems are often not fully utilized. In many large-scale irrigation perimeters, water is under-used owing to poor management, lack of knowledge and experience by farmers, land ownership disputes, absenteeism, difficulty in finding labor, and frequent problems with irrigation equipment and water availability. Water charges cover only 50 to 75 percent of operation and maintenance costs of the irrigation perimeters. As a consequence, the perimeters must rely on GOT subsidies. In addition, irrigation offices are not submitted to financial discipline to induce efficiency. Because financial and staff resources are also used for other activities (distribution of credit and inputs, marketing, research, extension), operation and maintenance do not receive adequate attention. A complicating factor is GOT (a) imposition of maximum and minimum farm sizes on the perimeters and (b) land consolidation efforts. On one hand, farmers with holdings in excess of the maximum, do not wish to give them up. On the other hand, even when offered better land in exchange for current holdings as part of GOT consolidation efforts, the farmers have refused, arguing that their lands were their fathers

A number of commodity specific issues persist.

- For citrus, marketing is a problem. The GOT must (a) identify export marketing, (b) maintain strong quality controls, and (c) promote the product, Opportunities abound for fruit juice if Tunisian can penetrate successfully the EEC market. The Maltaise orange is already treasured in Europe, especially in France.

- With Portugal and Spain's ~~recession~~ accession into the EEC market, Tunisia will have to withdraw from olive oil production. In any case, olive oil is no longer the cheapest oil. The stated GOT policy is that current production levels will be maintained while additional olive tree plantings will be discouraged.

- While price incentives for cereal production are now favorable, input distribution is weak. In particular, seed distribution and development is less than optimal. The less than optimal development relates to extremely strict development laws inherited from the country's metropole France.

- As for livestock, grasslands have not been managed well. The country has placed too much emphasis on feed concentrates and investment in rangelands, as well as rainfed crops, has been insufficient. In addition, imported meats whose production is subsidized by the EEC are offering strong competition to domestic production.

In the past, inadequate price incentives had been the single most important impediment to agricultural production. In the 1960s and 1970s, farmgate prices had been fixed by the GOT -- cereals, industrial crops, olives and wine grapes -- and were adjusted infrequently to account for changes in production costs. Agricultural producer prices in recent years, however, have been increased to levels at or near global lelves. For instance, prices of soft wheat and barley have increased over 200 percent and hard wheat (durum) almost 200 percent. Moreover, prices are now reviewed annually with new prices announced at planting time rather than harvest to permit farmers to respond to price incentives. The higher producer prices together with continued subsidization of fertilizer is now providing a very favorable environment for increased agricultural production, especially grain.

While subsidized inputs, particularly fertilizer, promote production, we remain concerned over the subsidization. Since 1972, fertlizer prices were hiked only once, about 40 percent in late 1982. The subsidies have induced excessive use of inputs and even waste. They have tended to benefit only a small number of farmers because of an inadequate number of sales points and a paucity of domestic supplies. Also, they have generally amounted to only a small percentage of total farm input cost. An exception are irrigated crops (most fruits and vegetables) which profit from heavily subsidized water charges and whose output prices generally speaking are not fixed. Subsidies tend to be provided for the most modern inputs (pure bred cows) rather than cross-bred, feed concentrate rather than other types of livestock feed, irrigation water, fertilizer, pesticides, etc.) A perverse outcome of these subsidies had been the encouragement of production of animal products that are most heavily consumed by middle and higher income groups.

Proposals

A. Ideally, operations in public marketing and input supply enterprises should be discontinued. If domestic politics preclude such an action which, in all likelihood, is the case, private management contracts should be let and the enterprise be made financially viable. The GOT also should look closely at input subsidies with an eye toward their elimination. We, however, are not very hopeful of significant GOT advances here.

B. The various agricultural credit schemes should be consolidated. In addition, agricultural credit rates should be hiked and the GOT should make best efforts to ensure that loan repayments on past credits are made.

C. The land tenure system requires reworking. A study should be commissioned to assist in this regard.

D. Tariffs on water used in agriculture should be set at levels that cover operation and maintenance costs.

E. We welcome the recent actions by the GOT to increase producer prices to levels approaching global levels. Nonetheless, prices should continue to be monitored to ensure that they provide sufficient incentives for domestic production.

F. Commodity specific proposals consist of (~~a~~1) improvements in marketing of citrus and byproducts, (~~b~~2) the discouragement of additional olive tree plantings in light of anticipated competition from Spain and Portugal in olive oil production, (~~c~~3) facilitation of cereal seed distribution and development and (~~d~~4) reduction of emphasis on feed concentrates and enhancement of

investments in rangelands to spur ~~livestock~~ efficient [and]
livestock production.

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ENERGY

The total available domestic supply of energy products amounts to 120,000 barrels per days, including the equivalent of 10,000 barrels per day in natural gas from the El Borma field and others, and 7,000 barrels per day as royalties under the pipeline project. Domestic consumption stands at 70,000 barrels per day, leaving an exportable surplus of 50,000 barrels per day. However, no new substantial oil discoveries have been made since 1970 and consumption is expected to rise by as much as 8 percent yearly. Hence, by the early 1990's, the country conceivably could be a net importer of oil.

Energy is consumed in Tunisia in three forms, including petroleum products, electricity, and natural gas. Petroleum products are by far the most important (67 percent in 1983), followed by electricity (21) and natural gas (12). Petroleum products consist of fuel oil, gas oil, liquid petroleum gas, light oil, kerosene, premium and regular gasoline and jet fuel. The most significant of these products are fuel oil and gas oil. Liquid petroleum gas and kerosene are important items in the budgets of the poorer segment of the population. Electricity consists of low, medium and high voltage; high voltage is purchased by industrial users and private consumers buy low voltage.

The Director General of Energy has overall responsibility for the energy sector in Tunisia. It has two primary directorates -- (a) the Directorate for Production and Research and (b) the Directorate for Distribution and Refining. The state oil and refinery companies as well as the gas pipeline project also report to the Director General of Energy. While also reporting to the Director General, the Société de Maîtrise d'Energie -- Energy Control Company -- has a certain amount of autonomy. It is responsible for (a) technical interventions in energy to consist of audits and implementation of audit findings, (b) the sponsorship of renewable energy options, and (c) training and information.

In recent years, the growth of energy consumption has been slowing. As high as 13.5 percent per year over 1977-80, it stood at but 5.1 percent over 1981-83. Nevertheless, growth of energy consumption has been increasing more rapidly than GDP, implying an estimated income elasticity of 1.8. In addition to an incentive system which favored capital-intensive technology, the rapid growth over 1977-80 in energy consumption can be attributed to price policy, a problem that the GOT is addressing. Growth of energy consumption has been especially brisk in energy-intensive concerns in the industrial sector, including building materials (24.6 percent annually), chemicals (31.9), and hydrocarbon production (12.9).

Growth of consumption of petroleum products, accounting for most energy consumption, averaged 4.4 percent annually over 1981-83. This is in sharp contrast to 12.6 percent annually over 1977-90. Consumption of petroleum products actually fell 5.4 percent in 1984. Of all petroleum products, consumption of liquid petroleum gas and fuel oil has been the most brisk. Households have been substituting (a) liquid petroleum gas for kerosene and (b) fuel oil for electricity generation, and cement production has been rising. On the other hand, high prices of gasoline limited its consumption growth to under four percent annually.

Electricity consumption has been rising more rapidly than petroleum products consumption. Over 1981-83, consumption increased annually 8.4 percent, in comparison to 16.8 percent annually over 1977-80. On an annual basis, peak demand is up 13.4 percent, and the number of customers has been rising 11.4 percent. Of total electricity sales, high-voltage, medium-voltage, and low-voltage account for 23, 45 and 33 percent, respectively. Sales to high-voltage consumers have increased most rapidly with an average annual growth-rate of 24 percent as compared to 15 percent for medium and low-voltage consumers.

As for the future, the annual growth of energy consumption is expected to average between 5 to 8 percent annually.

USAID has been furnishing assistance to the GOT in energy under a program which has been highly successful. The program consists of three elements: (a) analyses of consumption by sector, (b) energy audits, and (c) renewable energy options.

In the analysis of consumption, sectors to be emphasized cover (a) commerce and institutional, (b) residential, (c) agriculture, (d) industry, and (e) transport. Reports for agriculture, industry and transport already have been completed. In undertaking these reports, primary focus was on gas oil and fuel oil, which together account for well over two-thirds of domestic consumption. These sector surveys have come up with interesting results. Some examples are worth noting. One, according to the report on agriculture, agriculture accounts for but five (5) percent of total energy consumption, implying that the sector should not be a major focus of any GOT activities. Two, a small quantity of gas oil is consumed by industry; the product also is utilized in agriculture, transport, and housing for heating. Three, fuel oil is primarily taken up by industry.

With AID financing, energy audits in selected key industries were undertaken. Ten (10) major plants were identified, consisting of cement, phosphates, steelwork, paper, sugar, chemical fertilizer, and brick, among others. These ten plants account for 10 percent of total domestic production and 20 percent of all energy consumption in the country. Follow-on French technical assistance is now helping these plants to take action, especially in the area of maintenance. Poor maintenance has produced sizable energy losses in the past.

Appropriate pricing policies are essential to achieve an optimal level of (a) energy consumption and (b) energy substitution towards more economic sources. Considerable progress has already been made in this respect. Nonetheless, more needs to be done.

The GOT is interested in energy conservation. For instance, a goal of its latest development plan was equalization of domestic and international prices by 1986; prices had been subsidized. Prices have been raised regularly and substantially. Over 1970-83, real price increases have averaged annually for light oil (1.4 percent), premium gasoline (1.7), gas oil (3.7), fuel oil (11.5) and medium and high voltage electricity (0.9) with most of the increases having taken place since 1976. On the other hand, during the period, real prices fell on an annual basis for liquid petroleum gas (-2.6 percent) and low voltage electricity (-1.7). Prices of all petroleum products were raised in 1981 and 1982. In February 1984, gasoline prices were hiked 13 percent and gas oil 10 percent. At the time, prices of other products were not increased. At the end of November 1984, energy prices were again hiked, this time across the board. Price rises included light oil (11.4 percent), liquid petroleum gas (11.1), fuel oil (13.4), kerosene (10.0), premium gas (5.6), regular gasoline (5.9) and gas oil (12.5).

Today, average domestic prices on a weighted basis including taxes are, at least, at 80 percent of corresponding international prices. At the end of the first quarter of 1984, domestic prices, as a percent of global prices, totalled for liquid petroleum gas (73 percent), kerosene (44), premium gasoline (202), light oil (54), gas oil (89), fuel oil (58), and natural gas (67). Premium gasoline is roughly double the world price, and the price of gas oil, the most important energy product in the country, is near global levels. On the other hand, prices for liquid petroleum gas and kerosene, items looming large in the budgets of the poor, are still less than global prices. Also, average electricity tariffs are approaching economic costs; they are at least 86 percent of global levels.

Other reforms are envisioned. Specific measures are to be introduced in the public enterprises sector to decrease energy consumption and investment policy will be restructured to reduce the number of high energy-consuming projects.

Some inefficiency in the energy sector, nonetheless, exist. Private consumers appear to be subsidizing industrial users. Such a policy dampens private energy consumption, but artificially stimulate energy use in industry. The policy, thus, runs counter to not only any energy conservation strategy, but an employment creation strategy; it unduly stimulates the creation of energy and capital-intensive industries to the detriment of labor-intensive ones. For both petroleum products and electricity, private consumers are charged well above world market prices while industry purchases its energy at highly subsidized prices. For instance, although gasoline is sold at over twice the world market price, fuel oil can be purchased at but sixty percent of the international price. While low voltage electricity is sold at over 40 percent above its economic cost, high voltage is subsidized by about 15 percent. The policy for electricity, however, appears to have a rational basis. The cost of distribution is much higher for low voltage.

The state oil company today sells oil at a highly subsidized price to the state-owned refinery. The subsidization of the state-owned refinery is of recent vintage. Prior to 1973, the state oil company did not subsidize the oil refinery. However, with the massive OPEC oil price hikes and failure on the part of the state oil company to adjust prices charged to the refinery accordingly, the state oil company is now subsidizing the refinery. The refinery in turn, sells its refinery products at a low price to the distribution companies. At that point, the GOT imposes heavy excise taxes on the refinery products. This pricing system is administratively cumbersome. Moreover, it gives misleading information to final consumers. Final consumers feel that the excise taxes more than offset the subsidy; with the exception of gasoline this is simply not true.

Industry accounts for over 45 percent of all hydrocarbons consumed in Tunisia and over 60 percent of electricity generation. Preliminary audits, financed by AID, indicate that the potential for energy savings in industrial plants could range from 10 to 20 percent of present consumption. Up to now, Government has relied on pricing to induce conservation by raising the prices of energy (petroleum products, gas and electricity). However, this policy has two main shortcomings. One, since the prices of industrial products (cement, paper, steel, etc.) are not allowed to increase in line with higher energy costs because of price controls, the profits and cash flow of companies decrease, eroding their ability to undertake major investments to improve or update energy technology. Two, since most of the energy-intensive industries are publicly owned, little incentive exists to conserve or reduce energy consumption. Thus, energy price increases are absorbed through lower profits or even deficits which the Government seems willing to accept.

To complement efforts to conserve energy, the GOT needs to encourage petroleum exploration, recognizing that the probability of discovering a relatively large reserve is small. However, little headway has been made so far in promoting additional exploration. The GOT must rely on foreign companies and foreign companies are reluctant to intensify exploration. They (a) have a perception that the laws presently governing production sharing provide inadequate incentives, (b) encounter delays in forging an agreement with the GOT on a compensation package once oil is discovered, and (c) are subject to foreign exchange controls. Also, expatriate tax rates are high. A significant breakthrough, however, is being made; a new law is to be introduced. In addition to reducing the expatriate tax rate in the oil industry, the law will provide added flexibility. A better deal will be furnished to the oil or natural gas producer seeking to develop a field where prospects for oil are, at best, problematic.

Proposals

The GOT has made progress in rationalizing the energy sector. We especially welcome the interventions in pricing and the new legislation which will give added encouragement to energy exploration. As for the future, the GOT should continue to seek to align domestic energy prices with global levels. In this regard, the prices of liquid petroleum gas and kerosene, products consumed by the poor, will have to be monitored carefully. The GOT should seize any opportunities that may arise to adjust gradually the prices of these two products toward global levels. Industry energy tariffs also should be raised. This would promote conservation in the industrial sector and, in limiting stimulus to energy and capital intensive industries, encourage employment. In addition, the GOT should eliminate any policies that are impediments to energy conservation such as price controls, the existence of parastatal enterprises, etc.

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