Policies to strengthen trade competitiveness in Tunisia

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Abstract

The Euro-Med Agreement between Tunisia and the European Union resulted in free bilateral trade for industrial products from January 1st, 2008. The stepwise dismantling of industrial tariff barriers *vis-à-vis* Tunisia's main trading partner without encountering major disruptions in the domestic market is a significant achievement. But now a new challenge looms. In order to achieve the economic growth rates of 6.1 percent that the country is aspiring to in its 11th Development Plan, policy makers and private sector operators will have to shift from a stance that is focused on defending domestic interests against import competition to an offensive strategy that enables Tunisian exporters to take part and benefit from dynamically evolving global markets. Indeed, strengthening Tunisia's export performance is a major challenge and requires attention to the incentives that actual and potential exporters face, the efficiency of service providers in the economy, and the effectiveness of trade support institutions that help private sector firms to discover and exploit international market opportunities.

Keywords

Tariffs, services trade, incentives, regional integration, trade support institutions

JEL Classification

F13; F14; F15; O24

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1. TOWARDS AN OFFENSIVE TRADE STRATEGY

Tunisia's trade policy is on the verge of a fundamental paradigm shift. After independence, the country pursued a policy of import substitution that shielded domestic producers from international markets behind high trade barriers. In 1972, the government started to attenuate the strong anti-export bias of the restrictive import regime by creating an "off-shore" regime to attract foreign direct investment for export-oriented production, and during the following two decades preferential trade agreements were negotiated with countries within the Mena region and beyond in order to integrate with partners on a selective basis. The Euro-Med Agreement with the European Union is arguably the most important of the country's preferential trading arrangements, resulting in free bilateral trade for industrial products by January 1st, 2008. Indeed, the stepwise dismantling of industrial tariff barriers *vis-à-vis* Tunisia's main trading partner without encountering major disruptions in the domestic market is a significant achievement. But now a new challenge looms. In order to achieve the economic growth rates of 6.1 percent that the country is aspiring to in its 11th Development Plan, policy makers and private sector operators will have to shift from a stance that is focused on defending domestic interests against import competition to an offensive strategy that enables Tunisian exporters to take part and benefit from dynamically evolving global markets.

Over the past 25 years, many developing countries have managed to increase the well-being of their population and reduced the incidence of poverty by taking advantage of opportunities in international markets. Some have benefitted from the discovery, exploitation, and (recent) price surge for fuel and commodities, while others have gained strongly following structural transformations in the transition from centrally planned to market-based economies. Yet, even among the non-fuel exporting, non-transition countries, there is a sizeable number of economies that have achieved sustained long-term growth. Indeed, sixteen of these countries managed to more than triple their GDP between 1980 and 2005, which corresponds to an average annual growth rate of more than 4.5 percent. [1]

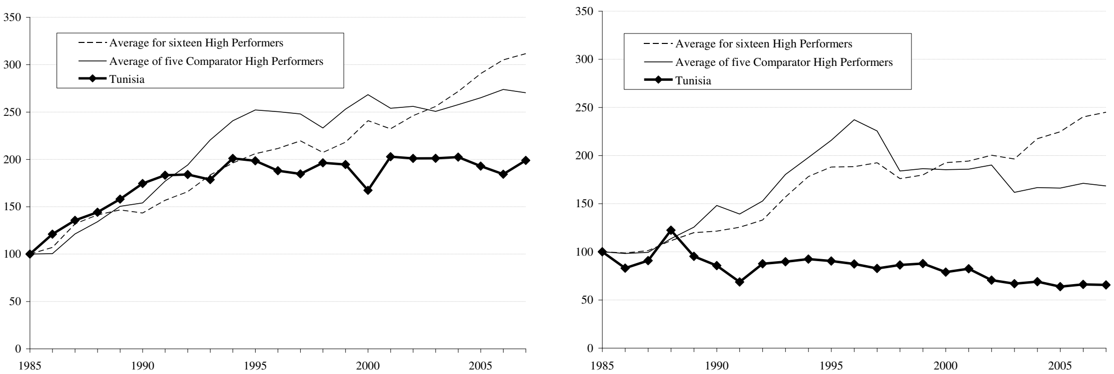
The success of the High Performers has been based on an export-oriented strategy. Such an outward-looking paradign seems appropriate for most developing countries, given the generally limited size of the domestic market that does not make it possible to take advantage of benefits of economies of scale and competition-driven productivity gains. Jones and Olken (2005) find that growth take-offs are strongly associated with a large and steady expansion of international trade. In fact, the sixteen High Performers pursued a strategy of export-led growth and increased their share of world non-fuel merchandise exports and world services exports substantially over the past two decades (Figure 1a).

[1]. The 16 High Performers are Botswana, Burkina Faso, Cambodia, Chile, China, India, Indonesia, Korea, Malaysia, Mauritius, Pakistan, Singapore, Sri Lanka, Taiwan, Thailand, and Uganda. Five of these countries (Chile, Malaysia, Mauritius, Thailand, and Sri Lanka) can be seen as direct middle-income comparators for Tunisia.

Figure 1: Tunisia's share of world exports has been stagnant

a) Share in world non-oil goods exports (1985 = 100)

b) Share in world services exports (1985 = 100)



Source: World Bank staff based on IMF World Economic Outlook databases.

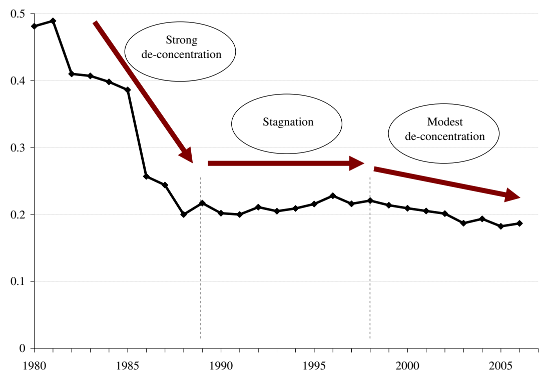
In contrast, Tunisia's export performance has been mixed. The country's share in world services exports has declined over the past two decades (Figure 1b), and the loss of market share has accelerated since the beginning the new Millenium. In contract, Tunisia has maintained its share in world goods markets since the mid-1990s, the apparel sector has resisted well to increasing world market competition following the phase-out of the Multi-Fibre Arrangement, and non-tradional export sectors, such as car parts and electronics, have been gaining traction. Moreover, after the push towards export diversification seemed to have petered out during the 1990s, the structure of exports has gradually been becoming more diverse over the past decade, reflecting the shift into new production activities (Figure 2a). Also, Tunisia exploits an increasing, yet still relatively small fraction of the potential markets for the country's export products (Figure 2b).. Brenton and Newfarmer (2007) derive an index of export market penetration (IEMP) that measures the extent to which a country is actually exploiting its geographical market opportunities from the existing set of export products. For the given range of products that a country exports, the IEMP will be higher for countries that reach a large proportion of the number of international markets that import those products. Countries that only export to a small number of the overseas markets that import the products that the country exports will have a low value of the index.

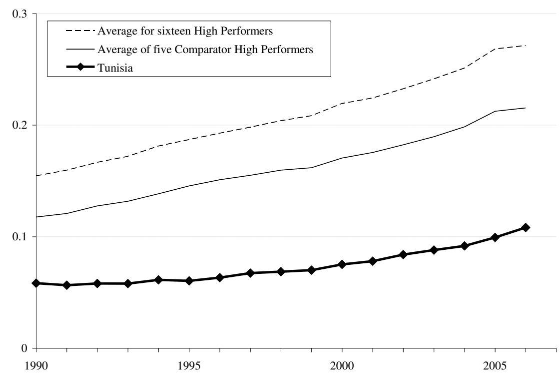
The uneven and overall unspectacular export performance has not resulted from external factors that temporarily reduce competitiveness. Instead, the comparison with the group of high performers, many of which have a similar exposure to terms of trade and commodity price effects as Tunisia, suggests a gap in the capacity to take advantage of international market opportunities. Addressing these shortcomings in Tunisia's export performance is a major challenge and requires attention to the incentives that actual and potential exporters face, the efficiency of service providers in the economy, and the effectiveness of trade support institutions that help private sector firms to discover and exploit international market opportunities. These three aspects of export competitiveness and economic integration will be discussed in turn.

Figure 2: Tunisia's goods exports remain concentrated

a) Concentration by product (Herfindahl index *)

b) Concentration by export market (Index of export market penetration **)





Note: *) higher means more concentrated.
**) the index is the ratio of all product/market export relationships a country has, divided by the potential number of trade relationships if the country was to export its products to all countries that import these products (higher means broader market penetration).
Source: UNCTAD Handbook of Trade Statistics, and Brenton and Newfarmer (2007).

2. THE INCENTIVE REGIME NEEDS TO ALLOW FOR FLEXIBLE ADJUSTMENT

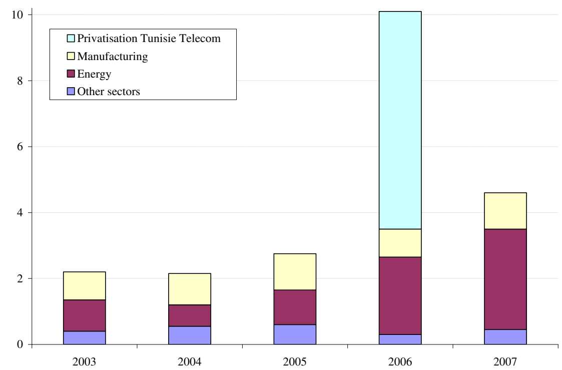
Improving export performance will require movement of capital and labor resources from less productive firms to more productive exporting companies. Also, resource mobility will facilitate the export of higher quality products, which will tend to have a somewhat different input mix than traditional or lower quality products. Finally, resources need to be flexible enough to allow the emergence of new export activities, including in non-traditional services. Hence, a key challenge for policy makers is to ensure that land, labor, capital and technology are moving to (a) sectors in which the country has a long-term capacity to compete and (b) to the most productive firms within sectors. This necessitates a clear understanding of how the business environment and trade and tax policies interact to affect investment, output and trade decisions.

The Tunisian authorities have played a useful role in helping the private sector cope with increased import competition from European supplier. The government has accompanied the opening of the industrial sector with the implementation of a "*mise-à-niveau*" upgrading program, aimed at enhancing the organizational, technological, and marketing capabilities of firms that were being gradually exposed to competition from EU-based producers. In parallel, efforts were made to promote trade development through electronic documentation processing (Tunisia Trade Net), as well as streamlined technical controls, improved customs procedures, and increased access to information on standards and technical regulations.

Tunisia has also been relatively successful in creating an environment that is attractive for export-oriented foreign investors. Inflows of FDI have continued to be strong, and the privatization receipts from the sale of *Tunisie Telecom* pushed the FDI stock to GDP ratio above 70 percent in 2006 (Figure 3). However, the FDI inflows have been concentrated on only a few sectors, notably energy and telecommunications, and foreign investment into agriculture and manufacturing has been relatively low. The challenge, hence, is to attract more FDI into goods production.

Figure 3: FDI inflows remain strong

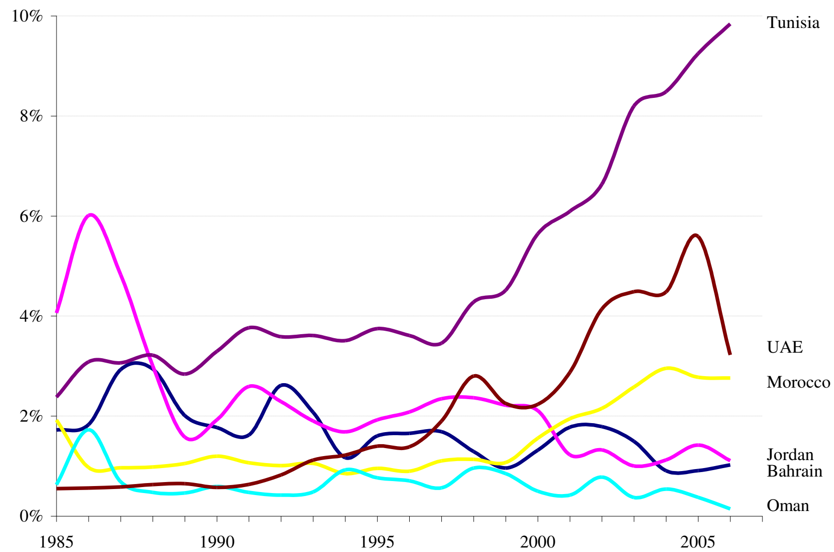
FDI inflows to GDP (%)



Source: IMF.

There are some encouraging signs, though, as some of the recent FDI has stimulated the emergence of cross-country networks of suppliers. Over the past two decades, such networks have been established in the car industry in Eastern Europe and in electronics in East Asia, and have significantly contributed to the international economic success of these regions. The systems of interrelated suppliers take advantage of inter-country wage differentials within the region, short transport distances, and economies of scale from specialization (Haddad, 2007). In Tunisia, the increased participation in EU automobile production networks has led to double-digit growth rates of exports of engineering and electrical components and a doubling of the share of mechanical and electrical engineering products in total exports from 9.5 percent in 1995 to 19 percent in 2006. Exports of parts and components, which can be seen as a proxy for exchanges in production networks, has expanded more dynamically in Tunisia than in other Mena countries (Figure 4).

Figure 4: Exports of parts and components have increased dynamically
(Share of parts and components exports in total exports)



Source: World Bank (2008b).

On the other hand, among import-competing firms there remains a wide-spread perception of discrimination and of a skewed operating environment. In particular, access to land, including agricultural land, remains difficult, and firms that sell into the domestic market often complain about stringent restrictions to worker dismissal, anti-competitive practices and the unfair advantages of informal competitors that do not pay tax and social security contributions. In a recent Enterprise Survey, about 60 percent of firms operating in the domestic market denounced anti-competitive practices such as implicit agreements, discrimination among clients and linked sales (IEQ 2006). While Tunisia's competition laws seem in line with international standards, implementation issues remain. Moreover, the ongoing institutional dualism between the export-oriented offshore and import-competing onshore sectors generates numerous administrative and regulatory inegalities that contribute to the reluctance of domestic firms to engage in investment.

There are a number of sector-specific regulations that are a hindrance to investment and export growth. A recent microeconomic study of several key export sectors highlighted the adverse impacts of elaborate production and investment regulations (LINPICO, 2008). The market for olive oil, for example, is controlled by the Office National de l'Huile (ONH), which maintains a marketing monopoly. Prohibitions of olive oil imports make blending impossible, administered prices impede enterpreneurial activity, and mandatory quality controls through ONH add to production costs. As a result, private investment to upgrade the downstream sector has been discouraged and about 95 percent of olive-product exports occur in raw form. In a similar vain, the dominant position of the Centre National d'Informatique, onerous procurement practices, and late payment on government contracts have made it difficult for small and medium-sized IT firms to establish a record of reference projects that makes it possible for them to acquire foreign clients and export their services.

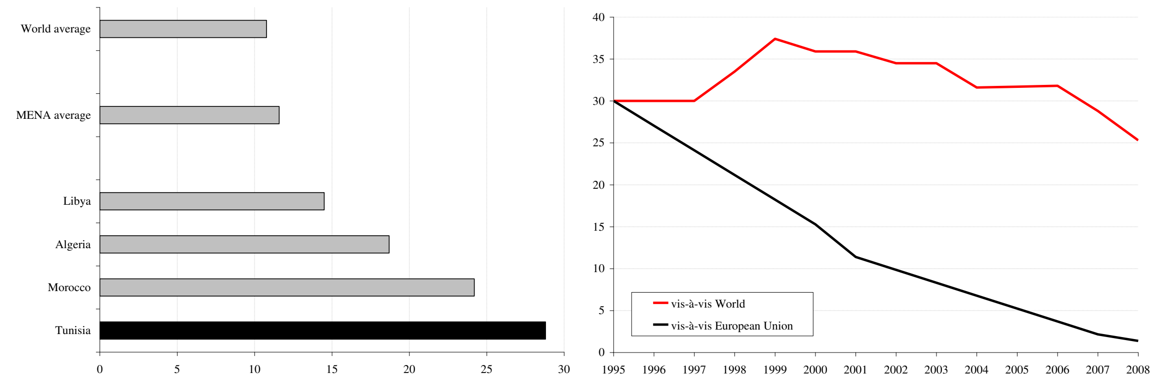
The government is aware of the complexities and distortions of its incentive and regulatory regime and, as exposure of domestic firms to EU imports has grown, has, for example, gradually reduced the differences between the offshore and onshore sectors. Tariffs on raw materials, equipment and capital goods were reduced or eliminated, the use of export promotion tools and funding was extended to onshore firms, the onshore corporate tax was reduced from 35 to 30 percent, the top-VAT rate was suppressed and the remaining rates re-aligned, and VAT reimbursement rates were increased to 100 percent. In parallel, offshore firms were allowed to sell up to 30 percent of their production in the domestic market when complying with the onshore fiscal regime on that proportion. Moreover, the recent law on economic initiative, promulgated in December 2007, is intended to foster a more investment-friendly business environment by simplifying administrative procedures, facilitating financing, and reducing the tax burden. These measures complement initiatives in tax administration aimed at improving the quality of services for taxpayers.

Border procedures and taxes are also undergoing reform. Customs formalities are being comprehensively streamlined, with the objective of reducing the total holding period for merchandise from 9 days in 2006 to 3 days in 2009. The tariff regime is similarly being simplified. The number of tariff bands was reduced stepwise from 54 in 2003 to 9 in 2008. Over the same time period, the simple average of most favored nation tariff rates was cut by more than 9 percentage points. These efforts to shift towards a less complex and more open import regime are in line with developments in the region and world-wide.

Yet, Tunisia's tariff policy remains highly distortive and has arguably become even more so with the preferential liberalization vis-à-vis the EU. The average import tariff is the highest in the Maghreb region and more than twice as high as the Mena and world averages (Figure 5a). Moreover, the move to free trade for industrial products with the EU has introduced a substantial wedge between the duties that imports from the EU and those from third countries are subject to (Figure 5b). In the extreme, imports from third countries are liable to duties of 43 percent, while the same product could enter the Tunisian market from the EU duty free.

Figure 5: The tariff regime remains distortive

a) Average MFN import duties (%), 2007   b) Evolution of EU-preferential and MFN tariffs (%)

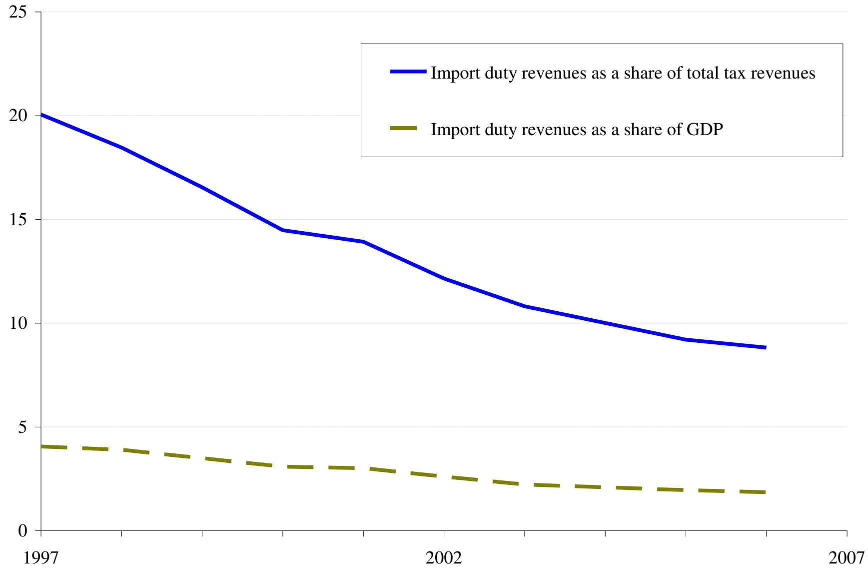


Note: Averages calculated as simple mean of tariff lines at the HS 6-digit level. Calculations include customs duties and surcharges
Source: International Monetary Fund, and national authorities.

The large preferential margin granted to EU exporters provides strong incentives for trade diversion, as well as for illicit activities. With high external trade barriers, there is a risk that trade is diverted from low-cost third country producers (e.g. Indian suppliers of pharmaceutical generika) to high cost EU producers (e.g. European suppliers of branded pharmaceuticals). The tariff wedge is also susceptible to foster smuggling and fraud related to certificates of origin. In order to avoid or contain the ensuing fiscal and economic losses, the process of reducing MFN tariffs should continue and be re-enforced with the aim of providing economic operators with a viable choice of domestic or foreign suppliers based on product price and quality rather than on considerations of particular customs regimes.

Fiscal constraints should not represent a major obstacle for further tariff reform, due to the limited importance of trade taxes for government finances. The share of import duty revenues in total tax revenues has fallen from more than 20 percent in 1997 to less than 10 percent since 2005 (Figure 6). In fact, because of preferential agreements, duty exemptions, and investment incentives, the implied average tariff from customs collections is at about 2.7 percent of import value (data for 2007) significantly below the average listed rate. Hence, the fiscal risks from further tariff reform seem manageable. Indeed, lowering MFN duties might generate additional revenues by triggering increased imports from third countries to replace duty-free shipments from the EU.

Figure 6: Tariff revenues have lost in importance
(in percent)



Source: World Bank, World Development Indicators.

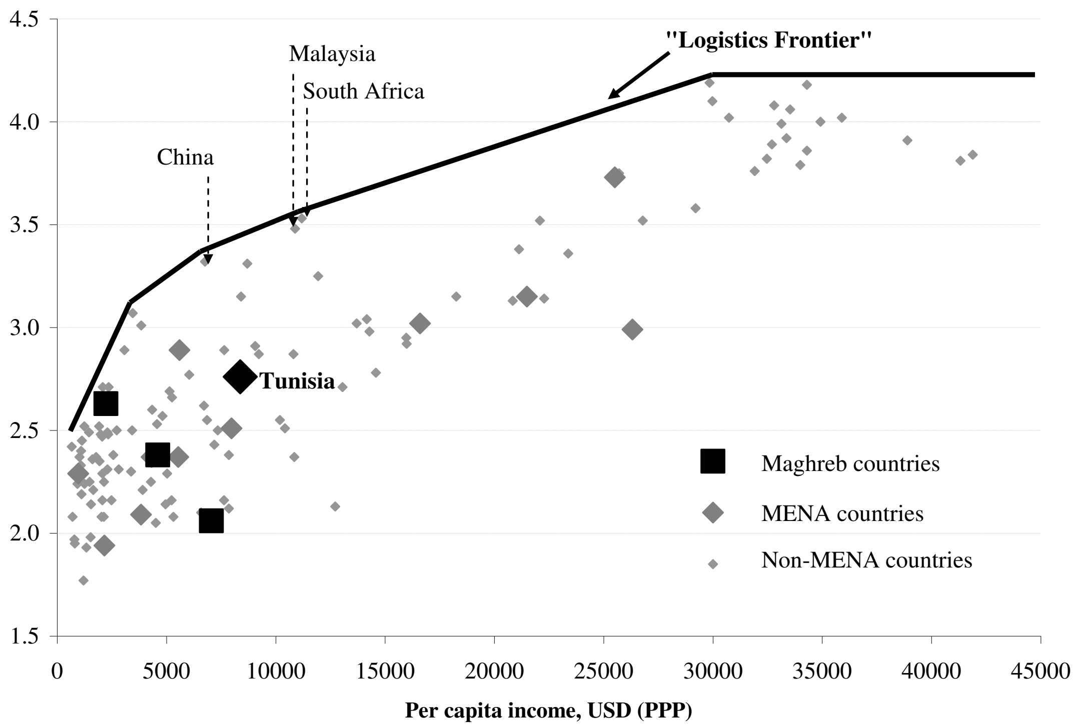
3. Efficient Backbone Services are Key for Success

Of great importance in today's globalized economy is that domestic firms have access to efficiently produced backbone services inputs. Firms that have to pay more than their competitors for energy, telecommunications, transport and logistics, finance and security will find it hard to compete in both the domestic and overseas markets. Export diversification into products of higher quality will tend to increase the importance of activities that require the more intensive use of these backbone services than traditional activities. Moreover, the globally rapidly expanding exports of services rely heavily on the use of other services as inputs.

For a country like Tunisia whose competitiveness is closely linked to its proximity to its main export market, i.e. Europe, efficient transport logistics are of paramount importance. In fact, Tunisia scores quite well with respect to several transport and trade facilitation dimensions of the newly developed Logistics Performance Index (World Bank, 2007b), which is based on a world-wide survey of global freight forwarders and express carriers. The country is perceived as having the best transport and trade logistics in the Maghreb region, is not very far behind the much richer Mena countries of the Gulf peninsula, and scores better than the world-wide average of countries in its per capita income range. However, Tunisia's logistics performance falls substantially short of that in countries that are the best in its income range, such as China, Malaysia, and South Africa (Figure 7). Several of these "frontier" countries are direct competitors in major export markets, so that the gap in logistics performance constitutes an important disadvantage that merits policy makers attention.

Competition in the textile and clothing industry has already substantially intensified since the end of the quotas under the Multi-Fibre Arrangement. Labor costs in Tunisia are lower than those of some Eastern European countries and Turkey, but significantly higher than those of their Asian competitors. Hence, the future of the clothing sector in Tunisia depends on its exporters' ability to better exploit the locational advantages vis-à-vis the European Union (World Bank, 2006). Proximity allows buyers and suppliers to build strong relationships and permits a better understanding of customer preferences. Firms can be competitive in exporting time-sensitive, replenishable products to the European market because their inventory costs and risks are lower than those of distant suppliers. They can exploit focus on products that must be replenished quickly during the selling season. Reducing lead time—the time required from receipt of an order to shipment to markets—is therefore a key priority to resist competitive pressures from Asian clothing suppliers.

Figure 7: Tunisia scores well on logistics, but remains far from the frontier
(Logistics Performance Index, higher is better)

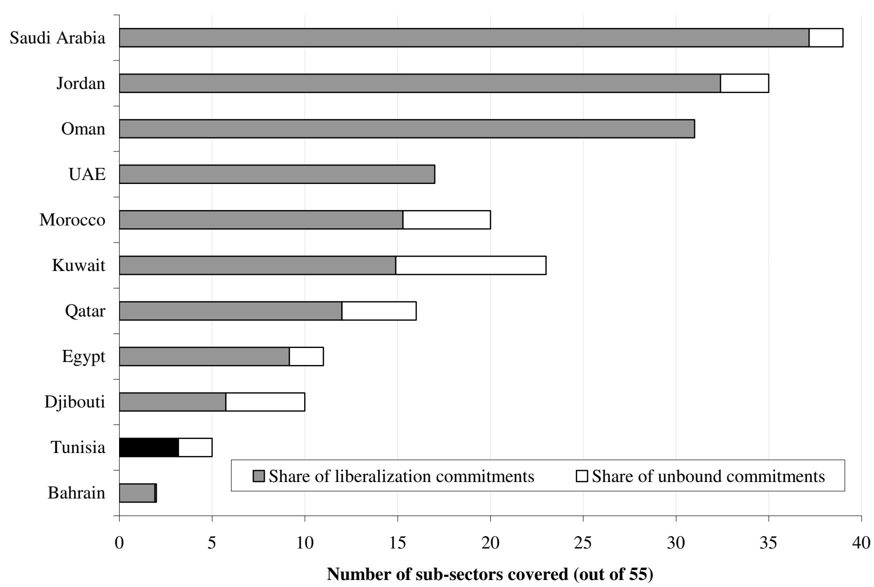


Source: World Bank (2007b).

Moreover, to realize the growth objectives of the 11th development plan, exports will likely have to grow by 12-15 percent annually, which might lead to the emergence of serious bottlenecks in trade and transport infrastructure. A recent study highlighted the absence of a deepwater port, the lack of warehousing space and logistics platforms, the fragmentation of road transport services, and the weak state of professional education and training in logistics as major constraints to export-led development (Newton-Vaureal Consulting and COFINTER, 2007). The regulatory framework might also need to be developped with the aim of facilitating and encouraging the implantation of foreign logistics services providers in Tunisia. The recent success of Morocco in attracting large-scale industrial investments based on major new infrastructure developments illustrates the importance of efficient logistics operations for the location decisions of multinational firms and export growth.

More generally, greater openness of backbone services to trade and investment could invigorate the Tunisian economy, as the experience of some segments of the telecom sector (mobile) has shown. Tunisia has undertaken a gradual opening of backbone services sectors to competition among private and public service providers, but many entry barriers still hinder activities of foreigners. Up to now, the country has no free trade agreement that covers services. Multilateral liberalization of services under WTO's General Agreement on Trade in Services has been very limited with only three sectors (tourism, telecom and financial sectors) included in the GATS Uruguay Round schedules. This coverage compares poorly with other countries in the region (Figure 8). While some of the services sectors not included are quite open (e.g. maritime transport), entry into many others is restricted. For instance, all trading activities, including wholesale distribution and retail trading services, are reserved for enterprises in which Tunisians hold a majority interest. For several other services activities, foreign investment requires the prior agreement of the *Commission Supérieure des Investissements* (CSI – Investment Commission) if the foreign participation exceeds 50 percent of the company capital (e.g. in insurance). Finally, the measures affecting the presence of natural persons (mode 4) remain unbound, with the exception of wholly exporting enterprises that can recruit up to four executives and managers of foreign nationality.

Figure 8: Tunisia has engaged in few GATS liberalization commitments

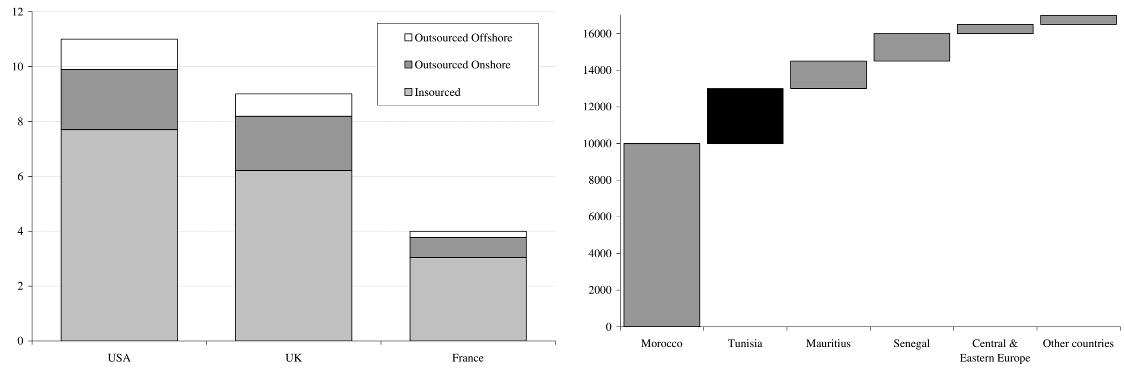


Source: World Bank (2008b).

Tunisia is well positioned to benefit from dynamic developments in trade of professional and ICT-enabled services. In particular, the country's geographical and cultural proximity to Europe, its established commercial ties, and its strong French-speaking communities make it the destination of choice for "near-shoring" by French and other francophone companies. The outsourcing of back-office and information technology functions in order to take advantage of advanced skills and lower labor costs is not as prevalent yet in francophone Europe as in anglophone countries, so that ample room for catch-up growth in the demand for these specialized services exists (Figure 9). But taking full advantage of these emerging opportunities requires a strategic approach that establishes an internationally oriented regulatory framework for the professions, continues to upgrade and expand specialized training, and encourage structural consolidation of service providers to gain economies of scale.

Figure 9: Tunisia is well placed to benefit from catch-up growth in outsourcing

(Call center seats per 1000 inhabitants) (Call center seats serving francophone clients)



Source: Roland Berger Strategy Consultants, 2006.

Nationality requirements have a particularly negative impact on medical tourism. A good international reputation is key for success, so that attracting blue chip reference investors from abroad is of substantial importance for the development of the sector. Restrictive regulations on the establishment of foreign medical providers (with the exception of more lenient rules for off-shore clinics and medical training) are in this context counterproductive to the stated objective of FDI promotion. In other areas, Tunisia's regulatory framework for the medical profession does not appear to pose particular impediments to medical tourism, even though a review of existing rules to adjust them to the needs of medical services trade seems warranted..

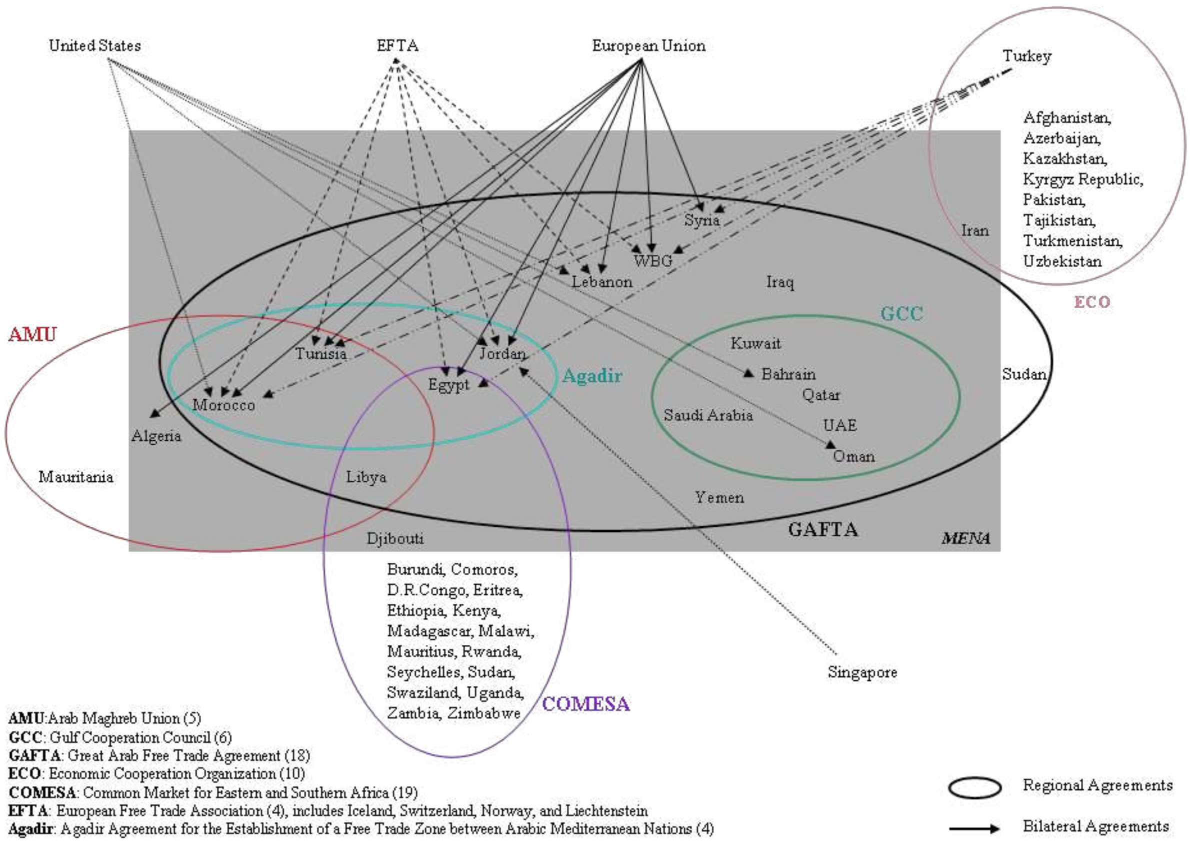
The ongoing bilateral negotiations with the EU on services in the context of the Euro-Med Agreement have considerable potential. They offer the opportunity for Tunisia to secure better market access for its services providers to Europe. In particular, a relaxation of restrictions in obtaining visas and mutual recognition agreements for diplomas and professional qualifications with some EU countries would be of major interest for Tunisian services exporters.

4. Trade Support Institutions Can Play a Useful Role

Both market and government failures tend to afflict developing countries as they seek to expand exports and growth. Laissez faire policies are often not sufficient to prompt dynamic export drives or overcome obstacles in other areas. In many cases these constraints to competitiveness impinge more on higher quality and differentiated products and require specific interventions and institutions.

Tunisia's past institutional approach to international integration can be summarized as gradual and largely preferential. The country has signed a number of bilateral and regional trade agreements and the focus has been on slowly and partially integrating with preferential partners. However, progress with negotiated duty reductions has often been compromised through the use of non-tariff barriers, such as technical norms or restrictive rules of origin. Moreover, the multitude of Tunisia's preferential agreements forms a veritable spaghetti bowl of intertwined relationships and overlapping associations (Figure 10), and the implementation of the agreements' provisions poses an enormous administrative challenge since they have different implementation schedules, varying product coverage, and distinct rules of origin. Partly because of the high transactions costs, trade with preferential partners other than the EU has not been very important for Tunisia.

Figure 10: Tunisia is at the center of a dense network of preferential agreeements



Note: Only major agreements are depicted.
Source: World Bank (2008b).

Pro-active export policies have rested on several pillars in Tunisia. In addition to the geographically neutral offshore regime, the government created several spatially confined special economic zones since the early 1990s, notably the ones in Bizerte and Zarzis. Similar to offshore producers, firms in the special zones are entitled to a number of incentives, such as an exemption of taxes on profits or incomes, a suspension of the VAT on local purchases, an exemption of reinvested profits, duty-free imports of necessary raw materials and equipments, flexible labor contracts ("limited duration contract"), and a One-Stop-Shop to facilitate administrative processes.

Moreover, in order to help emerging exporters overcome information and other market failures related to penetrating new markets, the government created several trade-

support institutions. These include CEPEX (Centre de Promotion des Exportation), which provides a one-stop shop for exporters, implements the export promotion strategy under the Ministry of Trade, manages the computerized trade database Trade Net, and organizes training missions, in-country fairs, and exhibitions. In addition, the government in collaboration with the World Bank in 2000 established FAMEX (Fonds d'Accès aux Marchés d'Exportations) to provide matching grants to emerging exporters with export potential, firms exporting new products, and exporters seeking to penetrate new markets. FAMEX also provides co-financing to professional associations such as export associations, chambers of commerce, and professional consulting organizations in order to make it possible for these entities to support groups of Tunisian firms in the development of their export programs.

Government assistance in the area of export financing is available through the World Bank sponsored Pre-Shipment Finance Guarantee (PEFG) program. PEFG seeks to encourage financial institutions to provide pre-shipment working capital financing to emerging exporters with viable export contracts by bearing a part of the nonperformance risk. It thereby aims to alleviate the asymmetry of information between banks and exporters regarding ability of the latter to execute export orders according to buyers' standards of quality, cost, and delivery. PEFG got off to a good start, but the performance of the facility deteriorated markedly following a change in management six months after its launch (Alavi 2007). The coverage and outreach of PEFG declined and banks lost confidence in the facility. Many banks reverted back to ex ante evaluation of nonperformance risks, which not only delayed the financing process, but also increased administrative costs and substantially reduced outreach to emerging exporters. The disappointing experience highlights the importance of strong and credible management for institutions that aim to be catalysts for export growth.

Experiences in Latin America suggest that attention to program incentives and networking effects is crucial for success of export promotion efforts. For example, Macario (2000) identified policies that determined successes and failures in Brazil, Chile, Colombia, and Mexico. On the basis of interviews with successful exporters, she sets out a set of recommendations for export promotion agencies: they should be directed at firms with new products or who are entering new markets; they should emphasize cost-sharing to ensure that programs are used only by those truly dedicated to export; support should be given for a maximum of 2-3 years so that it does not turn into a subsidy; programs should be submitted to external evaluation; and agencies work best when they are subject to a mix of public and private management. More recently, Alvarez (2004) provided evidence from a survey of 295 small-and-medium-sized sporadic and permanent exporters in Chile on what type of program, institutional set-up, and financing is more likely to succeed. While trade shows and trade missions did not affect the probability of being a successful exporter, a program of exporter committees turned out to have positive and significant impacts. These committees were composed of groups of firms with common objectives in international business, which cooperate on research, marketing and promotion.

5. MAKING GLOBAL INTEGRATION WORK FOR TUNISIA

The earlier discussion highlighted a number of issues that ought to be addressed in order to make better use of Tunisia's export potential. A corresponding set of policy reform priorities that warrants the attention of policy makers is listed below:

- Reduce MFN tariffs to limit adverse effects from trade diversion and the growth of parallel markets.
- Strengthen the competition authorities and the implementation of pro-competitive regulations.
- Continue the process of aligning offshore and onshore regulations, including with respect to administrative aspects.
- Review investment restrictions in services sectors, with a view to facilitate the participation of foreign investors.
- Encourage investment in modern warehouses and logistics platforms, and develop specialized logistics education and training programs.
- Pursue the planned development of a new deep water port, and streamline trade procedures in the ports in cooperation with private sector operators.
- Consider alleviating the nationality requirement for entry into the medical, accounting, legal, and engineering professions.
- Develop a services exports strategy and improve surveyance of services sector activities and trade, including by strengthening the statistical apparatus.
- Improve services coverage in (future) trade agreements, and harmonize provisions in free trade agreements.

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