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All in the family: State capture in Tunisia

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ABSTRACT

We examine the relationship between entry regulation and the business interests of former President Ben Ali's family using firm-level data from Tunisia. Connected firms account for a disproportionate share of aggregate employment, output and profits, especially in sectors subject to authorization and restrictions on FDI. Quantile regressions show that profit and market share premia from being connected increase along the firm-size distribution, especially in highly regulated sectors. These patterns are partly explained by Ben Ali's relatives sorting into the most profitable sectors. The market shares of connected firms are positively correlated with exit and concentration rates in highly regulated sectors. Although causality is difficult to establish, the results are consistent with the hypothesis that the Ben Ali clan abused entry regulation for private gain at the expense of reduced competition.

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1. Introduction

The potential for regulatory abuse is well known. Countries with more cumbersome entry regulations have higher levels of corruption and are less developed, yet do not have better public goods (Djankov et al., 2002; Ades and Di Tella, 1997). While these patterns may in part be explained by limited administrative capacity in developing countries, they have also been associated with capture by special interests. Political connections account for significant market value in traded firms (Fisman, 2001) and are especially prevalent in countries with weak rule of law (Faccio et al., 2005). Nonetheless, microeconomic evidence on capture of investment regulation remains limited in spite of in-depth theoretical analysis of the nexus between corruption, rents, and regulation (see e.g. Stigler, 1971; Shleifer and Vishny, 1993, 1994; Bliss and Di Tella, 1997; Ades and Di Tella, 1999; Acemoglu and Verdier, 2000).

To help fill this gap in the literature, this paper documents the association between the business interests of President Ben Ali and his family and entry regulation ordained in the Tunisian Investment Incentives Code, *Code d'Incitations aux Investissements* (hereafter referred to as the investment code). The investment code is the main investment legislation governing economic activity in virtually all sectors of the economy with the exception of mining, finance and domestic commerce. Two clauses in the code restrict investment in some sectors, notably (i) authorization requirements obliging investors to obtain permission from the government to run a business, and (ii) restrictions on Foreign Direct Investment (FDI). These entry regulations are potentially susceptible to abuse, as they can create market power by stifling competition both from prospective entrants and incumbents, and/or steer foreign funds to particular firms. Should such capture occur, it is arguably most likely in sectors subject to both these type of restrictions, where entry regulation is most arduous.

To assess the relationship between entry regulations and state capture, this paper assembles a database on political connections, firm performance and entry regulation. Using the Tunisian firm census, we identify 662 firms owned by the Ben Ali family that were confiscated in the aftermath of the Jasmine revolution.[1]

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[1] As the firms are directly linked to the Ben Ali family, we use "Ben Ali firms" and "connected firms" interchangeably to refer to these firms.

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These data are merged with administrative data from the tax authorities, containing balance sheet information. We also create a database of entry restrictions ordained in the Investment Incentives code.

The resulting dataset enables us to document the association between the severity of entry regulation and the performance of politically connected firms, which public choice theory predicts to be positively correlated (Stigler, 1971; Peltzman, 1976; McChesney, 1987; De Soto, 1990; Shleifer and Vishny, 1993,1994). By virtue of spanning the universe of registered firms, it allows us to analyze how the prevalence of political connections and the returns to them vary across the distribution of output and profits. Moreover, it enables us to assess how competition evolved as the Ben Ali family expanded its business empire, and whether potential adverse impacts on competition associated with this expansion were more pronounced in sectors subject to entry regulation.

Tunisia provides a pertinent case study to assess the link between regulation and state-business relationships. Like many other developing countries, Tunisia has a development strategy predicated on extensive state intervention. The Ben Ali family's involvement in the economy was well known, and Tunisia's investment promotion agency advertised his close interactions with the business community as enhancing public welfare. In part because Tunisia registered stable positive growth rates hovering around 4–5% per annum, Ben Ali also had a fairly favorable external image. The World Economic Forum repeatedly ranked Tunisia as the most competitive economy in Africa and the IMF as well as the World Bank heralded Tunisia as a role model for other developing countries. Yet, the Tunisian model had serious flaws; unemployment and corruption were high over the period studied, and contributed to Ben Ali's downfall. Last but not least, Tunisia has a high-quality firm census, and authorities willing to grant access to data on both firm performance and political connections.

The first step in the analysis is showing the importance of Ben Ali firms in the Tunisian economy and the link with entry regulations. While only 0.2% of all private firms reporting positive output and employment were connected, they accounted for 5% of private sector output and appropriated 16% of all net private sector profits.[2] These contributions are to a large extent driven by the performance of Ben Ali firms in sectors subject to authorization and restrictions on FDI. Connected firms are approximately four times more likely than non-connected firms to operate in such sectors, and are important players in these sectors, accounting for 11% of all jobs, 43% of output, and 55% of net profits, in spite of accounting for only 0.9% of all firms. In other sectors, by contrast, they account for 1% of employment, 1.2% of output and 3.3% of net profits. Within the sample of sectors covered by the investment code that we analyse, 88% of connected-firm net profits originate from the highly regulated sectors; in contrast, unconnected firms receive only 17% of their net profits from the highly regulated sectors.

Second, quantile regressions show that the market share and profit premia on being connected rise along the distribution; connections are most valuable for the largest and most profitable firms, which make disproportionate contributions to output and profits. This heterogeneity helps explain why weighted OLS regressions that take into consideration the contribution of each firm to aggregate job creation, productivity, or profits, tend to result in higher estimates of the aggregate Ben Ali premium then conventional unweighted OLS regressions.

Third, the premium on being connected is shown to be especially large and significant amongst firms at the top end of the market share and profits distribution in sectors subject to authorization and FDI restrictions. As a consequence, the aggregate Ben Ali profit and market share premia are significantly higher in such intensely regulated sectors, with the results driven by a handful of firms in each sector. The superior aggregate performance of connected firms in these sectors is consistent with state capture (Stigler, 1971) and obtains using measures of both the *de jure* and the *de facto* severity of entry regulation.

Fourth, while these findings are robust to controlling for sector fixed effects, the premium on being connected reduces when these are controlled for, suggesting that the connectedness premia are in part driven by connected firms sorting into lucrative sectors with high barriers to entry. Still, at the top of the firm-size distribution, controlling for sector fixed effects, Ben Ali firms continue to have greater market shares and higher profits in highly regulated sectors, consistent with the largest Ben Ali firms benefiting from regulatory capture.

Fifth, examining the relationship between the expansion of Ben Ali firms and competition at the 5-digit sector level shows that growth in the aggregate market share of Ben Ali firms was associated with higher concentration and higher exit rates in sectors subject to authorization requirements and restrictions on FDI. Greater Ben Ali presence was thus associated with attenuated competition in these sectors.

These findings contribute to the literature in a number of ways. While causality is difficult to establish, to the best of our knowledge this is the first paper to document microeconomic evidence on the association between entry regulation and the performance of politically connected firms. Moreover, we demonstrate that the premium on being politically connected is highly heterogeneous and highest for the largest firms. This may help explain why previous studies, which have tended to focus on relatively large firms such as publicly listed enterprises (see e.g. Fisman, 2001; Faccio, 2006; Ferguson et al. 2008), often find large returns to being politically connected. Moreover, they underscore how a relatively limited number of connected firms can have a marked impact on aggregate outcomes, thus contributing to the growing literature on firm granularity following Gabaix (2011). Moreover, our paper is among the first to establish a correlation between political connections and competition indicators. Finally, the paper aids our understanding of the causes of the Arab Spring. Among the complaints common to all Arab Spring protests are the established system of cronyism, which rewarded an elite few, and a demand for social justice. While media reports abound, very little quantitative information exists on the prevalence and economic significance of state-business relationships in the region with the notable exception of Chekir and Diwan, (2012) and Acemoglu et al. (2014), who study listed firms with political connections in Egypt.[3]

The remainder of this paper is organized as follows. The next section describes our data and the Tunisian Investment Incentives Code. Section 3 presents descriptive statistics demonstrating connected firms accounted for a disproportionate share of output, employment and jobs, especially in sectors in which entry is highly regulated, those subject to authorization and FDI restrictions. Section 4 presents the results of our analysis of firm

[2] Since we identify only firms with direct links to the Ben Ali family, as opposed to all firms with cultivated connections, this number is probably best interpreted as a lower bound on the importance of political connections. These estimates are not out of line with previous studies of the economic significance of connected firms. For example, in his study of firms with connections to the Suharto regime, Fisman (2001) observes that the 25 business groups he identifies account for approximately a third of Indonesian GDP. Similarly, Ferguson and Voth (2008) argue that firms with ties to the Nazi regime accounted for three quarters of stock market capitalization in Nazi Germany. A key difference with these studies, which have focused on publicly listed firms, is that we focus on the universe of firms and almost exclusively on firms with family ties to the Ben Ali regime.

[3] In addition, in a companion paper Rijkers et al. (2015) demonstrate that connected firms in Tunisia were more likely to evade import tariffs.

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