Tunisia’s Upcoming Challenge: Fixing the Economy Before It's Too Late

→ Ishac Diwan
During its first years of transition to a democratic order, Tunisia’s efforts were predominantly focused on addressing political challenges. The performance of the country in this regard has been generally positive, as it has managed to consolidate democratic gains despite challenges related to the polarization of politics around identity and religious issues, the rise in insecurity related to attacks by extremist groups, and even the general disenchantment of voters for the existing political elites. However, the gains on the political front came at the expense of economic setbacks. One of the main challenges for the coming period will thus be largely economic. High unemployment, unfulfilled demands for social justice, the rise in corruption, and most importantly in the short term, an unsustainable macroeconomic trajectory, all threaten to upset recent political gains. If the upcoming administration does not address them, social discontent would endanger the hard-won democratic gains.

The many economic challenges ahead

The Tunisian economy is not in good shape. It had been hit early on after the 2011 revolution by several negative shocks, including a collapse in tourism (especially after the rising insecurity of 2012-13, and the terrorist attacks of 2015-16), the loss of the Libyan market, and a fall in the production of phosphates and oil, due to badly managed work-related disputes in state-owned enterprises. Moustapha Nabli evaluates these losses at 6% of GDP lost per year on average compared to 2010, and 14% of GDP lost relative to the GDP trend that existed in 2010.¹

These are very large magnitudes. Many countries get hit by shocks when undergoing political transitions, yet, they often recover rapidly. Studying countries that went through political transitions, especially those in Eastern Europe, Freund and Jaud found that growth dipped for four years on average following political change before it recovered.² Early in a transition, policy emphasis is typically on the political side, which tends to be the leading concern. But Freund and Jaud found that in countries where the economy deteriorated considerably and durably, like in the former Soviet Republics, political progress became harder to achieve, with the risk of such countries being caught in a transition trap.
Tunisia faces such a risk today. On paper, the country has all the ingredients needed to develop a high growing economy, as earlier done by the East Asian Tigers, including an educated middle class and closeness to the large EU markets. But economic underperformance has been pervasive under Ben Ali’s regime, with the country inability to realize its potential ultimately triggering the 2011 revolution. This situation has not improved after the revolution; instead, new maladies have appeared. In particular, four aspects are worth highlighting.

First, while some measure of expansionary fiscal and monetary policies to counteract the initial negative shocks made sense right after the revolution, the financial situation of the country, notably its elevated levels of public spending, has by now become clearly unsustainable. Between 2011 and 2018, public expenditures rose from 24 to 30% of GDP, while tax revenues rose much more modestly, from 23 to 25% GDP over the same period - see Table 1. As a result, public sector deficits rose, especially during the most recent period (2015-18) where they were at more than 5% of GDP every year. Being financed by domestic and foreign debt, this both crowded out domestic investments, and led to an exploding public debt, which rose from 40% GDP in 2010 to 73% GDP in 2019. In parallel, large balance of payment deficits, financed by foreign debt, pushed the external debt to shoot up from about 40 to 85% of GDP between 2010-2019. If debts keep rising at such rates, not only would interest payments continue to crowd out other public expenditures, but the risks of larger devaluations, inflation, and as a result lower standards of living will also rise. Sooner or later, the external debt will become unsustainable, and a painful and forced mega-adjustment in the fiscal and external balances will be imposed by the financial markets.

Second, and in spite of the expansionary policies, growth rates have not recovered over time, and unemployment has remained high. While this could be explained by the rise of insecurity until 2016, the low growth between 2017-19 suggests that the causes of the malaise go deeper. In parts, the business climate has deteriorated with a perceived rise of corruption and an expansion of informal (and illegal) activities such as contraband. This could be related to a weakening of state capacities to enforce laws, but also, to the rise in cronyism (see more below). As in all economies dominated by cronyism, firms want to be as close or as far from the state as possible. In the case of Tunisia, since the 2011 revolution, private
firms have not increased their investments, and they shifted to less growth inducing rent-filled sectors, such as construction. These trends are especially worrisome as they come on the heels of older structural weaknesses in the Tunisian economy, which traditionally focused more on the creation of labour intensive jobs than on productivity gains and innovation. There has been an active debate on the structural causes of this malaise, which has been related to cronyism and the lack of dynamic competition and innovation, the concentration of skills in the public sector, and the unfavourable trade agreements with the EU. None of these factors have improved, and several have deteriorated over the past years.

Third, the rise in public expenditures has not been accompanied by a sufficient shift towards more useful spending. To increase growth, ultimately, the share of overall expenditures will have to shift from consumption to investment. Instead, even though public expenditures increased by six percentage points between 2010 and 2018, public investment fell over the period (see Table 1), and its effectiveness was hurt by bottlenecks in project execution. The civil service wage bill by contrast rose from 11 to 15% GDP between 2010 and 2018, a level much higher than that of comparable countries (for example, twice the level in Turkey, see Table 2). While one can understand that the state came under pressure to attenuate the shock on households, the particular methods used have not only increased inequality, but they have also created inflexibilities in the budget that will be difficult to undo in the future. Social expenditures rose, too, especially in the more recent years, but this too was achieved in ways that advantaged insiders such as civil servants, as opposed to reducing the glaring regional inequality.

A political economy evaluation

These economic weaknesses can be largely related to the particular political developments that took place, notably the rise of the politics of consensus, which may have been essential from a political point of view but have paralyzed the ability of addressing the important economic challenges facing the country. Ennahdha's victory in the first elections (for a Constituent Assembly), followed by
the difficulties in finding common ground in the writing of the new constitution, and the deterioration in the security situation, created a rising polarization between Islamists and seculars (not unlike in Egypt). After the first full election of 2014, political pacification pushed for the formation of a national coalition government between the two largest parties, Nidaa Tounis and Ennahdha, later formalized in the 2016 Carthage Agreements. While this compromise and power-sharing helped Tunisia avoid some of the pitfalls that affected other Arab countries, from an economic policy perspective, however, the politics of consensus led to myopia and inaction.\(^\text{13}\) None of the two major parties wanted to pay the price of significant economic reforms, including austerity measures, or reforms to level the playing field, given the low probability of benefiting from the resulting economic improvements in the future, as both felt they were in a weak position – Nidaa because of its internal divisions, and Ennahdha because of the deteriorating regional situation (especially after the 2013 coup in Egypt). As the election cycle approached (municipal 2018, parliament and presidency 2019), there were incentives to continue with expansionary policies, as is usually the case in democracies, and especially young ones.\(^\text{14}\)

But if the political parties, driven by their myopic concerns, were unwilling to be disciplined by the prospects of a worsening future, why is it that the main labour union, the Tunisian General Labour Union (UGTT), which, because of its sheer size, could go beyond the traditional role of a labour union and advocate for more responsible policies, instead, continued to push for higher wages even when it became clear that the economic situation was becoming unsustainable? Recent interviews conducted with labour union leaders reveal that while they were well aware of the risks facing the economy, they found the government too divided to be in a position to negotiate credibly on issues of burden-sharing and reform. As a result, it seems that they have preferred to build up their bargaining power in view of future negotiations with a more decisive government.\(^\text{15}\)

Besides macro policy, politics have deeply affected the working of the private sector. There were two mechanisms at play. First, firms that were privileged in the past lost these privileges and became less invested - indeed, the assets of many firms associated with the Ben Ali regime were expropriated.\(^\text{16}\) Second, the investment climate has not yet improved sufficiently to strongly encourage the
emergence of new private actors. Instead, the heightened political competition has pushed parties to seek political finance from firms by offering economic privileges in return. As a result, new interest groups connected to old and new political business, and regional elites have gained prominence.

In the parlance of Lant Pritchett, the "deals space", while becoming more "open", has also become more "disordered".\(^{17}\) Compared to the previous situation then, one can expect gains over time if this greater "openness" allows the capitalistic base to widen, as politicians do not see the private sector anymore as a major threat, as was the case under Ben Ali. But at the same time, like the situation under Ben Ali, the new political regime continues to exert a corrupting influence on the business sector. One can argue, however, that the effects of corruption may be less damaging than in the past as it becomes more "disordered" and less focused on growth sectors.\(^{18}\)

Importantly, useful reforms can move forward under particular circumstances. While the influence of large firms and conglomerates persists, other actors can now also exercise effective pressure. For example, the recent reform of the investment code offered major simplifications relative to the past by reducing the tax differential between onshore and offshore systems, which will increase competition and push for more efficiency. In this case, it was the pressure from the EU (and the classification of Tunisia as non-cooperative tax jurisdiction) that accelerated the process. Still, improved regulations will not be easy to implement in the face of opposition, as seen after the recent reforms of the state owned banks, which were reorganized and recapitalized, but not privatized, mainly because of pressures from the national labour union, which was weary of losing financing for SOEs.

Regional inequalities have become more salient since the revolution, as was evident in the turmoil in Gafsa and Sidi-Bouzid. While nearly a third of the population living in the interior, subsiding on relatively unproductive agriculture, two thirds of Tunisia’s poor live there, and unemployment is much higher than in the richer Sahel region.\(^{19}\) Access to infrastructure is poorer, making it harder for firms to create jobs.\(^{20}\) Social spending did rise since 2010. A sizable increase in cash transfers to poor families had significant impact on poverty. But much of the rise in social spending was related to higher fuel subsidies, which mainly benefit

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richer households.\textsuperscript{21} With the parallel rise in public sector wages, inequality between insiders and outsiders has likely increased, and social grievances, which were at the heart of the 2011 revolution, have remained largely unaddressed.

A final tension relates to the support Tunisia received from the donors' community. While European financial support rose substantially after 2012, the two IMF programmes (in 2013 and 2016) had been disappointing and ineffective in boosting economic performance. In retrospect, it appears that Tunisian politicians were well aware that they had the upper hand at bargaining ex-post with the IFIs, and loan conditions were often broken (especially on the public sector wage bill) with little consequence for disbursements. With moral hazard at full play, international support ended up financing increased consumption rather than investment. At a deeper level, the failure of the international community to more effectively help in the stabilization of Tunisia can be related to its inability to offer, so far, effective incentives for gains on the productivity side, as had been the case with Eastern European countries in transition, which were offered to join the EU market once they had reformed their economies and policies according to European standards.\textsuperscript{22}

**Gains since 2011**

These failures should however not obscure the important gains achieved in the past eight years. One could more generously compare Tunisia’s performance not with Eastern European transition countries, but with Egypt.

On the political front, democracy has taken root in spite of predictable tensions caused by gains of political Islam in the first elections, and identity issues are unlikely to be the main social cleavage in the coming ones. There was a smooth transition after the death of President Essebsi. There was no coup or temptation of one in spite of the collapse in public opinions about the attractiveness of democracy.\textsuperscript{23} The army and security forces have been strengthened, under democratic control, leading to a decline in terrorism.\textsuperscript{24} But these democratic gains remain fragile, especially given the poor functioning of the political system, as reflected in the recent voters’ rejection of traditional parties in the first round of
presidential elections. A further consolidation is likely to require constitutional reforms.

There has also been some modest economic progress. There are hopes of starting to tackle regional inequality with some progress on decentralization and the holding of the first local elections under a new law. To reduce pressure on the current account, Tunisia has allowed its currency to adjust over time, with the dinar losing a third of its value against the US dollar since 2014 – in contrast, Egypt only adjusted when it could not sustain the pressure anymore, with a massive 50% devaluation in 2016. A more informed public freely scrutinizes government and such scrutiny is laying the basis for longer-term reforms – even if such reforms have been slow in coming. In recent years, policies have started to focus on measures to fight corruption, trim the bureaucracy, or reduce tax evasion, and the discussions have moved to issues of ambition and effectiveness. In Egypt, on the other hand, there is very little public understanding among the citizens about the state of the economy, as the mainstream media has become a regime mouthpiece, and the authorities severely limited freedom of expression and association.

On the private sector side, while the situation has not yet improved, one can argue that – structurally – the scaffolding for future progress is now in place. While corruption has risen, its economic impact remains less corrosive than in Egypt. As noted earlier, private investment has by 2018 nearly recovered to its 2010 level. In Egypt on the other hand, larger state deficits and crowding out of domestic finance, plus larger political risk have pushed down total investment to about 13% GDP, the lowest rate since independence. In both countries, cronyism and corruption have weighted down on the business climate. In Tunisia, however, increased cronyism is linked to the need for parties to raise political finance, which impacts growth essentially in rent-filled low growth sectors. Meanwhile, in Egypt, President Sisi, like President Mubarak before him, is wary of allowing private-sector players to gain political clout and has instead propped up army-controlled firms whom he can trust in an attempt to exclude possible opposition from gaining ground in the private sector. Such predation occurs mainly in the growth sectors and is this much costlier from a growth perspective.  

Much of the political gains in Tunisia have been attributed to its middle class, a tradition of moderation, and a dynamic civil society. Still, many observers have
noted a plunge in the popular appeal of democracy in Tunisian opinion polls, which was reflected in the low participation rate in the first round of the presidential election on 15 September 2019. Arab Barometer data shows that by 2016, Tunisia ranked among the lowest in the region on questions related to the attractiveness of democracy, trust in government, and trust in the political parties. Recent research reveals that this phenomenon is closely connected to the high levels of economic insecurity. Tunisians’ disenchantment with their political elite does not seem to translate into support for autocratic, theocratic, or socialist regimes. Moreover, support for the separation between state and mosque has risen over time. But personal trust and social tolerance have taken a big hit, which would weaken civil society if unaddressed in future. All these developments in public opinions and values point to a loss of “innocence”, with the realization that the democratic system requires improvements over time.

Questions for the future

The economic weaknesses described above suggest a large agenda leftover for the next administration, which includes an explosive macroeconomic situation, a challenging structural agenda going from public sector reform (starting with SOEs) to making markets work better, in addition to a social justice agenda focused on the development of the peripheral regions.

In the immediate future, some measures of fiscal stabilization will be necessary. This will be no doubt difficult for any new administration. Politically, questions such as how to adjust fiscal policy to attain sustainability and at the same time foster social justice will require not only the attention of technocrats, but also hard negotiations among politicians and with citizen groups. The social demands for more and better jobs will also remain high, requiring discussion around sacrifices in the present for gains in the future. On this front, the issues of competition and innovation will be particularly important.

The outcome of the upcoming elections will determine the nature of the range of the possible. There is a possibility of electing a weak president and a fragmented Parliament. In that case, much of the challenges of the coming period will
probably reside in Parliament, where solutions will require the building up of reform coalitions and the pressures of a constructive opposition.

But in any case, Tunisia’s democratic transition is likely to make economic policy-making messier. After all, contrary to one-party systems where all initiatives tend to emanate from the top, decisions have now to be negotiated with many actors and take into account competing interests. Yet, as witnessed in many young democracies around the world, "messy" democratic orders are not necessarily incompatible with economic progress. As evident, for example, in Kenya, Ghana, Bangladesh, or Mexico, newly established democracies often manage to perform economically quite well while sitting "on the edge of chaos". The pressure of electoral politics often pushes them to manage to solve some of the important tensions facing the economy, if on an in-extremis fashion. This means that while progress is unlikely to come from state-led development efforts, it may end up being driven forward by the lobbying of an increasingly dynamic private sector and civil society, who will pushed for more performing state and markets, in spite of corruption.

As a result, and while tackling structural weaknesses remains a priority, it is more likely that progress would come from improvements in the workings of democracy. On the reform front, the agenda includes rethinking the rules of the democratic order (power-sharing between the Presidency and Parliament, political finance, methods for local elections), the level of empowerment and involvement of civil society (in particular, in horizontal accountability systems), and the strengthening of independent regulatory agencies. Such improvement will reduce market predation and political risk, generating bottom-up gains even in the absence of state-led industrial policies.

The role of the international community, particularly the EU and the IFIs, will become even more important in the future in stabilizing Tunisia. External financing has started to dry out and there is some level of “Tunisia fatigue” in the international community. But rather than a sole focus on financing, what Tunisia needs foremost is a credible external anchor that helps it to modernize its competition, innovation, trade, and investment systems in ways that provide incentives for its local firms to become globally competitive so as to benefit more fully from the nearby large European market. Equally, an improved regional
security situation in Libya and Algeria will do much to reduce security risks and improve the business climate.

Whether Tunisia will be able to escape a macroeconomic crisis remains very much a question mark. Whether a crisis occurs, or Tunisia is obliged to learn how to live for the next few years on "the edge of chaos", the most important long-term determinant of success will be whether Tunisia has, in its character so to speak, what it takes to resist the maladies of contemporary democracies, which are entrenched cronyism and destructive populism. Both beasts are already showing up their ugly heads. Tunisia’s elections and their conduct are themselves a sign of its progress. This progress should be saluted. But the hard work of governing is just starting.

* Thanks to Nadim Houry, Abdoulaye Sy, and Mustapha Nabli for helpful discussions and suggestions.

Table 1. Tunisia - main macro-economic indicators, 2010-2019

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<td>15.5</td>
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<tr>
<td>Inflation</td>
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<td>16.9</td>
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### Table 2. Cross-country comparison (latest data available)

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<td>Rule of law (high better)</td>
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<td>37</td>
<td>57</td>
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<td>Political stability (high better)</td>
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<td>35</td>
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<td>Size of central government (% GDP)</td>
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<td>Corporate tax rate (percent of profits)</td>
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<td>Public wage bill (% GDP)</td>
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<td>Subsidies and transfers (% exp)</td>
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<td>Public debt (share of GDP)</td>
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<td>External debt (share of GDP)</td>
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<td>33</td>
<td>68</td>
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<td>FDI (share of GDP)</td>
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<td>5</td>
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<td>33</td>
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<td><strong>Doing Business</strong></td>
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<td>Competitiveness ranking (index, low better)</td>
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<td>Control of corruption (index, high better)</td>
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<td>Gini index (index, low more equitable)</td>
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<td>Informal sector (% GDP)</td>
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**Source:** IMF article 4, various years. Note: social spending includes food, transport, and energy subsidies, social protection transfers, and payment to the social security fund.

Sources. Complied, using the most recent available information, from: World Bank
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Endnotes


4. Adding contingent liabilities, such as SOEs losses, and the deficit of the pension system increases this figure to over 150% GDP. Ibid.


6. The unemployment rate was already high before the revolution, at 10% in 2010. It shot up to 19% in 2012, and has since then recovered a bit, hovering at around 15% since, with much higher rates among the youth, and women (Asaad and Boughazala 2018).

7. According to Transparency International, corruption fell between 2012 and 2015, but then rose again, and was in 2018 at the same level as a decade earlier, during the previous regime. Informal activities, while badly measured, are estimated to have risen from 30 to 40% GDP between 2010 and 2018 (Nabli 2019).


11. Many analyses point to the fact that the Euro-Med agreements are not favourable enough to Tunisia and the other Maghreb countries, compared to what was offered to Eastern European countries. These agreements do not include agriculture nor trade in services. As a result, while MENA imports from EU have increased rapidly, exports to the EU have stagnated. Importantly, the impact of the agreements on the development of more sophisticated products intensive in skills has remained limited (Diwan and Mouhoud, 2016).

12. With a Gini coefficient of around 40 percent, Tunisia is considered to have moderately high level of inequality. Recent work reveals that within-region inequality has fallen in the past decade, while the between-region inequality has increased (Amara and Jemmali 2017).


19. The interior here refers to the 11 governorates which are on the western side of the country.

20. For example, 32% of firms report regular electricity outages in the interior, but only 8% in Tunis and the Sahel; and 13% report that transport is a major constraint to their expansion, compared to 7% in Tunis and the Sahel (World Bank Enterprise Survey 2013).

21. By 2015, subsidies reached 24% of total spending, which is equivalent to the combined expenditures on health and basic education. Of these, two thirds went to fuel subsidies.

22. Only in 2017 has the EU started to innovate by proposing guarantees and other financial instruments to support investment and trade.

23. Comparing the behaviour and interest of the armed forces in Tunisia and Egypt largely explain why the latter, but not the former, organized a coup against what was in both cases, highly unpopular governments (Bellin 2013). In Tunisia, military and security spending rose post-2011, while in Egypt, the Morsy regime was trying to reduce the power of the military (Grewal 2019).


27. Such as: “democracy is indecisive and full of problems”; “the economy is weak in a democratic system”; “democracy is ineffective in maintaining stability”; “people are not ready for democracy”.


29. In 2016: 69% responded "absolutely not" when asked if they prefer "a strong ruler that does not consult" represented. 79% responded absolutely not when asked if they preferred "a system that obeys Islamic law; 69% rejected "a system that exclude Islamic parties"; and 64% rejected "a dictatorship that establishes social justice".

30. When asked if "religious leaders should interfere in voters’ decisions in elections" 72% responded “absolutely not” in 2016, compared to 48% in 2013, and 28% in 2011.


34. It is also going to be crucial to allow the constitutional court to start working, as its absence has so far weakened the independent regulatory institutions, and in particular, the anti-corruption commission.
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