MALCOLM H. KERR
CARNEGIE MIDDLE EAST CENTER

OCTOBER 2024

A Path Out of Tunisia's Economic Crisis

Ishac Diwan, Hachemi Alaya, and Hamza Meddeb

During the past year, the authors have been monitoring Tunisia's economic and social situation, and have issued several reports on the dangers ahead. This article closes the year's efforts by evaluating the country's macroeconomic risks and making recommendations for how to avoid them. We have done so by asking what the best course of action would be if Tunisia's leadership were constructive—in other words if decisionmakers were to engage in a genuine reform process addressing its structural economic and financial challenges. This is not naivete. Rather, it aims to share ideas that can help empower activists and civil society actors to push for the type of political change allowing Tunisia to exploit its potential and achieve economic prosperity.

Introduction

Tunisia's economy is characterized by low productivity, a private sector lacking in dynamism, and decay in the state's capacities, which has led to a deterioration in the quality of its services. These maladies have fed social grievances since at least 2011, when Tunisians overthrew president Zine al-Abidine Ben Ali. Today, the financial situation is about to worsen. Dire economic conditions have led to a precipitous decline in confidence, with many youths seeking to emigrate. Growing political contestation, fueled by a flawed electoral process, and long-neglected economic grievances exacerbated by a tightening of budgets, are setting the stage for potential sociopolitical chaos. In recent years, expansionary public spending financed by debt has alone preserved stability, but this process has run out. Public debt levels are now very large, putting more pressure on budgets and making the current path highly vulnerable to a financial meltdown.

What is the path to national salvation for Tunisia's economy? There is a need for belt-tightening since the country is spending beyond its means. However, austerity alone is not the best way forward and risks igniting a social explosion. Instead, economic growth should be at the center of any new reform agenda. Reforms can improve short-term prospects, igniting a virtuous cycle of progress, boosting growth in the medium term. But for this to happen, political reforms are needed to allow for ambitious economic reforms.

Disregarding Macroeconomic Problems Could Lead to a Financial Crisis

Tunisia's primary challenge is its growing debt. This reflects deep structural economic problems, long neglected by successive governments, which preferred to maintain the status quo rather than engage in necessary economic reforms. External shocks have further aggravated the situation, pushing Tunisia to the brink of default. The public debt to GDP ratio has been on the rise since 2011, as fiscal policies have become more expansionary and economic growth has fallen to dramatically low levels—only 0.4 percent in 2023 and a projected 0.7 percent in 2024. By 2024, the total debt of the state, both domestic and external, was approaching a dangerously high 100 percent of GDP, and debt servicing consumed 20 percent of export revenues.

Since 2019 however, several negative shocks have exacerbated the situation. The first was the COVID-19 pandemic in 2020. Growth collapsed by minus 8.8 percent, at a time when expanded public spending coincided with reduced revenues, leading to larger fiscal deficits. More recently, the war in Ukraine raised global prices for fuel and food, which Tunisia imports massively. Subsidies have risen to alleviate the impact on households—from 6.6 percent of GDP in 2019 to 12.5 percent in 2023—widening internal and external deficits and increasing the public and external debts. In 2022, global interest rates rose and yields on Tunisian bonds shot up making it impossible to refinance maturities coming due in the near future. With interest costs now exceeding growth, and fiscal deficits high, debt dynamics rapidly deteriorated, threatening to make debt servicing unsustainable. If such trends continue, a debt default may be unavoidable.

The dire financial and fiscal numbers have impacted Tunisia's economic situation, crowding out private investment, as domestic savings are largely financing public deficits. To control inflation and preserve a modicum of stability, interest rates have been kept high, undermining investment and exports. Total investment, both private and public, was lower in the past decade than in the decade prior to that. After 2019, it fell below 14 percent of GDP, a historical low for Tunisia. This decline has aggravated unemployment, which has risen to above 15 percent. Some 17 percent of the population lives below the poverty line, with the average higher in rural regions.

Addressing Tunisia's dire economic and financial situation requires tackling the debt problem. The adjustments needed to avoid a debt crisis are significant. If austerity is the sole stabilization mechanism used, fiscal accounts will need to improve by a large amount. However, this would be self-defeating as austerity would lead to lower economic growth. On the other hand, if economic growth were to rise, fiscal deficits would improve enough to prevent the debt trajectory from exploding.

Toward a Credible National Renewal Plan

What are the elements of a national plan to place Tunisia on the road to recovery? Four approaches stand out: balancing austerity with growth-oriented reforms; redirecting public expenditure; addressing debt restructuring; and determining the type of International Monetary Fund (IMF) support required. Tunisia must focus on two simultaneous tracks: macroeconomic stabilization—reducing the deficit and securing international funding—and implementing structural reforms to boost its growth potential. However, the most critical factor is political leadership. To drive economic progress, leadership is needed to offer a compelling vision of reform, mobilize those who would benefit from it, weaken opposition to change, ensure a fair distribution of costs and benefits, and rebuild trust in the state and its capacity to govern effectively.

Political Reforms Must Be at the Heart of a Renewal Agenda

The conditions for progress are in place in Tunisia, but inaction could be disastrous. The economic, political, and social impacts of the country's democratic collapse have forced all actors to learn difficult lessons, lower their expectations, and recognize that a salvation process must be inclusive, with the burden shared collectively. The interests of small and large businesses are more aligned than in the past, as both would benefit from macroeconomic stability and a stronger application of the rule of law. Unions and other interest groups have also learned that shifting the costs of reform onto others only leads to a destructive, zero-sum outcome. After 2011, Tunisian society became polarized along identity lines, though it is now clear that the Islamist-secular divide should not dominate political life. Despite disappointing outcomes, the Arab uprisings showed there was no sustainable alternative to democratization, as democracy is often, unjustifiably, made a scapegoat for poor economic performance and authoritarian systems tend to perform inadequately economically. Yet building an effective democracy takes time and can be arduous.

Political and economic elites and civil society actors have key roles to play in reviving hope. Political elites in particular need to transparently explain the risks ahead and convince fragmented actors that collective and concerted action will generate opportunities for progress. This can only occur through political openness and pluralism allowing for useful collective action. Organizing processes of national consultation, reconciliation, and dialogue would confirm such a commitment, as would enforcing a level playing field among all firms, respect for human rights, and a widening of free spaces for discussion and criticism. Fairness in the distribution of the costs and benefits of reform is essential to gain popular support for any economic renewal plan.

Balancing Austerity and Reorienting Expenditures to Secure Economic Stability

A prerequisite for a renewal plan is to minimize austerity while reorganizing expenditures. Besides interest payments on debt, most public expenditures now go to civil servant wages, subsidies, and support for state-owned enterprises, all of which benefit powerful political constituencies. An iron-fist approach to cutting spending was standard practice during the 1980s, but today it could trigger social and political instability. At the same time, the upside of reforms has risen. The higher risks of inaction and the greater gains from action suggest Tunisian decisionmakers can no longer kick the can down the road, while further delays will only increase the pain. A growth strategy requires that some expenditures be directed toward public and private investment. Aside from investment in infrastructure, spending on health and education also needs to rise to support growth and improved social mobility. This means that sizable reductions in expenditures will be required. While this is politically challenging, what is needed is mobilizing constituencies that stand to benefit from a pro-growth renewal agenda.

A second prerequisite is to reorient public expenditures toward social spending. While safety nets are needed, they are not sufficient. Inflation has hit the poor, as basic consumption represents a large share of household budgets. However, universal subsidies are not the solution. They are fiscally expensive, often representing a large share of public spending, economically inefficient in fostering over-consumption, and unfair socially, benefiting the rich more than the poor. Targeted social safety nets, directed at the poor, resolve such problems. Tunisia's social safety nets can be improved to increase coverage and focus on those in need. Digitalization and transparency have to be enhanced, and clientelism and corruption eliminated. Removing subsidies also hurts middle-income households, but the main problem for the middle class is not a lack of social protection, but the scarcity of good jobs and poor quality of state services.

A third prerequisite is recognition that debt restructuring has limited upsides. When external debts are "too" high, especially because of an exogenous shock, reducing debt can benefit both the debtor and creditor. The debtor country then regains access to liquidity, allowing it to grow again. When the debt overhang is caused by faulty internal policies, addressing this works only if credible reforms are on offer. Tunisia's debt structure holds little potential for restructuring because of the prominence of domestic debt and the inflexible structure of the external debt. That is because a large share of the external debt is owed to multilateral creditors, who do not engage in debt workouts. Commercial debt, which can be restructured, represents a small share, and so restructuring it would not meaningfully alleviate the debt burden.

Therefore, there is a need to count more on internal efforts. A reduction in the domestic debt burden is likely to be the main adjustment mechanism. This is often implemented through "financial repression," where real interest rates are negative (typically low nominal rates in an inflationary environment). Such a strategy is often blunted by leakages (informal foreign exchange markets, illicit capital flight), and risks weakening the banking system. To be effective, financial repression relies on a moderate tax on capital and accrued gains over long periods.

A fourth prerequisite is that any IMF program should be adapted to Tunisian realities. In the future, the IMF will continue to play crucial roles: providing liquidity, determining the extent of debt restructuring needed, enforcing policy conditionality, and ensuring that Tunisia puts sufficient efforts in reform and that creditors share the burden fairly. There is experience with IMF programs in the region. While such programs have helped stabilize difficult financial situations, they have not led to higher growth. Consequently, for an IMF program to be successful, it needs to be adapted to Tunisia's context.

This implies, first, understanding that deep austerity risks generating social instability, without addressing the root causes of the crisis. Instead, an IMF program should be conditioned on a commitment to inclusive growth and be inscribed in a broad national renewal strategy. Second, any program will be important not just for the liquidity it brings, but also for the stamp of approval needed to unlock funds from official and private sources. Together, the IMF and the international community—especially the European Union and Gulf Cooperation Council (GCC)—should provide sufficient liquidity to avoid a destabilizing austerity and support aggressive investments making the economy more dynamic. Third, while deep debt reduction is unlikely, external debts should be partly refinanced with new public debts of longer tenor and lower cost.

Growth Opportunities Exist and Can Produce Quick Gains

Tunisia's existing economic weaknesses are due not only to recent shocks but also find their source in long-existing structural imbalances. To boost job creation, a national renewal program must tackle the perennial challenges of improving state capacity, injecting dynamism into the private sector, and making the labor market more inclusive. New challenges also need to be addressed, including catching up with digitalization and addressing climate change challenges.

A growth compact requires political involvement and courage, which have been absent. Between 2011 and 2021, power-sharing governments have feared the reaction of those losing out in the short term, and have failed to mobilize coalitions of forces that would gain in the long term. Important constituencies—especially labor unions, economic elites, and consumers—need to be convinced that short-term sacrifices are worth it. This would be easier if gains accrue rapidly. To achieve such an outcome, policies need to create a major shock of expectations that make future reforms easier to implement. Successful reform plans, therefore, need to be based both on early actions and a credible narrative of renewal and progress. These would contribute to rallying politicians, social activists, and entrepreneurs to build a pro-growth coalition. A sound reform package that unleashes a virtual circle can raise short-term growth in several ways. Macroeconomic reforms may have a quick impact, attracting more international finance. This reduces business risk, helping to generate a private-sector supply response. Early gains, in turn, help improve citizens' faith in the future, facilitating reforms as they accept short-term sacrifices.

Growth cannot take place unless the macroeconomy is stabilized, agents can form expectations and have access to finance, and Tunisia's exchange rate is competitive. Three types of policies are necessary, but not sufficient, for growth. First, on the fiscal front, a gradual reduction in the deficit requires that the remaining deficit be largely financed externally. Second, an accommodating monetary policy needs to improve firms' access to finance. Third, a real devaluation of the currency might cause social pain at first (through higher import prices), but can also improve competitiveness, and, if followed by a supply response, it could help instigate an economic revival.

Modernizing the state is necessary for improving the quality of services, which have deteriorated. Increasingly, Tunisians, especially richer households, are relying on private health and education. Modernization involves shrinking the civil service, raising wages, generalizing e-government processes, improving checks and balances, and increasing decentralization. Credible signals of resolve in implementing this agenda include shifting spending to productive uses and providing space for citizens to hold officials accountable—from ministers to schoolteachers.

In addition, the authorities must unshackle the private sector. Private investment has declined because of tighter financing constraints, a loss of international competitiveness, and rising political risk. Credible signals of a determination to dynamize the private sector begin with pro-growth macro policies—competitive exchange rates and access to finance, among others—but also recognition of the crucial role of a level playing field. Fundamentally, to improve growth, performance needs to replace rent-seeking with competition that pushes firms to innovate. Crony capitalism, both before the uprising in 2010–2011 and after, encouraged monopolies, leading to low levels of innovation and investment and little job creation. All these trends need to be reversed.

Global structures of production are being reshaped by digitalization. Digital transformation presents a great opportunity to improve labor productivity and create good jobs, especially in the service sector. It is also important for the modernization of state services. Tunisia has invested in digital infrastructure, greatly expanding mobile and fixed broadband subscriptions. But more tangible progress requires building human capital more rapidly and encouraging firms to move more quickly on this front.

After decades of hyper-globalization, we are at a turning point in global trade. There is a shift to relocalize manufacturing closer to consumers, thereby reducing carbon dioxide emissions and producing in nearby countries that mitigate geostrategic risks. Green policies in Europe will soon lead to taxing goods from countries with low environmental standards, increasing incentives to adopt greener production techniques. Basing production in Tunisia can be attractive to European and GCC investors, especially if the country becomes more business friendly and develops its renewable energy sector.

A recent World Bank report shows Tunisia's economic challenges have been exacerbated by an increasing vulnerability to climate change. The country faces major impacts from rising sea levels, precipitation variability, desertification, and increased fresh-water scarcity. Population growth and urbanization are interacting with the impacts of climate change, adding a level of exposure that is particularly acute in the Mediterranean region (one that no other region in the world will face). Precipitation volumes have declined, water scarcity has reached critical levels, and climate hazards have become more frequent and intense. Tunisia requires massive investment to adapt to global warming, but policies have been limited so far. Adaptation is costly, with needs estimated at around 2 percent of GDP per year for the next decade. But it is far costlier to do nothing. Adaptation offers employment and growth opportunities, though projects have to be funded by the state, and raising green finance is the next big challenge. On the mitigation side, there is much potential in renewable energy, which will be vital for encouraging European states to move more global value chains to Tunisia.

Conclusion

Tunisia stands at a crossroads. President Kais Saied won a second term in the presidential election of October 6, but with a very low participation rate. This reflected growing dissatisfaction with his rule among the population. In the near future, the economy is bound to resurface as a central issue, given the severity of the crisis.

The international community now faces a difficult situation. European countries and international financial institutions are obliged to engage with a president who is weak and contested. Tunisia will face the paradox of a hyper-presidential system, where the chief executive holds significant formal power but is seen as lacking in genuine authority. Just as Saied capitalized on the coronavirus pandemic to consolidate power, the economy could now become a trigger for a regime crisis that might take Tunisia into the failed-state zone and exacerbate social tensions, before paving the way to a political change. Ultimately, for the country to embark on a path toward economic reform, sound and committed political leadership is crucial. Without it, the economic crisis will only deepen, and Tunisia will face further instability.

About the Authors

Ishac Diwan is the research director at Finance for Development Lab (FDL) at the Paris School of Economics.

Hachemi Alaya is an economist and the founding director of TEMA, a Tunisian think tank, and the editor of the macroeconomic newsletter ECOWEEK.

Hamza Meddeb is a fellow at the Malcolm H. Kerr Carnegie Middle East Center.

MALCOLM H. KERR
CARNEGIE MIDDLE EAST CENTER