



# TUNISIA'S ECONOMIC CHALLENGES

Lahcen Achy

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CARNEGIE MIDDLE EAST CENTER

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**Lahcen Achy**

**DECEMBER 2011**

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## Summary

As Tunisia moves away from its former regime, policymakers need to seize this historic opportunity to pursue an innovative economic strategy to overcome four key challenges: high rates of youth unemployment, a large number of marginal jobs, increasing income inequality, and substantial regional disparities.

To overcome the first challenge, Tunisia needs to develop a sustainable process of job creation that relies on a competitive private sector, and the government must remove barriers to entrepreneurship and investment. Although the country has achieved relatively high economic growth during the past decade, the contribution of private investment has remained low, and the former regime pursued a political agenda vis-à-vis the private sector. The government now instead needs to open different economic sectors to competition and pursue related reforms.

To overcome the second challenge, policymakers need to design incentives to channel resources toward selected high-value-added and knowledge-intensive sectors, and likewise stimulate product innovation and market diversification. The country must also pursue its real opportunities in agriculture, industry, and services to promote an intensive use of human capital and to diversify its markets beyond Europe.

To overcome the third challenge, Tunisia must review its public finance system to achieve social justice and equitable sharing of the tax burden by streamlining tax regulations and eliminating unjustified tax breaks, cracking down on tax evaders, and ensuring that all taxpayers contribute according to their capacity. Likewise, the government needs to rationalize public spending, reduce costly and regressive universal fuel subsidies, better target assistance programs to the poor, and improve the delivery of public services.

To overcome the fourth challenge, the government should design a comprehensive development strategy that promotes parity in access to basic services such as education and health across the country's regions. Thus, the government can promote labor mobility between regions by investing in transportation infrastructure, easing access to affordable housing, and developing regional complementarities. Such measures will expand opportunities for the people who live in the interior of the country without depriving those on the coast and eventually lead to a more balanced standard of living across regions.



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## Introduction

As Tunisia moves away from its former regime in the wake of the 2011 Jasmine Revolution, policymakers need to seize this historic opportunity to take a fresh look at how the country's economic strategy can seek to overcome four key challenges: high rates of youth unemployment, a large number of marginal jobs, increasing income inequality, and substantial regional disparities.

As it addresses these four challenges, the government's focus needs to shift from supporting economic growth in sectors with a low technology content and limited markets to removing structural bottlenecks in the business environment. Tunisia has built its growth strategy on low-skilled sectors that rely on cheap labor and do not provide enough jobs for new educated workers. During the last decade, the labor force's level of education has substantially increased, but this fundamental change has not been matched by a similar trend in labor demand. Tunisia's growth strategy has also suffered because of political interference in business, many administrative and regulatory barriers, and ineffective social and regional redistribution mechanisms.

To overcome the first challenge of high rates of youth unemployment, Tunisia needs to develop a sustainable process of job creation that relies on a competitive private sector; the government must remove barriers to entrepreneurship and investment. Although the country has achieved a relatively high average economic growth rate of nearly 5 percent during the past decade, private investment has remained low. The former regime pursued a political agenda vis-à-vis the private sector that entailed costly incentive programs, tolerance of tax fraud, and easy access to financing and public-sector contracts as tools to gain the loyalty of private business. The government now instead needs to open different economic sectors to competition and abolish the system of privileges, revise the investment code to rationalize state aid mechanisms, fight corruption, and enforce business regulations.

To overcome the second challenge of a large number of marginal jobs, policymakers need to design adequate incentives to channel resources toward selected high-value-added and knowledge-intensive sectors, and stimulate product innovation and market diversification. There are real opportunities in agriculture, industry, and services to promote an intensive use of human capital and adapt education and training to meet labor demand. For instance, the country can progressively shift from low-return and highly volatile mass beach tourism to medium- and high-service content tourist niches. It can also shift from call centers to software development

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**Tunisia needs to develop a sustainable process of job creation that relies on a competitive private sector**

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and communication services that have a high value added. To diversify markets, Tunisia needs to break its heavy reliance on the sluggish European market and intensively target the expanding African and Asian markets.

To overcome the third challenge of increasing income inequality, Tunisia must review its public finance with a view to achieving social justice and equitable sharing of the tax burden. The current tax system creates several distortions that make income distribution even more unequal. To this end, the

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**The government can promote labor mobility between regions by investing in transportation infrastructure, easing access to affordable housing, and developing regional complementarities.**

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government needs to streamline tax regulations and eliminate unjustified tax breaks, crack down on tax evaders, and ensure that all taxpayers contribute according to their capacity. The government also needs to rationalize public spending, reduce costly and regressive universal fuel subsidies, better target assistance programs to the poor, and improve the delivery of public services.

To overcome the fourth challenge of ineffective social and regional redistribution mechanisms—which have led to wide disparities between the country's interior and coastal regions in public infrastructure and access to social services—the government should design a comprehensive development strategy that promotes parity in access to basic services, such as education and health, across the country's regions. The government can also promote labor mobility between regions by investing in transportation infrastructure, easing access to affordable housing, and developing regional complementarities. Such measures will expand opportunities for the people in the interior of the country without depriving those on the coast and eventually lead to a more balanced standard of living among the regions.

## Tunisia's Economy Under Ben Ali

Before the January 14 Jasmine Revolution, Tunisia was neither an economic miracle nor a full success story, but it was doing better than its neighbors. It has achieved an average economic growth rate of nearly 5 percent during the last decade, outpacing other Middle Eastern and North African and lower-middle-income countries' averages. It has also kept its domestic and external economic imbalances under control. Thanks to its successful family planning policy, the population growth rate has declined sharply, to less than 1.1 percent a year. As a consequence, Tunisia has boasted a per capita growth in gross domestic product (GDP) of more than 3 percent a year during the past decade, a relatively impressive performance compared with most Arab countries. Its per capita income, which stood at \$2,713 in 2005, reached \$3,720 by the end of 2010. Furthermore, its economy was relatively diversified, with an increasingly important role for the service sector, whose share has increased from 55 percent in the early 1990s to more than 62 percent currently. In the meantime, the contribution of agriculture to GDP has declined from 13 percent to 8 percent

since the 1990s. The country has diversified its exports with a relatively high share of manufacturing.

Despite its economic growth and macroeconomic performance, however, Tunisia is a complex case, with a delicate authoritarian bargain between the regime and society. For a long time, the regime was able to provide economic and social gains to large segments of the population and secure its legitimacy and political stability in return. The authoritarian bargain, however, broke down due to the growing inability of the economy to create jobs for educated labor, the proliferation of marginal and poorly paid jobs in the informal sector, and rising income inequality and regional disparities. Gradually, the losers from the status quo became more numerous than the winners, which led to the erosion of the regime's legitimacy. Repression alone could no longer keep the Ben Ali government afloat.

## Managing the Economic Transition

Before the downfall of Ben Ali's regime, Tunisia's economic growth in 2011 was expected to reach 5.4 percent, the budget deficit was not to exceed 2.5 percent of GDP, and the public debt ratio was expected to remain below 40 percent. The country's interim government had to handle different economic prospects due to revolution-related disruptions and the negative impact of the Libya conflict, and it had to face higher fuel and food prices on international markets. With the economic cost of the revolution estimated at 5 percent of GDP, growth for 2011 is expected to range between 0 and 1 percent.<sup>1</sup> Tourism, which represents 6.5 percent of GDP and is the largest provider of foreign exchange, declined by more than 50 percent. Foreign direct investment (FDI) dwindled by 20 percent and more than 80 foreign companies left the country. The situation in the labor market worsened, both due to layoffs and the return of Tunisian migrant workers fleeing Libya. The number of unemployed people increased to 700,000, compared with fewer than 500,000 at the end of 2010. As a result, the unemployment rate reached 17 percent, compared with 14 percent before the revolution. Both the public deficit and current account deficit increased. The complementary financial law approved in June set the deficit to no more than 5 percent. The country had to face the double handicap of a liquidity shortage and the high cost of external finance due to the downgrading of its sovereign rating.

In its efforts to address this situation, the interim government made two key sets of decisions. First, on April 1, it announced the "short-term economic and social program," composed of seventeen measures, whose objective is to create an immediate economic impact without harming future prospects. The program has five priorities: security, job creation, support for economic activity and access to finance, the promotion of regional development, and the provision of targeted social aid. But except for job creation and the support of economic

activity through fiscal and financial incentives, most of the other measures seem vague and lack any firm schedule for implementation. For instance, one measure is to launch infrastructure projects necessary for investments, another is to launch a program to promote Tunisia's new image.

Second, the interim government amended the 2011 State Budget, and a complementary budget bill was approved in June 2011 with the objective of readjusting state resources, so as to take into consideration the financial impact of the exceptional measures taken after the Jasmine Revolution. Public projected spending was increased by 11 percent (including a 17 percent increase in current spending and a 13 percent decline in capital spending).

The interim government faced three constraints. First, it had a short and uncertain time horizon. Second, it had limited resources for absorbing the economic cost of the revolution and facing the negative impact of the Libyan turmoil, while still responding to the high expectations of large segments of society. Third, it also had to confront the issue of its legitimacy and deal with ambiguity about the exact boundaries of its jurisdiction. According to government statements, this mission tends to be skewed more toward managing daily concerns and paving the road for free and fair elections than toward engaging in broad reforms. In practice, however, there are differences in opinion among the Interim Cabinet's various members.

### **The Issue of the Time Horizon**

Ben Ali fled Tunisia on January 14, 2011, but Mohammed Ghannouchi kept his own position as prime minister. On January 17, he announced a new government that included several of Ben Ali's loyalists in key positions, such as defense, interior, and foreign affairs. Under the pressure of street protests, the Cabinet's composition changed three times to oust members with close ties to Ben Ali's regime. By the end of February, Ghannouchi was forced to resign and a new prime minister, Beji Caid Essebsi, was appointed. Essebsi was initially expected to serve until July 24, when the elections would be held. Later on, however, the elections were delayed, and the term of his Cabinet was extended until the end of October.

The short and uncertain duration of the interim government's mandate makes it challenging to assess its performance. First, there is the readiness issue. Some members of Essebsi Cabinet were new to the field of public policy-making and needed time before making decisions with confidence. Second, there is the coordination issue. A technocratic and ad hoc government needs to learn on how to coordinate its actions. Third, most decisions do not have an immediate impact.

### **The Issue of Resources**

Tunisia's interim government faced the dilemma of high economic and social expectations in a difficult environment with declining economic indicators

(including a decrease in economic activity, and collapsing tourism and FDI), which led to limited borrowing opportunities on international markets, and timid offers from regional and international donors.

### The Issue of Legitimacy

The interim status of Tunisia's government in the postrevolution era is leading to frequent contestations of its decisions in the court of public opinion. This delicate situation has pushed some ministers to focus only on managing daily issues and avoid making any commitments, especially if these commitments have effects that go beyond the interim period.

Overall, the post-revolution period in Tunisia has been extremely troublesome—with a sharp decline in domestic economic activity; a highly turbulent regional neighborhood; and high fuel and food prices in international markets. Yet despite these difficulties, the interim government has managed to keep the economy from collapsing, preserve a decent level of foreign exchange reserves, and control inflation. Ennahda, a moderate Islamist party, won Tunisia's elections in October. Ennahda is expected to dominate a new coalition government, which, more than a month later, has yet to be formed. The party's leaders have promised to pursue liberal, business-friendly economic policies. In a December 1 press release Tunisia's central bank urged the quick formation of a government to restore confidence and reassure investors about the country's future. The economy is expected to face a difficult time with the recession in Europe, which accounts for 80 percent of Tunisia's trade. Although Tunisia's economy grew by 1.5 percent in the third quarter, overall growth in 2011 will be close to zero. Tunisia's draft budget forecasts that the economy will rebound and grow 4.5 percent in 2012.

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## Challenges and Policy Options

Tunisia's newly elected government needs to develop a comprehensive and consistent strategy, a credible discourse, and concrete goals, as well as a timetable for achieving them. To address the country's major challenges, this strategy needs to pay particular attention to four pillars. First, a sustainable process of job creation must rely on a strong and competitive private sector. Second, policymakers should design adequate incentives to channel resources toward selected high-value-added and knowledge-intensive sectors. Third, those responsible for public finance need to remove distortions and achieve social justice through an equitable sharing of the taxation burden and more effective social spending. Fourth, policymakers need to design a comprehensive regional development strategy that provides the country's governorates and local councils with workable policy frameworks and adequate human and financial resources for coping

with the responsibilities devolved to them by the state. The country is divided into 24 governorates, which in turn are divided into 264 delegations or districts and further subdivided into 2,073 sectors or municipalities. At the same time, the government needs to create synergy among regions and consistency between national and subnational objectives.

### Promoting Private Investment and Creating the Right Kinds of Jobs

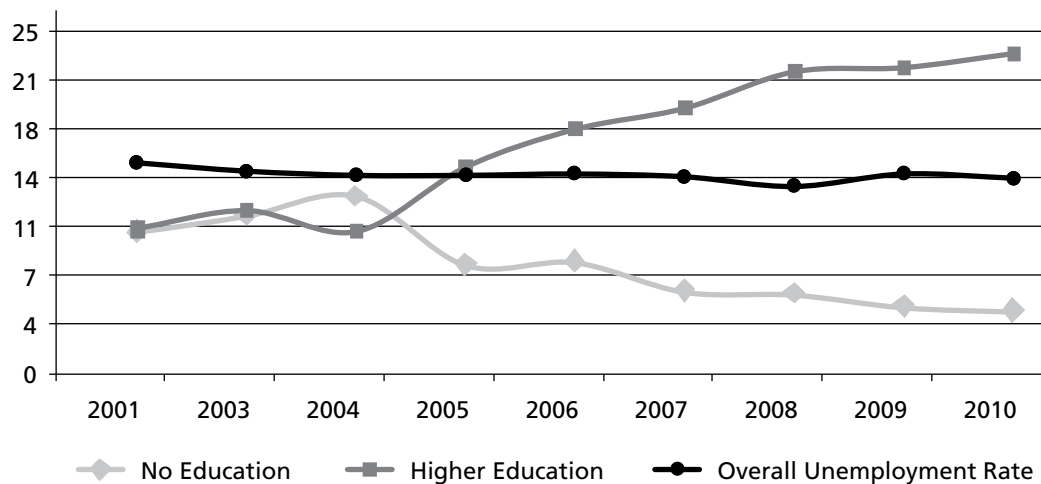
Of all the issues facing Tunisia, none is more critical to the average citizen than the question of employment. Tunisia has been facing a structural unemployment crisis for the past three decades, with an unemployment rate persistently above 14 percent.

#### *Labor Market Challenges: Making the Right Diagnosis*

Although unemployment among university graduates was negligible until the mid-1990s, it has increased dramatically since then. By the end of 2010, almost one of four university graduates was not working (figure 1). Unemployment is particularly prevalent among youths, given that 70 percent of the jobless are under 30 years of age and 85 percent are under 35.

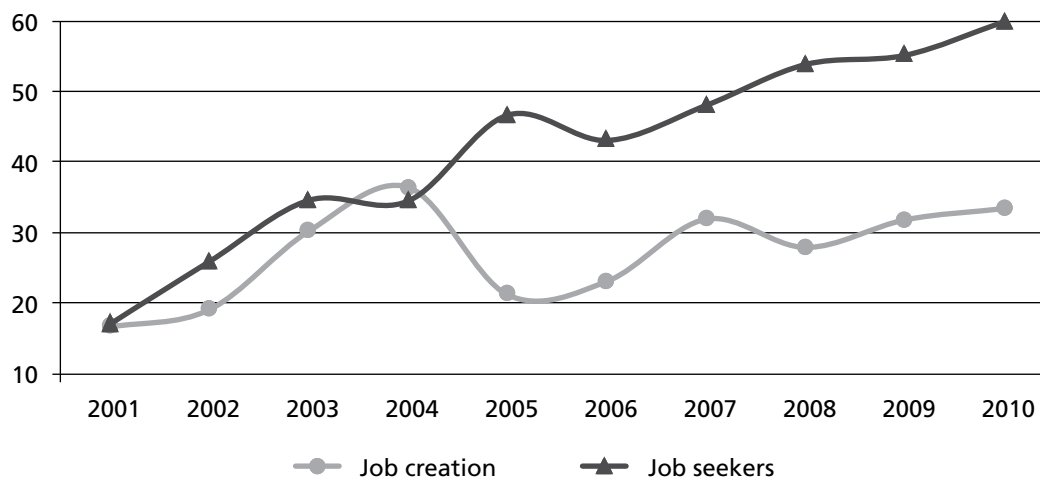
Three major causes underlie the high unemployment rates among graduates. First, larger flows of graduates entered the labor market than before. This fundamental change in the profile of new entrants to the labor market in Tunisia was not accompanied by any significant transformation in labor demand. In general, the same sectors continue to generate employment. During the last decade, the average annual growth rate of the Tunisian labor force was 2.6

**Figure 1. Unemployment Rates by Level of Education in Tunisia, 2001–2010 (percent)**



Source: National Institute of Statistics, Tunisia

**Figure 2. Job Creation and New Entrants in the Labor Market with Postsecondary Education in Tunisia, 2001–2010 (thousands)**

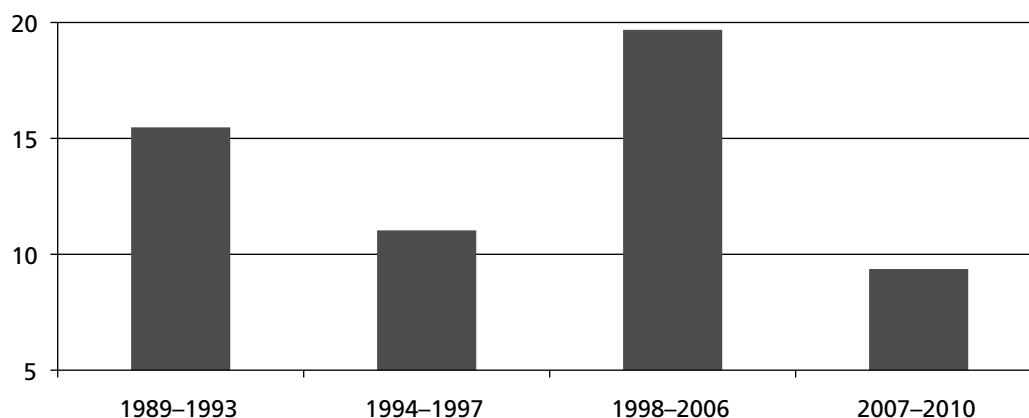


Source: National Institute of Statistics, Tunisia

percent. This average hides two contrasting trends, with the postsecondary educated growing at 10 percent a year, compared with a negative growth rate of 2 percent for those without any education (figure 2). As a result, the share of postsecondary education among job seekers increased from 20 percent in 2000 to more than 70 percent by the end of 2010.

Second, the civil service and state-owned enterprises, which were the traditional avenues for high-skilled graduates, could no longer guarantee employment (figure 3). In the past, the public sector provided better job stability and higher wages compared with the private sector.<sup>2</sup> A study by the Ministry of

**Figure 3. Average Number of Jobs Provided in Tunisia's Government Sector per Year, Four Periods From 1989 to 2010 (thousands)**



Source: Author's calculations based on data from the National Institute of Statistics, Tunisia

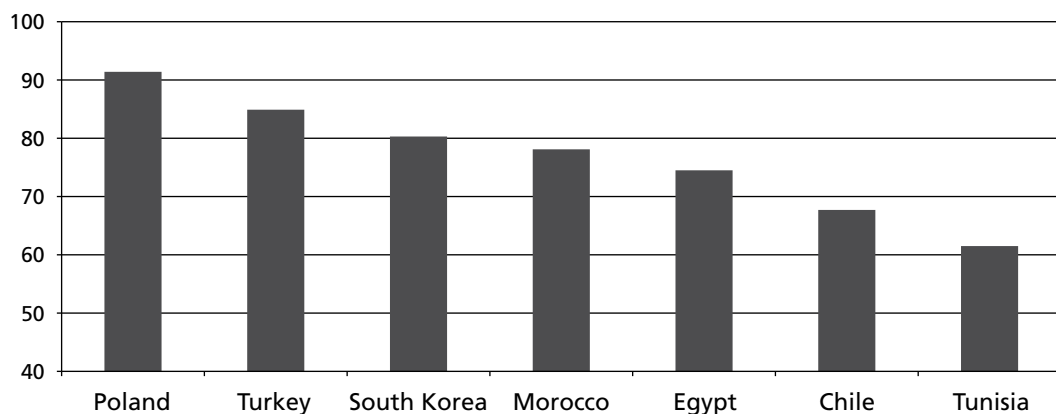
Vocational Training and Employment reveals that, on average, civil servants earn 17 percent more than private-sector employees. The wage gap between public and private jobs reaches 40 percent for university graduates (except engineers). Education turned out to be a double-edged sword by raising the expectations of educated youths and fueling their frustrations. Most educated youth choose to wait for jobs in the formal and public sectors, which offer better wages and benefits. On average, each university graduate remains unemployed for two years and four months, which is nine months longer than for of nongraduates.<sup>3</sup>

Third, the private sector is not able to absorb flows of new entrants. In Tunisia, private investment is low (figure 4), and most of the job opportunities it provides are for unskilled workers. In the tourism sector, for instance, only eight of 100 jobs created are for postsecondary educated employees.<sup>4</sup> Additionally, apart from a small number of large enterprises that are partly or entirely in the public sector, the majority of Tunisian firms are small and private. Most of them provide fewer than five jobs (97 percent of all firms based on 2009 National Institute of Statistics data) and use very basic technologies that do not require educated labor.

Although medium-sized and large firms pay a 30 percent corporate tax (unless they are eligible for tax holidays or can use political connections to underreport profits), microenterprises and small firms can evade taxation or pay a modest amount as they are subjected to a lump tax system. These tax distortions do not encourage small firms to grow or modernize.

From a political-economy perspective, transparent and effective institutions are prerequisites for the development of mid-sized and large corporations. Bureaucratic red tape and corruption are frequently encountered by

**Figure 4. The Share of Private Investment in Total Investment in Tunisia, 2008 (percent)**



Sources: World Bank data and author's calculations.

entrepreneurs. The business environment on the ground seems more constrained than what has usually been suggested by the World Bank's *Doing Business* report.<sup>5</sup>

### *Labor Market Challenges: Shifting From the Wrong Policies*

To address the country's unemployment situation, the Tunisian government has launched a number of programs and policies. First, the government has used coercive and incentive-based tools to prevent layoffs. Second, the government has implemented active labor market policies. Overall, the cost of these therapies has been substantial, yet they have failed to address the real distortions.

First, the government has introduced some flexibility in labor regulations as part of its market reform agenda. In practice, however, the authorities control collective layoffs and decide to grant or refuse approval. At the same time, they offer incentives to troubled firms to prevent them from downsizing their staffs or exiting the market. The incentives have historically taken the form of subsidies to cover the debt burden and tax holidays. Although these measures can reduce job losses in the short term, they are costly and generate perverse effects in the long term because they prevent the healthy reallocation of capital and labor from unsuccessful companies and declining activities to the emerging sectors. As a result, the government's interference in the labor market impedes the process of structural economic change.

Second, the government has spent a large amount of money on ineffective labor market initiatives—the equivalent of 1 percent of its GDP every year, which is comparable to the European Union's average budget for the same purpose. Active labor market policies include wage and employment subsidies granted to employers to stimulate them to hire more employees, training and retraining programs to increase the employability of job seekers, public works programs, and preferential credits to promote self-employment initiatives. However, labor market policies have entailed a large number of fragmented interventions that have been too narrow and uncoordinated. The design of labor market policies has led to the dispersion of financial, human, and administrative resources. The National Employment Fund, which is the main source of finance for labor market policies, was managed by the president's office, and thus lacked transparency and was not subject to any evaluation. The eligibility criteria applied restricted large segments of the unemployed labor force from benefiting from these policies. Only 25 percent of those unemployed in Tunisia take advantage of labor market programs. As a result, the average amount spent per beneficiary is extremely high and causes both inequity and inefficiency.

Even if these programs can help to improve the matching of supply and demand vis-à-vis labor, they can never be the solution to structural economic issues such as a low level of private investment, the limited demand for skilled labor, an educational system in need of reform, or a dominant role for informal networks in providing access to job opportunities. These are the issues that the newly elected government needs to address.



*Private-Sector Investment: The Number One Priority*

A vibrant and flourishing private sector is a prerequisite for creating employment, enhancing productivity, and ensuring competitiveness. Job creation depends primarily on economic growth, which itself requires investment. In high-growth countries, private investment typically exceeds 25 percent of GDP, whereas in Tunisia it struggles to reach 15 percent. As a result, Tunisia's growth relied more on public investment, and less on private investment and human capital.<sup>6</sup>

Policymakers in Tunisia need to pinpoint the factors that impede the dynamics of private domestic and foreign investment and implement the appropriate reforms. They must overhaul the business environment by engaging with the private sector to identify reform priorities and monitor their implementation.

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**Policymakers must overhaul the business environment by engaging with the private sector to identify reform priorities.**

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In Tunisia, the productive sector is still largely controlled by the state, which also permeates the private sector through a complex web of cross-ownership.<sup>7</sup> The state is present not only in network industries—such as telecommunications, energy, transportation, and banking—but also in other sectors, such as fertilizers, mining, and construction materials.<sup>8</sup>

The newly elected government should launch a number of critical reforms to ensure that different economic sectors are open to competition, and abolish the prevailing system of privileges, revise the investment code to streamline and rationalize economic incentives, and fight the corruption and clientelism that were institutionalized under Ben Ali's regime.

*Removing Restrictions on Private-Sector Investment and Promoting Competition*

Tunisia needs to review its investment restrictions in the services sectors and focus on facilitating the participation of private domestic and foreign investors. Despite the trade and investment liberalization reforms of the mid-1980s, there is only limited openness to private investment in the services sector.

The country has no free trade agreement that covers services, and its multilateral commitments under the World Trade Organization have been very limited when compared with both regional and international levels. Entry into many services, such as trading activities (wholesale distribution and retail trading), are reserved for enterprises in which Tunisians hold a majority interest. For several other services activities, FDI requires the prior agreement of the Investment Commission if the foreign ownership exceeds 50 percent. Because of these restrictions, Tunisia has missed out on the flow of FDI and the potential gains in productivity. The inner circle of Ben Ali's regime used these provisions to impose themselves as inescapable partners for foreign operators, which had detrimental effects on private investment.

Tunisia should address the issue of bad loans in the banking sector and open it to competition. The weakness of the Tunisian financial system is another handicap to growth because it raises the cost of capital and leads to inefficient resource allocation. The banking sector, in which the government maintains firm control over the three largest public banks, continues to suffer from limited competition and excessive levels of nonperforming loans. These loans account for more than 12 percent of total loans in the banking sector in Tunisia, compared with 8 percent in Jordan and 4.8 percent in Morocco.<sup>9</sup>

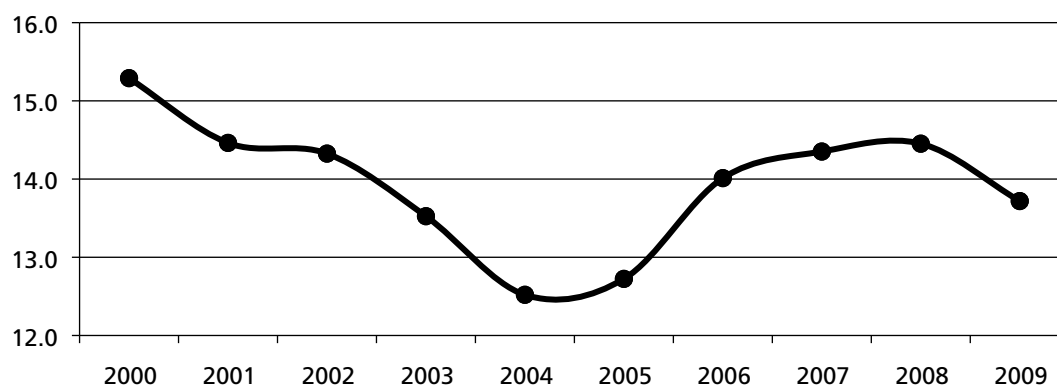
The country needs to reinforce the competition authorities and the implementation of procompetitive regulations. Tunisia's competition laws seem in line with international standards; implementation issues remain, however.

### *Reviewing and Streamlining Investment Incentives*

The Tunisian authorities need to review the incentives provided under the country's investment code and design a more effective, consistent, and transparent set of supportive measures for investment and exports. The implementation of the investment code under Law 120-93 and its multiple amendments is complex and each year costs the equivalent of 2.2 percent of GDP, or 11 percent of the state's fiscal revenues. Despite this excessive cost, the fiscal and financial incentives granted under the code are ineffective in stimulating private investment.<sup>10</sup> Figure 5 reveals that during the past decade, the share of private investment in GDP declined from 15.3 to 12.5 percent between 2000 and 2004, and has stagnated at about 14 percent since 2006.

Ben Ali's regime seems to have primarily used the system of incentives to buttress its legitimacy and strengthen its political and administrative control over the private sector.<sup>11</sup> By discriminating between enterprises on the basis of their characteristics—such as size, economic sector, location, and export

**Figure 5. The Share of Private-Sector Investment in GDP in Tunisia, 2000–2009 (percent)**



Source: Central Bank of Tunisia

orientation—the investment code in Tunisia has granted significant discretionary power to the bureaucracy and generated large distortions in the business environment. On average, the state incentives accounted for 40 percent of the investment cost of those projects that qualified between 1994 and 2007.<sup>12</sup> Thus, to overcome the structural deficit in private-sector investment, the elected government must design a new code that supports the objectives of job creation and economic diversification, and that stimulates a healthy process of regional convergence between the country's coastal and interior regions.

*Fighting the Corruption and Clientelism  
Institutionalized Under Ben Ali's Regime*

For the sake of both Tunisia's social and economic future, the newly elected government must deal a blow to the culture of corruption. Corruption, however, is a systemic issue that may not have left Tunisia with Ben Ali. Fighting corruption will entail cracking down on bribes, tax fraud, and evasion, while also undoing the allocation of social services for political purposes.

Although the media and public opinion focused exclusively on high-profile corruption among the members of Ben Ali's family who were abusing their positions to illegally accumulate wealth, the issue of corruption and nepotism in Tunisia transcended the regime's inner circle and trickled down to large segments of society. The regime in Tunisia used different public policies—such as privatization, the investment code, and export promotion—to create and nurture a form of crony capitalism in which businessmen were heavily dependent on the state for access to power and favors. By doing so, the regime achieved two goals. First, it created a new social coalition as a counterweight to the traditional supporters hit by market reforms. Second, it preserved its control over the economy through its entrenched central and regional layers of authority and bureaucracy.

Of all the autocratic governments in the region, Tunisia's Ben Ali regime mastered the art of using government-organized nongovernmental organizations especially well.<sup>13</sup> The regime created and nurtured a clientelistic solidarity network, which, though not part of the government, was led by the ruling party's elite. The network, by granting access to favors and social services in exchange for the regime's support, transformed the culture of patronage into widespread corruption across all segments of society.

Curbing systemic corruption is a challenge that is likely to require strong measures, and also more time and money than most "corruption fighters" usually think. Policymakers—in synergy with other stakeholders, including the private sector, political parties, and civil society organizations—need to implement a comprehensive anticorruption strategy. Such a strategy needs to target not only those who used to abuse their positions, but also those private individuals and organizations who took advantage of the system. Public awareness campaigns—which explain the harmful effects of corruption on economic

growth, investment, and competition—are not sufficient. Raising awareness without adequate enforcement may lead to cynicism among the population and increase the incidence of corruption.<sup>14</sup>

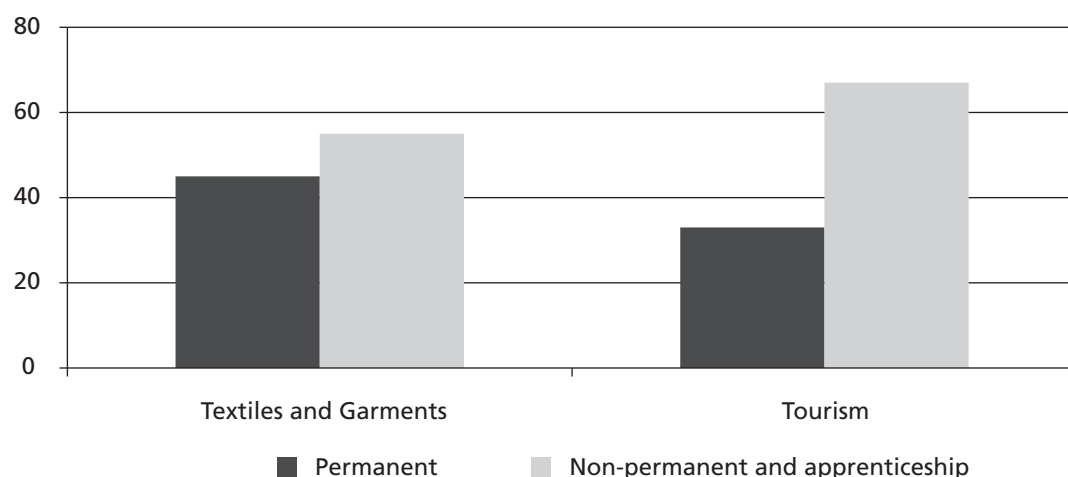
### Moving Up the Value-Added Ladder

Policymakers in Tunisia need to design adequate incentives to channel resources toward selected high-value-added and knowledge-intensive sectors. There are real opportunities in agriculture, industry, and the services sector to promote an intensive use of human capital and to adapt education and training to meet demand.

It would be incorrect to limit the number one concern of Tunisian citizens to unemployment. The social situation in Tunisia has worsened due to the proliferation of irregular and poorly paid jobs in the formal private sector as well as the rise of the informal sector as a response to the formal economy's failure to offer decent jobs. It is telling that the social unrest that erupted in Tunisia and ended with the collapse of the former regime was sparked by the public self-immolation of a youth who was not unemployed and working in the informal sector, and who was constantly harassed by the local authorities.

In the tourism sector, only 35 percent of employees have a permanent contract. The rest are either temporary employees (53 percent) or apprentices (12 percent).<sup>15</sup> In textiles and garments, one other key job provider sector, 44 percent of employees have a nonpermanent status and 11 percent have apprenticeship (figure 6). Only 45 percent of all employees are permanent.<sup>16</sup> In addition to their vulnerability, nonpermanent employees earn 25 percent to 40 percent less than those who are permanent. In both sectors, it seems that Tunisia's competitiveness is largely the result of poor working conditions and low wages.

**Figure 6. The Status of Jobs (Permanent, Nonpermanent, and Apprenticeship) in Textiles and Garments and Tourism in Tunisia (percent)**



The contribution of the most export-oriented sectors to economic growth has been limited due to their low value added and weak integration with the rest of the economy. The value-added portion accounts for only 18.5 percent of the total output value of Tunisia's manufacturing sector.<sup>17</sup> This rate is even lower in the case of textiles and electromechanical industries. Incentives for the private sector have overlooked the key role of links and interactions between leading exporting firms, on the one hand, and domestic production, on the other. The result is that Tunisia's onshore firms have not benefited from liberalization and openness to FDI.

Tunisia's strategy has been to promote exports, especially manufactured products, while heavily protecting enterprises producing for the domestic market. This strategy has created a dualism within the economy that has hampered the integration of domestic market and export-oriented activities. It has increased the dependence of exporters on imported inputs and made it necessary to subsidize enterprises that process locally produced goods for export.

The country should progressively shift from low-return and highly volatile "cheap tourism," to "high-quality tourism." It should also shift from call centers to software development and information and communication services

with a high value added. Tunisia also needs to develop a comprehensive strategy to promote exports of medical services for Libyan, Algerian, and sub-Saharan patients.<sup>18</sup>

In terms of market diversification, Tunisia needs to review its trade policy to break its heavy reliance on the European market. Diversification of business partners is another area in which Tunisia can enhance its entrepreneurial know-how.

Currently, the bulk of tourism, FDI, exports, and remittance monies come from Europe.<sup>19</sup> However, Tunisia's ability to export to the European Union has already been impaired by fierce competition from dynamic exporters, such as China, India, and other emerging-market countries.

The government, in partnership with the business community, needs to launch marketing and outreach programs to introduce Tunisian products and services to new country partners and explore new markets worldwide.

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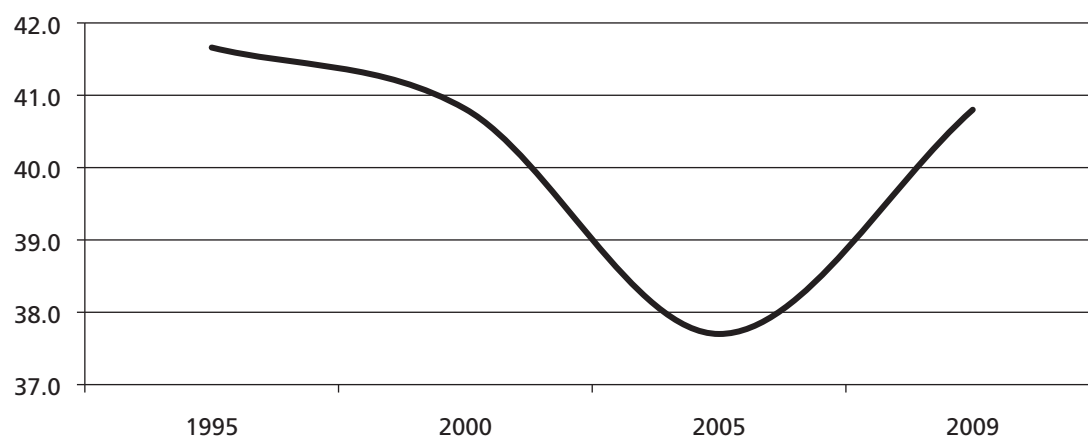
### **Tunisia needs to review its trade policy to break its heavy reliance on the European market.**

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### **Pursuing Social Justice and an Equitable Sharing of the Tax Burden**

The gap between the rich and the poor has been worsening during the past five years in Tunisia.<sup>20</sup> The government needs to streamline tax breaks and other unjustified public transfers, improve the transparency of the tax system, crack down on tax evaders, and ensure that taxpayers contribute according to their capacity.

The Gini Index, a commonly used measure of inequality, declined between 1995 and 2005 but has increased since then (figure 7).<sup>21</sup> Three factors in

**Figure 7. Income Inequality in Tunisia, 1995–2009 (based on the Gini Index)**

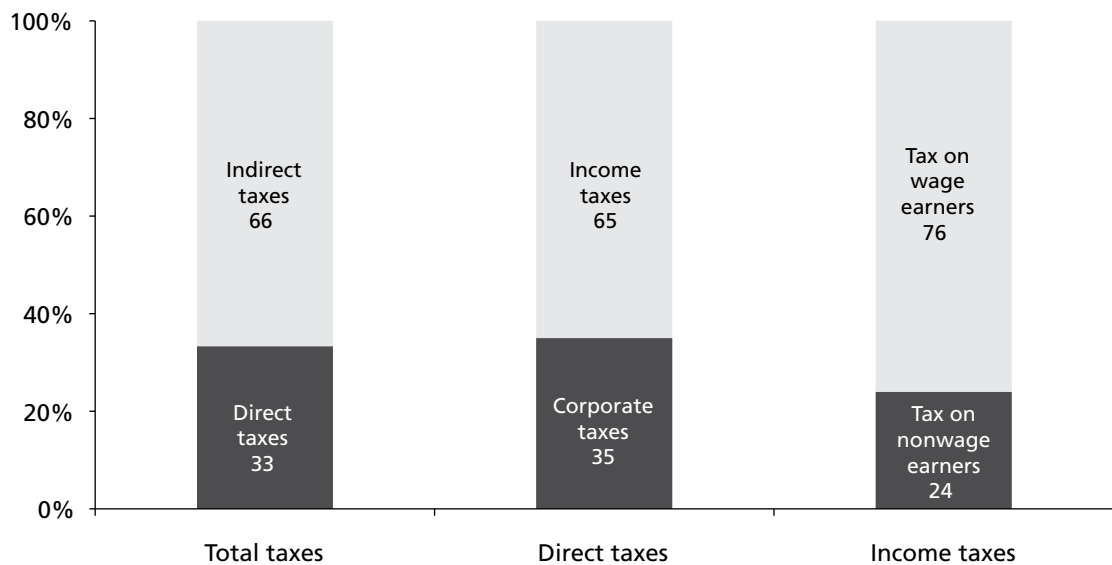
Source: National Institute of Statistics, Tunisia, and the World Bank

particular have contributed to more inequality: a higher level of unemployment among youths from the poor and middle classes, the absence of redistributive tax policies, and the regressive effects of public social spending.

Tunisia's model was perceived as an economic success, but beyond the facade, it was a severe social failure and a source of frustration. In a survey conducted by Gallup a few months before the Jasmine Revolution, it appeared that 49 percent of young Tunisians dreamt of emigrating, as opposed to 37 percent in Morocco, and 32 percent in Algeria. Tunisian youths are also significantly less willing to say that they would retrain for a different career or start their own business if they became unemployed for at least six months.

Low returns to education due to longer periods of post-graduation unemployment and a scarcity of permanent positions in both the public and private sectors have constrained social mobility and increased inequality in Tunisia. The poor and middle class invest in the education of their children and reap frustration and unmet dreams and expectations. The prevalence of patronage and nepotism exacerbates the issue. Unlike youths from richer backgrounds who rely on dense networks, those from unprivileged families usually end up unemployed or stuck in dead-end jobs.

Although the tax system seems fairly well designed, with a progressive income tax and a corporate tax of 30 percent on profits, it hides three major distortions that make the country's income distribution even more unequal. First, the government collects more indirect taxes than direct taxes. On average, only one-third of Tunisia's tax revenues are from direct taxes, compared with two-thirds from indirect taxes.<sup>22</sup> The burden of indirect taxes falls much more on the poor, as they usually consume their entire income. The rich can escape indirect taxes and can benefit from tax favors by saving or investing part of their income.

**Figure 8. The Tax Structure in Tunisia, Average for 2005–2009 (percent)**

Source: Central Bank of Tunisia

Second, individuals pay much more in taxes than companies do (65 percent for the former, 35 percent for the latter) (figure 8). The modest contribution of corporate taxes is largely due to the generous fiscal incentives granted to big companies under the investment code. During the period from 2000 to 2007, every year the government gave up between 50 percent and 60 percent of the corporate taxes that were due, in the form of tax incentives. Yet despite such generosity, these tax breaks and exemptions were ineffective in promoting private investment and creating jobs.

Third, wage earners—who mostly belong to the middle class—pay three-quarters of income taxes, compared with one-quarter for nonwage earners.<sup>23</sup> The lack of social justice in Tunisia is magnified by ineffective social spending policies. To meet the objective of social justice, which was at the heart of the Jasmine Revolution, policymakers should review the current structure of public spending and search for more effective public spending programs. Latin American countries' experiences with transfers to selected groups of the poor and vulnerable can be useful to study.

Tunisia spends between 4 percent and 5 percent of GDP in transfers and subsidies yearly. Fuel and food subsidies absorb between 2.5 percent and 4 percent of GDP, depending on the international prices of oil and cereals, and benefit both rich and poor households. The International Monetary Fund conducted various studies that show the regressive nature of subsidies. Subsidies tend to benefit the rich more than the poor, and thus have a perverse effect on inequality.<sup>24</sup>

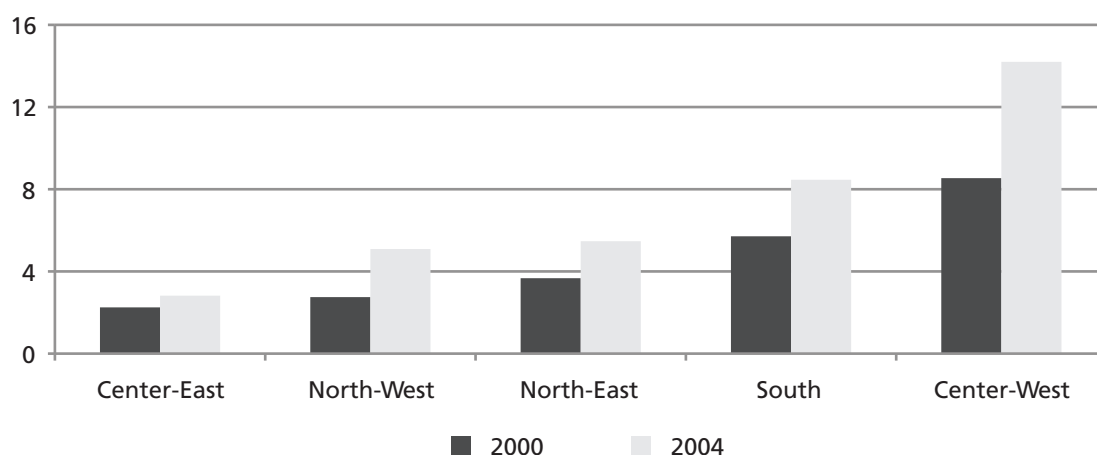
## Addressing Regional Disparities

In Tunisia, financial inequality among the country's regions has played a key role in fueling social unrest. Thus the hardest-hit cities of Sidi Bouzid, Kasserine, and Thala in the country's Center-West led the uprising against the regime.

To address this interregional inequality, the newly elected government needs to design a comprehensive regional development strategy. It should promote regional convergence in terms of access to basic services, such as education and health, and allocate part of the state resources to regions and local districts based on socioeconomic criteria, such as unemployment and poverty.

Official statistics show that during the past two decades, poverty rates have declined and the overall economic situation has improved. Large parts of the country have been neglected, however, and as a result, regional inequality has been exacerbated. For example, the gap in poverty rates between the capital and the rest of the country shows that the regional variation in terms of living standards increased between 2000 and 2004 (figure 9).<sup>25</sup>

**Figure 9. Poverty Ratios Across Tunisia Compared With Tunis, the Capital, 2000 and 2004 (percent)**

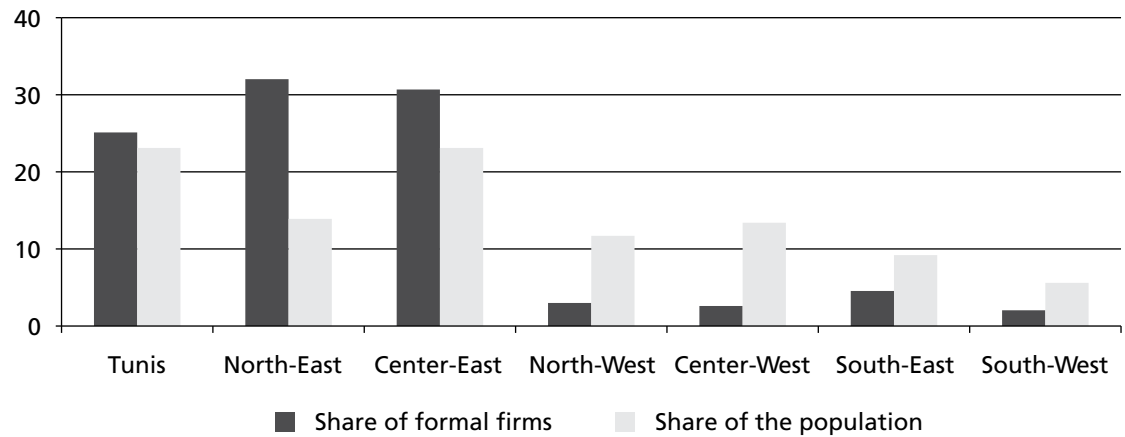


Source: Author's calculation based on African Development Bank data

The gap with respect to Tunis increased in all regions. The North-West and Center-East, which benefited from public investments as well as private-sector projects in tourism and offshore manufacturing, are much closer to the capital city. The South and Center-West, conversely, are lagging behind. In the Center-West, the poverty rate was 14 times higher than in Tunis in 2004, compared with 8.5 times higher in 2000.



**Figure 10. The Regional Distribution of Formal Firms and the Population in Tunisia, 2009 (percent)**



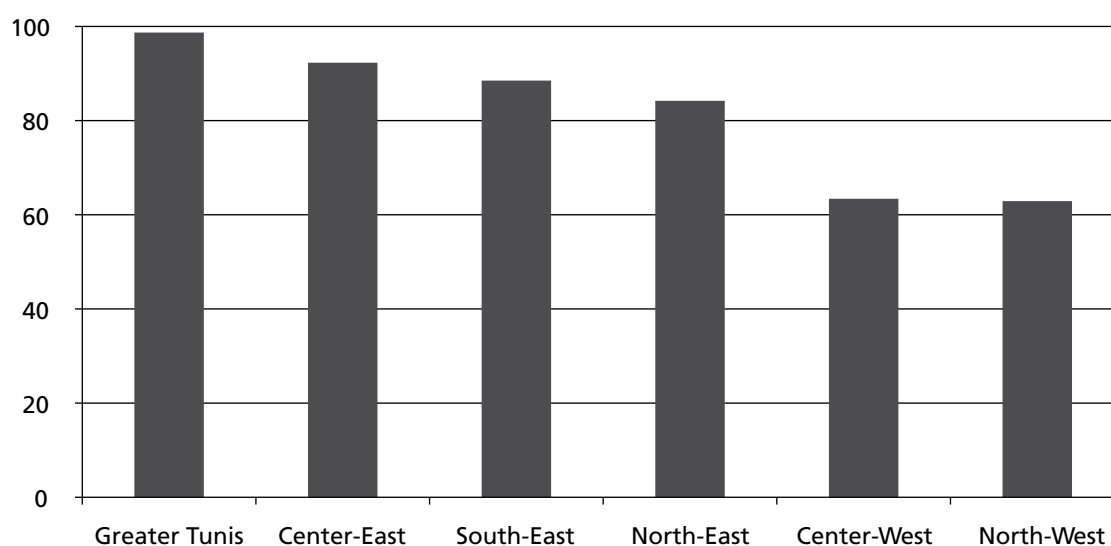
Source: National Institute of Statistics, Tunisia

Other indicators corroborate the persistence of large disparities between the country's coastal and interior regions in access to basic infrastructure, education and health services, and job opportunities. The poorest regions lack adequate economic and social infrastructure and suffer from higher unemployment rates. The three most privileged regions—Greater Tunis, the Center, and the North-East—are home to 60 percent of the population and almost 90 percent of formal enterprises (figure 10).<sup>26</sup> Conversely, the three deprived western regions—the North-West, Center-West, and South-West—accommodate 30 percent of the Tunisian population and less than 8 percent of enterprises.

Regional inequality was not only the result of differences in natural endowments among the regions; it was exacerbated by public policy. Decentralization, which can offset part of the disparities, remains underutilized in Tunisia. Local administration in Tunisia has been mainly an administrative and executive dimension with no political functions.

The government needs to design a comprehensive regional development strategy and promote regional convergence in terms of access to basic services, such as education and health. To meet such objectives, the government should allocate part of the state's resources to regions and local districts based on socioeconomic criteria, such as unemployment and poverty. At the same time, the government needs to ensure consistency between regional and national objectives.

Currently, more than 90 percent of public spending is managed by the central government, compared with 7 percent at the regional and subregional levels.<sup>27</sup> The criteria used to share state resources among regional administrative units tend to aggravate disparities.<sup>28</sup> Two-thirds of public investment managed by the central government was allocated to the coastal areas.<sup>29</sup>

**Figure 11. Households' Access to Potable Water in Tunisia, 2010 (percent)**

Source: National Institute of Statistics, Tunisia

The official discourse of regional development has lost its credibility over the years. Policymakers based their actions on a very reductive approach to the provision of electricity, water, and access to roads, and they neglected other social services, such as health and education (figure 11). Rural areas have a higher level of poverty and deserve more government services and transfers.

The government needs to strike the right balance between the search for economic efficiency and social justice in territorial planning and the efficient allocation of resources. Not every region, however, can be equally developed or prioritized, due to scarcities of resources. Despite its appeal, a sudden reallocation of resources to unprivileged regions could be costly and counterproductive. In an open economy, the regional concentration of economic activities improves competitiveness and efficiency. Giving regional tax incentives to poor regions may shift jobs away from territories that do not receive the subsidy, rather than create new ones. The government, however, should promote labor mobility by investing in transportation infrastructure, ease access to housing, and develop regional complementarities. Such policies would expand job opportunities for the people outside the coastal region and lead in the long term to a more sustainable convergence of standards of living among regions.

## Conclusion

For a long time, Tunisia's Ben Ali regime was able to provide the country with economic and social gains and thus secure its legitimacy and political stability in return. But the authoritarian bargain failed with the growing inability

of the economy to create jobs for educated labor, the proliferation of marginal and poorly paid jobs in the informal sector, and rising income inequality and regional disparities. Gradually, the losers from the status quo outnumbered the winners—thereby eroding the regime's legitimacy.

As the country moves away from its former regime, policymakers need to build the confidence of citizens in the ongoing democratization process and set

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**Policymakers need to build the confidence of citizens in the ongoing democratization process and set the foundations for the rule of law and good governance. The newly elected government should devise a consistent package of policies, relying on a credible discourse, concrete goals, a timetable to achieve them, and accountability to the population.**

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the foundations for the rule of law and good governance. The newly elected government should devise a consistent package of policies, relying on a credible discourse, concrete goals, a timetable to achieve them, and accountability to the population.

Striking a delicate balance between efficiency and social justice in economic policy and between a favorable investment climate and transparent incentive programs will no doubt be challenging. Tunisia's elected government will not have much room to maneuver and increase public investment because a large part of the budget is absorbed by nondiscretionary spending. It will also need to keep both the public deficit and debt under control. In the current international context, the country's excessive level

of public debt may only weaken investors' confidence and hurt growth prospects. The private sector is therefore essential for Tunisia's economic future. The newly elected government must promote private-sector development by removing inefficient regulations and fighting corruption. Instead of rents for patronage, the government needs to offer appropriate incentives based on economic efficiency and social justice.

## Notes

- 1 According to the Ministry of Planning and International Cooperation, expected GDP growth for 2011 is 0.2 percent.
- 2 In Tunisia, a public-sector wage premium raises public wages about 18 percent (between 24 and 30 percent for women) above those of the private sector. Ummuhan Bardak, Henrik Huitfeldt, and Jackline Wahba, "Employment Policy Reforms in the Middle East and North Africa," European Training Foundation, 2006, [www.etf.europa.eu/pubmgmt.nsf/\(getAttachment\)/C93440BDFEF9672C12572FB0050E2E7/\\$File/NOTE75WLGU.pdf](http://www.etf.europa.eu/pubmgmt.nsf/(getAttachment)/C93440BDFEF9672C12572FB0050E2E7/$File/NOTE75WLGU.pdf).
- 3 Marco Stampini and Audrey Verdier-Chouchane, "Labor Market Dynamics in Tunisia: The Issue of Youth Unemployment," *Review of Middle East Economics and Finance* 7, no. 2 (2011), [www.bepress.com/rmeef/vol7/iss2/art1](http://www.bepress.com/rmeef/vol7/iss2/art1).
- 4 Tunisian Ministry of Vocational Training and Employment, "Employment Statistics: 2010," 2011, [www.emploi.gov.tn/?id=3&L=2](http://www.emploi.gov.tn/?id=3&L=2).
- 5 See the Doing Business website, [www.doingbusiness.org](http://www.doingbusiness.org).
- 6 Aristomene Varoudaki and Paloma Anós Casero, *Growth, Private Investment and the Cost of Doing Business in Tunisia*, World Bank Working Paper 34 (Washington, D.C.: World Bank, 2004), 8, <http://siteresources.worldbank.org/INTMENA/Resources/wp34september2006.pdf>.
- 7 The distinction between the public and private sectors is not always clear in Tunisia. The definition of a public enterprise has evolved over time. A total of 10 percent government ownership was enough for an enterprise to qualify as public up to 1985. The threshold was raised to 34 percent that year, and to 50 percent for nonfinancial enterprises in 1989. These changes in definition reduced the number of firms classified as publicly owned; but in the aggregate, public assets have not decreased substantially. In 2007, the state's portfolio consisted of 192 fully owned enterprises and 493 partially owned enterprises (of which there were 100 with more than 50 percent ownership, 55 with an ownership between 35 and 50 percent, 198 with an ownership between 10 and 35 percent, and less than 10 percent in the remaining enterprises).
- 8 United Nations Conference on Trade and Development, *Voluntary Peer Review of Competition Policy: Tunisia* (Geneva: United Nations Conference on Trade and Development, 2006), [www.unctad.org/en/docs/ditcclp20062\\_overview\\_en.pdf](http://www.unctad.org/en/docs/ditcclp20062_overview_en.pdf).
- 9 International Monetary Fund, *Regional Economic Outlook: Middle East and Central Asia, April 2011* (Washington, D.C.: International Monetary Fund, 2011), [www.imf.org/external/pubs/ft/reo/2011/mcd/eng/pdf/mreo0411.pdf](http://www.imf.org/external/pubs/ft/reo/2011/mcd/eng/pdf/mreo0411.pdf).

- 10 Kamel Ghazouani, *Evaluation des incitations à l'investissement privé: Cas du CII* (Tunis: Institut Arabe des Chefs d'Entreprises, 2011), <http://iaceonline.com/ctee/documents/CII-IACE-Presentation.pdf>.
- 11 Béatrice Hibou, Hamza Meddeb, and Mohamed Hamdi, "Tunisia After 14 January and Its Social and Political Economy," Euro-Mediterranean Human Rights Network, 2011.
- 12 Ghazouani, *Evaluation des incitations*.
- 13 Fadhel Kaboub, "The Middle East's Neo-Liberalism–Corruption Nexus," June 2011, <http://personal.denison.edu/~kaboubf/Pub/Media/2011-May-DS-NeoliberalismCorruptionNexus.pdf>.
- 14 United Nations, "Draft Manual on Anti-Corruption Policy," June 2001.
- 15 Tunisian Ministry of Vocational Training and Employment, "Employment Statistics."
- 16 Ibid.
- 17 World Trade Organization, *Trade Policy Review: Tunisia* (Geneva: World Trade Organization, 2005), [www.wto.org/english/tratop\\_e/tpr\\_e/tp252\\_e.htm](http://www.wto.org/english/tratop_e/tpr_e/tp252_e.htm).
- 18 According to a study conducted by Lautier, Tunisia hosted more than 100,000 foreign patients in 2003 (80 percent from Libya, 11 percent from Europe, 3 percent from Algeria, and 6 percent from other countries), which generated about one-quarter of the clinics' total revenues. The study estimated that export of medical services created more than 10,000 jobs (half of them in the health sector). The requirement that only nationals can practice medicine in Tunisia is one key constraint on the further development of medical tourism. M. Lautier, "Export of Health Services from Developing Countries: The Case of Tunisia," *Social Science and Medicine* 67 (2008): 101–10.
- 19 International Monetary Fund, *Tunisia: Selected Issues*, IMF Country Report 10/109 (Washington, D.C.: International Monetary Fund, 2010), [www.imf.org/external/pubs/ft/scr/2010/cr10109.pdf](http://www.imf.org/external/pubs/ft/scr/2010/cr10109.pdf).
- 20 There is a large information deficit in Tunisia with regard to the recent trend of household living standards and income distribution.
- 21 The Gini Index, as a measure of inequality, has a value that ranges between 0 and 100. A value of 0 means perfect equality, and a value of 100 indicates full inequality, with one person having all the income.
- 22 These figures are based on the data on fiscal revenues (not including revenues from oil companies) for the period 2005–2009.
- 23 Empirical research shows that authoritarian governments turn away from tax sources that require a substantial degree of voluntary cooperation such as non-wage earners and corporate taxes and rely more on trade taxation (indirect taxes), seigniorage, and a greater use of state enterprises.
- 24 International Monetary Fund, *Consumer Food Subsidy Programs in the MENA Region*, Report 19561-MNA (Washington, D.C.: International Monetary Fund, 1999).
- 25 These are the most recent data available. Other more up-to-date statistics reveal that the regional divide has been exacerbated since 2004.
- 26 Here the author uses the ad hoc definition that defines a formal enterprise as an enterprise with more than five employees.

- 27 In Morocco, for instance, the total spending of local governments represents the equivalent of 13 percent of the state budget.
- 28 The criteria are stipulated by Law 75-36 of May 1975, amended by Law 2007-65 of December 2007. There are two tiers of local administration in Tunisia. The first tier is governorates, of which there are 24; they receive 14 percent of state resources allocated to local administration. The second tier is delegations, of which there are 264; they receive the remaining 86 percent of state resources. Each governorate receives 25 percent as a lump sum, and the rest is proportional to its population. Each delegation obtains 10 percent as a lump sum, 45 percent proportional to its population, 41 percent proportional to its local tax revenues, and 4 percent inversely proportional to its fiscal strength (adjustment factor to offset disparities).
- 29 African Development Bank, *The Revolution in Tunisia: Economic Challenges and Prospects*, Economic Brief (Abidjan: African Development Bank, 2011), 4.



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## About the Author

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