

Executive Summary

1. Context

i. **Tunisia was often recognized in the period preceding the 2011 revolution as one of the leading performers in the MENA region in terms of economic and human development outcomes.** One of the first countries in the region to embark on early structural reforms that contributed to the successful economic performance since mid-1990s, Tunisia saw in parallel significant progress in social and human development indicators. In the two decades prior to 2011, the country benefitted from growth rates¹ above the regional average, sustained progress in access to primary education (today almost universal) and health care, and a tremendous reduction in overall poverty incidence, which was halved in the decade between 2000 and 2010.² As of today, Tunisia remains one of the most progressive countries in MENA in terms of women rights and female emancipation.

ii. **Despite notable achievements and progress, Tunisia's pre-revolutionary development model failed to generate inclusive growth in its most comprehensive sense. A deterioration of economic governance and pervasive elite capture during the decade preceding the revolution undermined the country's social progress, hindered further economic development and ultimately fed the social discontent that culminated in the 2011 fall of the regime.** Economic progress and socio-political stability were obtained at the price of denied civil liberties and political freedom. The past policies, implemented for the two decades preceding the 2011 revolution, failed to address—and sometimes exacerbated—the deep-rooted distortions in the economy that prevented operation of the channels for a more equal and inclusive society (productive employment and job creation above all) and resulted in the unequal outcomes still observed today. These distortions, grounded at the time in a tightly controlled social and political space that favored the elites, have limited citizens' active political, social, and economic participation, and therefore hampered the long-term economic and social sustainability of the country's development model. Growing inequality and unequal access to opportunities and assets eventually fueled a rising resentment among the population, undermining the implicit social contract that was holding the development model in place, which eventually imploded with the revolution of January 2011.

iii. **Significant strides toward a more open, inclusive, and transparent society have been achieved since the 2011 revolution, laying the foundations for a new social contract embodied in the new 2014 Constitution.** Tunisia successfully implemented a sometimes rocky, but altogether remarkable democratic transition. Since the revolution, policies have mainly focused on the most immediate challenges (first and foremost combating security threats), while ensuring a most-needed successful democratic transition, thereby leaving many of the structural economic and social challenges unaddressed. Boosting shared prosperity will require a concerted effort to further strengthen the social contract, particularly in the area of promoting equality of opportunity. In the case of Tunisia, this will mean first and foremost re-establishing trust in public institutions and ensuring active citizen participation in political and social affairs. Significant progress has been made during the 2011-2014 political transition to strengthen transparency and

¹ Real GDP grew at an average of 5 percent yearly between 1995 and 2008. Growth was mainly driven by large public investment and strong domestic demand, coupled with more dynamic exports and a sharp increase in FDI inflows. Tunisia also benefitted from an improved macroeconomic management since the 1990s, when a first wave of structural reforms started. Strengthened management of monetary and fiscal policies allowed containing the fiscal deficit (lower than 3 percent of GDP between 2000 and 2008) and inflation, safeguarding in this way most of the real purchasing power of the poor.

² Poverty rates (based on a national poverty line estimated at 1,077 dinars in 2010, date of the most recent poverty survey which amount roughly to \$3.42 per day (2005 PPP). Based on a \$2 per day poverty line, poverty rates stand at 4.3 percent.

participation, particularly by enhancing civil and political rights as highlighted by the first free and fair elections in the country, increased freedom of press and association, easing restrictions on the operations of civil society organizations and other associations, and improving economic governance. These major advances in terms of institutional, legislative and judicial framework, and the recognition of rights which are now enshrined under the 2014 Constitution,³ will set the stage for furthering social progress and strengthening opportunities.

iv. **Having successfully completed a historical and remarkable democratic transition, Tunisia can now embrace an unprecedented opportunity to unlock the economic and institutional reforms necessary to put the country on a faster and more inclusive development path.** Tunisia, as many middle income countries, has made considerable strides in meeting the basic needs of the population (as shown in the improvement of human development indicators). However, the need to strengthen the link between growth and social progress, notably through the channel of more and higher quality employment opportunities, remains an imperative and will determine the extent to which Tunisia could embark on a more robust, sustainable, and inclusive growth path. Advances in terms of citizens' participation and agency, and improved governance in the economy and in the society at large would in fact unleash the potential for higher growth thanks to a more dynamic private sector, higher productivity and innovation and a more efficient public sector, all enhancing human and social capital. The opening of the political and social space brought by the new democratic setting offers an unprecedented opportunity to build on a participative social and economic dialogue to identify channels to strengthen the link between growth, welfare, and citizen participation. This dialogue, conducted by domestic stakeholders with the technical support of international partners as needed, will reinforce the design and implementation of policies to deliver higher growth and inclusion.

v. **Substantial and timely action is now required to trigger the structural transformation of Tunisia's economy, which would ensure sustained, sustainable, and inclusive growth.** Growing evidence suggests that improving access to economic opportunities and social services and tackling disparities are not only about "fairness" and building a "just society," but also about realizing a society's aspirations of economic prosperity. While reinforcing security for citizens and businesses will continue to be a major policy focus in the medium-term, deep structural reforms, including promoting value creation and innovation, and continuing to dismantle undue economic rents and privileges, remain crucial to enabling a lasting economic recovery, and to join the path of upper MICs in other regions, which have performed much better than Tunisia over the past two decades. These reforms would need to tap on the country's underlying capabilities and realign incentives to facilitate sustained and inclusive growth. In this context, this Systematic Country Diagnostic identifies the promotion of private-sector- driven growth (and job creation) and the improvement of equality of opportunities as the two key drivers of change where it is advisable to decisive policy initiatives.

2. Tunisia Systematic Country Diagnostic

vi. **A sound macroeconomic framework and a stable socio-political context are necessary conditions toward the development of a truly inclusive economic model.** Higher economic growth that translates into better jobs is a necessary condition to increase people's prosperity, requiring a sound

³ The new Constitution recognizes the right of access to information as a prerequisite for transparency and accountability of the government, allowing citizens to make informed choices, and safeguarding them against mismanagement and corruption. It also strives to guarantee that adequate check and balance processes are in place. Among its main achievements, the new Constitution preserves and further guarantees women's rights and equality of female and male citizens and confirming the right to conscious and limits the parliament in restricting freedoms and fundamental rights, especially through the newly created constitutional court.

macroeconomic framework and (especially for countries that have just exited a political transition period like Tunisia) a suitable level of political stability and security. Macroeconomic and financial stability is central to protecting the income and wellbeing of the less well off and creating the basic conditions for private investment, growth, and shared prosperity. Together with ensuring that the political, security, and economic environment is stable and conducive to both public and private investment, restoring macro and fiscal sustainability represents an essential precondition for fostering economic growth. Addressing fiscal risks and ensuring fiscal space for growth enhancing investments are therefore first order policy priorities.⁴ Among the critical (though not exhaustive) policy actions needed to maintain debt sustainability and assure macro and financial sector stability are: i) consolidating fiscal support to public enterprises, while reinforcing their governance; ii) containing the increase in the public sector wage bill; iii) controlling the expanding imbalance of social security schemes; and iv) rationalizing consumption subsidies and social assistance programs so that the composition of expenditure can be rebalanced toward productive and growth-enhancing investment as well as key social services, notably in disadvantaged regions.⁵ Steps have been taken to initiate fiscal consolidation and the recent governments have demonstrated commitment to structural reforms to halt the rise in public debt. The first reforms of the fuel subsidies system have been implemented,⁶ and the acceleration in the restructuring of public enterprises, foremost the major public banks, are encouraging steps in the right direction. Initiatives have been taken also to improve budget composition by increasing capital spending—particularly in poorer regions—while measures are considered to increase the absorption capacity for public investment programs, notably by increasing the efficiency of public procurement practices.

vii. **Progress toward increased and shared prosperity will depend on whether or not specific groups can participate in, and benefit from, economic growth.** The extent of real and perceived inclusion can have significant impacts on overall sustainability. Strengthening the social pact that weaves together all Tunisians, a primary challenge of the post-transition period, will be therefore another crucial prerequisite and condition to the long-term sustainability of the desired inclusive economic model.

viii. **This Systematic Country Diagnostic identifies some key areas where opportunities that build on Tunisia's multiple strengths arise, which could help guide the future development policies of the country.** To seize these opportunities a (non-exhaustive) platform for reforms actions to address some of the most binding constraints to growth and inclusion is presented in this diagnostic, based on the strength and depth of their potential development impact in the medium term, but with a view also to the long term development goals of the country. The feasibility of implementation as well as the conditions in place for the sustainability of reforms are taken into account—together with the results of the technical analysis—in the identification and selection of areas where opportunities for advancement toward the goals are most compelling. The next sections summarize the main areas where the SCD sees Tunisia's strengths and opportunities, and where ongoing reforms or dialogue on reforms would sustain progress toward more inclusive growth and a new development model.

⁴ In June 2013 Tunisia joined a 24-month Stand-By Arrangement program by IMF in an amount equivalent to \$1.75 billion. The focus of the program is to contribute to short-term macroeconomic stabilization and laying foundations for higher and more inclusive growth, including moving forcefully on banking reforms.

⁵ The implementation of a tight monetary policy and a more flexible exchange rate policy are also essential to reduce external vulnerabilities, improve Tunisia's price competitiveness, and rebuild foreign exchange buffers

⁶ For example, all energy subsidies to the cement sector have been eliminated since 2013. Recent increases in electricity and fuel prices, and the introduction of a reduced electricity tariff for households consuming less than 100 kwh, are also steps in the right direction. Public spending savings from these measures are estimated at 0.2 percent of GDP. Eliminating energy subsidies for the other energy-intensive industries and increasing electricity and fuel prices for industrial users will result in an additional reduction in public spending of 0.5 percent of GDP in 2015.

A. Sustain reforms of the business environment to stimulate productive investment and prevent elite capture in the future

ix. **Reforms in the business environment have great potential for growth, job creation, and ultimately inclusion.** Removing the barriers to entry and competition would substantially improve the performance of the Tunisian economy and boost the ability of the most productive firms to grow and create good quality jobs, thereby contributing to the establishment of a genuine “economic democracy” where entrepreneurs access resources on the basis of the merits of their projects. This is the time where the socio-political space for this type of reform is open and therefore the opportunity to advance is the greatest. The removal of barriers to market competition would open up investment in these sectors, and should start with backbone services sectors, which were the most shielded from competition in the past, and sectors with high potential for jobs creation, notably commerce and telecommunications. The gains from heightened competition in Tunisia would be considerable and result in faster jobs creation. There is ample empirical evidence internationally on the substantial benefits of allowing greater competition. The empirical analysis presented in the 2014 Tunisia DPR found that a five percentage point decrease in firms’ profit margins (driven by greater competition) would translate into additional GDP growth of around 4.5 percent per year and approximately 50,000 new jobs per year. Since the 2011 revolution, important measures have been taken to enhance competition and promote a level playing field. For instance, a draft competition law that reinforces the role and independence of the Competition Council is under consideration and is expected to be adopted in 2015. The Council can play a key role in stimulating competitive forces to the benefit of consumers, including lifting barriers that may be preventing retail and wholesale prices from falling toward their competitive levels. Similarly, key reforms are being undertaken at the sector level, for instance in telecommunications, to allow for more service providers to be able to enter the markets. Other important areas of reform to improve the investment climate include tax reform, the alleviation of the regulatory burden, the fight against corruption and the acceleration of public infrastructure programs, notably through the increased recourse to public-private partnerships (PPPs) in infrastructure.

x. **An open and engaged public-private dialogue should accompany deeper regulatory reforms.** However, many of the regulations and practices that create market power rents still exist and many companies continue to benefit from them. A drastic simplification of the pool of regulations hindering private sector activity with a view to reducing the room for discretion in their implementation is critical for a private sector-driven growth and ultimately inclusion. Moving forward, it will be crucial to build on a strong public-private sector dialogue on regulatory reform and develop tools to ensure that existing and new regulations are fit for the purpose and serve the public and private interests.⁷

B. Develop and implement a national financial sector strategy to increase economic opportunities

xi. **Improving access to financial services for both households and firms is critical to catalyzing private sector development, improving access to essential services increasing economic opportunities for the most vulnerable.**⁸ Strengthening access to credit for firms, particularly those with no credit history and limited collateral (mostly MSMEs and startups), and developing alternative sources of financing, will enable resources to be channeled to the most productive projects and allow companies to expand and invest productively.⁹ Some programs to improve access to finance for high value added exports

⁷ Detailed areas of opportunities where reforms are already ongoing or where conditions might be in place for their implementation are provided in Annex I.C.

⁸ More details on reform areas in Annex I table C2.

⁹ Better performance in the banking sector could increase the level of credit to the private sector by at least 10 percent of GDP, which could generate in excess of US\$10 billion in additional investments to be injected in the economy over the next 10 years, corresponding roughly to an additional 38,000 additional jobs per year (Tunisia 2014 DPR).

have been already implemented, with support of the WBG.¹⁰ There is indeed opening for additional support and instruments to be tested with a sector-specific focus and with a more inclusive lens (for instance focusing to address regional disparities in access to finance). To improve the efficiency of the banking system and competition within the sector, the most compelling reforms should focus on the restructuring state owned banks (SOBs), strictly enforcing bank regulations, and revising procedures to deal with banks in financial difficulty. At the household level, increasing financial inclusion (access to and usage of formal financial services such as accounts, consumer and housing finance, and insurance) is critical to support access to basic services (housing, education, etc.), spur income generation and employment as well as help manage economic shocks. Financial inclusion is also positively correlated with financial stability and greater efficiency of financial intermediation, both important pre-requisites for job creation and private sector development. Further reform and expansion of the microfinance sector should be pursued together with the development of innovative financial instruments and approaches to cater the needs for non-salaried and low-income households. The development of a national financial sector strategy and its immediate implementation represents a clear opportunity to determine a feasible road map of actions to achieve both sector development and stability objectives.

C. Design and implement policies to stimulate growth and job creation in sectors where Tunisia holds a strategic advantage

xii. **In an effort to modernize past industrial policies, a new type of sector-focused strategic development policy coupled with reforms to incentivize formal employment would support the structural transformation of the economy and advance progress toward a more inclusive growth.**¹¹ The government can play an active role in the development of high potential sectors through enabling the investment climate by correcting sector-specific regulatory and coordination failures. Policies to improve the overall business environment could be complemented with targeted interventions aiming to create jobs in specific sector and regions. Indeed, as discussed in this diagnostic, higher investments alone do not necessarily guarantee that the economy will create the jobs needed to improve the opportunities and standards of living of all Tunisians. It is important, therefore, that the government, in close consultation with concerned stakeholders (private sector, labor organizations) also identifies sectoral policies geared to stimulate investment and employment. This implies mapping key sub-sectors and value chains within the economy to understand the potential for job creation and the types of bottlenecks and regulatory failures that would need to be removed to achieve it. This mapping would provide information about the types and level of investments that are necessary, the quantity of jobs that can be created, their composition in terms of skills, and their regional distribution.

xiii. **These policies will also need to be accompanied by reforms to consolidate social insurance regimes and align labor regulations to incentivize formal employment and better protect living standards.** In terms of social insurance, greater harmonization among private and public sector regimes, improving portability, enhancing the governance and management of social security schemes, and aligning financing with benefits more explicitly will help to improve incentives for job creation, sustainability, and coverage. In terms of labor regulations, curbing the growth of labor costs,¹² while improving income protection and services to workers would go hand in hand with social insurance reforms. Employment protection legislation plays a critical role in shielding workers from the negative consequences of arbitrary actions by employers, and facilitates industrial stability along with the build-up of firm-specific

¹⁰ These include the third Export Development Project and the MSME facility.

¹¹ Industrial policies pursued will have to change their nature that has so far not targeted market failure and have favored firms, rather than sectors.

¹² Reducing the tax-wedge, rationalizing redistributive arrangements, reforming dismissal procedures, and reducing discretion in the setting of the minimum wage.

human capital and innovation. When employment protection and contracting is too rigid, however, firms' ability to respond quickly to changes in technology or market demand in terms of hiring or retraining is hampered. Moving forward, it is important to accompany the targeted investment policies with the flexibility of employment policies, as well as better targeted Active Labor Market Policies (ALMPs), that are crucial for efficient job reallocation, greater job creation, and economic growth. Strengthening inclusive social dialogue will help support the development of an integrated social protection and labor system needed to achieve the right balance between flexibility and security.

D. Use the social dialogue to catalyze the adoption and implementation of more effective social assistance policies and that will improve the equity and efficiency of social assistance programs

xiv. **More rational targeting of universal price subsidies and social safety nets will improve equity and fiscal space needed to jump-start graduation programs to productive livelihoods.** Strengthening Tunisia's social safety net system is a necessary complement to pro-growth reforms in order to effectively protect the poor and vulnerable from unforeseen shocks, and maintain purchasing power and living standards. As is the case in other countries of the region, the current excessive outlay on untargeted subsidies fails to reach the poorest and paradoxically largely benefits the better off, thus exacerbating inequality. Existing cash transfer and health cards programs, which benefit some of the poor, can be better targeted by further developing the recently conceived unique identification system for all social protection and labor programs and introducing exit strategies to ensure equitable access and transition to work for the able-bodied. Combined with the fiscal deficits facing the social security system (pensions and health insurance), inadequate coverage and sustainability of social protection programs highlight the need for comprehensive reform beginning in the near term. The new "Social Contract" signed between the Government and social partners in 2013 shows the commitment of the Government to developing the policy dialogue on important reforms such as labor regulations, social security reform, subsidy reform, social assistance reform, reform of employment programs, and investment policies targeting lagging regions. Further steps in this direction (as already demonstrated by the progress on the social protection reforms with the development of a unified social registry and a unique identification system with a link to the national identification card) are needed, and are likely to have a significant impact on growth and inclusion.

E. Decentralization as a gateway to increase and equalize opportunities

xv. **Inclusive growth can be promoted by policies aimed to at addressing spatial inequalities in access to and quality of basic services, access to good infrastructure, and more generally targeting institutional failures that generate unequal "opportunities."** We argue in this diagnostic that equal opportunities are a crucial part of the "shared prosperity" goal. Increasing parity of access to quality basic services (notably water, health, and education services) in lagging areas will improve people's employment opportunities, their quality of life, and ultimately contribute to long-term economic growth. Improving the governance, institutional, and regulatory framework to allow both more accountable and efficient services would incentivize investment and allow more viable service provision, hence reducing enduring inequality in access and quality across regions.

xvi. **The government commitment to decentralization could improve provision of services at local level.** The new Constitution includes clear commitments to decentralization, local governance, and empowered local entities. The provisions of the new Constitution create the framework for fully devolved

and empowered local government with autonomy for executing their mandates of providing local services according to transparent principles of participation by, and accountability to, their electorate.¹³ The expansion of formal authority of local governments requires reform of the intergovernmental fiscal transfer system and measures to increase the capabilities of local governments including through measurement and public dissemination of local government performance. Over time, these measures are designed to lead to better provision of services and infrastructure and improved governance in part through greater accountability of local governments to their electorate and to the central government

3. Sustainability of a long term development trajectory

xvii. **Whether Tunisia can sustain the progress observed in previous years while moving on the path of higher and more inclusive growth depends on the extent to which attention is paid to critical socio-political, economic, and environmental issues.** On all these fronts, emerging issues are overlapping with ongoing structural weaknesses and, together, could threaten the effectiveness and impact of identified reforms. There are however also new and unique opportunities to move forward and to strengthen the link between specific policies and a long-term development vision. Challenges and opportunities to maintain socio-political and economic stability are presented below.

A. Political and social stability

xviii. **Tunisia has suffered from increased instability following the revolution.** Besides the generalized spread of violence in everyday life (increases in burglaries, petty crimes, and assaults), there has been an upsurge in explicitly socially, politically, and religiously motivated violence. The unrest intensified during 2013 with the assassination of two prominent opposition politicians. Although slightly improved in 2014 with installment of the neutral government and the agreement of the new constitution and ultimately with the peaceful conclusions of the elections at end 2014, the situation has suddenly deteriorated. The brutal terrorist attack in March 2015 in the Bardo area is yet another blow at an already fragile security situation. Issues of reforming the police and security services will be extremely complex and delicate, and the former have occasionally gone on strike to protest efforts to sanction their members. This uncertain security, political, and policy environment has significantly impacted investor confidence in Tunisia since the revolution, affecting both domestic and foreign investments. Continued uncertainty on these fronts will undoubtedly affect the sustainability of Tunisia attracting necessary private investment into the country over the coming years.

xix. **The volatile regional environment and the difficult security situation, coupled with an economy that is still struggling to take off, might contribute to weaken the initial support of the Tunisia population for democracy.** A very recent poll from the Pew Center¹⁴ highlights how today only about half of Tunisians (48 percent) believe that democracy is preferable to any other kind of government, against a vast majority (63 percent) in 2012, soon after the revolution. About a quarter of the respondents

¹³ To this end, the Constitution lays down the mandate for LGs to achieve the following: (i) financial and administrative autonomy; (ii) participatory local democracy and open election of municipal representatives; (iii) formal assignment of functions according to principles of subsidiarity; (iv) own source revenues and transparent, objective and predictable systems of inter-governmental fiscal transfers, including consideration of issues addressing equity, equalization and national policy priorities; (v) governance structures that ensure participatory governance and accountability of municipalities to electorates in decision-making and program implementation; (vi) inter-municipal cooperation in metropolitan areas and (vii) restructuring of the *tutelle* system to play an ex-post rather than an ex-ante oversight role.

¹⁴ The latest survey in Tunisia by the Pew Research Center is based on face-to-face interviews conducted with 1,000 respondents from April 19 to May 9, 2014. The poll results were released on October 15, 2014.

replied that in some circumstances a non-democratic form of government is preferable (26 percent) or that the type of government does not matter (24 percent).¹⁵ According to the poll, a great part of the public's discontent is explained by the economy. Fully 88 percent describe the country's economic situation as bad, and 56 percent say it is very bad. But a majority is optimistic that the economy will turn around soon: 56 percent expect it to improve in the next year. Instability also plays an important role: when asked which is more important, having a democratic government with some risk of political instability, or a stable government with a risk it will not be fully democratic, 62 percent of Tunisians say they prefer stability. This has increased dramatically since 2012 when just 38 percent said they would prefer stability to democracy. The toned down enthusiasm and engagement is reflected in the voter turnout for the most recent—October 26, 2014 —parliamentary elections, where participation was estimated at 62 percent of the 5.3 million registered voters. Contrary to some international media, which characterized participation as a success, the local feeling is that it is a disappointing turnout, as the absolute number of voters is below that of 2011. Reports suggest very weak youth participation, especially in the inland/lagging regions.

xx. **Despite waning confidence in democracy's ability to produce results, Tunisians continue to want key features of a democratic system, such as a fair judiciary, competitive elections, the right to protest, and equal rights for men and women.** A strong majority—94 percent—believe that having a judicial system that treats everyone in the same way is very important for the country's future, up 13 points since last year. Similarly, 92 percent of Tunisians say having honest, regularly held elections in which people have a choice of at least two parties is very important, an increase of 21 percentage points in just a year. Law and order is a priority for most Tunisians: 81 percent believe that stability is crucial for Tunisia's future. More than six-in-ten also think that certain freedoms are critical for Tunisia's future: the freedom to peacefully protest (68 percent), equal rights for women (66 percent), freedom to criticize the government (64 percent), and an uncensored media (63 percent).

xxi. **A whole new approach to transparency, media, and civil society will facilitate sustainability of reforms by facilitating citizen engagement.** The post-revolutionary period has seen an unprecedented expansion of free expression. Safeguarding the progress made in protecting fundamental citizens' rights will be crucial to guarantee social stability, and a continued and informed dialogue between stakeholders and society at large will facilitate the implementation of much needed—although at times unpopular—reforms.

B. Macro and Fiscal Sustainability

xxii. **While Tunisia has remained vulnerable to shocks, lower growth and greater external unbalances threaten macroeconomic and fiscal sustainability.** For the three years since the revolution, Tunisia has been running down its policy buffers. The macroeconomic space for expansionary policies has now vanished. While public and external debt remained at an acceptable level compared to international standards, they are expected to reach unsustainable levels if reforms are not implemented.

(i) Fiscal sustainability

xxiii. **Expansionary fiscal policy since the revolution resulted in growing fiscal deficit and public debt.** The fiscal deficit increased from 1 percent of GDP to 6.2 percent between 2010 and 2013 and

¹⁵ Findings in Tunisia closely reflect those in Colombia and Thailand, the former in partial transition from conflict and the latter in a state of chronic political upheaval. Attitudes in transition countries often reflect the dichotomy of the public's interest in balancing stability with rights and freedoms. In periods of political turmoil citizens may be more willing to trade enhanced rights for greater stability. However, without public engagement and pressure difficult reforms are less likely to be addressed effectively. Implementation of reforms will be heavily dependent on a civil service, which in the past has lacked efficiency and effectiveness.

the public debt from 40.7 percent of GDP to 44.8 percent during the same period. While this increase was an acceptable range, public debt is expected to reach 56 percent of GDP by 2017 before slowly declining over the medium term, according to the baseline scenario of the most recent debt sustainability analysis.¹⁶ This baseline scenario assumes the fiscal consolidation and growth pick up in 2015, however if fiscal consolidation reforms are not implemented, it would result in growing public debt that could reach around 62 percent of GDP by 2019, while a permanent negative growth shock would increase public debt to about 67 percent of GDP by 2019. Public debt dynamics are vulnerable to a slower adjustment path, lower growth, a marked depreciation of the exchange rates, or a shock on contingent liabilities.

xxiv. **In addition, since the revolution, the budget has remained centered on the growing current spending rather than investment.** Notably the wage bill and subsidies continued to increase until 2013, despite freezes for salaries and hiring of public servants, and a gradual increase of subsidized fuel prices. In 2013, the wage bill accounted for 12.5 percent of GDP (against 10.6 percent in 2010), and subsidies and transfers represented 7.8 percent of GDP (against 3.6 percent in 2010). Only in 2014, the expansionary policy put to a halt, leading the way to a medium-term fiscal consolidation, by slowing down the increase in current spending and progressively improving expenditure composition. In particular, spending on subsidies should decrease by 0.6 percent of GDP in 2014, thanks to the initial phase-out of energy subsidies. Measures have also been taken on the revenue side, including streamlining exemptions and widening the tax base. Assuming the intensification of fiscal consolidation over the medium term, the deficit is expected to gradually decline from 6.5 percent of GDP in 2014 to 3.2 percent in 2019. The fiscal consolidation will require continued action on wage bill discipline in the public sector, further phase-out of subsidies, SOE restructuring, and public sector pensions system. To mitigate the social costs of reforms, a better-targeted social safety net system and a new strategy for the financing of social security should be quickly put in place.

(ii) Macroeconomic sustainability

xxv. **Tunisia's external position has gradually eroded in the face of the expansionary policies favoring domestic consumption, delays in structural reforms to support exports, political uncertainty, and exogenous factors.** The trade balance deficit widened from 10.4 percent of GDP in 2010 to stand over 13 percent in 2014. Tourism receipts have been very volatile since the revolution, as the price competitiveness of Tunisian destinations has not offset concerns over the security situation until recently. Remittances have, on the other hand, quite steadily sustained the current account by about US\$2.2 billion a year, but the overall imbalance has increased from 4.8 percent of GDP in 2010 to over 8 percent by 2014. Foreign direct investment has been negatively impacted by political uncertainty and the delays in reforms. The Central Bank has used up significant reserves since 2011, dropping from about US\$9.5 billion at the end of 2010 (or 4.4 months of GNFS imports) to approximately US\$7.3 billion toward the end of 2014 (or 3.1 months of GNFS imports) to support the currency first, before limiting interventions to manage an orderly depreciation. While the exchange rate depreciation should sustain exports and the decline in international energy prices provides temporary relief, external imbalances will remain a source of vulnerability over the medium-term that can only be addressed by reforms favoring an adequate supply side response when foreign markets recover, especially in Europe.

C. Environmental sustainability

xxvi. **Sharing prosperity with future generations requires addressing the sustainability of Tunisia's development model.** Tunisia's ecosystems support its economic development and provide

¹⁶ IMF December 2014.

income and jobs to most vulnerable population. For example, the coastal zone is home to over 65 percent of Tunisia's population and to its major industries; it also supports its tourism sector, which relies in its mass on mass beach activity, and which contributes 7 percent of GDP (2008) and provides employment opportunities for 380,000 (10 percent of Tunisia's active population). Tunisia's water and soil ecosystems support its agricultural activity that contributes 8 percent of GDP and employs 16 percent of the national workforce. Tunisia's development path is, however, depleting its natural resource stock. The adjusted net savings (ANS) measures the real difference between national income and consumption. It takes into consideration investment in human capital, depreciation of fixed capital, depletion of natural resources, and damage caused by pollution. While Tunisia's ANS rose from 2.6 percent of GDP in 1980 to 19 percent in 1999, it steadily declined over the next decade to reach -3.2 percent by 2012 due to energy depletion, local pollution damage, and mineral and forests depletion (WDI 2014).

xxvii. **The unsustainable use of natural capital reduces the flow of economic and social benefits such that it is more difficult to achieve sustainable development, poverty reduction and other development goals.** The linkages between these issues are stronger in Tunisia because an important proportion of the population is dependent on natural capital. It is therefore important to ensure an inclusive and participatory approach to: (i) consider natural resources as an integral part of a more comprehensive and sustainable socio-economic development paradigm, whereby these resources would be viewed as key support for improved livelihoods; (ii) consistently improve current practices characterized by slow, inefficient, and top-down decision-making processes; and (iii) significantly reconcile broad environmental protection concerns and local socio-economic priorities, as well as optimally balance potential gains in natural capital and productivity including at household level. Furthermore, the approach should be put on strengthening and enhancing sustainable and low-carbon local development practices (by reducing greenhouse gas emissions), improving the capacities of natural ecosystems to sequester carbon, maintaining and improving the value of goods and services of natural ecosystems, and reducing the pressures facing these ecosystems.

4. Conclusion

xxviii. **The next five years represent an unprecedented window of opportunity, as Tunisia stands at a crossroads to capitalize on its assets and potentials, by implementing sustained reforms.** Now that the democratic transition is coming to an end and many path-breaking reforms have been initiated, Tunisia can now "shift gears" and proceed to implement the next generation of reforms, including deep and vital changes that will span from the economic structure to the overall governance dimension of the socio-economic and political context. This new development model, underpinned by the renewed social contract enshrined in the Constitution and a dialogue promoting accountability and opening up of the policy space would unleash the potential to achieve higher growth and shared prosperity. The success of this large agenda of reforms will depend on the ability of the new and more complex political and social landscape of Tunisia to work efficiently, combining adequate consultation and participation with decisive implementation that minimizes the gap between the adoption of reforms and the results they deliver on the ground. This will further require institutional changes, notably in the public sector, to best serve the economic transformation and social inclusion agenda.