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# On the Brink: Preventing Economic Collapse and Promoting Inclusive Growth in Egypt and Tunisia

By Hafez Ghanem and Salman Shaikh

The Brookings Project on U.S. Relations with the Islamic World  
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For the tenth annual U.S.-Islamic World Forum, we returned once again to the city of Doha. The Forum, co-convened annually by the Brookings Project on U.S. Relations with the Islamic World and the State of Qatar, is the premier international gathering of leaders in government, civil society, academia, business, religion, and the media to discuss the most pressing issues facing the United States and global Muslim communities.

Each year, the Forum features a variety of platforms for thoughtful discussion and constructive engagement, including televised plenary sessions with prominent international figures addressing broad issues of global importance; sessions focused on a particular theme led by experts and policymakers; and working groups that bring together practitioners to develop partnerships and policy recommendations. The 2013 Forum continued its strong record of success. Over three days together, we assessed the impact of the significant transitions underway in Afghanistan and Pakistan, examined the economic challenges still looming in the aftermath of the Arab Spring in Egypt and throughout the region, and evaluated the regional effects and impact of the crisis in Syria. We also explored how art functions as a vehicle for political expression and accountability, and we examined how the events of the past decade in the Middle East have helped to shape Arab identity. For detailed proceedings of the Forum, including photographs, video coverage, and transcripts, please visit our website at <http://www.brookings.edu/about/projects/islamic-world>.

Each of the four working groups this year focused on a different theme, highlighting the multiple ways in which the United States and global Muslim communities

interact with each other. This year's working groups included: Rethinking the "Red Line": The Intersection of Free Speech, Religious Freedom, and Social Change; On the Brink: Avoiding Economic Collapse and Promoting Inclusive Growth in Egypt and Tunisia; Diplomacy and Religion: Seeking Common Interests and Engagement in a Dynamic World; and Advancing Women's Rights in Post-Conflict States: A Focus on Afghanistan, Egypt, and Libya.

The opinions reflected in the papers and any recommendations contained therein are solely the views of the authors and do not necessarily represent the views of the participants of the working groups or the Brookings Institution. All of the working group papers will be available on our website.

We would like to take this opportunity to thank the State of Qatar for its partnership and vision in convening the Forum with us. In particular, we thank H.E. Sheikh Ahmed bin Mohammed bin Jabr Al-Thani, the Minister's Assistant for International Cooperation Affairs and the Chairman of the Permanent Committee for Organizing Conferences; and H.E. Ambassador Mohammed Abdullah Mutib Al-Rumaihi for their collective support and dedication to the U.S. Islamic World Forum and the Project on U.S. Relations with the Islamic World.

Sincerely,



Dr. William F. McCants  
Fellow and Director  
Project on U.S. Relations with the  
Islamic World

# Abstract

## **Conveners:**

Hafez Ghanem and Salman Shaikh

**E**conomic frustration and anger helped fuel the Arab revolutions – but after two years, Egypt and Tunisia are facing an increase in the fiscal and balance of payments deficits, a decline in economic growth, and a rise in unemployment. It seems clear, therefore, that economic recovery should be a top priority for the new leadership in Tunisia and Egypt, as well as for the international community, which has a stake in a successful transition to democracy. The Arab revolutions provide an opportunity for the international community, particularly the United States, to revise its policies in support of Arab countries with a greater focus on supporting democracy, human rights, and inclusive economic growth. This roundtable brought together economists and political activists from Egypt and Tunisia, as well as experts from bilateral and multilateral donor agencies to focus on three broad questions: What should governments and donors do to achieve macro-financial stabilization and avoid economic collapse? What measures can be taken to increase economic opportunities for youth and other disadvantaged groups, and to encourage job creation? Can we identify some “quick wins” in the area of good governance that could support inclusive and sustainable growth, particularly corruption control?

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# On the brink: Preventing economic collapse and promoting inclusive growth in Egypt and Tunisia

On June 9-11, 2013, participants in the Islamic World Forum convened a working group on Egypt and Tunisia that brought together economists and political activists from Egypt and Tunisia, as well as experts from bilateral and multilateral donor agencies. Participants in the working group agreed that worsening economic conditions posed a threat to democratic transitions in Egypt and Tunisia. Most participants also stressed the importance of achieving some level of political consensus in order to build new democratic institutions and implement much needed economic reforms. The political and the economic, they said, cannot be separated, and a failure to address polarization in Egyptian and Tunisian society was threatening both democracy and economic development.

The ouster of President Muhammad Morsi on July 3, 2013 – three weeks after the working group meetings – underlines the importance of both consensus building and economic growth for the success of democratic transition. The *Tamarod* (or “Rebel”) movement, which led the anti-Morsi demonstrations, was started by revolutionary youth who felt that President Morsi and the Muslim Brotherhood had excluded them

from the political process. They argued that the Brotherhood was not willing to listen to the opposition and was not interested in forging consensus around major national issues. Although those political grievances may be real, it is unlikely that *Tamarod* would have been able to mobilize millions of Egyptians had the economy been doing well. Polls show that 65 percent of Egyptians felt that their standard of living had declined since President Morsi came to office. About the same number (64 percent) believed that corruption had increased since the 2011 revolution. Many of those who joined the *Tamarod* demonstrations on June 30, 2013, did so because they were suffering from unemployment, rising prices, and shortages of key necessities.<sup>1</sup>

On August 14, 2013 Egyptian security forces moved to clear two pro-Morsi sit-ins in Cairo. Hundreds were killed. Armed clashes broke out across the country, with more victims. In the immediate aftermath of the crackdown, Coptic churches, Christian schools, police stations, and government offices were attacked, apparently by angry Brotherhood sympathizers (although the group blamed security forces). At the same time, other citizens, exasperated by the Brotherhood,

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1. Poll results are from the Pew Research Center, “Global Attitudes Project,” 2012, <http://www.pewglobal.org/>.

joined the security forces in attacking Islamists. The military-backed interim government closed Islamist television stations, jailed Brotherhood leaders, instituted Mubarak-era emergency laws, and imposed curfews on major Egyptian cities.

There is no doubt that the military ouster of Egypt's first democratically-elected president is a setback, regardless of whether one refers to it as a coup d'état or not. The country may appear as if it has taken a step backwards all the way to the Mubarak era, complete with police brutality, extra-legal procedures, and limitations on political freedoms. Mubarak himself has been allowed to leave jail, which to some symbolizes the end of Egypt's democratic revolution. It is even possible to argue that the current situation is worse than conditions during the Mubarak era. In 2010, the last year of Mubarak's thirty-year rule, a majority of Egyptians were united against dictatorship. Today the same majority seems to be united in support of the security establishment's actions.

But the hopes for democracy in Egypt are not yet dead. The interim government has announced a roadmap for elections and a return to civilian rule. Perhaps more importantly, the youth of Tahrir Square continue to push for democratic reforms. Egypt's youth have learned how to deploy "people power" effectively, and have done so against two presidents in three years. It is unlikely that they will accept a permanent return to the dark days of autocracy and repression.

The Egyptian transition process is back to more or less where it was in February 2011 when the Supreme Council of the Armed Forces (SCAF) took power after the fall of President Mubarak. But the challenges are even greater this time around. The country is much more polarized. Secularists and Islamists, who were united in 2011 in their opposition to President Mubarak, are now fighting each other on the streets of Egyptian cities. During the working group, participants emphasized the importance of a genuinely inclusive political process. In view of the

violence and the increased polarization it is unclear how such a process could be established. Moreover, the economy is in worse shape now than it was in 2011. At the fall of President Mubarak, the Egyptian economy was growing at 5 percent, unemployment was at 9 percent, and the country had foreign reserves covering about seven months of imports. At the ouster of President Morsi, growth was down to about 2 percent, unemployment rose to 13.5 percent, and foreign reserves barely covered three months of imports.

The actions undertaken by the transitional government over the next few months will determine whether President Morsi's ouster symbolizes a temporary bump on the road to a stable democracy or a return of autocratic rule. The working group's conclusions are particularly relevant at this sensitive juncture. There is a need to build a broad, inclusive political process so that all factions in society – including Islamists – feel that their voices are heard during the transition process. Special attention should be paid to the economy and every effort should be taken to reduce the hardships faced by poor and middle class Egyptians.

In the intervening period since the workshop, Tunisia has been struck by its own political crisis precipitated by the assassination of Mohammed al-Brahmi, a secular opposition leader and member of the National Constituent Assembly, by a Salafi extremist on July 25, 2013. This was the second political assassination in five months, following the killing of prominent secular MP Chokri Belaid on February 6, 2013. Brahmi's death shook the country, prompting thousands of Tunisians to take to the streets in protest against the ruling al-Nahda party. The opposition blamed al-Nahda for failing to ensure security and restrain the activities of radical Salafi groups in the country, leading to a dramatic withdrawal of confidence from the government. Over 50 members pulled out of the Constituent Assembly, demanding the dissolution of the Nahda-led government and the formation of a new technocratic government.

Unlike Egypt, however, anti-government protests in Tunisia remained largely peaceful and the country did not descend into violence. In an effort to overcome the political impasse, the government held intra-party talks and negotiations, offering substantial concessions to the opposition including forming a national unity government and suspending sessions off the Constituent Assembly. On September 28, after weeks of talks with the opposition, the government agreed to resign once all major parties settle on a road-map for a new interim non-partisan government and a timetable for parliamentary and presidential elections. While a final agreement had not been reached at the time of writing, all political parties were intent on continuing negotiations to resolve the crisis and lead the transition forward.



## Introduction

Economic conditions in Egypt and Tunisia have deteriorated since the start of the Arab Spring, contributing to a popular sense of disillusionment and frustration, particularly among the young. Survey results for 2012 from the Pew Center's Global Attitudes Project indicate that 83 percent of Tunisians and more than 70 percent of Egyptians are unhappy with current economic conditions. This situation poses risks for the process of democratic transition – risks that are only too clear in the aftermath of President Morsi's removal from power. Some 59 percent of Tunisians believe that a strong economy is more important than a good democracy, and only 40 percent prioritize democracy over the economy. Egyptians are more divided on the subject, with 49 percent believing that the economy is more important and 48 percent believing that democracy is more important.<sup>2</sup> Those who took to the streets against President Morsi toward the end of June were motivated by a range of factors. One element that united them, however, was growing frustration with the government's failure to improve economic conditions.

Will the deteriorating economy ultimately lead to the failure of the democratic transitions and a return to autocratic rule? According to the same Pew Center survey, 63 percent of Tunisians and 67 percent of Egyptians believe that democracy is the preferred form of government. Sizeable minorities, however, 37 percent in Tunisia and 33 percent in Egypt, still feel that a strong leader is needed to solve their country's problems. An extended period of economic hardship, together with political instability and security

concerns, could swell the ranks of those yearning for a return to authoritarian rule, with its promise of stability, law and order, and a growing economy. This could partly explain why so many Egyptians cheered the return of the generals and the ouster of their first freely-elected president. Tunisia faces similar risks. A Tunisian *Tamarod* movement has been formed, inspired by the Egyptian experience, and a mass movement against the Islamist-led government has rapidly grown in strength following the assassination of a second secular opposition leader in July.

For many, democracy is not simply a non-negotiable end in and of itself, but something that is expected to bring tangible benefits, whether political or economic. In countries with weak institutions and a lack of consensus around the "rules of the game," the failure of democracy to deliver those benefits can set in motion a breakdown of democratic governance. This suggests the importance of integrating our understanding of both the economic and political requirements for transition, rather than adopting a "sequencing" approach. Economic recovery should be a top priority for the new leaderships in Tunisia and Egypt, as stressed by a majority of participants in the working group. The international community, which has a stake in a successful transition to democracy, committed itself during the 2011 G8 summit in Deauville to support economic recovery in those countries. Participants were equally clear, however, in stressing that the prioritization of economic recovery cannot come at the cost of neglecting the political dimension. Where transitions do not enjoy popular support and

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2. Pew Research Center, *Global Attitudes Project*.

broad-based backing by political forces for challenging reforms, economic recovery becomes even more difficult than it otherwise might be.

Faced with high levels of political polarization, many in the region as well in the international community believed that focusing on so-called easier technical reforms might provide a pathway for progress. Indeed, in the Egyptian case, economists and representatives of both the then-governing Muslim Brotherhood and the liberal opposition argued that there was considerable consensus (with notable exceptions on the left) on necessary economic reforms, including on subsidy and tax policy for example. However, in the absence of a minimal degree of political consensus – and the temptation for opposition groups to play spoiler – the implementation of reforms becomes extremely challenging. Again, the run-up to June 30 in Egypt made this all too clear. An Islamist economist in the group even argued that some within the then opposition had adopted a policy of actively trying to bring about economic collapse. Secular participants denied this accusation. They blamed Egypt's deteriorating economy on the incompetence of president Morsi's government and its failure to prioritize economic recovery.

This paper summarizes the working group's discussions. It reviews economic developments in the two years following the revolutions in Tunisia and Egypt. It shows that both countries suffer from increasing deficits and declining international reserves. At the same time, unemployment has been increasing and little or no progress has been achieved in the fight against corruption. The Arab revolutions provide an opportunity for the international community, especially the United States, to further revise its policies in support of Arab countries, particularly in Egypt and Tunisia, where transitions to democracy – however troubled – are already underway. Considering the dire economic state in these two countries, the United States, Europe and Japan – along with international financial institutions – must consider how to better coordi-

nate donor strategies so as to maximize the benefits of their financial support.

The paper focuses on the common challenges facing Egypt and Tunisia: macro-stabilization and economic recovery, youth unemployment, and weak governance, as well as the potentially dangerous feedback loop between political polarization and economic deterioration. However, this should not mask the fact that there are many differences between the two countries, not least of which are their sizes, the structure of their economies, income per capita, and levels of education. The paths followed by each country since 2011 are also sharply distinct. Egypt's transition appeared to move faster but failed to achieve broad consensus on institutional structures and the sequencing of reform. The situation now mirrors February 2011, with the military installing an interim authority with temporary powers. On the economic side, Tunisia's economy appears to be less vulnerable as it has limited the loss of international reserves and kept its public debt in check. Tunisia recently reached agreement on an IMF (International Monetary Fund)-supported stabilization program, while Egypt has not. Even though the two countries face similar challenges, therefore, the solutions need to be adapted to their particular situations.

Because the working group discussion took place before the current round of political turmoil, it was naturally more optimistic about the kind of economic reforms that can be implemented and the level of international financial support than it otherwise might have been. It now appears unrealistic to expect that the type of reforms recommended here could be implemented in the very short term. Priority should first be given to national reconciliation and political stability. But once this is achieved it is very important that economic issues take center stage in order to achieve growth and create a climate that is supportive of democratization. Egypt and Tunisia may be able to postpone reforms a few months, especially if they receive financial support from Gulf oil producers, but the reforms proposed here cannot be postponed indefinitely.

## The Looming Economic Crisis

In addition to freedom and dignity, the young men and women who led the revolutions in Tunisia and Egypt demanded an end to corruption, improved living conditions, and economic opportunities (particularly better jobs). Working group participants agreed that those economic demands are far from being met. Unemployment has actually increased in both countries, and educated youth remain jobless. There has been very little progress on corruption control, and living conditions have worsened as the price of necessities has risen in both countries. In Egypt, scarcities of some key items such as fuel and electricity are making life increasingly difficult.

### *Increased macro-financial instability*

Egypt and Tunisia face increasing budget deficits, dwindling international reserves, and deteriorating credit ratings. Dealing with those problems is not easy, because it entails tackling politically sensitive issues like price subsidies and the exchange rates of the Egyptian pound and the Tunisian dinar versus the dollar.<sup>3</sup>

***Public finances have deteriorated.*** The two years following the Arab revolutions witnessed increasing fiscal imbalances in both Tunisia and Egypt. Tunisia's fiscal accounts showed a small deficit of one

percent of gross domestic product (GDP) in 2010 and this rose to nearly five percent of GDP in 2012 (see table 1). Faced with economic stagnation and rising unemployment, the transition government in Tunisia has been trying to bring about a recovery through an expansion in public spending, especially public investment. Government spending rose from about 23 percent of GDP in 2011 to 26 percent in 2012, which explains the rise in the deficit. Tunisia received exceptional financing from Qatar as well as a U.S.-backed bond issuance. Thus, public debt which stood at about 40 percent of GDP in 2010 rose to nearly 46 percent in 2012, which is still manageable by international standards.

**Table 1:** Tunisia-fiscal accounts 2008-12 (percent of GDP)

	2008	2009	2010	2011	2012
Revenues	24.4	23.9	23.4	25.6	26.2
Expenditures	24.8	26.1	24.4	28.2	30.8
Government Balance	-0.4	-2.2	-1.0	-2.6	-4.6

Source: International Monetary Fund

Egypt already had a large fiscal deficit of eight percent of GDP in 2010. The main impact of the political upheaval has been a decline in government revenue from 22 percent of GDP in

3. This section relies on information from: International Monetary Fund, "Arab Republic of Egypt: 2010 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Arab Republic of Egypt," IMF Country Report No. 10/94, April 2010, <http://www.imf.org/external/pubs/ft/scr/2010/cr1094.pdf>;  
International Monetary Fund, "Tunisia: 2012 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Tunisia," IMF Country Report No. 12/255, September 2012, <http://www.imf.org/external/pubs/ft/scr/2012/cr12255.pdf>.

2010 to 19 percent in 2011 and 20 percent in 2012 (see table 2). Unable to cut spending because of political pressures, successive transition governments have allowed the deficit to continue rising, and in 2012 it reached up to 11 percent of GDP. The public debt, which was already high at 73 percent of GDP in 2010, rose to 80 percent of GDP in 2012. Simultaneously, however, the Egyptian government was not borrowing from abroad. External debt fell from 12.4 percent of GDP in 2010 to 10 percent of GDP in 2012. In other words, the government's domestic debt increased from about 60 percent of GDP in 2010 to 70 percent in 2012. The Egyptian government has been sucking liquidity from the domestic market, crowding out private investors. For example, at one point in 2012, the government was borrowing at a 16 percent interest rate, a rate that could not be matched by private borrowers. Thus fiscal policy in the two years following the revolution was not supportive of private sector growth or job creation because government borrowing left very little room for credit to be expanded to the private sector.

**Table 2:** Egypt-fiscal accounts 2008-12 (percent of GDP)

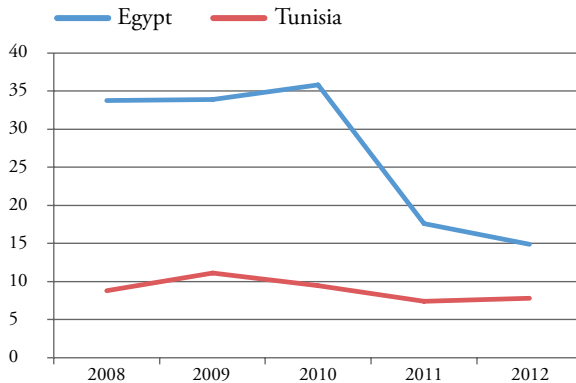
	2008	2009	2010	2011	2012
Revenues	24.7	27.1	22.2	19.3	19.7
Expenditures	31.5	33.7	30.3	29.3	30.5
Government Balance	-6.8	-5.6	-8.1	-10.0	-10.9

Source: Economist Intelligence Unit

**Price subsidies pose a particular problem.** Resolving the fiscal problem will require dealing with the politically explosive issue of subsidies. Tunisia spends about four percent of GDP on subsidies, and Egypt spends close to nine percent of GDP. The Egyptian government allocates about six to seven percent of GDP on fuel subsidies and some two percent of GDP on food subsidies. Combined, they are roughly equal to the

entire sum the government (including health and education ministries) pays in wages and salaries, and more than double the amount the government invests in infrastructure. Unfortunately, fuel subsidies present a particularly difficult hurdle for the government. First, they encourage the over-consumption of energy which has environmental as well as economic implications. The energy intensity of the Egyptian economy is estimated to be 2.5-3 times higher than the average for advanced countries. Second, fuel subsidies are regressive in nature. In Egypt, 57 percent of the fuel subsidy benefits the richest two-fifths of the income distribution. In Tunisia the households with the highest income benefit about forty times more from energy subsidies than the poorest households. Participants in the working group were in agreement on the urgent need to address what one Egyptian economist called the “chronic problem of subsidy distortion”. The major challenge, they stressed, would be finding ways to address this politically sensitive issue effectively.

**International reserves have declined to worrisome levels.** Political and economic instability led to a decline in tourism, a fall in foreign direct investment, and an increase in capital flight. The result has been a decline in both countries' foreign reserves (figure 1). The deterioration in the security situation – particularly in Egypt – made things worse. The government of President Morsi was unable to reform the police and deal with rising insecurity. It argued that this was due in part to the unwieldiness of Egypt's security establishment which was opposed to the Muslim Brotherhood and resisted reforms. In Tunisia, foreign reserves were about \$9.5 billion in 2010 and are now at about \$7 billion, covering some 3.5 months of imports. Egypt's foreign reserves were approximately \$36 billion in 2010, covering some seven months of imports. They fell to around \$14 billion in 2012, which is below the three month import cover that is usually considered as a minimum prudential level.

**Figure 1: International Reserves**

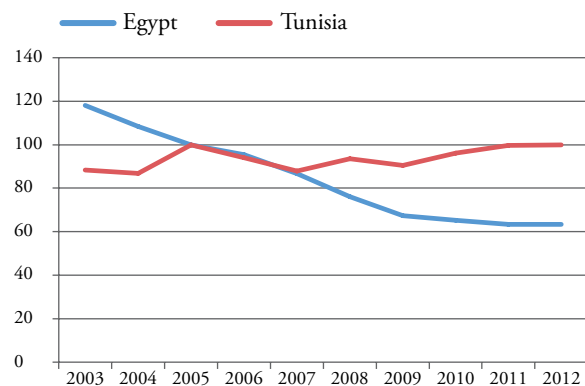
Source: IMF

As a result, both countries' credit ratings have suffered. Tunisia's debt is rated by Moody's as "Ba2", which means that it is speculative and subject to substantial risk. Egypt's debt has been recently downgraded to "Caa", which means that it is speculative, of poor standing, and is subject to very high credit risk. According to Moody's, the outlook for both countries continues to be negative.

The decline in credit rating and increased sovereign risk makes it more difficult for the private sector to engage in international business, and particularly to obtain credit on the international market. This complicates international trade and makes it more difficult for the country to import. Some Egyptian businessmen complain that now it takes about six weeks to open a letter of credit to import goods, whereas it only took three days to obtain one prior to the revolution.

***Further devaluations of the Egyptian pound and Tunisian dinar may become necessary.*** A devaluation of the national currency is one way to deal with external imbalances and limit the loss of reserves. Figure 2 shows that neither Tunisia nor Egypt has actively used the exchange rate as a tool to protect their reserves. The graph presents the real exchange rate indexes for Egypt and Tunisia,

versus the dollar for the period 2003-12. There are many definitions of the real exchange rate. The definition used here is the simplest one. It is the exchange rate of the national currency versus the dollar, corrected for the inflation differential (using the consumer price index, (CPI)) between the country and the United States. A decrease in that index indicates a real appreciation of the domestic currency.

**Figure 2: Real Exchange Rates**

Source: International Financial Statistics and author's calculations.

Tunisia has kept its real exchange rate relatively stable versus the dollar, with nominal depreciations compensating for the higher domestic inflation. Between 2010 and 2012, the Tunisian CPI increased by 9.3 percent compared to 5.3 percent in the United States. The dinar/dollar exchange rate moved during this period from 1.44 to 1.55, which is a 7.6 percent nominal depreciation. As a result, the real exchange rate depreciated slightly and remained more or less at the same level as it was in 2005. But keeping the real exchange rate stable is not necessarily the right policy. Given increased political instability, declining tourism revenue, and lower investment and growth, the equilibrium real exchange rate has probably depreciated.

In Egypt, the real exchange rate has been continually appreciating since 2003, and has continued to

appreciate since the January 2011 revolution. Between 2010 and 2012, the Egyptian CPI rose by 17.7 percent. The Egyptian pound depreciated by 8.8 percent, from 5.8 pounds/dollar to 6.3 pounds/dollar, but this was not sufficient to offset the inflation differential between Egypt and the United States and the real exchange rate even appreciated slightly. In a 2010 report, the IMF stated that the Egyptian pound appeared to be “somewhat overvalued.” If the Egyptian currency was “somewhat overvalued” when the economy was growing at five percent and the country had reserves covering seven months of imports, it was almost certainly overvalued in 2012 when the country was only growing at two percent and reserves barely covered 2.7 months of imports.<sup>4</sup>

With dwindling reserves in 2013, the Egyptian Central Bank was no longer able to stabilize the pound’s exchange rate. Moreover, there is much debate surrounding the desirability of stabilizing the pound’s exchange rate. The Central Bank has put in place a foreign exchange auction, and the nominal exchange rate has depreciated by a further 15 percent in the first quarter of 2013. But even with this depreciation, the supply of foreign exchange at the auction does not cover all of the demand and a black market for foreign exchange has developed.

### *Low growth and high unemployment*

The protesters in Tahrir Square called for “bread, freedom, social justice, and human dignity.” The goals of more bread and greater social justice have so far proven elusive, as unemployment – and hence poverty – has increased. As a Tunisian economist and politician in the working group put it, “the relation between development and poverty can be summed up in unemployment.” Youth and women in particular continue to face difficult labor market conditions.

***Low growth in both countries has led to rising unemployment.*** The global financial crisis led to a slowdown of investment and growth in Tunisia and the revolution has only worsened an already troubled economy. As a result of the global financial crisis, gross investment remained flat during 2009-10 and GDP growth declined from about five percent to three percent (table 3). Political instability surrounding the revolution has negatively impacted the economy of Tunisia, as gross investment fell by 3.5 percent in 2011, tourism decreased, and GDP contracted by about two percent, with the largest contraction occurring in the industrial sector, where output declined by 4.4 percent. The economic slowdown led to an increase in unemployment from 13 percent in 2010 to 18 percent in 2012, with youth unemployment reaching 42 percent.

The Tunisian economy is also greatly affected by developments in the Eurozone. About 79 percent of Tunisia’s exports go to Europe and more than 80 percent of tourists who visit Tunisia are European. Moreover, 87 percent of remittances flowing to Tunisia and 72 percent of foreign direct investment are from Europe. Recession in Europe, therefore, is making it more difficult for the Tunisian economy to recover.

**Table 3:** Economic growth in Tunisia, 2008-2012 (annual percent change)

	2008	2009	2010	2011	2012
GDP growth	4.5	3.1	3.0	-1.8	2.9
Agriculture growth	-0.7	9.2	-9.3	9.2	3.5
Industry growth	-0.5	1.8	5.2	-4.4	3.3
Services growth	7.1	5.7	-2.5	16.1	3.4
Gross Investment growth	9.1	0.0	0.7	-3.5	3.2
Unemployment rate	12.4	13.3	13.0	18.3	18.1

Source: Economist Intelligence Unit

4. For a discussion of exchange rates in Egypt, see Hafez Ghanem, “First Confront Discontent: Egypt’s Teetering Economy,” *The Milken Institute Review* (January 14, 2013): 24-34.

**Table 4:** Economic growth in Egypt, 2008-2012 (annual percent change)

	2008	2009	2010	2011	2012
GDP growth	7.2	4.7	5.1	1.8	2.2
Agriculture growth	3.3	3.2	3.5	2.7	2.9
Industry growth	7.1	5.6	4.6	0.5	1.1
Services growth	8.2	3.8	6.0	2.8	2.9
Gross Investment growth	14.8	-10.2	7.7	-5.6	0.7
Unemployment rate	8.7	9.4	9.0	12.0	12.5

Source: Economist Intelligence Unit

Egypt's economy has followed a similar path to that of Tunisia. It too was affected by the global financial crisis. Gross investment fell by 10 percent in 2009 as a result of the global slowdown, and GDP growth also fell from about 7.2 to 4.7 percent (table 4). The economy started picking up in 2010, however, with investment rising by 7.7 percent and GDP growth accelerating to 5.1 percent. But this nascent recovery was short lived. Political instability following the revolution led to a 5.6 percent decline in investment in 2011; it remained flat in 2012. As a result, GDP growth fell to about two percent, less than half its level during the global financial crisis. According to official figures, unemployment – which stood at around 9 percent before the revolution – rose to 12.5 percent in 2012 and 13.5 percent in 2013.

***Youth and women's employment is of particular concern.*** Official unemployment figures tend to underestimate the magnitude of the problem, especially in relation to youth exclusion and women's access to jobs. In Tunisia, the youth (15-30 year olds) make up about 33 percent of the labor force, but account for 75 percent of the unemployed. The youth unemployment rate is above 40 percent. Counter intuitively, the probability of being unemployed seems to increase with the level of educa-

tion. For example, the unemployment rate for university graduates was above 20 percent in 2010 and jumped to close to 30 percent in 2011. Although females receive the same education as males (more than 60 percent of university graduates are female), the female labor force participation rate (25 percent) remains much lower than that of males (70 percent). Unemployment is similarly higher among women. The female unemployment rate stood at 19 percent before the revolution and at 27 percent in 2012. When employed, women usually receive lower pay.<sup>5</sup>

Egypt faces the same problem. Youth with secondary education or above represent about 95 percent of the unemployed in Egypt. The problem is particularly acute for young women who are 3.8 times more likely to be unemployed than young men. Of the young men and women who do find jobs, only 28 percent find formal sector jobs (18 percent in the public sector and 10 percent in the formal private sector). As a North Africa expert in the working group said, "black market economies are the real ones that matter to youth in the region." The vast majority of youth, 72 percent, end up working in the informal sector, often as unpaid family workers. Those who are paid receive very low wages.<sup>6</sup> The average wage for male workers in 2011 was \$3.70/day; for female workers it was \$2.60/day. Roughly 50 percent of workers in that sector are without labor contracts, job security, or social benefits.

### *No progress on corruption control*

The transition governments in Egypt and Tunisia vowed to eliminate corruption and brought corruption cases against many figures of the old regimes. Nevertheless, available data indicate that very little has changed on the ground. Most Egyptians and Tunisians actually believe that corruption increased after the revolutions.

5. Mongi Boughzala, "Youth Employment and Economic Transition in Tunisia" Global Working Paper no. 57, Global Economy and Development at the Brookings Institution, January 2013.

6. Ragui Assaad and Ghada Barsoum, "Youth Exclusion in Egypt: in Search of Second Chances," Issue 2 of Working Paper, Wolfensohn Center for Development at the Brookings Institution, 2007.

***Corruption is an old problem in Egypt and Tunisia.*** Corruption, nepotism, and crony capitalism are major concerns of the peoples of the Arab Spring countries. Before the revolutions, the Worldwide Governance Indicators ranked Tunisia and Egypt low for control of corruption and government effectiveness. The middle classes are highly dependent on government services (health, education, transportation, and security), and they suffer from the continual deterioration of those services. Children going to public schools often have to pay their own teachers for private tuition in order to pass exams, and patients in government hospitals often need to pay bribes in order to receive assistance.

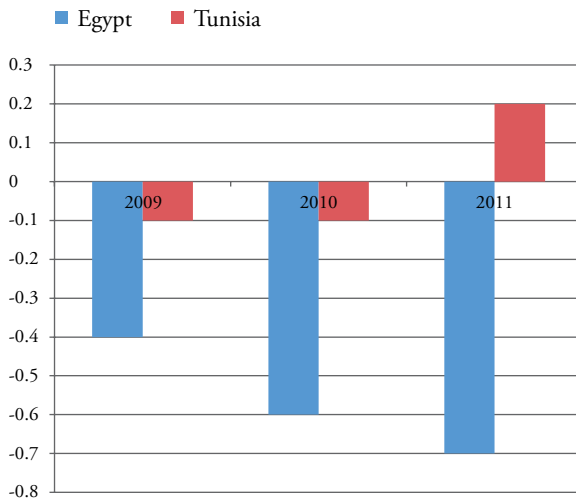
***Corruption has economic costs.*** Corruption and weak governance have hampered private sector development, particularly for small businesses that have no links to the political establishment. Over the last two decades Tunisia undertook important reforms, including administrative and fiscal changes, and provided incentives for enterprise creation, which attracted substantial amounts of foreign direct investment. Yet, Tunisia's private investment remained relatively low, around 15 percent of GDP and below 60 percent of total investments. Rules were not uniformly applied, and there was a great deal of room for deals, abuses, and corruption. The business environment has been plagued with corruption and a lack of transparency, and was not conducive to substantial investment and enterprise creation, especially for small and medium enterprises.

Small businesses in Egypt have also suffered from corruption. A 2011 survey of small enterprises found that 61 percent of entrepreneurs considered government licensing and registration requirements as key constraints to doing business. From 2004 to 2010, the government, as part of its

economic reform program, embarked on a massive deregulation and simplification effort, which earned it praise from the World Bank in its *Doing Business* reports. However, that effort does not seem to have affected small businesses, based on the results of the abovementioned survey. A possible explanation for this is that the deregulation and simplification measures are not being applied by a bureaucracy that is keen to protect possible sources of rents. The implication is that reforms of laws and regulations need to be implemented by an efficient and non-corrupt civil service; failing that, such reforms are only articulated on paper and are never implemented.

***The revolutions have not brought about a decline in corruption.*** Figure 3 showcases the corruption control indexes for Egypt and Tunisia from 2009 through 2011. It indicates that one year after the revolution corruption control had improved marginally in Tunisia while it had actually worsened in Egypt. Moreover, Tunisia's ranking according to Transparency International fell from 59 in 2010 to 75 in 2012, while Egypt's went from 98 to 118 over the same period. This decline came about despite the more than 6,000 corruption investigations and numerous high profile incriminations witnessed in Egypt since February 2011. These types of investigations and police actions send a signal that corruption will not be tolerated, but are not effective in ending corruption. Countries that succeeded in controlling corruption – one cited by a participant in the group was Indonesia – usually build partnerships between government, civil society, the press, and business owners in order to bring about greater transparency and hold civil servants accountable. This has not yet occurred in either Tunisia or Egypt, where relationships between the different stakeholders continue to be somewhat adversarial.



**Figure 3:** Progress in Corruption Control

Source: Worldwide Governance Indicators

According to Transparency International (TI), most Egyptians and Tunisians believe that corruption has increased after the revolutions. Table 5 presents data from TI's 2013 Global Corruption Barometer. It shows that only seven percent of Tunisians and 16 percent of Egyptians believe that there has been an improvement in corruption control after the revolution. More than 80 percent of Tunisians and nearly 65 percent of Egyptians feel that corruption has increased since the revolutions. The perception that democracy was associated with more rather than less corruption could provide some explanation for youth disillusionment in the two countries. Failure to deal with corruption may have contributed to Egyptians' discontent with the performance of the Morsi-appointed government. For his part, a representative of that government complained during the working group about the endemic, deep-rooted nature of corruption. "Public servants often don't know they are doing anything wrong," he said, adding that corrupt practices were so widespread that their elimination could involve "emptying entire ministries." The data on Tunisia, too, is worrisome and indicates that the al-Nahda-led transition government should act much more forcefully on corruption control.

**Table 5:** Response to question on the change in corruption over the last two years (percentage)

	Egypt	Tunisia
Increased a lot	37	61
Increased a little	27	20
Stayed the same	21	14
Decreased a little	11	5
Decreased a lot	5	2

Source: Transparency International: Global Corruption Barometer, 2013

According to TI's barometer, Egyptians and Tunisians perceive some of the institutions that are crucial for a well-functioning democracy as being particularly corrupt. Some 72 percent of Egyptians and 66 percent of Tunisians consider that political parties are corrupt. The media is also seen as corrupt by 80 percent of Egyptians and 53 percent of Tunisians. Similarly, parliament is considered corrupt by 71 percent of Egyptians and 40 percent of Tunisians, while the judiciary is perceived as corrupt by 65 percent of Egyptians and 56 percent of Tunisians. It is hard to imagine a successful transition to democracy without concerted efforts to control corruption in these institutions, and to change the public's perception of them.

## Policy Priorities: Stabilization, Jobs and Fighting Corruption

Since the revolutions, public debates in Tunisia and Egypt have focused on politics and issues of national identity. The primary concerns of major political parties seem to have been the place of Islam in public life and whether to adopt presidential or parliamentary systems. There have been endless debates on those issues, and, particularly in Egypt, little consensus has been reached. Economic issues have been put on the back burner.

Egypt, as well as Tunisia, would have seemed particularly ripe for economic, class-based appeals. To be sure, parties and candidates routinely promised more jobs, better wages, and campaigns to root out poverty, corruption, and any number of other social ills. Yet, it was hard to pinpoint significant differences among the circulating economic programs, which, with few exceptions, offered variations on the same theme: market-driven growth coupled with protections for the poor and social justice for all. To the extent that economics mattered in the elections, it was often in the form of old fashioned patronage, such as when the Muslim Brotherhood launched the *millionyyat al-khayr* (“million-man charity march”) initiative on the eve of parliamentary elections, providing 1.5 million kilograms of meat to 5 million Egyptians.

Whatever the reasons, the results are not encouraging. A growing number of Egyptians and Tunisians are questioning their support for the revolutions. They argue they had greater economic security under Mubarak and Ben Ali, despite those regimes’ many

faults. Economic insecurity and deteriorating living standards can easily translate into crises of legitimacy, as has happened in Egypt. The democratic transitions, then, depend on urgent economic action.

And yet, at times of unprecedented polarization, achieving the political will and support for that economic action can be – to put it mildly – extremely difficult. Participants in the dialogue emphasized that the political and the economic development cannot be separated. Indeed, a past emphasis on economic recovery (on the part of the international community, at least) has neglected to deal with a political impasse in Egypt that has precluded macro-economic stabilization. Some working group participants argued that there has been, in fact, a great deal of consensus among major parties in support of economic stabilization measures. An important dissenting view, meanwhile, stressed that the “same old neo-liberal market-economic model” – that entailed in the IMF deal – had in the past failed to address the country’s problems. Participants agreed that whatever programs are adopted in Egypt and Tunisia, they must achieve *inclusive* growth and avoid a return to past growth patterns that, however high, excluded large segments of the population.

The governments of Tunisia and Egypt face serious capacity constraints. Hence, they need to be selective and focus initially on the most urgent priorities. Ending political polarization and building a minimal consensus on a vision for the future is a clear top priority.

On the economic front, macro-economic stability is the first priority. Ensuring the availability of sufficient foreign exchange to import necessities (especially fuel and food) that are sold domestically at reasonable prices is the main responsibility of any government. Food and fuel inflation (or shortages) have led to riots and the fall of governments in many parts of the world. But macro-economic stabilization often implies the adoption of difficult and unpopular policies. These policies must be accompanied by other measures that help make the overall economic reform package more palatable. Governments need to demonstrate they are responsive to the demands of the youth who represented the vanguard of the Arab Spring movement. Two other economic priorities, therefore, should be job creation and fighting corruption.

### *Macro-economic stabilization*

Macro-economic stabilization programs in both Tunisia and Egypt need to tackle the difficult issues of fuel subsidies (to reduce the fiscal deficit and lower the public debt), and the exchange rate (to reduce the balance of payments deficit and rebuild reserves). Tunisia is tackling macro-economic problems in the context of an IMF-supported program. The situation is different in Egypt, where political unrest makes it difficult to implement far-reaching economic reforms. The newly appointed transition government has already announced that it will not seek a resumption of talks with the IMF in the near future. This means that Egypt will depend mainly on financial support from Saudi Arabia, the United Arab Emirates, and Kuwait to pull through the second half of 2013.

***Reductions in fuel subsidies will need to be carried out carefully.*** The fact that in Egypt 57 percent of the fuel subsidy goes to the top two-fifths of the income distribution can be misinterpreted; the vast majority of this group lives on between four

and ten dollars per day. The bulk of this segment of society should be classified as either middle class or even poor, but certainly not rich. Moreover, the 57 percent figure implies that 43 percent of the subsidy benefits people who live on less than four dollars per day. Therefore, notwithstanding the regressive nature of the subsidy, it seems clear that reducing or eliminating it will hurt the middle class and the poor. One Egyptian activist in the working group raised the fear that “subsidy cuts will put many more into poverty.” Under these circumstances, such measures will be politically difficult – if not impossible – to implement unless the current political crisis is resolved.

This issue of subsidies is not unique to Egypt and Tunisia alone, nor is it a new concern. In 1977, when President Anwar Sadat tried to reduce subsidies, there were massive street riots, and he was forced to immediately reverse the decision. President Habib Bourghiba in Tunisia faced the same problem when he too tried to ease subsidies. In 2011, Nigeria tried eliminating fuel subsidies; but, faced with massive protests, the government was compelled to restore them in part. Jordan also faced street riots in 2012 when it lowered fuel subsidies.

On the other hand, there are developing countries (including Ghana and Indonesia) that have succeeded in reducing energy subsidies. Tunisia and Egypt can draw important lessons from these experiences. A recent World Bank report studied 20 developing countries and found that they managed to reduce the average cost of energy subsidies in their budgets from 1.8 percent of GDP in 2004 to 1.3 percent in 2010, and that accomplishing this, in turn, ultimately led to both a reduction in energy intensity and increased energy efficiency.<sup>7</sup>

Programs that succeeded in reducing energy subsidies have usually included two features, which were equally emphasized by participants in the discus-

7. Maria Vagliasindi, “Implementing Energy Subsidy Reforms: an Overview of Key Policy Issues,” Policy Research Working Paper no. 6122, The World Bank, July 2012.

sion: compensatory measures to help the most vulnerable and a strong communications strategy to convince the public of the program's benefits. In Indonesia, President Megawati Sukarnoputri tried to implement energy price reforms in 2003, but was faced with stiff opposition and had to roll back the program. Three years later President Susilo Bambang Yudhoyono tried again, starting with a public information campaign that clearly identified the benefits of the reform and the safety net programs for the poor. The people were apparently convinced by the need for the reform and the government's commitment to protect the most vulnerable. Only then was he able to reduce subsidies with little opposition.

In 2004, the government of Ghana launched a study on the impact of fuel subsidies. The study's steering committee included a variety of stakeholders (including government officials, academics, and company representatives). By 2005, the government was able to use the committee's report to launch a public information effort that subsequently led to a 50 percent reduction of fuel prices. The study had detailed social mitigation measures and how to minimize backlash in order to achieve its end goal. As a result, the government knew how best to avoid public opposition on the issue and how to communicate its policies to the public.

***As in most countries, the exchange rate is a political variable in Tunisia and Egypt.*** Most successful macro-economic stabilization programs include a devaluation of the national currency to help enhance competitiveness, improve the balance of payments situation, and rebuild international reserves. A competitive real exchange rate is also important for attracting foreign investment – desperately needed by Tunisia and Egypt. Many countries try to avoid devaluations, however, because they lead to an increase in the domestic price of imports, raising the cost of living. Thus, in countries that are

highly dependent on food imports, like Tunisia and Egypt, the poor can be hurt by devaluation. Moreover, a devaluation of the Tunisian dinar and the Egyptian pound would raise the domestic price of fuel, and make a reduction in fuel subsidies more difficult politically.

As central banks run out of foreign reserves, they become unable to defend their currencies, which then enter into a free-fall. The ruble crisis of the late 1990s offers an example of such a scenario. It is usually less painful to let the currency depreciate in an orderly fashion while the central bank still has some reserves.

Finally, it should be noted that devaluation is not the only way to deal with the problem of an overvalued real exchange rate. An economy can regain international competitiveness through deflationary policies that drive domestic inflation below inflation in its trading partners. However, as the current experience in Cyprus and Greece demonstrates, such “internal devaluations” are usually much more painful than a nominal devaluation. Cyprus and Greece are forced to implement massive deflationary policies because they are members of a monetary union and do not control the value of the common currency (in their case, the euro). Tunisia and Egypt do not face such a constraint.

### *Opportunities for youth*<sup>8</sup>

Traditionally the public sector has been the largest employer of young people in Tunisia and Egypt. It is no longer able to play this role because of fiscal constraints and the fact that public enterprises and government departments already suffer from over-staffing. Hence, policies to create employment need to focus on expanding the private sector and encouraging foreign and domestic private investment.

8. See AfDB et al., “*African Economic Outlook 2012: Promoting Youth Employment*,” 2012, <http://www.oecd.org/site/devyewa/Pocket%20Edition%20AEO2012-EN.pdf>.

***Supporting small business could be a priority.***<sup>9</sup>

New governments in Egypt and Tunisia need to avoid a return to pre-revolution systems of crony capitalism. There is already a perception that the revolutions only succeeded in replacing an old group of cronies with a new group. One way to counter this perception would be to announce and start implementing a new private sector development strategy that stresses the importance of small and medium enterprises (SMEs), while also adopting special programs to encourage youth involvement in small businesses, as entrepreneurs and workers. This does not mean a bias against large enterprises, which are needed to develop exports, create mass employment, and adopt new technologies. It would simply imply a correction of governments' past bias against small businesses.

Rather than simply returning to old growth patterns that left large segments of the population behind and are considered unfair, post-revolutionary governments should focus on achieving "inclusive growth." This goal would be supported by a strategy in which small business and youth entrepreneurship play a key role. The key short-term challenge is to create more opportunities for youth, who currently suffer from social and economic exclusion. Young women, who are discouraged and drop out of the labor market, pose a particular problem, because families increasingly need two earners in order to ensure a decent living for both parents and children.

The objective of government policies should not simply be to support the growth of the existing SME sector, which consists mainly of low-productivity service businesses. Rather, it should aim to transform the sector by raising its productivity and improving linkages to domestic and international markets. The goal should be to support the modernization of the sector such that it becomes more dynamic, providing better living standards for young entrepreneurs and decent jobs for new entrants to the labor mar-

ket. The sectors in Europe or Japan, where SMEs lead in innovation, often operate in clusters, and have strong links to larger firms as well as to national and international markets, could serve as a model.

***A comprehensive approach to support small businesses is needed.***

Programs focused on providing credit to small businesses are insufficient. SME programs also need to provide an injection of technical design and marketing expertise that link small producers to new ideas and major markets. A key challenge to the implementation of this vision is that most young Tunisians and Egyptians are not prepared for a life of entrepreneurship and risk-taking. Arab education systems have been geared to produce civil servants, and do not provide graduates with the skills needed to thrive in a 21st century market place. Educated youth generally do not have the skills or the inclination to start their own businesses. They prefer the security of a public sector job even if it implies a long period of unemployment as they wait for a job opening. The obvious solution to this problem is to reform and modernize education systems. This is clearly an important developmental priority, but will take time to implement and will not affect the millions of youth currently in the labor market. As an immediate priority, governments could develop entrepreneurship programs to help young people start their own businesses.

***Governments alone cannot provide all the solutions.***

Past government interventions to support the SME sectors in Tunisia, Egypt, and elsewhere have often proven to be ineffective (deregulation and simplification in both countries, for instance, do not appear to have encouraged more enterprises to enter the formal sector). On the contrary, certain interventions have proven to be quite harmful to the economy (subsidized credit schemes in Indonesia, for example, did more to hurt than help the sector by limiting access to bank credit<sup>10</sup>).

9. This section relies heavily on Hafez Ghanem, "The Role of Small and Micro Enterprises in Egypt's Transition," Global Working Paper no. 55, Global Economy and Development at the Brookings Institution, January 2013.

10. Hal Hill, "Small and Medium Enterprises in Indonesia: Old Policy Challenges for a New Administration," *Asian Survey* 41, no. 2 (March/April 2001): 248-270.

It is important that a new SME development strategy be devised based on a broad consultation with owners and workers as well as with graduating students. Large firms can also contribute to the debate, with the aim of increasing inter-firm linkages and subcontracting. This could be an opportunity for governments in Tunisia and Egypt to prove the benefits of newly-open and democratic political systems. For decades, Arab youth have felt that their voice was not being heard, which left them cynical and disheartened. Now could be the right time to engage youth in a broad national debate about their future and their country's development.

Non-governmental organizations (NGOs) play a significant role in supporting SMEs. Many NGOs already provide financing to small businesses. They also are in a good position to provide technical and marketing support, and to help organize broad consultations with relevant stakeholders. Governments can improve the role of NGOs by passing new laws regulating their activities and simplifying procedures for their registration and operations.<sup>11</sup>

***A review of the policy and regulatory frameworks affecting SMEs is needed.*** There is a high level of noncompliance with tax laws and regulations, which raises the question of whether they should be revised and simplified to encourage more enterprises to enter the formal sector. Governments may wish to consider providing tax incentives for small businesses and young entrepreneurs. Businesses continue to complain about the regulatory framework in spite of recent simplifications. It may be necessary to take another look at the processes affecting small enterprises, in consultation with entrepreneurs. Governments should also consider policies to encourage foreign investors to partner with domestic SMEs to help them obtain technical design and marketing expertise. In the case of the garment

industry in Bali, the Indonesian government reduced the minimum level of foreign investment from \$1 million to \$250,000 in order to encourage small foreign investors to partner with local SMEs, bringing in their technical know-how and market access.

### *Fighting corruption*

Obviously there is no quick fix for the corruption problem, especially when it is as deeply rooted in the structure of the economy and society as it is in Tunisia and Egypt. Here, too, the economy and politics are closely linked. New ministers are in charge of government departments, but often face bureaucratic elements which are defensive of their turf and access to rents. In polarized contexts, "purging" corrupt elements and replacing them with new, presumably less corrupt, individuals becomes controversial and politically costly. For example, critics and opponents of the Muslim Brotherhood in Egypt complained that president Morsi was only recruiting Islamists to the civil service (painting this as part of a campaign of "*Ikhwanization*"), while the Brotherhood argued that they were just purging corrupt elements.

Despite these obstacles, new democratic governments need to differentiate themselves from past regimes by taking clear and visible steps towards corruption control. One option is police action and public investigations; but such steps alone will have limited impact on corruption, particularly in countries where the police and the judiciary themselves are not above suspicion. Corruption control needs to include measures to enhance transparency and accountability, and to professionalize the civil service. The results will take time to materialize, but simply taking the necessary first steps can help democratic governments enhance their credibility and empower them to enact other economic reforms.

11. Homi Kharas and Ehaab D. Abdou, "Regulatory Reforms Necessary for an Inclusive Growth Model in Egypt," Global Views no. 37, Global Economy and Development at the Brookings Institution, November 2012, <http://www.brookings.edu/-/media/research/files/papers/2012/11/inclusive%20growth%20egypt%20kharas/11%20inclusive%20growth%20egypt%20kharas.pdf>.

***Egypt and Tunisia could benefit from Indonesia's experience in corruption control.*** At the time of its own transition, Indonesia approached corruption as an extraordinary crime that needed to be dealt with through extraordinary processes. An Indonesian participant familiar with the case stressed that the fight against corruption was carried out on the legal, constitutional, enforcement, and societal levels. The country's new constitution was designed with the fight against corruption in mind. A special commission on the issue was created to focus on corruption in state institutions and on crimes above \$100,000, and only on these issues. A partnership with civil society and the private sector was set up to fight corruption on a social level.

***Voice, transparency, and accountability are central to corruption control.*** Dealing with the lack of transparency and accountability that has plagued governance systems in Egypt and Tunisia will require the development of political parties, a free press, employer's associations, free labor unions, and civil society organizations. These are all institutions that ensure that citizens' voices are heard in national debates and help with whistleblowing. A recent case in France, in which an investigative news report uncovered a minister's tax evasion, provides a useful illustration of how these institutions are useful in corruption control. The minister in question was forced to resign and is currently facing legal charges. The case was subsequently used by opposition parties and civil society organizations to push for wider investigations and greater transparency (it has already been decided that all financial declarations of ministers and members of parliament will be made public). In the absence of a free press, strong political parties, and an active civil society this instance of high level corruption would not have been stopped.

The development of institutions that improve transparency and accountability in Tunisia and Egypt will probably require legal changes that permit independent labor unions, professional associations,

and other civil society organizations to form without government approval. A reform of Egypt's NGO law is particularly urgent. As is normally the case under autocracy, Egyptian NGOs were given very little space to operate, and were heavily regulated by the state. This state of affairs is inconsistent with a new democratic system. A series of real reforms that would allow NGOs to fully play their role are still being resisted by a state bureaucracy that is fearful of losing its privileges and protection, as well as by governing parties that fear civil society will become a focal point for anti-government agitation.

There is also a need to launch wide-ranging transparency initiatives. These could include establishing freedom of information laws, as well as public disclosure and public debate requirements for budgets and new laws prior to their passage by parliament. Increased transparency would also require new public procurement rules and strengthened public financial management. Japan's system of setting five-year development plans through a broad consultative process, which includes all government departments as well as representatives of the private sector and civil society, provides an example of how economic policies can be developed in a transparent and participatory fashion. As participants in the working group made clear, an important element of "inclusive" growth is ensuring that decision-making on proposed reform measures is transparent, well communicated, and, indeed, inclusive.

Finally, accountability can be enhanced by civil service reforms aimed at professionalization and establishing meritocratic practices. Such measures need to be accompanied by efforts to strengthen the capacity of the legislature, the judiciary, and audit institutions. Taking significant steps in this direction will remain exceedingly difficult if the reforms in question are perceived as partisan or beneficial to one party over others. With this in mind, partnerships that bring together the government and opposition, as well as civil society organizations, are crucial.

## Support From the International Community

The international community has important interests in the Arab region. These include maintaining stability and security and pushing for peace between Palestinians and Israel; ensuring a continued flow of oil from the region; stemming the rise of extremism and terrorism; avoiding the proliferation of weapons of mass destruction; and reducing the flow of illegal immigration from North Africa to Europe. All these interests would be served by successful transitions to democracy in the Arab Spring countries, as was recognized by the international community when it created the Deauville Partnership at the G8 summit in 2011. The challenge, of course, is prioritizing the long term over the short term, particularly when the short term is so fraught with political instability. In order to mitigate instability, short-run economic support in Egypt and Tunisia should focus on the areas mentioned above, including macroeconomic stabilization, opportunities for youth, and fighting corruption.

An important question now is whether the international community should cut its assistance to Egypt in response to the ouster of the democratically elected president Muhammad Morsi and the crackdown on the Muslim Brotherhood. There is no consensus on this issue. Some influential voices in the United States and Europe are calling for the freezing of financial assistance. The majority view, however, seems to be that such a step would be counter-productive. The authors of this report believe that the international community needs to

remain engaged in Egypt, while also firmly supporting a quick return to democratic governance. International actors should continue to strive to play a constructive role in supporting consensus building and ensuring that no party is excluded from the national dialogue.

***The United States is a key partner.*** Efforts by the international community to support the Arab Spring countries are sometimes complicated by the negative perceptions that Arab peoples have of the United States, and therefore of the international financial institutions (mainly the IMF and the World Bank) where the United States plays a leading role. According to the Pew Center's 2012 survey, 57 percent of Tunisians and 52 percent of Egyptians believe that the United States is opposed to democracy in the Arab world.<sup>12</sup> In the near term, the United States will continue to grapple with the question of whether to cut military and economic assistance to Egypt's interim administration – and whether such steps will have the desired impact of returning Egypt to a viable path of democratization. Any economic support package should be designed in a way that demonstrates to average Tunisians and Egyptians that the international community, and particularly the United States, strongly supports democratic transition. One course advocated by a U.S. State Department representative in the working group was for Washington to have more sophisticated negotiations with Egypt and Tunisia that identify shared objectives that both parties can then work on together. These could be mutual commit-

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12. Pew Research Center, *Global Attitudes Project*.



ments (focused on areas outlined in the conclusion to this paper) that organize roles and responsibilities for the United States and the recipient country.

***Europe has a special role.*** Europe's proximity to North Africa, as well as its historical, cultural, economic, and political ties to the region puts it in a strong position to support the democratic transition in Tunisia and Egypt. The European Union played a key role in Eastern Europe's successful transition. Accession to the EU provided a common goal towards which all political groups in Eastern Europe worked, and thus facilitated the process of consensus building that is necessary for the creation of new democratic institutions. In the case of the Arab Spring countries, the European Union can offer deeper economic ties with its southern neighbors and a strengthening of existing association agreements, particularly by further opening its markets to exports of goods and services from the south. The idea would be to build a sense of shared destiny on both sides of the Mediterranean.<sup>13</sup> The EU too faces questions over whether to cut assistance to Egypt – particularly given its adoption of a “more for more” policy in the aftermath of the Arab uprisings, tying increased assistance to certain reform benchmarks. In late August, EU foreign ministers agreed to maintain economic and civil society support, while cutting some military aid.

***Japan is an important donor to Egypt and Tunisia.*** Arab economic links with Asia are strengthening rapidly, and today about 85 percent of Arab oil exports travel east. It is not surprising, therefore, that Japan has an important stake in the region's stability, and in successful transitions in Arab Spring countries. Japan's success in rebuilding its economy after World War II is widely admired in the Arab world. Moreover, Japan is seen as a neutral partner with no colonial past in the region that has not taken strong positions on

the Arab-Israeli conflict. Japan is uniquely placed to support the transitions in Tunisia and Egypt, particularly by sharing East Asia's experience in economic and governance reforms, and through the transfer of technology.

### *The importance of greater coordination between all development partners*

Representatives from the international community participating in the working group called for greater coordination between development partners. Many pointed to the lack of such coordination since the initial efforts of the Deauville Partnership, and to a more general failure to harmonize assistance with regional actors such as GCC states and Turkey. There remain several challenges to the establishment of an effective multilateral framework, including reconciling the diverse interests and “logics” of different donors. Yet the advantages of a more linked-up approach were clear. Coordination of this nature, one EU representative said, would also help improve governments' responsiveness to donor initiatives. Finally, more communication is needed in order to better organize the efforts of the various development partners, matching their expertise and sector-focuses to the needs of the countries in question.

In the near term the bulk of financial support, especially to Egypt, will come from GCC countries. Saudi Arabia, the United Arab Emirates, and Kuwait quickly pledged \$12 billion in support to Egypt after the ouster of president Morsi. This is more than double the size of the loan that Egypt was negotiating with the IMF, and will help the interim government avoid taking difficult and unpopular decisions in a period of political turmoil. It would seem that Western donors will, therefore, also need to coordinate with the GCC and try to build synergies between their different interventions.

13. Jean-Pierre Chauffour, “From Political to Economic Awakening in the Arab World: The Path of Economic Integration,” MENA Development Reports, The World Bank, 2013.

## Reflections of the Working Group

Democratic transitions are not measured in months, but in years and often in generations. It will take Egypt and Tunisia many years to put in place the institutions necessary for democracy and to bring about a change in political culture. Given the current turmoil in Egypt and the uncertainty in Tunisia, it is probably unrealistic to expect that all of the working group's recommendations can be implemented in the short term. It currently seems unlikely that development partners will increase their assistance – on the contrary, the United States and European Union have been conducting reviews of their assistance to Egypt, following the ouster of president Morsi. In the next few months priority needs to be given to national reconciliation and building consensus around a new vision for a democratic society.

This is not to say, however, that economic issues should be put off. Worsening economic conditions and increasing popular dissatisfaction could jeopardize the democratic transition in both countries. Only 45 percent of Tunisians think that their country is better off for having gotten rid of Ben Ali, while 42 percent believe that it is worse off. Similarly, only 39 percent of Egyptians believe that their country is better off after the fall of Mubarak and 30 percent think that it is worse off. Recent events in Egypt have shown that the political leadership in both Tunisia and Egypt, and their international partners who have an interest in peace and stability

in the region, should be seriously concerned by this growing discontent. Economic reforms – and particularly macro-stabilization, the creation of more opportunities for youth, and controlling corruption – must remain a priority. While the desire of Western governments to reduce their regional footprint is understandable, the basic fact remains that the economic challenges are huge and cannot be met by the countries alone.

The analysis in this paper and the discussions of the working group point to eight broad recommendations for local actors and the international community to help improve economic conditions and support transitions to democracy:

1. Experiences from around the world demonstrate that successful implementation of economic reforms requires broad national consultations and some degree of political consensus.<sup>14</sup> Governments are encouraged to make their economic programs public, and to reach out to opposition groups to try to build a common understanding of economic challenges and possible solutions. The international community can support this effort by providing technical assistance, capacity building, and examples of international best practices.<sup>15</sup> Development partners usually rely on NGOs as a vehicle for delivering parts of this as-

14. Kei Sakamoto, "Efforts to Introduce Inclusive Planning in Egypt," Global Working Paper no. 54, Global Economy and Development at the Brookings Institution, January 2013.

15. World Bank and OECD, *Integrating Human Rights into Development: Donor Approaches, Experiences and Challenges*, 2nd ed. (World Bank Publications, March 2013).

sistance, and support in this area requires an appropriate legal framework for NGO operation – the like of which remains absent in Egypt.

2. Security and political stability are important prerequisites for a resumption of economic growth. Therefore, security sector reforms, as well as efforts to bring about national reconciliation (for instance through truth and reconciliation commissions) should be given high priority.
  3. Macro-stabilization programs are needed to reduce fiscal and current account deficits, and stop the hemorrhaging of international reserves. Their implementation is a key first step to regain investor confidence and to pave the way for a resumption of growth. However, a return to past growth patterns that excluded large segments of the population should be avoided. Greater inclusion and social justice are key demands of the Egyptian and Tunisian revolutions. Therefore, macro-stabilization needs to be accompanied by: (a) a strengthening of social safety net programs, (b) an effort to better control corruption, and (c) programs to support small and medium enterprises (SMEs) to create more economic opportunities – especially for youth. Stabilization that is not accompanied by social mitigation measures and by actions that lay the ground for inclusive growth is unlikely to be politically acceptable.
  4. Successful stabilization requires adequate levels of foreign funding. In 2011 the international community committed to provide financing to Arab countries in transition through the Deauville partnership. Strong donor coordination is needed to ensure that financing is forthcoming to support home-grown national economic programs.
- Ideally, those coordination efforts should include GCC member countries. The governments of Egypt and Tunisia will need to take the lead in defining priorities that are necessary for successful donor coordination. Where more funding is made available, stabilization programs can become more gradual and therefore more politically acceptable. Moreover, a greater availability of foreign exchange through donor financing could imply that a smaller depreciation of the national currency would be needed, reducing pressure on the domestic prices of imported goods.
5. Social safety nets will need to be expanded and better targeted to protect those who are most in need. There is a need to move away from generalized price subsidies that disproportionately benefit better-off households, and toward targeted cash transfers and the use of “smart cards” to ensure that only the poor benefit from subsidies. Public works programs could also be used to provide temporary employment and help improve infrastructure. Social protection is an area where development partners’ technical and financial support could be extremely useful, and several partners are already active in this area. Future donors support can help Egypt reform the fuel subsidies system, improve governance and financial viability of key energy sector actors, replace untargeted subsidies with an efficient and well-targeted social safety net system, and provide immediate protection to the poor and the vulnerable.
  6. Corruption control is necessary for inclusive growth and social justice. Egypt and Tunisia could benefit from experiences of other countries, such as Indonesia, that set up successful anti-corruption systems (relying on partnership between government-sponsored anticorruption commissions, the

media, and relevant NGOs). This is an area, therefore, where South-South cooperation and knowledge sharing could be particularly relevant. Development partners could also play an increased role in capacity building for public or civil society institutions focused on this issue. Organizations such as the United Nations Development Program are well placed to provide needed support to NGOs, legislatures, and the free press without necessarily being accused of political meddling – as has often been the case for bilateral actors (not least the United States) in the past. The IMF and the World Bank have important experience in the area of public financial management, procurement policies, and civil service reforms, while Japan International Cooperation Agency (JICA), the European Commission, Canada, and the United Kingdom are also all active in this field, including in Tunisia and Egypt.

7. Developing the SME sector and encouraging informal firms to join the formal economy would help create jobs and encourage inclusive growth. A two-pronged approach should be adopted. First, the legal and regulatory framework facing small businesses will need to be streamlined and simplified, including by reforming taxation of SMEs. Second, specific programs that target SMEs (especially those managed by youth and women) should be expanded. These programs should include support for technology transfer and market access in addition to credit. Vocational training programs can also play an important part in helping address some of the weaknesses of Arab education systems. Many development partners are working in this area and plan to scale up their interventions. The SME development programs should be based on partnerships between govern-

ments (that provide funding), civil society organizations (that provide training), and the organized private sector (that provides technology and markets).

8. Growth in Egypt and Tunisia will depend on a return of foreign and domestic investment, a rise in tourism, and an expansion of exports. Development partners should support the two countries in improving the overall climate for investment and tourism, and work on opening up their markets to Egyptian and Tunisian exports. The international community could facilitate exports of manufactured goods from these countries, especially for mechanical and electrical industries and construction materials, by negotiating mutual recognition agreements that reduce technical barriers to trade. Access to agricultural markets could also be improved by removing non-tariff barriers to agricultural trade. This would require, among other measures, the abolition of quotas, reference prices, and seasonal restrictions, especially for the export of fruits, vegetables, and olive oil.

## About the Brookings Project on U.S. Relations with the Islamic World

The Brookings Project on U.S. Relations with the Islamic World is a research initiative housed in the Saban Center for Middle East Policy at the Brookings Institution. The Project's mission is to engage and inform policymakers, practitioners and the broader public on the changing dynamics within Muslim-majority countries and to advance relations between Americans and Muslim societies around the world.

To fulfill this mission, the Project sponsors a range of activities, research projects, and publications designed to educate, encourage frank dialogue, and build positive partnerships between the United States and Muslim states and communities around the world. The broader goals of the Project include:

- Exploring the multi-faceted nature of the United States' relationship with Muslim states and communities, including issues related to mutual misperceptions;
- Analyzing the social, economic and political dynamics in Muslim states and communities around the world;
- Identifying areas for shared endeavors between the United States and Muslim communities on issues of common concern.

To achieve these goals, the Project has several interlocking components:

- The U.S.-Islamic World Forum, which brings together key leaders in politics, business, media,

academia, and civil society from the United States and from Muslim societies in Africa, Asia, Europe, and the Middle East. The forum also serves as a focal point for the Project's ongoing research and initiatives, providing the foundation for a range of complementary activities designed to enhance dialogue and impact.

- An Analysis Paper Series that provides high-quality research on key questions facing Muslim states and communities.
- Workshops, symposiums, and public and private discussions with government officials and other key stakeholders, focused on critical issues affecting the relationship;
- Special initiatives in targeted areas of demand. In the past these have included Arts and Culture, Science and Technology, and Religion and Diplomacy.

The Project's Steering Committee consists of Martin Indyk, Vice President and Director of Foreign Policy Studies (currently on leave); Tamara Cofman Wittes, Senior Fellow and Director of the Saban Center; William McCants, Fellow and Director of the Project on U.S. Relations with the Islamic World; Bruce Riedel, Senior Fellow in the Saban Center; Shibley Telhami, Nonresident Senior Fellow in the Saban Center and Anwar Sadat Chair for Peace and Development at the University of Maryland; and Salman Shaikh, Fellow and Director of the Brookings Doha Center.

# The Saban Center for Middle East Policy

## Charting the path to a Middle East at peace with itself and the world

Founded in 2002, the Saban Center for Middle East Policy brings together the most experienced policy minds working on the region, and provides policymakers and the public with objective, in-depth, and timely research and analysis. Our mission is to chart the path—political, economic, and social—to a Middle East at peace with itself and the world. Current research in the Center includes:

- What Makes Two States Possible?
- U.S. Strategy in a Changing Middle East
- Politics and Security in the Persian Gulf
- The Future of Counterterrorism
- U.S. Relations with the Islamic World
- Natural Resources and Conflict in the Middle East

The Saban Center was established on May 13, 2002 with an inaugural address by His Majesty King Abdullah II of Jordan. The Center was made possible by a generous grant from Haim and Cheryl Saban of Los Angeles, and is part of the Foreign Policy Studies Program at Brookings. The Center upholds the Brookings values of Quality, Independence, and Impact.

The Center is home to the Project on U.S. Relations with the Islamic World, which convenes a major international conference each year in Doha and a range of activities to educate, foster frank dialogue, and build positive partnerships among U.S. and Islamic communities. The Center also houses the Brookings Doha Center in Doha, Qatar—home to three permanent scholars, visiting fellows, and a full range of policy-relevant conferences and meetings.

### Signature Activities

The Saban Center organizes numerous events and conferences throughout the year, bringing together leading officials, scholars, business executives, academics, and journalists. Center events include:

- **The Saban Forum:** A high-level strategic dialogue on common challenges facing the United States and Israel.
- **The U.S.-Islamic World Forum:** A premier annual gathering of U.S. and Muslim world leaders to advance constructive partnerships, held in Doha or Washington.

The Saban Center's analysis is communicated through a variety of publications that serve as a resource for policymakers and their staffs. Center publications include:

- **Analysis Papers:** Four times a year, the Center publishes studies authored by its own scholars, as well as outside experts.
- **Middle East Memos:** The Saban Center's Middle East Memo series provides timely analysis of critical issues facing the region. The memos present offer insights and recommendations for policymakers.
- **Iran@Saban:** A vibrant blog focusing on politics in Iran, and policy towards Iran, written by Brookings experts.

## Experts

Our team includes experienced and knowledgeable scholars, collectively offering decades of experience in government and in the field. Within the Center, a core group of experts conduct original research, bringing keen insight and fresh perspectives to bear on the critical challenges facing the Middle East today and on the policy choices facing American and regional decision makers. Their work is supplemented by nonresident scholars across the Middle East.

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