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Operation Name	Investment, Competitiveness and Inclusion Development Policy Financing
Region	Middle East and North Africa
Country	Tunisia
Sector	Trade and Competitiveness (20%); Banking and Finance (30%); Energy (30%), Social Protection and Jobs (20%)
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Borrower(s)	Government of Tunisia
Implementing Agency	Ministry of Development, Investment and International Cooperation
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Corporate Review Decision	*TBD*

I. Key development issues and rationale for Bank involvement

Tunisia's growth performance over the last seven years has been weak and has not delivered on much-needed private sector jobs. Economic growth has been low and mostly been driven by consumption while investment, exports and productivity growth have been low. On the factor side, the contribution of capital formation to GDP growth remains extremely low compared to the 1990s, when parts of the economy were liberalized. As a result, unemployment is high (15.5 percent in 2017), particularly among women (22.6 percent), young university graduates (31 percent), and the population in the interior regions of the country. Accelerating the pace of growth will be critical to reducing unemployment in the medium term.

Urgent and sustained policy actions are also needed to stabilize the macroeconomic situation. The political transition, recurrent social tensions, domestic and regional security shocks, combined with delays in implementing the needed reforms have negatively affected production and exports. In addition, the increase in public sector hiring and salaries in response to high unemployment and social tensions has increased the public wage bill from 10.7 percent of GDP in 2010 to 14.7 percent of GDP in 2017, and now represents more than 60 percent of tax revenues. These developments, with monetary policy remaining accommodative, have in turn weakened Tunisia's macroeconomic situation with the fiscal and current accounts deteriorating sharply (6 and 10 percent of GDP, respectively, in 2017). The large current account deficit, along with depressed FDI and the large Central Bank interventions in the foreign exchange market, have led to a rapid fall in gross international reserves, which dropped to 3.1 months of import by end-2017 and below 80 days in March 2018. Consequently, the dinar has depreciated, which - in combination with increases in wage, some administered prices and the value-added tax (VAT) - has fueled inflation over the last year.

The lack of economic opportunities, combined with rising inflation, contributes to household vulnerability, and poses a risk to social stability. While the poverty incidence was halved in the decade before the Revolution, disparities among regions and age groups have persisted or widened. Just as important, the data suggests that many households (including those from the middle class) remain slightly above the poverty threshold, making them vulnerable to exogenous shocks such as the loss of employment or hikes in the price of essential goods.

The proposed operation supports mutually reinforcing reform actions aimed at improving private investment, competitiveness and entrepreneurship; energy sector efficiency and sustainability, and economic and social inclusion. The proposed operation will help accelerate reforms aimed at removing barriers to investment, improving the efficiency and transparency of trade procedures, and promoting the development of young and unprivileged SMEs. Furthermore, by focusing on critical reforms in the energy sector, the proposed operation will contribute to reducing the costly and distortive energy subsidies amid rising international prices and a depreciated currency; improving the commercial performance of the state-owned power utility whose financial situation has deteriorated; and creating space for private investment, particularly in renewable energy. Finally, the proposed operation will support the Government's efforts to advance safety net reforms, which are critical to mitigating the impact on poor and vulnerable populations of potential shocks arising from macroeconomic and fiscal reforms or exogenous factors. The proposed operation is part of a broader engagement and is complemented by TA and other operations to support reform design and implementation.

While the Government has initiated a series of legislative reforms to stimulate private sector growth and job creation, there is a need to accelerate implementation of concrete actions to boost private investment, trade and entrepreneurship. Implementation of the legislative reforms and the market response have been slow, and there is a need to create more space for the private sector to participate and invest in productive and competitive sectors. To this end, the Government is committed to reducing barriers to investment in key sectors as part of the implementation of the Investment Law, improving trade facilitation to reduce the time and cost to trade and improve the transparency of trade procedures, and enhancing access to markets and credit for SMEs. Promoting innovation and digital entrepreneurship will also be essential to creating new markets, increasing competitiveness, and improving productivity in the economy.

In the energy sector, the Government's objective is to accelerate sector reforms given their impact on fiscal and current accounts, the need to address climate change, and the potential to attract sizeable investments. These reforms will entail reducing energy subsidies while mitigating potential negative impacts on the poor and vulnerable; as well as improving the performance of the power utility, and the energy mix. The Government will implement its energy reduction policy – aiming to reach full elimination of energy subsidies by 2022 (IMF EFF program) – starting with electricity and tariff adjustments in 2018 (under the proposed operation), combined with more systematic application of the existing fuel price adjustment mechanism (anchored in the IMF EFF program). To implement its existing performance contract with the State, the power utility will take actions to improve its technical and commercial performance and reduce losses. On renewable energy, the Government is firmly committed to scaling up and implementing its renewables plan through concession schemes, and to making greater use of public-private partnerships (PPPs) for key investments. The Government also plans to establish an energy sector regulatory authority to improve the transparency of tariff structures and encourage greater private sector participation.

The Government also recognizes the need to modernize and improve the targeting of social safety nets (SSN), and to promote access to micro-finance among youth, women and populations in interior regions. Since 2010, the Government has significantly expanded the coverage of SSN programs and the value of cash transfers: between 2010 and 2017, the number of beneficiaries rose from 108,000 to 242,000 households and cash transfers rose from TND 75 per household every quarter to TND 150 per household per month (equivalent to 25 percent of poverty threshold). Further, in January 2018, in the context of establishing the national social protection floor and rising inflation, the Government announced that cash transfer amounts would be increased by another 20 percent (effective April 2018) to support the purchasing power of poor and low-income households. The Government also aims to improve the targeting and fiscal efficiency of safety nets and to strengthen their role in promoting investment in children's human capital. In addition, the Government seeks to promote greater access to microfinance for income-generating activities, with an emphasis on locations and socio-economic groups with fewer economic opportunities.

The proposed operation is rooted in the MENA regional strategy and the Tunisia Performance and Learning Review (PLR). The proposed operation builds on the analysis and pillars set out in the Systematic Country Diagnostic (SCD) for Tunisia, including the three highest priorities: macroeconomic stability, security and cohesion and improved governance. The operation is consistent with and would contribute to (a) the pillar of the MENA strategy on renewing the social contract; (b) pillar 1 of the PLR on restoring an environment conducive to sustainable economic growth and private sector-led job creation; and (c) pillars 2 and 3 of the PLR on improving economic and social inclusion. A political economy filter has been applied to the proposed operation with the aim of improving its effectiveness and impact by identifying and responding to relevant governance and political economy constraints and opportunities.

The Government's program is underpinned by the development vision and reform agenda set out in the *Note d'Orientation Stratégique*[1], the Five-Year Development Plan for 2016-2020, and the Government's Economic and Social Program for 2018-2020. The *Note d'Orientation Stratégique* lays out the Government's economic and social vision for the country, placing strong emphasis on the importance of the private sector for boosting job creation and driving inclusive and sustainable economic growth. Building on the *Note d'Orientation Stratégique*, the Five-Year Development Plan specifies a program of reforms that rests on five axes:

- **Axis 1 – Financing the economy.** This axis aims to (a) strengthen the regulatory and supervisory framework for the banking sector, including adoption of a new Banking Law and Central Bank Law; (b) modernize the governance of state-owned banks and improve the

[1] Following the 2014 presidential and parliamentary elections, the Government developed a concept note, the *Note d'Orientation Stratégique*, for a 2016-2020 development plan. The *Note d'Orientation Stratégique* was organized around five strategic pillars: (a) good governance; (b) a dynamic "hub" economy; (c) human development and social inclusion; (d) regional development; and (e) green growth. The *Note* was followed by the Five-Year Development Plan, approved by Parliament on April 12, 2017.

resilience of the banking sector; (c) enhance financial inclusion by promoting mobile payments and improving access to affordable housing finance; (d) increase access to finance for MSMEs and innovative enterprises by developing SME credit guarantee schemes, promoting microfinance development, and strengthening the legal and regulatory framework for private equity and venture capital investments; and (e) deepen the capital markets by strengthening the legal and regulatory framework and promoting development of the secondary market.

- **Axis 2 – Fiscal consolidation.** This axis focuses on (a) improving public expenditure management on the basis of the new Budget Law; (b) strengthening revenue collection through reforms to the tax and customs administration; (c) restructuring the civil service and improving SOE governance and performance; (d) reforming the pension system; (e) reforming energy and commodity subsidies; (f) improving the public investment execution framework; and (g) reforming the legal framework for financing local development, including the decentralization of tax collection and promotion of local investment.
- **Axis 3 – Human capital development.** This axis focuses on (a) reforming primary, secondary and higher education; (b) strengthening scientific and industrial research and development (R&D) at the national level; (c) improving vocational and on-the-job training programs; and (d) reforming labor market policies and regulations, including establishing of insurance for job loss and revisions to the Labor Code to allow for flexibility in the labor market.
- **Axis 4 – Redesign of the social security system.** This axis focuses on (a) reforming the health care system, through a review of health care funding arrangements, health insurance reform, and the establishment of a health insurance system; (b) enhancing the sustainability of the pension system by reviewing its parameters, diversifying funding sources and improving governance; and (c) reforming the social assistance program by improving beneficiary targeting and expanding coverage to the most vulnerable.
- **Axis 5 – Business climate and private investment.** A set of wide-ranging reforms has been outlined to improve the investment climate and encourage private investment. These include actions to (a) strengthen the legal framework of competition, including the adoption of a new Competition Law; (b) enhance the regulatory framework for public procurement, and improve efficiency and transparency of the public procurement system; (c) adopt a new Investment Code, and reduce the complexity and administrative burden of investment requirements; (d) strengthen the regulatory framework for PPPs; and (e) reform the legal framework for energy and natural resource management, including renewable energy resources.

The Government has made gradual progress toward improving the business environment. This includes the adoption of the Competition Law, the PPP Law, as well as the new Investment Code, which came into effect in April 2017. The Government has also made progress on establishing the Tunisian Investment Authority, which will act as a one-stop-shop to facilitate the procedures required for investors to create new companies and conduct business in Tunisia. In addition, several laws and decrees have been adopted to stimulate access to finance for MSME and promote digital entrepreneurship. These include a draft Credit Bureau Law; a draft code for Seed and Equity Capital to reduce the regulatory burden on investors; and the Start-up Act, which aims to enhance the regulatory framework for innovative high-growth SMEs and increase their access to early-stage equity finance. While some reforms in the energy and natural resource sectors have been launched (e.g., adoption of a legal framework for electricity generation through renewable energy in 2015), the challenge is to deepen reforms of energy subsidies and scale up and implement Tunisia's Renewables Plan, as outlined in the Government's recently approved decision.

Tunisia has also laid the foundation for social inclusion. The 2013 Social Contract – adopted by the Government and the two worker and private sector unions (UGTT and UTICA) – addressed the crucial challenge of social inclusion. This included improving the targeting and coverage of the social safety net program. The Five-Year Development Plan also made inclusion a strategic priority and laid out a vision for building a national social protection floor that includes components for children, old age, and extension of health insurance. In January 2018, the Government also announced an increase in cash benefits under the Needy Families Program (*Programme Nationale d'Aide aux Familles Nécessiteuses,* PNAFN); an increase in the minimum pension to mitigate living costs for retirees; and health insurance coverage for job seekers. Lastly, to promote inclusion of youth, the Government has made priority investments in the Active Labor Market Programs (ALMP), but with mixed results due to design and implementation challenges. The Government is therefore keen on improving the ecosystem of the employment services to boost their performance and inclusiveness.

The Economic and Social Roadmap 2018-2020, launched in 2017, aims to accelerate the reform momentum started under the Five-Year Plan and further boost entrepreneurship, competitiveness and economic growth. The Roadmap is comprised of nine key initiatives: (a) removal of barriers to investment; (b) improvement of SME financing and the enabling environment for high-growth start-ups; (c) development of a national program to boost exports; (d) infrastructure investment through PPPs, to improve regional development and connect industrial zones and technological parks to highways; (e) implementation of a Digital Tunisia 2020 program; (f) implementation of the Tunisia Renewables Plan; (g) initiatives for improving the Rades port; (h) initiatives to manage tourism sector debt and the launch of new strategy to support the sector; and (i) harnessing PPPs for critical projects

II. Proposed Objective(s)

The proposed Development Policy Financing operation is a stand-alone, single-tranche operation aimed at supporting the Government's effort to promote private investment and competitiveness, entrepreneurship, a more efficient and greener energy sector, and greater economic and social inclusion. The operation is motivated by the need to (a) shift to a growth model underpinned by private investment, trade and productivity; (b) support Government reform efforts to promote job creation and entrepreneurship, in the context of high youth and female unemployment and social pressures; and (c) strengthen the safety nets for vulnerable populations and promote greater productive economic inclusion. This operation also responds to a fragile macroeconomic context characterized by widening twin deficits, the deteriorating financial situation of the power utility, costly and distortive energy subsidies, and the need to improve the energy mix, which will attract potentially sizeable investments in renewable energy (solar and wind).

III. Preliminary Description

The DPL is organized under three pillars: (a) removing barriers to investment, trade and entrepreneurship; (b) moving towards a more efficient, sustainable and inclusive energy sector; and (c) promoting greater economic and social inclusion. The reforms will either build on previous DPF pillars and complementary advisory services and analytics (ASA), or catalyze upstream consensus around critical reform principles that future operations can support as they move toward implementation. Specific prior actions were developed during intensive dialogue between the Government and the Bank; the dialogue benefited from continuous technical support to ensure that the prior actions adhere to quality standards and produce expected development outcomes in terms of economic and social opportunities.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

A detailed Poverty and Social Impact Analysis (PSIA) on prior action #6 (electricity and gas tariff adjustment) has been prepared. The remaining prior actions were also reviewed for their potential impact on poor and vulnerable households via price or employment. Using the latest 2015 Tunisian household survey, the PSIA on prior action #6 estimates the direct effect on household well-being of electricity and gas tariff adjustments. Using the 2010 input-output matrix in combination with the household survey, the PSIA also estimates the indirect effect via changes in prices of all the other products. In addition, the costs and benefits of the Government's recently introduced compensation mechanisms were also simulated. The main caveat of this analysis is that the Tunisian household survey does not allow separation of the electricity bill from the gas bill. Since poor and low-income households consume much less gas than the more well-off households, the analysis provided in this document may underestimate the progressive nature of the reform.

Environment Aspects

The World Bank has assessed whether any specific policies supported by the proposed operation are likely to cause significant effects on the country's environment and natural resources. Based on that assessment, a conclusion was reached that the policies supported by the proposed operation are not, in general, likely to lead to negative impacts. In fact, the assessment suggests that the implementation of some policies may lead to positive impacts such a reduction in air pollution. However, some prior actions may lead to adverse environmental impacts if the required Environmental Impact Assessments (EIA) and mitigation plans are not prepared and implemented adequately.

Over the last years, Tunisia has confirmed a consistent, high-level and long-term commitment to environment protection, supporting a green economy and tackling climate change. Strategic direction for these issues, which are clearly addressed in the 2014 Constitution, is provided by the New Five-Year Development Plan (2016-2020), which stresses the importance of a new development model based on efficiency, equity, and sustainability. By laying the foundation for increased interdependence among agriculture, forestry and natural resources, the Plan seeks to engage all key actors (public, private, civil society organizations) in strong partnerships while increasing rural household incomes and strengthening the resilience and sustainability of natural resources. Implementation of the accompanying action plan will help to ensure a rational use of natural resources, better environmental protection, and greater control of energy consumption. Furthermore, the National Strategy for a Green Economy in Tunisia focuses on synergies and trade-offs between the environmental and economic pillars of sustainable development, in which economic outputs are directly increased by improved environmental conditions, leading to a virtuous circle of further economic growth.

Tunisia has strong and well-defined institutional, legal and regulatory frameworks concerning the management of social and environmental impacts of investments. The Ministry of Environment and Local Affairs (MELA) is the key player in the definition and implementation of environmental policies and strategies. It proposes policies related to the environment and ensures the coordination and monitoring of actions by state and local authorities for protection of nature and the environment, and the mitigation of pollution and nuisances. MELA publishes an annual report on the state of the environment, and implements action plans to address various environmental problems related to water, solid waste, biodiversity, natural resources and urban planning).

Overall, the proposed operation is expected to lead to positive impacts on Tunisia's environment and natural resource base. The policy interventions under Pillar 2, aimed at ensuring the sustainability of Tunisia's energy supply by increasing electricity and gas tariffs, will lead to a reduction in electricity and gas demand and consumption, which will in turn reduce emissions of air pollutants and greenhouse gases. Prior actions will support measures to reduce energy losses by the utilities and improve the enabling environment for investments in renewable technologies. Risks of greater use of biomass by poorer households as a result of the electricity and tariff adjustment will be mitigated by the significant increase in cash transfers and their planned future expansion. It is important for the Borrower to develop additional measures focusing on protecting vulnerable consumers, particularly efficiency measures for lower-income households to reduce energy consumption and improve affordability. A full menu of options should be considered in order to provide energy services to the poor and vulnerable, including renewable energy sources and fossil fuels combined with cleaner and more efficient energy technology.

The prior actions under Pillar 1 aimed at removing barriers to investment, trade and entrepreneurship are expected to contribute to investment growth, which may entire environmental risks and impacts. However, the environmental regulatory framework and the current institutional capacity in Tunisia are deemed to be adequate to ensure that the necessary environmental management and mitigation measures are well in place. Any industrial, commercial or agricultural activities that may result from the reforms supported under the proposed operation, and may have a significant effect on the environment, will be subject to an Environmental Impact Assessment (EIA), which must take place before licensing and investments under such activities.

The prior actions in the third pillar are likely to have overall positive effects on environment, forests and natural resources. More specifically, prior actions that aim to improve the impact and effectiveness of Tunisia's social assistance programs and promote access to microcredit will likely reduce the pressure on fragile natural resources by providing vulnerable groups and local populations with the means to diversify their livelihoods. However, it should be stressed that microfinance institutions, as financial intermediaries, need to adhere to sound environmental and social management practices and screen the activities they finance to ensure that they are prepared and implemented in accordance with sound environmental and social management practices and national law.

V. Tentative financing

Source:		($m.)
Borrower/Recipient: Republic of Tunisia		
IBRD		500
Others (specifiy)		
	Total	500

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