PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

March 13, 2018
Report No.: 126665

Operation Name	Investment, Competitiveness and Inclusion Development Policy Loan
Region	Middle East and North Africa
Country	Tunisia
Sector	Trade and Competitiveness (20%); Banking and Finance (30%); Energy (30%), Social Protection and Jobs (20%)
Operation ID	P161483
Lending Instrument	Development Policy Financing
Borrower(s)	Government of Tunisia
Implementing Agency	Ministry of Development, Investment and International Cooperation
Date PID Prepared	March 13, 2018
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Corporate Review Decision	*TBD*

I. Key development issues and rationale for Bank involvement

Tunisia's post-Revolution growth performance has been weak and mostly driven by consumption while investment, export and productivity growth have been low. Economic growth averaged only 1.5 percent post-Revolution compared to 4.5 percent in the five years before the Revolution. On the expenditure side, this growth was primarily driven by public and private consumption while export and investment growth averaged only -0.9 and -1.2 percent per annum, respectively. Consequently, export and investment averaged 44 percent and 21 percent of GDP respectively in the post-Revolution period, compared to 49 and 25 percent, respectively, in the five years preceding the Revolution. On the factor side, the contribution of capital formation to GDP growth in the post-Revolution has been almost halved compared to the pre-Revolution years and to the 1990s when part of the economy was liberalized. Furthermore, productivity growth remains very low.

This growth profile has not delivered on much needed private sector jobs, particularly for youth, women and citizens in the interior regions off the coast. Weak economic growth, coupled with limited public and private investment and the slow pace of reforms, has resulted in few new private sector jobs. The unemployment rate has remained high (15.5 percent in 2017), especially among women (22.6 percent), young university graduates (31 percent), and the population in the interior regions off the coast (over 25 percent in the South-West and South East, compared to 10 percent in the Center-East and North-East). Demographic trends suggest that unless the pace of growth accelerates substantially, unemployment will worsen over the next decade.

The macroeconomic situation - with large twin deficits, high debt, shrinking international reserves and rising inflation - is fragile. The Government responded to the employment and social challenges by raising public sector hiring and salaries, which has helped maintain social peace, but has also contributed to the significant weakening of Tunisia's fiscal situation. Consequently, the public wage bill has increased from 10.7 percent in 2010 to 14.7 percent of GDP in 2017 and represents over 60 percent of tax revenues. Concomitantly, the political transition, recurrent social tensions, domestic security shocks, the political and security situation in the Middle East and North Africa (including in neighboring Libya), and delays in implementing the needed reforms have negatively affected production and exports. These developments have in turn weakened Tunisia's macroeconomic situation with the fiscal and current accounts deteriorating sharply. The large current account deficit, depressed FDI and the large Central Bank interventions in the forex market, have led to decreased gross international reserves which dropped to 3.1 months of import by end-2017 and dropped below 80 days (US$ 4.6 billion) in early March 2018. Consequently, the Dinar has depreciated, which in combination with wage increases, the increases of some administered prices and recent VAT increases, has fueled inflation.

Furthermore, the lack of economic opportunities, combined with rising inflation, poses a risk to past poverty reduction gains, the middle class and greater inclusion and equality of opportunity. While poverty incidence was halved in the decade before the Revolution, considerable disparities exist among regions and age groups, and household vulnerability remains considerable especially in the face of weak post-revolution economic performance. These disparities have persisted or widened. Inequality between regions has risen with poverty increasingly concentrated in a few regions of the country. Just as importantly, 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 prices of essential goods. Recent reports points to unequal opportunities for building human capital in early years and preserving it at the age of adolescence and the current design of existing safety nets programs is unable to tackle this challenge.

While the Government has initiated a series of reforms to stimulate private sector growth and job creation, more needs to be done to accelerate the implementation of concrete actions to boost private investment, trade and entrepreneurship. In recent years, the Government has made some progress on legislative reforms supporting private sector investment and entrepreneurship– such as the introduction of the Competition Law and Investment Code, as well as several laws aimed at facilitating access to finance for MSMEs. However, the implementation of these legislative reforms and the market response has been slow, and more needs to be done to create more space for the private sector to participate and invest in productive and competitive sectors, as well as to undertake more concrete actions to support entrepreneurs and SMEs. To this end, the Government is committed to reducing investment entry barriers in key sectors, improving trade facilitation to reduce the time and cost and improve the transparency of export procedures, and enhancing access to markets and credit for Small and Medium Enterprises (SMEs). Promoting innovation and digital entrepreneurship will also be essential to creating new markets, increasing competitiveness, and improving productivity in the economy.

The Government is also taking steps to accelerate the reform of the energy sector given its impact on fiscal and current accounts, the need to address climate change mitigation and adaptation, as well as to ensure more efficient, sustainable and inclusive service delivery.

Energy services of an adequate level and quality are essential to sustaining high rates of economic growth. In the context of Tunisia, with of high twin deficits, fragile financial situation of State-Owned Enterprises (SOEs) and high incidence of costly and distortive subsidies, critical reforms of the energy sector are needed to ensure the sustainable delivery of energy services to the economy. This will require reforming energy subsidies while mitigating potential negative socio-economic impacts on the poor and vulnerable; reforming SOEs and improving the technical and commercial performance of the power and water utilities, and the energy mix. On the latter, the Government is firmly committed to scaling-up and implementing its renewable plan through concession schemes, and to make greater use of Public-Private Entrepreneurship (PPPs) for key infrastructure.

Furthermore, modernizing the social safety nets and promoting greater economic and social inclusion are critical to ensuring economic growth is inclusive, as well as to protect the poor and vulnerable from shocks and potential negative impact of reforms. This will help lay the foundation for sufficient reform buy-in and depth and to respond to the demands of citizens for jobs, particularly youth, women and in the interior regions. The Government's main challenge and objectives in this area are to establish the basis for a well targeted and fiscally sound expansion of the coverage of social safety nets, modernize the safety net programs to enhance children's human capital accumulation and thereby contribute to equality of opportunity, promote greater access to credit for microentrepreneurs with an emphasis on locations and socio-economic groups with fewer economic opportunities (particularly youth, women and populations in the interior), and improving the inclusiveness and efficiency of services to job seekers to improve matching to job openings.

Therefore, the proposed operation is built around three pillars of complementary reforms that support Tunisia's objectives of achieving stronger, more inclusive and sustainable economic growth. The operation's support for reforms to boost investment, trade and entrepreneurship (pillar 1) will be complemented by support for job seekers and employment services (pillar 3), to ensure there is equitable access to new jobs created. Furthermore, reforms in the energy and water sectors (pillar 2) will create space for private investment, particularly in renewable energy, further generating jobs and contributing to greening Tunisia's energy mix and security. Reforms targeted at modernizing the social safety nets (pillar 3) will help achieve the two-pronged objective of mitigating potential shocks to vulnerable populations, the reduction of energy subsidies and other fiscal consolidation reforms, as well as promoting children's human capital accumulation.

The proposed operation draws lessons learned from the Bank's post-Revolution engagement in Tunisia in four ways: the nature of the political and economic transition, matching the structure of the operation to the country context, and monitoring and follow-up of reforms at highest level of government, and the need to accelerate implementation of reforms. Firstly, while the transition has proceeded in a manner that has frustrated Tunisia's citizens, it is important to make a distinction between the risks arising from the slow pace of reform from the risk of reversal – the latter risk being the one that would endanger the transition. Despite the unmet expectations, Tunisia's political system has remained focused on the social partnership model and the durability of the coalition government, which has preserved forward momentum. The international community has been supportive, through financing and technical support, giving the political system space to continue with reforms. Secondly, this will be a stand-alone operation with multi-sector coverage embedded in a larger dialogue. Past programmatic operations have proven difficult to follow through, given the impact of recurring political and security shocks on ability to deliver triggers, while needing to maintain the operations focus on key impactful reforms and the predictability of budget support. Thirdly, the WB has worked with the Head of Government and key cabinet members to establish prioritization, monitoring and follow-up of Bank-supported reforms by the Council of Ministers. Finally, previous engagements have revealed the need to strengthen the focus on implementation of reforms and support the Government in undertaking more concrete actions to boost private sector growth and job-creation. In this context, the proposed operation moves beyond legislative reforms to implementation and concrete actions to address specific bottlenecks to promote investment, trade, entrepreneurship and inclusion.

The proposed DPL builds on the work undertaken as part of the Tunisia Development Policy Review (DPR) and the SCD, as well as technical assistance activities and regional and global analytical reports. The Tunisia DPR and SCD provide the analytical underpinning for most of the reforms supported by the proposed DPL. The SCD identifies macroeconomic and fiscal stability as a pre-requisite for growth and job creation, and for achieving the twin goals of eradicating extreme poverty and promoting shared prosperity in a sustainable manner. The DPR and SCD argue that the Tunisian economy failed to generate sufficient good quality jobs because it is burdened by a system of rents and privileges that thrives on the pervasive web of regulations and restrictions. This system stifles competition and protects privileged firms, obstructing the development of a dynamic economic environment. The World Bank regional report Jobs or Privileges[1] provides evidence that in this context entrepreneurship is constrained, with very few firms entering the market every year and most new entrants remaining small or exiting after three to five years of existence. The DPR and the SCD recommend actions to remove rents, increase competition, open the economy and promote entrepreneurship. Several technical assistance and project preparation activities have also been delivered or are ongoing to diagnose the existing institutional and legal framework, and design and calibrate the reforms (e.g. energy sector, water sector, social protection reforms, public expenditure review etc.).

The proposed operation is in line with the World Bank Group (WBG) Strategy as outlined in the Tunisia Country Partnership Framework (CPF) for 2016-2020, MENA Regional Strategy and the WBG twin goals. The proposed operation is directly linked to the objectives outlined under Pillar 1 (Restoring an Environment Conducive to Sustainable Economic Growth and Private Sector-Led Job creation) and Pillar 3 (Promoting Increased Social Inclusion) of the CPF. In particular, the reforms proposed under operation are line with CPF Objective 1.1 which aims to achieve sound macroeconomic and fiscal management of the economy, as well as with CPF Objective 1.2 and 1.3, which seek to improve the enabling environment for private investment and trade, as well as increase access to finance for SMEs and innovative enterprises. The operation's support for economic and social inclusion is also directly aligned with CPF Objective 3.2 and 3.3. Moreover, proposed operation also contributes to the MENA Regional Strategy by promoting reforms that foster entrepreneurship and encourage private investment and trade, in line with the Renewing the Social Contract and Regional Cooperation pillars of the Regional Strategy. The operation's support to the Government in achieving its social and economic vision of inclusive and sustainable development is also aligned with the WBG twin goals of poverty reduction and

[1] World Bank MENA Regional Report: 2015 "Jobs or Privileges – Unleashing the Employment Potential of the Middle East and North Africa."

shared prosperity. The proposed operation also builds on the findings and lessons learned from the CPF Performance and Learning Review (PLR). The PLR highlighted the need to, inter alia, promote innovative solutions for entrepreneurship and SME development; to strengthen engagement on social protection and inclusion, particularly in lagging regions; as well as to increase WBG engagements on climate change mitigation and adaptation. The proposed DPL incorporates some of these findings by supporting more tangible reform actions that aim to simulate private investment and entrepreneurship, enhance social inclusion, and address the deficiencies in the energy and water sectors.

The Government's program is underpinned by the development vision and reform agenda set out in the *Note d'Orientation Stratégique*[2], the Five-Year Development Plan for 2016-2018, 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*[3], the Five-Year Development Plan for 2016-2018 specifies a program of reforms that rests on five axes:

- **Axis 1 – Financing of the economy.** These actions aim to: (i) strengthen the regulatory and supervisory framework for the banking sector, including the adoption of a new Banking Law and Central Bank Law; (ii) modernize the governance of state-owned banks and improve the resilience of the banking sector; (iii) enhance financial inclusion by promoting mobile payments, and improving access to affordable housing finance; (iv) 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 (iv) deepen the capital markets, by strengthening the legal and regulatory framework, and promoting the development of the secondary market.
- **Axis 2 – Fiscal consolidation.** These actions focus on: (i) improving public expenditure management, on the basis of the new Budget Law; (ii) strengthening revenue collection through reforms to tax and customs administration; (iii) restructuring the civil service and improving SOE governance and performance; (iv) reforming the pension and health insurance system; (v) reforming energy and commodity subsidies; (vi) improving the public investment execution framework; and (vii) reforming the legal framework for financing local development, including the decentralization of tax collection and promotion of local investment.
- **Axis 3 – Human capital development.** These actions focus on: (i) reforming primary, secondary and higher education; (ii) strengthening scientific research and R&D at the national level; (iii) improving vocational and on-the-job training programs; and (iv) reforming labor market regulations policies, including the establishment of unemployment insurance and revisions to the Labor Code to allow for flexibility in the labor market.

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[2] National Program of Major Reforms, 2016 - 2020

[3] Following the 2014 presidential and parliamentary elections, the Government developed a concept note (Note d'Orientation Stratégique) for the 2016-2020 development plan. The Note d'Orientation Stratégique is organised around five strategic pillars: (i) good governance; (ii) a dynamic "hub" economy; (iii) human development and social inclusion; (iv) regional development; and (v) green growth. The Note d'Orienttaion Strategique was followed by the Five-Year Development Plan, which was approved by Parliament on April 12, 2017.

- **Axis 4 – Redesign of the social security system.** These actions focus on: (i) reforming the health care system, through a review of health care funding arrangements, health insurance reform, and the establishment of a new health insurance system; (ii) enhancing the sustainability of the pension system, by reviewing pension system parameters, diversifying funding sources, and improving governance; and (iii) 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: (i) strengthen the legal framework of competition, including the adoption of a new Competition Law; (ii) enhance the regulatory framework for public procurement, and improve efficiency and transparency of the public procurement system; (iii) adopt a new Investment Code, and reducing the complexity and administrative burden of investment requirements; (iv) strengthen the regulatory framework for PPPs; and (v) reform the legal framework for energy and natural resource management, including renewable energy.

The Government has made gradual progress to improve the business environment. This includes the adoption of the Competition Law, PPP Law, as well as the new Investment Code which came into effect in April 2017. The Government has also made progress on the 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 MSMEs, and promote digital entrepreneurship including: the bankruptcy law; a draft law on Credit Bureau; a draft code for Seed and Equity Capital to reduce the regulatory burden on investors; and the draft Start-up Act which aims to enhance the regulatory framework for innovative high-growth SMEs and increase their access to early-stage equity finance. Lastly, while some reforms in the energy and natural resource sectors have been launched (e.g. the adoption of a legal framework for electricity generation through renewable energy in 2015), the challenge is to deepen reforms to energy subsidies, and scale-up and implement Tunisia's Renewable Plan.

Tunisia has laid the foundations of a social dialogue for inclusion. The 2013 Social Contract – developed by the Government and the two worker and business unions (UGTT and UTICA) – addressed the crucial challenge of social inclusion, with the need to target subsidies more effectively to make room in the budget for social investments. This included improving the targeting and coverage of the social safety net program, the Program for Households in Needs (PNAFN). In addition, Five-Year Development Plan 2016-20 made inclusion a strategic priority and laid out a vision for building a minimum social protection floor for all including components for children, old age, health insurance extension, among others.
In January 2018 following major protests on rising cost of living, the Government also announced several measures, including an increase of the Safety net amount for the PNAFN program, increase of the minimum pension to mitigate living costs for retirees, and coverage of health insurance for job seekers. Lastly, to promote socioeconomic inclusion, especially of the youth, the Government has given priority investments to Active Labor Market programs but these have yielded mixed results due to design and /or 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 and further boost entrepreneurship, competitiveness, and economic

growth. The Economic and Social Program complements the Five-Year Plan and is comprised of ten key initiatives: (i) removal of barriers to investment; (ii) improvement of SME financing and the enabling environment for emergence of high growth start-ups ; (iii) development of a national program to boost exports; (iv) investment in infrastructure through PPPs to improve regional development, and to connect industrial zones and technological parks to highways; (v) implementation of a 'Digital Tunisia 2020' program; (vi) implementation of the Tunisia Solar Energy program; (vii) initiatives for the improvement of the Rades port; (viii) initiatives to manage tourism sector debt and the launch of new strategy to support the sector; and (ix) harnessing PPPs for critical projects.

II. Proposed Objective(s)

The proposed DPL is a standalone single-tranche operation aimed at supporting the Government's effort to promote private investment and competitiveness, entrepreneurship, more efficient and greener energy sector, and greater economic and social inclusion. The operation is motivated by the need to: (a) shift from a domestic consumption-based growth in the post-Revolution to a growth model underpinned by private investment, trade, and productivity; (b) support government reform efforts to promote job creation and entrepreneurship, in a context of high youth and female unemployment and social pressures; (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, a deteriorating financial situation of the power utility, costly and distortive energy subsidies, 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 more efficient, sustainable and inclusive energy and water sectors; and (c) promoting greater economic and social inclusion. The reforms supported either build on previous DPL pillars and complementary ASA, or catalyze upstream consensus around critical reform principles that future operations can support as they move to implementation. Specific prior actions were developed during intensive policy dialogue between the Government and the Bank, and benefitted from continuous technical support to ensure that they adhere to quality standards and produce expected development outcomes in terms of economic and social opportunities. A political economy filter has also been used to help ensure that reform measures are informed not only by strong technical knowledge but also by a sound understanding of potential institutional and political bottlenecks, as well as local capacities and opportunities.

IV. Poverty and Social Impacts and Environment Aspects

The DPF series is organized under three key pillars: (1) enhancing fiscal efficiency by improving the budgetary framework, reforming the public investment framework, debt management and the social safety nets; (2) improving the business environment and promoting competition; and (3) supporting entrepreneurship and deepening access to finance. The reforms are the focus of the intensive policy dialogue with the Bank, and have benefitted from continuous technical support to ensure that they adhere to quality standards and produce expected development outcomes in terms of economic and social opportunities.

Poverty and Social Impacts

A broad PSIA on the proposed energy subsidy and safety net reforms is being prepared and will be finalized by decision meeting. However, this PSIA will not report point estimates on impact of proposed reforms due to limited access to data in Tunisia. Using the latest 2015 Tunisian household survey, the PSIA will estimate the direct effect on household's well-being of electricity and gas tariff adjustments. Using the 2010 input-output matrix in combination with the household survey, the PSIA will also estimate the indirect effect via changes in prices of all the other products. In addition, the costs and benefits of possible compensation mechanisms are also simulated using different targeting scenarios. The main caveat of this analysis is represented by data availability. At present the team has access to only a small portion of the household survey sample which is not enough to guarantee the stability of the estimates. To run the simulation on the full sample, the team must send the codes to the National Institute of Statistics (INS) and their staff will run the simulations. Although in principle feasible, this agreement can substantially delay the production of the PSIA.

Environment Aspects

Prior actions in the second pillar of the proposed operation are likely to have significant direct and indirect positive effects on environment, forest and natural resources. Through prior actions in the second pillar, change will be induced in the way environmental resources are currently used, by providing non-negligible and durable effects in terms of quantity and quality of resources. Adequate measures will be taken to mitigate any potential negative socio-economic impacts of the reform on the most vulnerable groups and to provide them with conditional social transfers (CSTs) – which could also include payments for ecosystems services (PES) – and improved access to microfinance to alleviate poverty. While reducing the current exclusive reliance of the poorest and most vulnerable households on unsustainable uses of forest timber and non-timber products and water, CSTs will have a direct impact on household wellbeing: their conditionality means that they will be provided in return for meeting specific environmental targets or adopting behaviors, such as actions to manage land and water resources in a sustainable manner.

Similarly, the prior actions in the third pillar are likely to have positive effects on environment, forests and natural resources. More specifically, a prior action will improve access to credit for micro-entrepreneurs thus promoting greater productive economic diversification of vulnerable populations. Furthermore, a prior action will improve the inclusiveness and efficiency of services to job seekers and will increase their access to available jobs. These prior actions are likely to reduce the pressure on fragile natural resources by local populations, by providing them with the means to diversify their livelihoods.

However, there are also inherent environmental risks linked to some prior actions in the proposed operation. Firstly, national institutions tend to adopt a "silo mentality", with their fragmented policies, duplication of services, lack of communication with each other about their agenda, and working to different time scales. This risk could be mitigated if the Borrower is committed to break down the current mentality, by putting in place efficient platforms to build institutional networks and collaboration between the key actors: the Ministry of Agriculture, Water Resources & Fisheries and the Ministry of Local Affairs & Environment, on one side, and the Ministry of Finance and the Ministry of Social Affairs, on the other side. This will help define broad aims and objectives, with negotiations on trade-offs and synergies, through detailed agreements on joint actions, budgets and timescales. Secondly, the reform of energy subsidies and the adjustment of water tariff structures, if not fully mitigated, may lead to the disenfranchisement of the poor and vulnerable population from energy use. This would create a situation of "energy poverty", that is a situation where vulnerable household are not able to adequately provide essential energy services in their homes and businesses at affordable cost. Therefore, the increase in utility prices could indeed drive them to cheaper alternatives, like fuelwood, with direct negative effects on forest degradation and air pollution.

Consequently, it is important for the Borrower to develop additional measures focusing on vulnerable consumer protection, 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, traditional biomass, and fossil fuels combined with cleaner, more efficient energy technology, and other policies that work for poverty reduction. Civil society groups and other nongovernmental organizations should be empowered to play a critical role in raising awareness of how to increase affordability of energy services and assisting the energy poor through various measures. As reliance on fossil fuels and biomass is likely to continue for many years, development plans should include them and climate issues in the overall energy strategy, which would particularly encourage more sustainable energy management and more efficient and cleaner uses.

V. Tentative financing

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

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