REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

IN AN AMOUNT EQUIVALENT TO US$150.0 MILLION

TO

THE REPUBLIC OF TUNISIA

FOR AN

INDUSTRIAL AND TRADE POLICY ADJUSTMENT LOAN

January 28, 1987
CURRENCY EQUIVALENTS
Currency Unit - Tunisian Dinar (TD)

<table>
<thead>
<tr>
<th>CY1985</th>
<th>Ten Months CY1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>US$1.00 = TD 0.757</td>
<td>US$1.00 = TD 0.781</td>
</tr>
<tr>
<td>TD 1.00 = US$1.321</td>
<td>TD 1.00 = US$1.281</td>
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</table>

FISCAL YEAR
January 1 to December 31

GLOSSARY OF ABBREVIATIONS

AFI : Industrial Land Agency
(Agence Foncière Industrielle)

API : Industrial Investment Promotion Agency
(Agence de Promotion des Investissements)

APIA : Agricultural Investment Promotion Agency
(Agence de Promotion des Investissements Agricoles)

ASAL : Agricultural Sector Adjustment Loan

BCT : Central Bank
(Banque Centrale de Tunisie)

BDETo : Economic Development Bank of Tunisia
(Banque de Développement Economique de Tunisie)

BNTD : National Bank for Tourism Development
(Banque Nationale pour le Développement du Tourisme)

BTKD : Tunisian-Kuwaiti Development Bank
(Banque Tuniso-Koweïtienne de Développement)

CFF : Compensatory Financing of Export Fluctuations scheme

CEPEX : Export Promotion Center
(Centre de Promotion des Exportations)

CNEI : National Industrial Studies Center
(Centre National d'Etudes Industrielles)

CNSS : National Social Security Fund
(Caisse Nationale de Sécurité Sociale)

COTUNACE : Tunisian Export Credit Insurance Company
(Compagnie Tunisienne d'Assurance du Crédit à l'Exportation)

CPI : Consumer Price Index

EMI : Electrical and Mechanical Industries

FPC : Exchange Equalization Fund
(Fonds de Péréquation des Changes)

ICB : International Competitive Bidding

MITAP : Medium-Term Industrial and Trade Policy Adjustment Program

OCT : Tunisian Trading Office
(Office du Commerce de Tunisie)

SME : Small and Medium Enterprises

SOE : Statement of Expenditures

SSI : Small-Scale Industries

STUSID : Tunisian-Saudi Company for Investments and Development
(Société Tuniso-Séoudienne d'Investissements et de Développement)

TFD : Customs Formalities Tax
(Taxe sur la Formalité Douanière)

UTICA : Tunisian Association of Industry, Commerce and Handicrafts
(Union Tunisienne de l'Industrie, du Commerce et de l'Artisanat)

VAT : Value-Added Tax
REPUBLIC OF TUNISIA

INDUSTRIAL AND TRADE POLICY ADJUSTMENT LOAN

Loan Summary

Borrower:
The Republic of Tunisia.

Amount:
US$150.0 million equivalent.

Terms:
17 years, including 4 years of grace, at the standard variable interest rate.

Loan Description:
The proposed Loan would support the first phase of implementation of the Government's program of industrial and trade policy reforms, within the framework of a general macro-economic restructuring program. The Government's macro-economic restructuring program is focusing on measures to limit growth of domestic demand (wage and salary, budget and monetary policies), to stimulate growth of non-traditional exports (exchange rate policies, export promotion), and to improve the allocation and use of scarce economic resources (interest rate liberalization, gradual liberalization of domestic prices, investments and imports); it should also result in a more rapid creation of new employment and reduced underemployment. The principal actions under the medium-term industrial and trade policy adjustment program (MITAP) support the macro-economic restructuring program through: (i) a reform of the investment code, liberalizing investment entirely except when incentives are asked for; (ii) a rationalization of policies on exchange rate coverage of foreign borrowings by banks and of central bank supervision of the financial sector; (iii) studies of the social security system, of the labor code and of productivity standards with a view to promote employment; (iv) a reform of institutions dealing with the industrial and trade sector; (v) a follow-through of export promotion actions; and (vi) the initiation of a tourism policy study with the view to optimize the sector's capacity in economic and financial terms. The foreign exchange provided by the Loan would...
be used to finance general imports based on a negative list and technical assistance for the study of productivity standards referred to in (iii) above.

**Benefits and Risks:**

The reforms supported by the proposed Loan are expected to create a more favorable environment for overall economic and sectoral growth at a time of resource constraints. In particular, changes in the overall incentives framework, investment code, reform of institutions supporting the sector and export promotion actions are expected to make manufacturing a more efficient producer of export products and import substitutes. Risks relate to the length and difficulty of the process, possible social and political pressures, unpredictable developments in the external environment and uncertainties in the response of the private sector. These risks are limited by the Government's strong commitment to the objectives of the macro-economic and sector adjustment programs, as evidenced *inter alia* by the actions already taken, and by the inherent flexibility of the phased medium-term approach.

**Estimated Disbursements:**

The proceeds of the Loan would be disbursed in two tranches: US$100.0 million equivalent after effectiveness; and US$50.0 million equivalent after implementation of specific actions, including an overall review of the implementation of the macro-economic and sectoral reform programs.

**Appraisal Report:**

This is a combined President's and Staff Appraisal Report.

**Map:**

No. IBRD 18707 of December 1984 (Tunisia - General Features).
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### MAP

This report is based on the findings of an appraisal mission which sojourned in Tunisia in October 1986, comprised of Messrs. H. Bachmann (Mission Chief); E. Sawaya (Deputy Mission Chief); B. de Vuyst; H. Dinh; A. Edwards (Consultant); J. Kientz (Consultant); and J. Lienert (Consultant).
1. I submit the following report and recommendation on a proposed loan for the equivalent of US$150 million to the Republic of Tunisia. It would help to finance an industrial and trade policy adjustment program within the framework of a general macro-economic restructuring effort. The loan would have a term of 17 years, including 4 years of grace, at the standard variable interest rate.

PART I - THE ECONOMY

2. An economic report entitled "Tunisia - Country Economic Memorandum: Mid-term Review of the Sixth Development Plan (1982-86)", in two volumes (No. 5328-TUN), was distributed to the Executive Directors in October 1985. An economic mission to review the macro-economic framework of the VIIth Plan (1987-91) visited Tunisia in January 1986; its findings, as well as those obtained at the time of appraisal of the proposed Loan in October 1986, and by an IMF Article IV consultation mission in July 1986, are reflected in this part and the country data attached in Annex I.

3. Tunisia is a medium-sized, middle-income country, with a population of 7.4 million, and a per capita income of about US$1,200.1 Much of Tunisia is arid or semi-arid. Only 3% of arable land is irrigated, and areas where rain-fed agriculture is possible are subject to severe year-to-year fluctuations in rainfall. Nevertheless, agriculture still occupies nearly one out of every three Tunisians in the labor force. Tunisia's most important raw materials are phosphates, petroleum and natural gas. Known exploitable reserves of oil and gas are approaching depletion, and the limited new reserves require costly off-shore drilling. Barring large new oil and gas discoveries, and given the rise in domestic energy demand, Tunisia is expected to turn into a net oil importer in the early 1990s. The low quality of phosphate deposits constrains the expansion of the highly efficient Tunisian phosphate processing industry. The country also has considerable tourism potential.

4. Tunisia has undertaken a massive effort to develop its human resources, paying special attention to family welfare, education, and technical and vocational training. As a result, between the early 1960s and the early 1980s, the infant mortality rate declined from almost 160 to 79, life expectancy at birth rose from 48 to 62 years, the adult literacy rate

1/ 1986 preliminary at current prices and 1986 average exchange rate.
increased from about 15% to about 62%, and average caloric intake per capita increased from 95% to 121% of minimum standard requirements. An active family planning policy pursued by the Government led to a decrease in fertility and birth rates. Even though mortality rates also decreased, the gross reproduction rate decreased markedly from 3.5% to 2.4% over the same period. However, since net emigration of Tunisians abroad was sharply reduced by restrictive measures taken in the EEC countries and Libya, the growth rate of the labor force accelerated, a main reason for the rapidly growing, serious unemployment problem. Open unemployment reached 14% in 1983 and underemployment is extensive. These problems are particularly serious among young school dropouts.

5. Recent Economic Developments. During the 1970s, the Tunisian economy did well. Rapid growth in the range of 7-8% was accompanied by substantial structural transformation as manufacturing and tourism became more important and their share in total exports increased. Economic performance benefited from substantial terms of trade gains due to the rapid price increase of oil, allowing both consumption and domestic savings to increase and investment to remain high (over 30% of GDP). It also benefited from improved economic management with a cautious shift toward a more liberal, market-oriented economy. The inflation rate remained modest, averaging 6.1% over the decade. The balance of payments current account deficit, averaging 5% to 6% of GDP over the period, was easily financed, much of it by direct foreign investment, and the debt service ratio was a low 10.7% in 1979. The only major problem was a persistently high rate of unemployment/underemployment.

6. The VIth Plan (1982-86) proposed a number of policy reforms to face the consequence of rising unemployment and the progressive decline in net energy exports. Its main objectives were employment generation, export promotion, regional development and public sector efficiency. Investment priority was given to agriculture, engineering industries and tourism. The overall rate of investment was projected to decline during the Plan period. To minimize the effects on economic growth and employment, measures were proposed to increase the efficiency of existing investments and to encourage a shift to labor-intensive activities. They were to be accompanied by a substantially tightened income policy, in particular cautious wage and salary policies, and a considerable slowdown in the growth of recurrent budget expenditures.

7. Economic performance, however, deteriorated during the Plan period. First and foremost, economic growth slowed down considerably, with the annual GDP growth rate averaging only about 3.7% compared to 6.3% targeted. Oil production virtually stagnated throughout the period; in 1982 and 1986 serious droughts depressed agricultural output and agro-industrial production; production and exports of phosphate rock and phosphate products suffered from depressed world market conditions; exports of manufactured goods were adversely affected by a lower growth of demand in Europe, high domestic prices and a sizable appreciation of the Tunisian Dinar vis-à-vis the currencies of most competitor countries as well as the US dollar; tourism suffered from the same problems as manufacturing industries, and furthermore was affected by the unsettled political situation in neighboring countries, which hit Tunisian tourism particularly hard.
8. Secondly, the Government was slow in adjusting domestic demand to the decelerated economic growth. In contrast to the Plan's macro-economic objectives, the investment rate remained high rather than declined, mainly due to high public enterprise investments in energy and transportation, and domestic consumption expanded rapidly, fueled by sharp increases in wages and salaries in 1982 and early 1983. This strong demand pressure, facilitated by rather liberal credit policies, was reflected in rising inflation which averaged nearly 10.5% in 1981-84, compared to 8.0% over 1977-81. It also contributed substantially towards the marked worsening of the current account deficit of the balance of payments, which rose to 11% of GDP in 1984. The Government's overall budget deficit also increased slightly from an average of 2.7% of GDP in 1981-82 to 3.2% in 1983-84, excluding debt amortization. This reflected increases in recurrent expenditures due to higher wage and salary outlays; higher subsidy payments to households and public enterprises; and higher public investments.

9. The trend observed during 1981-84 clearly could not be sustained. Faced with this deterioration, the Government started to implement a package of policy measures aimed at stabilizing the economy as described in some detail in Part II below. These measures together with the imposition of drastic foreign exchange and import restrictions, brought the balance of payments current account deficit back to about 7% of GDP in 1985, despite reduced exports of oil, phosphate, and manufactured goods to Libya. While this improved the immediate situation, the underlying disequilibrium was not resolved, and problems usually associated with controls, such as growing shortages of raw materials, semi-finished products and spare parts, appeared. For 1986, the Government expects a current account deficit of the balance of payments close to 9% of GDP. Meanwhile, the budget deficit rose to 3.7% of GDP in 1985 because of a slow growth in revenues, despite a substantial decline of subsidy payments in real terms. The authorities prepared a restrictive budget for 1986, as discussed below (para. 21).

10. Over recent years, the Government had consulted informally with the IMF on a wide variety of economic and financial issues, but had not asked for financial support. Before and during the July 1986 Article IV consultation mission, however, discussions started with the IMF on a possible stand-by agreement cum compensatory financing facility. As a result, on November 4, 1986 the IMF Executive Board approved an 18 month stand-by arrangement in an amount equivalent to SDR103.65 million and a purchase of SDR114.71 million under the Compensatory Financing of Export Fluctuations scheme.

11. Social Issues. Since independence, the country has gone a long way towards meeting the basic needs of its population. Over 15% of GDP is now devoted to social programs, and the number of absolute poor declined from 17% of total population in 1975 to 12.8% in 1980 (para. 48). This improvement was largely concentrated, however, in urban areas. Since 1981, social issues have faced a different context than in the 1970s, when an easy financial situation allowed a relatively unconstrained expansion of social services. On the one hand, the Tunisian population has become increasingly aware of and sensitive to income distribution issues, and the beneficial effects of past rapid expansion in social services have created a demand for improved standards in social services delivery. On the other hand, the provision of adequate social services — education, health, urban infrastructure, housing — is being increasingly hampered by budgetary constraints. To reduce the financial
burden of social services, the administration is reviewing the cost structure of the various types of social services, including free or below-cost delivery, the possible introduction of some user fees, and improved social infrastructure management, in particular as regards hospitals. Also, decentralization of social facilities to deprived zones will have to be assessed carefully because the costs of servicing and maintaining them could become prohibitive.

12. To reduce socio-economic differences, in particular between rural and urban areas, and between workers in the modern sector and those precariously employed in informal activities, the Government is channelling more resources into regional development and youth employment. Integrated rural programs are being developed to stimulate creation of productive jobs and grassroots participation. Subsidies and credit facilities are granted for young technicians to create their own enterprises and for entrepreneurs to create new projects in underdeveloped regions. More efforts are needed, however, to strengthen the coordination of vocational and on-the-job training with market demand and to ensure that rural programs create economically viable and sustainable assets and activities.

13. **External Assistance and Foreign Debt.** During the second half of the 1970s, foreign borrowing was modest and a large share of foreign funds was provided by public sources at relatively soft terms. At the end of 1979, debt outstanding and disbursed was estimated at US$3.0 billion, or 42% of GDP; debt service was less than 11% of export revenues. For reasons mentioned earlier (para. 8), the balance of payments deficit has increased substantially since then, as has foreign indebtedness. Total public foreign debt outstanding and disbursed reached nearly US$4.4 billion (about 54% of GDP) at the end of 1985 and the debt service ratio rose to 22%. However, the Tunisian authorities have always followed cautious debt management policies; while the share of short-term borrowings has increased slightly since 1980, Tunisia's overall foreign debt remains predominantly long- and medium-term, and debt service requirements are projected to increase only slowly. During 1981-85, over 60% of foreign loan disbursements were from official sources, and nearly 31% on concessional terms. Nearly 70% of official disbursements came from bilateral sources (mainly Arab oil producing countries, France, Japan, the Federal Republic of Germany), 20% from the Bank Group, and 10% from other multilateral sources. Overall borrowing terms were favorable, averaging 6% interest and 15 years maturity.

14. The balance of payments and foreign debt outlook, including Tunisia's creditworthiness, are assessed in paragraphs 43-46 below.

**PART II - THE GOVERNMENT'S ECONOMIC ADJUSTMENT PROGRAM**

A. **Structural Problems and the Need for Structural Change**

15. The brief description of recent economic trends and present situation as presented above highlights three major problems facing the Tunisian economy today, one rather immediate, two somewhat longer term. The immediate problem is the high and persistent deficit of the balance of payments current account, and the consequent rapid increase in the country's foreign debt. As mentioned above, after a slight improvement in 1985, the decline in oil prices, lower tourism revenues, and lower workers' remittances have put further pressure on
the balance of payments in 1986. While there is no danger of an immediate crisis, the situation cannot be allowed to continue much longer. The two longer term, but equally important, problems are the progressive decline in net hydrocarbon exports, requiring the development of other sources of export revenues and import substitution (non-traditional exports, tourism, agriculture), as well as the high and growing unemployment and underemployment rate and the danger of an even worse trend given the high rate of growth of the active population, at a time of lower overall economic growth.

16. No single policy instrument can deal successfully with all three problem areas; only a carefully balanced and timed package of different policy measures can do so. Such a comprehensive policy package should be based on three main considerations:

(a) a return to an export driven growth strategy, as was pursued quite successfully until 1981, is a key to the success of any future development program aiming to achieve satisfactory economic growth and employment creation, given Tunisia's limited domestic market and the fact that most obvious import substitution industries are already well developed. With petroleum production ceasing to be a major engine of export growth, and export possibilities in agriculture limited by market constraints in the EEC, manufacturing will have to become much more export oriented than in the past, when it catered primarily to domestic demand fueled by high petroleum revenues. This requires fundamental changes in industrial policies so as to increase incentives to export. Such changes are also necessary to revitalize existing export oriented economic activities, such as tourism, and to promote efficient import substitution in agriculture where Tunisia has some substantial comparative advantages;

(b) a major improvement in the efficiency of resource use and allocation is required. With the highly profitable production and export of petroleum declining progressively, economic resources in Tunisia, domestic as well as foreign and private as well as public, will become increasingly scarce. Under these circumstances, the country can only achieve a satisfactory rate of overall economic growth and an acceptable level of new employment creation if it uses and allocates these resources with the utmost efficiency. The liberalization measures covering prices, investments and imports, included in the Government's economic adjustment program, serve primarily to improve efficiency in the private sector by gradually introducing more competition, while proposed changes in budget policies, public investments and public enterprise management would improve efficiency in the public sector; and

(c) last but not least, economic development must become much more labor intensive in order to create more employment in spite of lower overall economic growth. Future increases in production should be obtained mostly through increasing the number of employed workers and new investments should serve mostly to create new employment. This would be achieved through a marked change in relative factor costs, making labor less expensive relative to capital. Macro-economic

1 Less than 10% that of Switzerland or about 5% that of Spain.
projections indicate that if real salaries had continued to increase by 4.5-5% per year, as was the case during the 1970s, and if interest rates had continued to be largely negative in real terms, not even half as many new jobs would be created during the period of the VIIth Plan (1987-91) as necessary to absorb the rising number of new job seekers. Furthermore, priority must be given to the development of labor-intensive sectors with relatively low investment costs such as small and medium enterprises, electrical and mechanical industries, and agriculture. There is in fact, a substantial potential for employment creation in these sectors.

B. Recent Policy Measures Taken by the Government

17. The Government of Tunisia had recognized the importance of such economic adjustments already during preparation of the VIth Development Plan (1982-86) and a substantial number of concrete policy changes have been implemented over the last few years, as detailed in this section, some of them bold and often unpopular. These efforts need to be pursued and expanded over the coming years, along the lines presented in Section C below.

18. For the last four years, the Government has pursued strict wage and salary policies. Since January 1983, when wage increases were delinked from the cost of living index, no general salary increases have been granted. As a result, average real salaries have declined by more than 15%. This decline has eliminated the main source of the rapid increase in domestic consumption experienced during 1980-83. While the Government raised the minimum salary by 10% in July 1986, other salaries were not increased in 1986 and are not planned to be in 1987.

19. Exchange rate policies have become more flexible since mid-1985, resulting in a gradual downward adjustment of the exchange rate by over 18% vis-à-vis a basket of seven currencies between mid-1985 and mid-1986. Together with the formal devaluation of 9% announced in mid-August 1986, this has reduced by about 27% the nominal exchange rate on a trade weighted average, more vis-à-vis the major European currencies (DM, FF), less vis-à-vis the U.S. dollar. While the real effective exchange rate has depreciated somewhat less by an estimated 22%, these changes nevertheless made it possible to more than offset the rise in the value of the Dinar in relation to competitor country currencies observed over the last couple of years, and so to improve the competitiveness of Tunisia’s non-traditional exports.

20. The Government has also started to use interest rate policies as a more active instrument of economic policy making. For the first time in four years, general interest rates were raised by 1-2 points in April 1985 and by 3-4 points for the particularly low special rates in the Spring of 1986. Together with the 1.7 point decline in the inflation rate in 1985, itself a very satisfactory achievement (from 8.2 to 6.5%), these nominal interest rate increases raised real interest rates by 3-5 points; most rates are now positive in real terms, in line with the recommendations of the Bank’s Financial Sector Report (No. 5263-TUN of December 16, 1985). As agreed with the IMF, interest rates have been set free on January 1, 1987 on about 75% of
all lending operations (i.e. all except for export activities, agriculture, small and medium-sized business, and energy savings projects) and on over two-thirds of all deposits with commercial banks.

21. **Budgetary outlays.** As mentioned above (para. 9), 1985 ended with a worse overall budget deficit (3.7% of GDP) in spite of a nearly 10% decline in subsidy outlays (in real terms) as Government revenues from oil and import taxes stagnated or declined slightly. In 1986, the situation improved gradually, in spite of a further decline in revenues, reflecting lower oil prices and depressed imports. Through a number of tough measures introduced in a revised mid-year budget, the Government reduced total budget outlays (net of debt service) by some 8% in real terms as a first step in a program of gradually reducing the size of public intervention in the economy. Sales taxes on alcoholic beverages and tobacco were raised; recurrent expenditures (net of interest payments) hardly increased in real terms, and subsidies to households and public enterprises as well as development outlays (net of debt amortization) were reduced by 19% in real terms. As a result, the overall deficit is expected to decline to 3.5% of GDP. The substantial reductions in subsidy outlays reflect the Government's policies of gradually adjusting the prices of goods subsidized by the budget and the tariffs charged by public enterprises for their services.

22. For several years, agricultural producer prices have gradually been decontrolled and the ones still controlled (particularly cereals and milk) have been raised more rapidly than inflation. As a result, by end-1985, nearly 75% of domestic agricultural production was sold freely in the domestic market and/or exported. As agreed with the Bank under the Agricultural Sector Adjustment Loan (ASAL—Loan No. 2754 of 1986), producer prices will gradually be aligned with border prices, while in the past they were determined by the estimated cost of production.

23. **Investment controls,** while not reduced, have been streamlined, and focused more sharply on new investment priorities. Among others, renewal investments and investments in tourism (other than hotels) receive priority and incentives similar to those of investments in other sectors.

24. **Export promotion.** A number of measures have been taken to stimulate exports, streamline export procedures, establish export credit and insurance, develop export marketing, and facilitate re-exports, in line with the recommendations of the Bank's Industrial Policy Mission of January 1985. They pertain to:

- elimination of export licenses, except for subsidized goods;
- partial elimination of export taxes;
- improvements in the system for reimbursing import duties and taxes, by including the Customs Formalities Tax (TFD) in the reimbursement, by granting reimbursement at the time of customs clearance or even after export, and by opening up the possibility of reimbursing the actual exporter (who is not necessarily the importer);
- improved customs arrangements for temporary admission and warehousing (para. 96);
- increased opportunities for export pre-financing from 10% to 20% of project costs;

- extending the authorized periods for settling export transactions and repatriating the proceeds from 90 to 180 days;

- expanded opportunities for forward coverage of exchange risks to 6-8 months;

- liberalizing the use of accounts in convertible currencies and increasing the amounts that may be taken out of the country for business travel;

- introduction of a system of export credit insurance with the first policies issued by the Tunisian Export Credit Insurance Company (COTUNACE) in mid-1985;

- establishment of a number of export companies, several of which have already begun operations;

- establishment in 1985 of an export promotion fund to finance a variety of export promotion measures;

- establishment of two export promotion committees, one in the Central Bank (BCT) and the other in the Ministry of Commerce and Industry, to deal with day to day problems at the working level.

C. The Short- and Medium-Term Adjustment Program

25. As indicated in paragraph 9 above, the package of policy changes implemented by the Government over the last few years has shown some positive results, particularly concerning private domestic demand and the budget deficit; however, its restrictive elements have also created a number of problems, such as the lack of essential imports for directly productive activities. Over the coming years, two kinds of actions are of vital importance: (a) to maintain and strengthen the positive measures already taken; and (b) to complement these measures through changes in other fields destined to reinforce the effectiveness of the program and minimize its adverse effects. Included in this second group are measures to restructure the economy through a progressive liberalization including prices, investments and imports. This program of macro-economic adjustment measures is supported by two policy based loans; one focusing on agriculture (ASAL, signed October 3, 1986), and the other focusing on industry and trade (this proposed Loan). It is described below, as well as in the Government's Letter of Economic Development Policy (Annex IV). It is in agreement with the adjustment program presented by the Tunisian Government to the IMF as a basis for the recent stand-by arrangement and the CFF (para. 10).

26. Wage and salary policy. Maintaining cautious wage and salary policies may well be the single most important policy measure to achieve a long-term sustainable balance of payments equilibrium and more rapid employment creation; it can also contribute significantly to achieving a rapid improvement in the present balance of payments deficit. Wages and salaries are an important
determinant of (a) domestic demand and in consequence of import demand; (b) the cost of production of manufactured goods and services, and consequently of the competitiveness of Tunisia's manufactured exports and tourism; and (c) relative factor costs and, thus, the labor intensity of future economic activities and growth of employment. The Government is determined to maintain the restrictive wage and salary policies started in 1983 and to limit the growth of the total wage bill to that of GDP during 1988-91, while limiting it to less than the increase of the CPI in 1986-87, when only the minimum wage is raised. While such measures will slow down the improvement in the standard of living of the labor force already employed, they are necessary and adequate to speed up the creation of new employment and, thus, reduce unemployment and improve income distribution.

27. Exchange rate policy. An appropriate exchange rate, allowing for competitive exports of non-oil/non-phosphate goods and services is a vital pre-condition for the success of an export-oriented growth strategy in Tunisia. The measures taken since mid-1985 have achieved this goal. The Government has committed itself to pursuing a flexible exchange rate policy with the objective of maintaining the real effective value of the Dinar and ensuring the international competitiveness of the Tunisian economy. Any adjustments in the exchange rate will be reflected, among others, in domestic producer prices for agricultural products.

28. Regarding interest rates, as a result of measures taken in 1985 and early 1986, most rates are now positive. Considering that most of these rates were set free on January 1, 1987, they are expected to remain well above the expected rate of inflation of about 6.5% p.a. during 1987-91.

29. As mentioned above (para. 21), budget outlays have been cut considerably in 1986. In the context of the VIIth Development Plan, the Government plans further reductions in the overall budget deficit over the coming years; in order to achieve its balance of payments and foreign debt targets during the VIIth Plan and beyond (paras. 43-46), the Government intends to eliminate the overall budget deficit by 1991 at the latest (see Table 1). This objective would be achieved largely through cuts in expenditures, since budgetary revenue is already high (nearly 31% of GDP), and is likely to increase less rapidly than GDP, given declining oil incomes, low growth of imports and the proposed reduction in many customs tariffs (para. 35), as well as the tax incentives given for exports and regional development. Even given the planned major Government effort to mobilize new sources of revenues (improved collection of direct taxes, full introduction of the VAT, introduction of additional sales taxes on luxury goods), a gradual decline in total budget revenues as a percentage of GDP is virtually unavoidable.
Table 1: OVERALL BUDGET TARGETS
(In percentage of GDP, net of debt amortization)

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<td>Revenues</td>
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<td>30.0</td>
<td>29.0</td>
<td>27.0</td>
<td>0.2</td>
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<td>Recurrent expenditures</td>
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<td>25.0</td>
<td>24.0</td>
<td>23.0</td>
<td>21.0</td>
<td>-1.3</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>11.3</td>
<td>9.4</td>
<td>8.0</td>
<td>7.5</td>
<td>6.0</td>
<td>-2.3</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>35.2</td>
<td>34.4</td>
<td>32.0</td>
<td>30.5</td>
<td>27.0</td>
<td>-1.6</td>
</tr>
<tr>
<td>Overall deficit</td>
<td>3.7</td>
<td>3.5</td>
<td>2.0</td>
<td>1.5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

30. Under these circumstances, gradual achievement of a balanced overall budget requires substantial reductions of expenditures in real terms as well as in relation to GDP. These can be achieved without impairing the provision of appropriate social and economic services by the Government, through careful setting of priorities among budgetary outlays. The recommendations of the Bank's recent Public Expenditure mission will be providing an important input into this task. For recurrent expenditures, it can be achieved primarily through two measures: (a) a considerable slow-down in the growth of salary outlays as the hiring of civil servants will be limited to a maximum of 2% p.a., and salary increases will be as limited as in the private sector; and (b) a systematic reduction in subsidies of 5% p.a. in nominal terms. Achievement of the latter objective will be aided by the public enterprise reform that the Government started in 1985 and plans to pursue more vigorously over the coming years; this reform aims at reducing the number of public enterprises and decreasing the deficits of the ones that will remain in the public sector. In addition, the Government is in the process of devising new policies to focus consumer subsidies more strongly on the really needy and to do away with the present across-the-board subsidization of the entire population (para. 49). For capital expenditures the reductions will be achieved by reducing Government subsidies and capital contributions to the remaining public enterprises, whose capital requirements will be progressively covered by their own increasing cash flow generation and by borrowings from development banks. Direct Government investments in social and other infrastructure would be maintained at about the present level in real terms.

31. Monetary and credit policies have been quite expansionary over recent years, with growth of money circulation (M2) exceeding that of GDP by a substantial margin (17% p.a. vs. 14% p.a. on average during 1981-85) in spite of comprehensive Central Bank controls. The Government intends to prevent the growth of money circulation during 1986-91 from exceeding that of GDP, and will keep it below that under normal circumstances. Given the considerable projected decline in the Government's overall budget deficit and, thus, in its
need for new borrowing, tighter monetary and credit policies can be followed
without hampering productive investments in the private sector. As agreed
with the IMF, this tighter and more careful management of money and credit
will be achieved through a major change in the Central Bank's instruments of
money supply management. In particular, Central Bank discounts at fixed rates
will be limited to priority sectors (agriculture, exports, SSIs, energy
saving), while the banks will have to raise the bulk of their funds on the
money market at the daily rate, subject to ceilings based on their deposits.

32. **The liberalization program.** As mentioned above (para. 16), a major
improvement in the allocation and use of economic resources, as well as in the
relative incentives for export production compared to production for the
domestic market, are key pre-conditions for Tunisia to achieve satisfactory
economic growth and employment creation at a time of tightening balance of
payments constraints. Progressive liberalization of the economy and
introduction of more competition - domestic as well as foreign - is the only
effective way to achieve this. Given the fact that Tunisia's modern sector
has operated for decades in a highly controlled and well protected
environment, the necessary phasing out of controls on prices, investments and
imports should be closely coordinated. The Government is determined to
complete the phasing out of controls before the end of the VIIth Plan (1991).

33. **Price controls.** In addition to the ongoing gradual decontrol of
agricultural producer prices, the Government intends to abolish price controls
for all manufactured goods by 1991, with the exception of a small number of
key staples such as bread and edible oils. In a first phase (1986 –
mid-1988), controls will be abolished (i) in well established industries where
the number of domestic producers is sufficiently large to ensure appropriate
competition. The list of such industries, which account for about 60% of
total manufacturing output, and a schedule for the decontrol of their prices
is included in the Letter of Economic Development Policy. In accordance with
that list, prices have been liberalized on September 1, 1986 for a first group
of products, and for a second group on January 2, 1987; and (ii) for all
products whose imports will be liberalized over the same period, i.e. all raw
materials, spare parts, capital goods and most semi-manufactures. These
account for an estimated additional 12-15% of total manufacturing output. In
a second phase (mid-1988 – end-1990), the controls will be abolished in all
other industries. With respect to those products for which price controls
will continue for an interim period, a new more flexible price control system
will be introduced in early 1987, which avoids the major shortcomings of the
present cost-plus system, such as over-investment, low use of installed
capacities, and lack of incentives to control production costs, including
energy use. The new system will allow the enterprises to adjust prices
unilaterally and to apply the new price following a reasonable lapse of time,
provided there is no justified objection on the part of the Government.
Criteria for price adjustments would include—in addition to changes in
production costs—the stated objective of gradually closing the gap between
controlled domestic prices and prices to be paid for imports so as to avoid to
the extent possible any major and abrupt price changes at the time prices and
imports of a given good are liberalized. Prices, thus, would become more
market oriented.

34. **Investment controls.** At present, all new investments need Government
approval, including replacement investments and expansions of existing
installations. At the same time, investment incentives are provided to
virtually all approved investment projects. As discussed in detail in Part IV
of this report (paras. 69-85), the new investment legislation to be introduced in early 1987 foresees the immediate, full decontrol of all investments. Government approval will be limited to the granting of a number of special investment incentives; however, these will be available only to a restricted number of high priority projects, particularly export industries and new investments creating employment in the most underdeveloped areas of the country.

35. **Import liberalization** is the third essential liberalization measure without which the effects of price and investment liberalization would remain very limited. It is also essential to improve incentives for export production, by making production for the local market less attractive. The Government intends to take two sets of measures in this respect:

(a) to phase out all quantitative restrictions on imports before the end of 1990 except for a limited number of infant industries which might receive quantitative protection not exceeding three years in exceptional circumstances. In line with the country's import priorities, liberalization has started with spare parts for use in industry, agriculture, hotels, hospitals and other services, raw materials and semi-finished products for enterprises that export at least 25% of their output, and capital goods for new investment projects approved by the Industrial Investment Promotion Agency (API), the Agricultural Investment Promotion Agency (APIA) and the Tourism Investment Board after October 1, 1986; these measures became effective in November 1986. They were followed on January 2, 1987, by the liberalization of semi-finished products for firms that are well integrated or that export at least 15% of their output, as well as all other raw materials and spare parts. Imports of capital goods and of the remaining semi-finished products will be decontrolled by January 1988. As a result of the above measures, about 75% of all imports would be liberalized by the end of 1988. During 1989-90, all remaining quantitative restrictions, essentially on consumer goods imports, would be phased out; and

(b) to reform the tariff system by reducing high import tariffs and the disparities in the levels of effective protection between the different sectors of the economy with the aim of achieving a lower and reasonably uniform effective protection rate of about 25% by the end of the VIIth Plan. To achieve this objective, the Government intends to prepare a program of gradual tariff reductions for implementation over the 1989-91 period. As an interim measure, it has amended the present tariff system on January 1, 1987 so that there is a universal minimum tariff of 15%, all existing tariffs between 25% and 31% are reduced to 25% and all tariffs presently between 32% and 56% are reduced by 6 percentage points, and all higher tariffs are reduced to a maximum of 50%. Not later than January 1, 1988 all tariffs then being between 25% and 34% will be reduced to 25% and all tariffs between 35% and 50% will be reduced by 9 percentage points. The Government intends to replace some of these reduced import tariffs by domestic sales taxes covering imports as well as domestically produced goods.
36. In line with its policy of progressive import liberalization, the Government also decided in the Fall of 1986 to apply for full membership in GATT. Tunisia has been a provisional member for several years.

37. The entire macro development program, as described above and in the Government's Letter of Economic Development Policy (Annex IV) would be monitored by the Ministry of Planning and Finance (with assistance from the Ministry of Industry and Commerce and the Central Bank) and by Bank missions (para. 141). Bank confirmation of satisfactory progress in implementation of the overall program would be a condition of second tranche release (para. 139).

D. Medium-Term Projections

38. As mentioned above, the economic adjustment program is aimed at achieving three major objectives. First, the direct export promotion measures together with the exchange rate adjustments and reduced import protection would stimulate the growth of non-oil exports to over 7% p.a., compared to an estimated 3.3% achieved during the VIth Plan. Second, the pricing and investment incentive policies aimed at raising the efficiency of resource utilization and allocation would reduce the investment rate from 28% of GDP in the last five years to 22% during the VIIth Plan without seriously affecting output growth, and would reduce the incremental capital-output ratio from the present high level of 10.4 to 6.3 between 1986-91. Third, the substantial changes in relative factor costs would stimulate the creation of new employment, expected to average between 50,000 and 55,000 new jobs p.a. or a 2.5-3% p.a. increase over the Plan period. Even this nearly 16% increase over the VIth Plan actual figures, however, will only permit absorption of about 70% of new job seekers.

39. Concerning growth of GDP (Table 2), the decline in the production and export of oil tends to overshadow at first glance the projected substantial improvements in the non-oil sectors, particularly when compared with historical performance. Such improvement is vital for Tunisia to achieve a satisfactory overall growth over the coming years. Table 2 shows that even though the average GDP growth of the VIIth Plan is somewhat lower than that of the VIth, the growth of non-oil industries is substantially higher (5.8% compared to 4.2% p.a.). Agriculture’s performance (4.3% compared to 4% p.a.) is a reflection of the exceptionally good recovery of agriculture in 1987 following a decline in 1986; the projected 3.5% p.a. growth of the sector in other normal years is significantly better than the 1.6% achieved during the 1976-81 period. Output of the non-oil productive sectors is expected to increase rapidly, as a result of direct measures stimulating the agricultural and industrial sectors (improving productivity and efficiency of rain-fed and irrigation agriculture, improving land use policy, strengthening export promotion measures and institutions) and indirect measures affecting the incentives framework. Developments in the oil sector are heavily influenced by world oil prices, as the production of small oil fields would only become attractive if oil prices increase again substantially. The present outlook is for production of crude to decline to 3.6 million tons by the end of the VIIth Plan, while in early 1986 the projection had been for 4.4 million tons. In 1985/86, actual production averaged 5.2 million tons. Production of associated gas would decline in parallel.
Table 2: GROWTH OF OUTPUT AND EXPENDITURES
(Annual growth rates in percentage)

<table>
<thead>
<tr>
<th></th>
<th>1976-81 (Actuals)</th>
<th>1981-86 (Preliminary)</th>
<th>1986-91 (Projected)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (mp)</td>
<td>6.1</td>
<td>3.6</td>
<td>3.4 /a</td>
</tr>
<tr>
<td>Agriculture</td>
<td>1.6</td>
<td>4.0</td>
<td>4.3</td>
</tr>
<tr>
<td>Industry</td>
<td>8.9</td>
<td>3.0</td>
<td>3.1</td>
</tr>
<tr>
<td>Hydrocarbon</td>
<td>(8.3)</td>
<td>(0.2)</td>
<td>(-5.9)</td>
</tr>
<tr>
<td>Non hydrocarbon</td>
<td>(9.2)</td>
<td>(4.2)</td>
<td>(5.8)</td>
</tr>
<tr>
<td>Services</td>
<td>6.5</td>
<td>3.9</td>
<td>3.4</td>
</tr>
<tr>
<td>Consumption</td>
<td>7.4</td>
<td>4.2</td>
<td>2.7</td>
</tr>
<tr>
<td>Private</td>
<td>(7.8)</td>
<td>(4.1)</td>
<td>(2.9)</td>
</tr>
<tr>
<td>Public</td>
<td>(5.8)</td>
<td>(4.5)</td>
<td>(2.0)</td>
</tr>
<tr>
<td>Gross Investment</td>
<td>6.6</td>
<td>-3.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Imports GNFS</td>
<td>10.8</td>
<td>-2.4</td>
<td>1.6 /c</td>
</tr>
<tr>
<td>Exports GNFS</td>
<td>8.5</td>
<td>0.8</td>
<td>2.8</td>
</tr>
</tbody>
</table>

/a Constant 1980 prices and calculated by least squares.
/b Growth rate is exceptionally high because bad weather conditions in 1986 provide a low base.
/c Due to reduction in oil imports on account of the new refinery.

Source: Ministry of Planning and Finance and Appraisal Mission estimates.

40. The two major exports of goods (table 3), oil and phosphate derivatives, are affected by two factors in addition to a depressed price outlook. The coming on stream of the refinery extension at Bizerte will reduce crude oil exports by 1.5 million tons, as more Tunisian crude will be processed locally for domestic consumption. While recently completed fertilizer plants could increase exports of phosphate derivatives by over 9% p.a., it is likely that this capacity cannot be fully utilized in view of the projected glut in world supply, and of the poor quality of indigenous phosphate rocks. These exports are, thus, expected to grow by little more than 7.5% p.a. during 1986-91.

41. In consequence, manufacturing industries (other than phosphate processing), tourism and agriculture will have to become the major engines of future export growth. Assuming that the policy measures concerning the agricultural sector agreed under ASAL are implemented in a timely fashion, there should be a significant reduction in the agricultural trade deficit through reduced imports and increased exports. Overall, manufactured exports excluding phosphate derivatives are expected to grow at 9.3% p.a., with the greatest potential in electrical and mechanical products, textile and other manufacturing industries. Tourism is expected to resume a more satisfactory growth at 6% p.a., albeit not at the rate experienced during the late 1970s (over 9% p.a.).

The medium-term projections assume an oil price of US$13.5 per barrel in 1986, gradually increasing to US$19, in current prices, in 1991, while the price of TSP, the major fertilizer product of Tunisia, is expected to increase from the present level of US$130 to US$169 per metric ton.
### Table 3: GROWTH OF EXPORTS

(Average Annual growth rates, constant 1980 prices)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Agricultural Products</td>
<td>2.4</td>
<td>0.7</td>
<td>4.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Crude Petroleum</td>
<td>7.4</td>
<td>-4.9</td>
<td>-20.2</td>
<td>15.0</td>
</tr>
<tr>
<td>Phosphate + Derives</td>
<td>2.7</td>
<td>4.1</td>
<td>7.5</td>
<td>13.5</td>
</tr>
<tr>
<td>Processed Food</td>
<td>-3.4</td>
<td>8.5</td>
<td>5.5</td>
<td>4.8</td>
</tr>
<tr>
<td>Textiles</td>
<td>23.7</td>
<td>3.7</td>
<td>7.8</td>
<td>18.7</td>
</tr>
<tr>
<td>Electrical/Mechanical</td>
<td>23.9</td>
<td>8.3</td>
<td>12.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Other Goods</td>
<td>6.8</td>
<td>1.6</td>
<td>20.0</td>
<td>2.4</td>
</tr>
<tr>
<td>NFS</td>
<td>9.2</td>
<td>2.4</td>
<td>6.1</td>
<td>37.6</td>
</tr>
<tr>
<td>Total Exports, GNFS</td>
<td>8.5</td>
<td>0.8</td>
<td>2.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Total, excluding petroleum</td>
<td>9.0</td>
<td>3.3</td>
<td>7.3</td>
<td>85.0</td>
</tr>
</tbody>
</table>

Source: Ministry of Planning and Finance and Appraisal Mission estimates.

42. Concerning imports, the pivotal role of exports in generating economic growth will require corresponding increases in imports, particularly of raw materials and intermediate goods needed for industrial growth; growth of these imports is assumed to be at par with industrial growth, allowance being made for the expected improvement in efficiency. The elasticity of energy consumption would decline to 1 during the VIIth Plan, compared to 1.3 at the present time, reflecting a continued energy conservation effort being supported, in part, by a recent Bank loan. Total energy imports are expected to decline by 5.9% p.a. throughout the period, partly as a result of the refinery extension mentioned above. In addition to stimulating exports, the policy measures proposed by the Government are expected to substantially stimulate import substitution of agricultural products. As a consequence, the growth rate of food imports is expected to decline substantially from 5.3% p.a. during 1977-86 to slightly less than 1% during the VIIth Plan, despite a rapid growth of the population (2.5% p.a.) and of food processing industries (4% p.a.). The greatest potential in this category includes wheat, barley, milk and beef. Imports of other consumer goods are likely to remain low during 1986-88, due to the impact of short-term stabilization measures, which are expected to keep growth of domestic consumption below that of total GDP; they are expected to pick up rapidly thereafter as growth resumes and the impact of import liberalization begins to be felt.

43. Balance of payments and external debt. Emigration has slowed down in the face of weakening demand for foreign workers in Europe, in Libya and in the countries of the Arab peninsula, and therefore inflows of workers' remittances are expected to decline slightly in real terms. Over the past five years, these remittances have averaged over 16% of commodity exports,
equivalent to about 4% of GDP. Given this and the above-discussed export and import outlook, the current account deficit is expected to decline from about US$810 million, or 9.2% of GDP in 1986, to about US$400 million, or 3.4% of GDP in 1991. In view of the depressed oil price outlook and assuming no major new oil field discoveries, direct foreign investment is expected to remain at the current level in real terms, with non-oil investments increasing rapidly but oil investments declining substantially.

Table 4: TUNISIA – PROJECTED BALANCE OF PAYMENTS

(Millions of current dollars)
(With adjustment)*a

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<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Exports of Goods and NFS</td>
<td>2,699.9</td>
<td>2,638</td>
<td>2,920</td>
<td>3,894</td>
</tr>
<tr>
<td>Imports of Goods and NFS</td>
<td>3,207.1</td>
<td>3,374</td>
<td>3,529</td>
<td>4,242</td>
</tr>
<tr>
<td>Net Factor Services + Transfers</td>
<td>-81.4</td>
<td>-75</td>
<td>-84</td>
<td>-50</td>
</tr>
<tr>
<td>Current Account Deficit</td>
<td>588.6</td>
<td>811</td>
<td>693</td>
<td>398</td>
</tr>
<tr>
<td>Net Foreign Investment</td>
<td>139.5</td>
<td>137</td>
<td>118</td>
<td>195</td>
</tr>
<tr>
<td>Public M &amp; LT Borrowing (gross)</td>
<td>750.6</td>
<td>1,130</td>
<td>1,301</td>
<td>1,018</td>
</tr>
<tr>
<td>Amortization on M &amp; LT Debt</td>
<td>436.5</td>
<td>567</td>
<td>588</td>
<td>821</td>
</tr>
<tr>
<td>Public M &amp; LT Borrowing (net)</td>
<td>314.2</td>
<td>562</td>
<td>713</td>
<td>197</td>
</tr>
</tbody>
</table>

Selected Financial Indicators

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</thead>
<tbody>
<tr>
<td>Debt Service Ratio (% of exports of goods and services)</td>
<td>22.4</td>
<td>29.3</td>
<td>28.0</td>
<td>27.9</td>
</tr>
<tr>
<td>Current Account Deficit (% of GDP)</td>
<td>7.1</td>
<td>9.2</td>
<td>7.9</td>
<td>3.4</td>
</tr>
</tbody>
</table>

*a This includes the effects of the Government's adjustment program described herein.

Source: Ministry of Planning and Finance and Appraisal Mission estimates.

44. Gross foreign loan disbursements required to finance such a current account deficit, to repay maturing debt and to increase reserves to a level equivalent to 1.6 month of imports by end 1988, would average about US$1.2 billion annually during 1987-91. Over 70% of this would come from official sources, compared to 60% in the last three years. Debt outstanding and disbursed as a percentage of GDP would increase from an average of about 55% in 1985/86 to about 61% in 1991 (after a peak of 67% in 1988), while the debt service ratio would be 27.9%. Average borrowing terms are not expected to harden much. The average interest rates would remain in the 6-7% range between 1987-91, while the average maturity would be within the current range of 15-17 years.
45. This scenario obviously hinges on the policy changes to be initiated during the next few years, in particular on a timely implementation of policy measures to accelerate exports, reduce public investments, slow down growth of domestic demand and liberalize the economy by phasing out regulations and controls. As mentioned in Section B above, the Government has already taken several steps in implementing such a strategy. Considering its long record of prudent external debt management, there are good grounds to assume that Tunisia will implement the necessary policy changes along the lines discussed above and remain creditworthy for a continued high volume of Bank lending.

46. Domestic resource mobilization. With exports growing faster than imports, the resource gap is expected to decline to about 3% of GDP by the end of the VIIth Plan. This still rather high overall gap, however, disguises a strenuous effort in savings mobilization in the non-oil sectors. Indeed, the non-oil resource gap declines from an average of 14% of GDP in 1984/85 to about 2.6% in 1991. The marginal propensity to save over the period 1987-91 is estimated at a high 26% (in current prices), assuming successful implementation of the structural reforms to control domestic demand. Limiting Central Government current budget expenditures to below 21% of GDP and capital expenditures net of debt repayment to about 6% of GDP by the end of the VIIth Plan period should allow public sector savings to finance over 70% of public sector investment (including public enterprises), up from 43% in 1984/85, and should increase the percentage of overall investment financing by domestic savings to about 90% on average over the period. While this would help to reduce the pressure on the balance of payments, it also gives a clear signal to the private sector that the public sector investment program will not lead to a crowding out of private investments but rather will supplement it by providing the necessary infrastructure.

47. The medium-term framework discussed above corresponds largely with the Government's own planning scenario for the VIIth Plan. While there are clearly downside risks involving such exogenous factors as the growth of the world economy, in particular in the EEC countries, and movements in international prices, it is clear from the analysis of the recent past that there is no alternative to the proposed export-oriented strategy. Slower export growth would lead rapidly to slower GDP growth, in order to keep the balance of payments manageable. Such a situation would greatly worsen the unemployment rate. As mentioned above, even implementation of the full structural adjustment program will not allow absorption of more than 70% of new job seekers during 1987-91; any lesser effort would further worsen the unemployment situation with serious political and social consequences.

E. Social Impact of the Adjustment Program

48. According to the latest household survey, almost 12.8% of the total Tunisian population (823,000 persons) was living below the absolute poverty level in 1980.1/ Most of the poor and lower income groups are located in rural areas, followed by smaller towns; these groups account for about 14% of

1/ In 1980, the absolute poverty level was TD 60/person/year in rural areas and TD 120/person/year in urban areas.
the total rural population, and 12% of the total urban population. They are largely employed in agriculture (43%) and construction (16%), where significant underemployment exists. Over 18% of the total work force in construction, 16% in agriculture, 14% in mining and 10% in transport are considered to be poor. They spend almost 85% of their budget on fulfilling their basic needs for food, housing and clothing.

49. The Government's program of economic adjustment could worsen the situation of the absolutely poor in two major ways: (i) through the gradual reduction of budget subsidies; and (ii) through increases in consumer prices triggered by changes in the exchange rate and increases in agricultural producer prices. The present system of consumer subsidies is clearly important to the well being of the poorest segment of the population, as such subsidies account for nearly 19% of their total expenditures - 20% for the urban poor and 17% for the rural poor. However, the subsidies overwhelmingly profit the better off segments of the population, with over 60% of all consumer subsidies going to the highest income groups, and only less than 10% going to the absolute poor, particularly to the urban poor (6%). This situation means that while it would appear socially and politically impossible and undesirable to deprive the absolutely poor from the support they currently receive, there is ample room to reduce consumer subsidies by as much as 90% without taking away anything from the really poor. This requires that ways and means be found to target this assistance more directly to the really needy. The Government is clearly aware of this situation; it recently established a Special Commission to study how to target and efficiently distribute consumer subsidies, so as to gradually introduce a more focused and less expensive system of support for the poor as overall subsidy outlays are reduced.

50. The adjustment program also includes a number of important measures designed to improve the situation of the poor: (a) the rural poor, particularly in rain-fed areas, will profit from increased agricultural producer prices as well as from increases in agricultural production for import substitution and exports; (b) the urban poor will profit from the increase in the minimum wage introduced in mid-1986; (c) both groups will profit from the stimulating effects of the adjustment measures on employment creation, as export industries, agriculture and tourism are all relatively labor-intensive sectors. As the bulk of the absolute poor are employed in sectors with a high underemployment rate, the expected more rapid creation of new employment and decline in underemployment ought to have a sizable effect on the standard of living of the poor labor force employed in the modern sector. Given the considerable under-utilized production capacity existing in several key export sectors such as textiles and tourism, the adjustment program is expected to show a positive, although limited, impact on employment almost immediately; in the longer term, it will be more pronounced. As referred to in para. 16, continuation of past macro policies would have limited the creation of new employment in the Tunisian economy to little more than 35,000 per year on average over the period of the VIIth Plan; this is less than half the expected number of new job seekers. As a result of the macro and sector adjustment programs, supported by the Bank, the number of new jobs created over this period is expected to average between 50,000 and 55,000 p.a., quite a substantial difference; and (d) given the fact that the informal sector will benefit little from minimum wage changes and the other measures mentioned above, the Government has initiated several specific programs for the support and development of this sector (para. 12).
PART III - BANK GROUP OPERATIONS IN TUNISIA

51. Since 1962, the Bank has committed to Tunisia seventy-two loans and ten IDA credits amounting respectively to US$1,625.5 million and US$75.2 million (net of cancellations) of which forty-five loans and credits have been fully disbursed. Annex II contains a summary statement of Bank loans, IDA credits and IFC investments as of September 30, 1986. Project implementation is generally satisfactory. As of September 30, 1986, overall disbursements amounted to 56% of appraisal estimates, which is in line with experience in other countries in the region. Disbursement performance for agriculture, energy, water supply and sewerage, highway and port projects has generally been above the country average, while longer than average disbursement delays have been experienced for education, health, technical assistance and urban projects, due to project-specific problems that are being addressed through supervision missions and sector discussions. In a number of sectors, important policy changes and institutional improvements have been achieved, and autonomous agencies have been created or strengthened to ensure the efficient management of the related sectors or sub-sectors.

52. The Bank's lending strategy in Tunisia aims at supporting the country's transition from a situation of reliance on petroleum exports to a sectorally-balanced post-hydrocarbon era through appropriate changes in economic policies and programs as described in Part II above, while taking measures to increase employment and target development to low income groups. In support of the above, the overall objective of Bank lending is to emphasize projects which have a direct and rapid impact on production, employment and exports (or import savings) and which minimize Government net contributions. The focus of lending for agriculture and industry meets this objective. In addition to the above, proposed Bank lending would focus on improvement of public enterprise performance, conservation and development of energy resources, and continued support to the social sectors and operations targeted to low income groups. For the latter, attention would be given to increased efficiency and cost-effectiveness of institutions and investments, and to linkages with directly productive sectors (e.g., education reforms stressing vocational training). We envisage only marginal lending for basic economic infrastructure, focussed in areas where Bank guidance would still be useful, such as rural water supply and highways maintenance.

53. Past Bank lending emphasized support for long-term investments in infrastructure and social development, with increasing support in recent years for agriculture and industrial financing. Bank/IDA commitments to date are distributed as follows: urban, water supply and sewerage, 23%; agriculture, 29%; industry, 20%; transport, 13%; energy, 9%; education, 4%; and health and technical assistance, 1% each. Within the broad framework noted in the previous paragraph, in our future lending, we expect a continuation of policy-based lending and traditional project lending in priority areas, for example, in the next couple of years, highway maintenance and forestry and credit lines to small-scale industries and agriculture.

54. The dialogue between the Government of Tunisia and the Bank on industrial development is of long standing and has kept evolving over time. Through its first loans to industry, the Bank aimed at providing general
support to industrial development; later on, it aimed at promoting industrial exports and labor-intensive industries, and financing high priority industries (e.g. electrical and mechanical industries (EMI) and small-scale industries (SSI)) in support of their priority in the Government's strategy. Bank support to industrial development in Tunisia has consisted mostly of lines of credit to the Economic Development Bank of Tunisia (BDET), which has now received eight Bank loans totalling US$129.16 million (net of cancellations) of which US$11.39 million remain undisbursed as of September 30, 1986. Most of these funds financed manufacturing industries; first through unrestricted lines of credit (Loan 1504-TUN and part of Loan 2113-TUN), then through lines of credit with special foci: on SSIs (Loans 1505-TUN and 1969-TUN) and EMI (Loan 2113-TUN). A credit line for a pilot SSI scheme (Loan 1505-TUN in 1978) prepared the ground for a US$30 million loan to SSIs (Loan 1969-TUN in 1981) that used for the first time commercial banks along with BDET as an intermediate. Two 1985 loans, for export industries (Loan 2522-TUN) and for EMI (Loan 2554-TUN), also used two of the new bilateral development banks, Tunisian-Kuwaiti Development Bank (BTKD) and Tunisian-Saudi Company for Investments and Development (STUSID) as intermediary along with BDET.

55. In addition to the lines of credit provided to BDET, four loans were made directly to industrial enterprises in Tunisia: the first was in 1974 (Loan 1042-TUN) to the Gafsa phosphate mining company to introduce advanced mining technology. It was followed in 1984 by a technical assistance loan for the mining sector (Loan 2346-TUN). A loan to SOGITEX in 1981 (Loan 2012-TUN) aimed at rehabilitating the textile industry. Finally, a foundry project (Loan 2301-TUN) was approved in 1983 to modernize and expand a large foundry, SOFOMEXCA, which should help improve the integration of the EMI sector in Tunisia. In 1982 the Bank made a loan to the Government which included a component to develop and promote new industrial projects (Loan 2197-TUN). The two main agencies involved were CEPEX (to study export promotion) and CNEI (to study specific sub-sectors and their potential for growth).

56. The Bank’s economic and sector work will address the increasing complexity of the macro-economic and sector problems that Tunisia will face in the medium term, and continue to focus on strengthening the macro-economic and sector base for our lending program. However, while in the past it was mainly devoted to the study of major structural problems, it is now focused on implementing the policy recommendations of these studies through sector lending in agriculture, industry and trade, public enterprises and transport; it will therefore concentrate on the following main tasks: (a) preparation and monitoring of the macro-economic framework of the VIIth Plan, which provides the policy base for structural adjustment and sector lending; (b) review of public expenditures under the VIIth Plan to provide guidance for the necessary reductions in budget outlays and a basis for support through structural adjustment lending; (c) assessment of public enterprise reforms prepared by the Government to reduce their drain on the state budget; and (d) monitoring of the agreed macro-economic and sector policy changes. The program also includes studies on education administration and finance, municipal finance and development, energy pricing, and the impact of the adjustment program on various income groups.

57. The Bank accounted for about 27% of total commitments from official sources to Tunisia during 1982-1985. Its share in total debt outstanding and disbursed at the end of 1985 (including loans from private sources) reached
about 12.1% and its share in debt service during 1985 was 13.6% (excluding IDA). The share of the Bank in Tunisia's disbursed external debt is expected to increase to about 23% and its share in the debt service to about 21% in 1991.

58. As of September 30, 1986, IFC's net commitments in Tunisia totalled about US$18.5 million. IFC has supported BDET to foster development projects, and the National Bank for Tourism Development (NBTD) to promote and invest in tourism projects. It has also assisted the Société Touristique et Hôtelière, a large hotel development; the Industries Chimiques du Fluor (ICF), a producer of aluminum fluoride from local fluorspar for export; and the Société d'Etudes et de Développement de Sousse-Nord for an integrated tourism development project. In FY85, IFC approved an equity investment in Fluobar, a project to privatize, rehabilitate and expand an existing fluorspar mine. Two investments in Tunisia Leasing Company, the first leasing company in Tunisia to provide financing to the industrial sector, were approved in FY85 and FY86. In FY86, IFC also approved an equity investment in Société Industrielle de Textiles (SIITEK) which would help privatize an existing state-owned textile mill, and an equity investment in Adwa S.A., a company which will produce pharmaceutical products from imported active ingredients. In FY87, IFC approved an investment in Rozzi Edilizzia Industrializzata Tunisia (REITSA). This project's objective is to manufacture a panel-based, integrated construction system for use in low-rise, medium-cost housing.

PART IV - THE MEDIUM-TERM INDUSTRIAL AND TRADE ADJUSTMENT PROGRAM

A. The Need for Adjustment

59. Tunisia, like many other countries that became independent in the 1950s and 1960s, began developing its manufacturing industry by concentrating on import substituting activities. In line with the shift in development strategy to open up the economy, Tunisia put gradually more emphasis on export-oriented industries during the 1970s, particularly textiles, while still pursuing an import substitution strategy behind a high level of protection. To generate employment without placing producers for local markets under excessive competitive pressure, the export industries were grouped into an enclave environment called off-shore industries. A policy of relatively generous investment incentives was followed to promote the growth of manufacturing. Where progress was lacking despite the high protection and investment incentives, the public sector seized the initiative and public enterprises were established. These now account for a significant share of manufacturing value added and investment (nearly 60%) with a particularly high concentration in phosphate processing, building materials and electro-mechanical industries. Generous investment incentives, relatively low interest rates, and rapid increases in wages resulted in manufacturing industries that are rather capital intensive, particularly among public enterprises.

60. These policies were quite successful during the 1970s and early 1980s, when they resulted in a rapid increase in manufacturing production and exports, averaging about 9% p.a. each in constant prices over 1971-1984, or nearly twice the growth of total GDP and total exports. Nevertheless, manufacturing remained a small part of the economy, accounting for only 14% of GDP in 1985, and about 20% of employment; it also remained little export-oriented. Although manufactured exports accounted for one third of
total exports in 1985, only the resource-based phosphate processing industry (82% exported) and the largely off-shore textile industry (45% exported) are major exporters. All other manufacturing sub-sectors sell on average over 90% of their production on the domestic market. This overwhelming orientation towards the domestic market did not present much of a bottleneck during the 1970s and early 1980s when manufacturing was still very small, possibilities for import substitution were large, and domestic demand expanded rapidly, fueled by the two massive world-wide oil price increases and substantial increases in local salaries. By the mid-1980s, however, the limits of the past growth strategy became obvious: by then the sector was no longer that small, the most obvious import substitution activities were all covered and growth of domestic demand slowed down markedly because of declining oil production and oil prices as well as wage freezes that began in early 1983. This revealed the very small size of the domestic market which, as mentioned before, is less than 10% that of Switzerland or 5% that of Spain. Furthermore, at about the same time, the only two export-oriented sub-sectors encountered increasing export difficulties; phosphate-based fertilizer because of depressed world market conditions and textiles because of increasing protectionism and slow growth of demand in Western Europe.

61. Two other weaknesses became increasingly apparent over the last years, namely the extreme dependence of manufacturing production upon imports and the high production costs. Given Tunisia's very limited endowment with raw materials, food processing and fertilizer production are the only two sub-sectors that use a significant amount of domestic inputs and the latter is crucially dependent on imports of sulfur. Thus, when foreign exchange earnings fell in 1985, the sharp import restrictions introduced in consequence have seriously hampered the normal functioning of manufacturing enterprises, as the country simply could not afford to import all the inputs needed to permit these enterprises to produce at or near capacity.

62. Production costs became high for a variety of reasons, but most importantly because of inefficiencies fostered by high import protection and large investment incentives granted almost indiscriminately to new enterprises, leading to an uneconomic choice of projects, high over-investments, sloppy management, low labor productivity and little regard for quality. In addition, labor costs were quite high, in particular after the large raises in salaries in 1982 and early 1983 which were exacerbated by high social security charges on employers. Finally, the appreciation of the Tunisian Dinar during the early 1980s eroded the competitiveness of manufactured exports.

63. Over the coming years, economic policies in the manufacturing sector will have to focus predominantly on stimulating exports, particularly in non-traditional sub-sectors, and this for two reasons: (i) together with tourism, manufactured exports will have to make up for most of the declining oil exports as well as for stagnating workers' remittances; and (ii) given the very limited size of the domestic market, manufacturing production can grow only at a satisfactory rate and create a satisfactory amount of new employment if the sector starts to export on a much larger scale. In fact, in many sub-sectors, satisfactory economies of scale can only be achieved if production for the domestic market is supplemented by substantial production for exports. The fact that Tunisian export industries tend to be particularly labor intensive is an additional argument in favor of manufactured exports at a time of increasing unemployment and underemployment.
64. To implement such an export-oriented growth strategy, Tunisia can count on a number of comparative advantages, in particular its geographic location and easy access to Western Europe (roll-on/roll-off service), very important for fashion products, its well trained labor force and its political stability. Substantial export possibilities exist in textiles and leather goods, EMI's and a number of miscellaneous industries. Implementation of the macro-economic adjustment program as outlined above, supplemented by the industry specific program of adjustments outlined below will go a long way to stimulate such exports.

65. The development strategy for the manufacturing sector should in the short term concentrate on improving the efficiency of existing manufacturing activities and increasing capacity utilization by intensifying competition, both domestic and foreign, to which the sector is exposed. In the longer term, it should aim to concentrate investments more strictly on the economically most profitable activities, by enhancing the responsiveness of allocating factors of production to market signals. All the policy measures required to implement the short-term strategy — such as maintaining an appropriate exchange rate, increasing the reliance on the market and on adjustments in relative prices to achieve better resource allocation, and utilizing both domestic and foreign competition to improve the efficiency of domestic production — are consistent with the longer-term strategy.

B. The Medium-Term Industrial and Trade Policy Adjustment Program

Objectives

66. The Medium-Term Industrial and Trade Policy Adjustment Program (MITAP) complements and reinforces the macro-economic policy adjustment program with three specific objectives in mind:

(i) to stimulate growth of manufacturing production in the short-term through better use of existing installations and in the longer term through an increased private sector role in investments;

(ii) to stimulate exports of manufactured products, other than fertilizers; and

(iii) to stimulate creation of productive employment in manufacturing industries.

While the macro-economic adjustment program is essential to the creation of an overall economic climate conducive to the achievement of the above objectives, there is a wide range of sectoral measures that can, and ought to be taken so as to strengthen the program in these three respects.

67. First and foremost, establishing an appropriate incentives framework is essential to the achievement of all three of the above objectives. This framework has to provide adequate incentives for private investors, encourage investments for exports, promote better capacity utilization and encourage entrepreneurs to invest in labor-intensive sectors and technologies. Decontrolling of investments, including the phasing out of Central Bank controls on individual credit applications, is important to encourage private investments. Reducing labor costs to employers will help achieve all three
objectives, be it through reduction in unit costs or through increased productivity. More flexible rules for hiring and laying off workers would facilitate the process of enterprise adjustment and make entrepreneurs more willing to hire additional employees. Last but not least, further improvements in government institutions dealing with private investments and exports and further streamlining of government regulations concerning imports and exports are an important part of the program.

68. Linked to the objective of stimulating private investment is the issue of public enterprise reform and privatization, consistent with the Government's desire to get the public sector out of manufacturing activities as rapidly as possible. Given the preponderance of public investments in this sector, this, obviously, is a long term process. This Loan is preparing the ground for this change through its macro and sectoral policy changes to make it more attractive for private entrepreneurs, not only to invest in new projects, but also to take over public enterprises. This Loan is not directly concerned, however, with public enterprise reform and privatization; this would be the main task of the Public Enterprises Mission, scheduled for January-February 1987, in preparation for a possible Public Enterprise Sector Loan.

The Incentives Framework

69. The new investment code to be implemented in early 1987 as part of the Industrial and Trade Policy Adjustment Program, brings about a number of important improvements over the existing law; it is a major step in the decontrol of the economy. First and foremost, it abolishes all Government investment licensing and controls. Government authorization would be required only for the granting of special investment incentives which will be available to no more than an estimated 25-30% of all new investments; all investments not eligible for such incentives, or not requesting them, can be implemented without any prior Government approval. Second, the number and importance of incentives is reduced substantially and those incentives no longer discriminate among sectors or against labor-intensive, small and replacement investments. Third, incentives are to be granted almost automatically to all enterprises meeting specified criteria. This would reduce to a minimum, the discretionary power of the Government's Incentives Approval Committee. Finally, Government considers these incentives as temporary measures to be reviewed and possibly phased out by the end of the VIIth Plan.

Required Changes

70. Tunisia's present investment laws require prior Government approval for all manufacturing investments by the Industrial Investment Promotion Agency (API), whose Board includes representatives from all the main economic ministries. Once approved, all investments automatically get a wide range of incentives, except replacement and renewal investments and those creating less than ten new jobs. The incentives themselves are divided into two separate systems; one applies only to firms exporting all their output, though limited home market sales are authorized; most of these firms are in practice offshore processing operations, many are foreign-controlled, with a heavy concentration in clothing. The law gives tax and import duty exemptions for all imports of inputs and capital goods, and exemptions from profit taxes for 20 years, plus other tax concessions. The other system applies to some 95% of all investments in Tunisian manufacturing, including firms which export part of their output. This law exempts capital goods imports, for new and extension
projects, from all customs duties (in excess of the minimum duty), and gives some direct tax relief to all firms. Partial exporters and investments in particularly underdeveloped areas of the country get substantial additional profit tax concessions; the former can obtain tax and duty-free those raw materials and semi-finished goods to be incorporated in exports, and the latter benefit from reductions in social charges, get job creation subsidies, and subsidized industrial land. Concessions are also given to encourage multi-shift operations, the development of local capital goods manufacturing, more technologically advanced operations, energy savings and above-average levels of Tunisian value added.

71. The present system has been regarded as too bureaucratic and ineffective in screening out poor projects; incentives were judged to be too complex, insufficiently selective, and often unnecessarily generous. They tended to favor capital rather than labor-intensive projects and to discriminate against small projects and replacement investments. The system did not focus enough on Tunisia's main current economic priorities, such as export promotion and employment creation. Finally, the comprehensive investment control system is no longer in tune with the general liberalization of the economy and massive incentives are no longer justified, given the fact that the new macro-economic policies will remove many of the distortions which the existing system sought to compensate for. Accordingly, a new investment law has been drawn up and discussed in detail with the Bank. It will be presented to the National Assembly before this Loan becomes effective and should be adopted well before the second tranche release. Incentives for companies exporting all their output are little affected by the proposed new law even though they are now dealt with in the same code as the ones applying to other companies. For other enterprises, however, the changes are sweeping. The new law is simpler, more selective in granting special incentives, but at the same time it is more balanced and neutral in terms of giving appropriate encouragement to all investments (including those outside the manufacturing sector) through automatic "common law" concessions.

The Continued Need For Incentives

72. There are a number of reasons to maintain a reduced arsenal of investment incentives to be granted on a selective basis during the period of the VIIth Plan: (i) since import protection and price controls are being phased out only gradually (1986–90), existing distortions will not be eliminated immediately and some investment incentives will continue to be needed to compensate for these. In particular, it is necessary to improve after tax returns from production for exports vis-à-vis that for the home market (at present, generally far more profitable); (ii) continued incentives are also needed to attract foreign investment, particularly in production for export since virtually all competitor countries offer a wide range of tax and other incentives, and the few who do not, have far lower rates of both direct and indirect taxation; (iii) the prevailing imbalance in the provision of Government infrastructure to the detriment of outlying areas justifies the granting of special investment incentives in those areas to rectify this situation; and finally (iv) the macro-economic changes now being introduced are not selective enough to permit a sharper focus on employment creation in the most disadvantaged parts of the country, one of the government's main preoccupations; in most countries, salaries tend to be lower in outlying areas than in industrial centres, but the current nationwide system of wage fixing
means that this is not presently the case in Tunisia. Until this can be modified, other means will have to be used to reduce labor costs in the West and the South.

The New Investment Law

73. The new law brings about six important changes:

a) **All investment controls are abolished.** No prior investment authorization will be required, only a simple declaration for statistical purposes.

b) **Only a limited number of investments, considered particularly important to the economic and social development of Tunisia, will be eligible to receive special investment incentives after approval by the Investment Incentives Approval Committee, the secretariat of which will be provided by API (para. 90).** They will apply only to enterprises exporting part of their output, to those creating new jobs in certain high priority areas of the country and to those introducing new, improved technologies.

c) **Special incentives are to be granted automatically,** provided specified criteria are met. The two main criteria — exports and location — are clear cut. Only the relatively minor incentives for the acquisition and adaptation of new technologies are based upon an approval process that involves, unavoidably, a judgmental element.

d) **The incentives will no longer make any distinction between projects of different sizes, nor among new, extension or replacement investments; thus, small and replacement investments will no longer be discriminated against.**

e) The new incentives will be **much less generous than under the old law, as some major ones are being withdrawn.** In particular, only off-shore enterprises exporting all their output will continue to benefit from cuts in tariffs on capital goods imports. Thus, the bias in tariff exemptions against labor-intensive projects has been reduced markedly, even though capital goods remain exempt from turnover taxes, whether imported or purchased domestically.

f) **All incentives, apart from some relating to export operations (e.g., duty exemptions on materials imports and export profits) and to encourage multi-shift production, are temporary in nature; they are either linked to the act of investing, or extend over a maximum of six years (ten years for off-shore companies).**

74. As is the case now, a number of other investment incentives are available as "common law" rights to investments in all sectors without need for prior Government approval. They affect in particular, those enterprises exporting part of their output. In addition, they provide encouragement
linked to the introduction of multi-shift work. All were available already under the old law but could only be obtained after prior Government approval of the investment project.

75. A general incentive to new investments is provided under these "common law" provisions in the form of an exemption from the income or profit tax on that part of personal income or enterprises' profits used to subscribe to the initial share capital of a new enterprise or to increases in its capital. For individuals 30% of the amount invested will be tax-exempt, for companies 50%; for share capital subscriptions in enterprises exporting one fifth or more of their output, exemption will be increased to 50% and 70%, respectively.

76. The most important "common law" concessions are those given to direct as well as indirect exporters in all sectors:

a) Imports of products to be processed for re-export will be admitted tax- and duty-free under temporary admission or industrial warehousing systems.

b) Local purchases of products and services needed for export production will be free of turnover taxes.

c) Exemption from company profits tax of the same proportion of profits as exports form of company turnover.

77. To encourage better capacity utilization through multi-shift production, half of employers' contributions to the National Social Security Fund (CNSS) will be borne by the Government budget for workers hired for newly introduced additional shifts, except for continuous process industries.

78. Two special incentives are given, after Government approval, to those exporting one fifth or more of their output. They will be:

a) Exemption from tax on distributed profits, or interest, up to 10% of the nominal value of the shares, during the first three years of operations (20 years for off-shore companies).

b) Accelerated depreciation provisions.

79. In addition, the following special concessions are to be given to encourage the creation of new jobs in particularly underdeveloped areas of the country:

a) In "centers of first priority" designated as such in the regional development scheme where there are Government industrial estates run by the Industrial Land Agency (AFI), or, on AFI approved sites, the cost of infrastructure on such estates or sites will be borne by Government. In "centers of second priority" the Government will bear half the costs.

b) The Government will bear the cost of the employers' contributions to CNSS and to the housing fund for three years (six years in "first priority centers") with regard to new or extension projects in the most underdeveloped areas, and will
also exempt these employers from the training tax for three years. The total benefit of this incentive is equivalent to 19% of wage costs.

c) Of much less importance are the limited profit-tax exemptions, reducing such taxes to a rate of 5-10% for a period of 7-10 years.

80. New investments in particularly underdeveloped regions will, thus, no longer profit from cash subsidies for job creation. However, exemptions granted from contributions to the main social security fund and the housing fund are somewhat more generous than under the old system; while the old system gave on average exemptions equivalent to 10.6% of the total wage bill over 4 years, the new one will give a 17% exemption for 3 years (plus 14% for an additional 3 years in "first priority centers"). The primary focus of the regional incentives, nevertheless, is on removing the disadvantages of these areas in respect to infrastructural services. In fact, the most important incentive granted under this title consists of the Government providing high priority infrastructure.

81. Finally, a number of minor special advantages are granted:

a) Introduction of adapted new technologies will be encouraged by the Government bearing part of the extra training and other costs involved up to a maximum of 5% of equipment costs, or TD200,000, whichever is smaller;

b) To encourage domestic production of capital goods, all imported inputs used in the production of such goods will bear a tax not exceeding that applicable to imports of the equivalent finished capital good; the arrangements would be agreed upon case-by-case. Furthermore, the Government can subsidize fully or partially the purchase of patents;

c) To encourage the reopening of closed enterprises (by a new owner), the Government can grant special fiscal advantages and subsidize social contributions by employers.

Impact

82. As already noted, the new proposed law represents a substantial improvement over the old code. Clearly, the most important change, representing a major step in liberalizing the economy, is that investments which request no special incentives will in the future need no prior Government authorization. This improvement is reinforced by the fact that the proportion of investments qualifying for special incentives — almost all at present — will be substantially reduced since special incentives will be granted more selectively. Firms which do not export and which are based in industrial areas along Tunisia's East coast will get no incentives at all (apart from the few qualifying for limited concessions for technological transfer or capital goods production). Approximately 70% of new projects are not likely to qualify for special incentives and so will not need to apply for any kind of Government approval under the new system. Moreover, it is likely that the number of new projects actually applying for special investment
incentives will be even lower since many promoters of small projects in the
most underdeveloped areas qualifying for such incentives, may often not bother
to request them; for example, if they are not intending to locate on an AFI
industrial estate, if employees are not officially registered (as is often the
case in the informal sector), and if there is no formal share capital or no
dividends are paid, there are no benefits to be derived.

83. Another major change is that the system should be far more simple and
automatic in operation. As a consequence, the discretionary investment
approval powers that have hitherto dominated API's activities, should become
very limited and of only minor significance and will be transferred to an
independent committee (para. 90). This is particularly so since many
important incentives, including most of the ones for exporters, are
sector-neutral and available as "common law" rights, including to
non-manufacturing enterprises, as part of the general tax and customs codes.
They could thus be obtained automatically without approval by the new
Investment Incentives Approval Committee.

84. The final big change is that the special incentives themselves are
less generous, less complex to apply, and not discriminatory against smaller
projects, replacement investments, or labor-intensive enterprises. Most
importantly, the new law will no longer grant duty-free imports of equipment.
On the other hand, all import tariffs on equipment goods will be reduced in
the 1987 budget law, with the objective of achieving a level of effective
protection of around 25% for such goods.

85. An interim measure, however, is envisaged to cover the period between
the introduction of the new investment law in early 1987 and the
liberalization of capital equipment imports at the beginning of 1988. A
procedure is being established to allow those firms whose investments will no
longer need approval to receive the necessary authority to import the capital
equipment.

2. Government Support and Regulatory Institutions

86. Implementation of the macro-economic adjustment program and the full
decentralization of investments in early 1987 will require major changes in
institutions dealing with the manufacturing sector to reflect the shift in
emphasis from control to promotion. Furthermore, overlapping responsibilities
have to be reduced, coordination has to be improved, and the participation of
the private sector has to be strengthened; among others, the private sector
has to assume greater responsibility in financing the institutions that
support the manufacturing sector. The role of these institutions was
initially conceived to assist the private sector by providing guidance and
information to local and foreign investors and facilitating the launching of
projects. Over the years, however, their role evolved into that of protecting
existing industries through increasingly tight investment regulations and
controls. As new needs arose, over 10 of these institutions were created
including API, AFI, CEPES, CNEI, and three technical centers.

87. The most visible of these institutions is API, created in 1973 to
promote investment. The initial objectives were to assist investors by
providing information and technical advice to overcome bureaucratic hurdles
created by the Government. Since then, API has become predominantly an
investment regulating agency, approving new projects in certain sectors and
not in others, often on the ground of product saturation in the local market. In recent years, this role has gained added importance as the foreign exchange shortage required the securing of API's agreement before an import license for investment goods can be granted. API also provided some technical assistance to SSIs and follow-up on project implementation. Its pre-investment identification activities were assisted by the CNEI, which was initially created to provide technical and managerial assistance to SSIs. CNEI now concentrates its efforts on sectoral surveys and studies for large projects, predominantly in the public sector. Technical assistance in post-investment phases is now provided by the three technical centers (leather and footwear, mechanical and electrical industries, building materials). Industrial estates are established by API. Exports are promoted by CEPEX aided by a new private group, the Federation of Exporters (FEDEX), a specialized organization within the largest employers organization in Tunisia, the Tunisian Association of Industry, Commerce and Handicrafts (UTICA).

88. The Government is fully aware of the need to refocus several of these public institutions, streamline their activities and improve coordination among them. In the longer term, it also envisages to turn many of them over to the private sector, or at least have them financed by the private users through charge-back schemes. Recently, the head of API was also made the president of API, while senior managers of these institutions have been named to the board of one another. API now collaborates closely with development banks and with the technical centers in the preparation of projects. The presidents of the technical centers are also non-voting members of API's Board of Directors. CEPEX and the Tunisian Trading Office (OCT) are in the process of creating joint representative offices abroad. Reflecting the investment liberalization decision, API's department of investment approval and control has been replaced by a legal department which plays a much reduced role, largely to determine whether investments requesting incentives are eligible and qualified.

89. These efforts need to be continued and strengthened. In particular, the introduction of the new Investment Code will alter completely the nature of API's activities. With investment control fully abolished in early 1987, its role has to revert to that of an investment promoter. It will need to actively seek and identify new investment opportunities, as well as to promote subcontracting and industrial linkages. The MITAP would seek to strengthen this role through merging CNEI and AFI into API. CNEI's many years of experience and knowledge on industrial sector studies will be a considerable asset in this endeavor.

90. Since the new Investment Code abolishes investment licensing, there is a need for an approval process of special investment incentives only. API will continue to act as secretariat to the Approvals Committee in charge of implementing the Investment Code. To leave no doubt in the mind of investors, as well as of API itself, on the priority to be attached to its promotional role, this Committee will be fully independent from API's Board of Directors with the latter focusing exclusively on supervising and guiding the agency's promotional activities.

91. To avoid duplicating efforts in export promotion and to save foreign exchange, the MITAP calls for merging the promotional work of OCT with CEPEX. The former is concerned with a large number of activities ranging from importing for the Government, to the controlling of exports of subsidized
products, but accessorily, it also organizes trade fairs and exhibitions abroad. These latter functions will be taken over by CEPEX which has focused its activities on promoting exports and on assisting exporters by conducting market surveys, providing advice and disseminating commercial information, as well as participating in trade fairs. The merger will considerably strengthen CEPEX promotional efforts. So as to further reduce costs of export promotion and streamline public efforts in this important field, Government is also studying the possibility of more closely integrating the commercial attachés stationed abroad into the enlarged CEPEX.

92. The adjustment program will undoubtedly increase the need for technical assistance at the production level, particularly to SSIs where limited resources may not allow them to identify and adopt measures to improve productivity entirely on their own. To this end, the activities of the existing technical centers which provide valued services to entrepreneurs, must be increasingly geared toward the needs of SSIs. Moreover, in line with the financial constraints faced by the Government, these centers must be made increasingly financially independent from the Government budget. Some of them, such as the Center for Electrical and Mechanical Industries (CETIME), already have less than half of their operating costs financed by the Government and have indicated the willingness to decrease this proportion further through imposing user and/or membership fees. This increasing financial independence has to be accompanied by an increased participation of the private sector in the management of these centers. At the moment, their boards normally include only one member from UTICA but three from the Government, usually from the Ministries of Industry and Commerce, Planning and Finance and Social Affairs.

93. The three existing technical centers are operating in separate fields and there is little experience or knowledge to be shared among them; hence, there would be little advantage in consolidating them into one organization. However, as other sectors develop, the need for assistance in other fields would undoubtedly rise. The MITAP calls for the Government to consult with the enterprises concerned and with the existing centers so that the necessary additional activities can be taken up by one of the existing centers, rather than creating a new one. The Government has also decided to work towards improved coordination among the centers and between them and other institutions in training and in establishing a data base. In this connection, efforts by UTICA to assist SSIs will also be strengthened.

94. The improved efficiency of public institutions has to be matched by more active private sector representation. Until now, the Chambers of Commerce have played a marginal role in Tunisia. Under MITAP, they will be reactivated and will take over greater responsibility in representing the private sector point of view, i.e. identifying the needs of industry, and acting as an intermediary between the Government and the private sector. Considering the need for extensive consultations and cooperation with the private sector, as well as with the regional authorities on the most efficient way to reactivate these institutions, delineate their attributions, decide on their staffing and agree on their financing, elaboration of a concrete proposal will take time. Government has agreed to discuss such a proposal with the Bank before the end of 1987.
3. Export Promotion

95. In line with the focus of the adjustment program on increasing trade and manufactured exports, the Government has made recently vigorous efforts to eliminate administrative obstacles facing traders and exporters (para. 24), many of which were identified in the Bank's Industrial Policy Report. The Government quickly moved to implement most of the Report's recommendations. Prominent among the measures promoted was the establishment of export trading companies (para. 24). In consequence, the program is well advanced; nevertheless, a number of additional improvements were agreed upon as part of MITAP.

96. Firstly, agricultural exports are, since the beginning of 1986, exonerated from taxes, and so are export-related profits. Also, the tax on fish exports has been reduced from 6 to 3 percent, and for other exports to 1.5 percent. Secondly, export licenses have been abolished, except for subsidized goods. Thirdly, the customs and indirect taxation regimes, including temporary admission and warehousing, have been reformed to benefit exporters, notably by the following measures:

(i) Reducing the number of customs forms required for exports from several into one, and in general, simplifying and computerizing procedures.

(ii) Ratifying the treaty on international road transport (TIR) customs procedures which integrates Tunisian road transport into the EEC transport system.

(iii) Reducing the bank guarantee to be provided for goods imported to be used in exports from 100 percent to 5 percent, and abolishing the guarantee in cases of permanent or intermittent customs supervision of operations.

(iv) Occasional exporters have been allowed to supply themselves from resident companies without payment of the domestic sales tax, instead of having to await reimbursement of this tax after exports.

(v) The import licensing document, titre de commerce extérieur, has been abolished for imports under the temporary admission regime, including imports of packaging materials for exports; this effectively cuts down on red tape.

Finally, a number of other measures have been implemented through an amendment to the Customs Code; chief among them is the improvement of the reimbursement of taxes on imported goods used for exports. The measures remaining to be taken relate mainly to the objective of further facilitating trading operations.

97. In an effort to further improve the import/export trade system, the Government intends, during 1987, to (i) complete the computerization of customs services, for the about 15 percent of services not yet covered; (ii) strengthen the computerized handling of operations; (iii) decentralize customs
offices; and (iv) in concert with other export-related Government services, unify working hours, regroup services in a single location, integrate computer treatment and in general, try to place a single Government respondent vis-à-vis the exporter. The Government has informed the Bank in detail about this program.

4. **Money and Credit**

98. Liberalization of banking activities. As mentioned above (para. 20), the main features of monetary policy adjustments were agreed upon with the IMF in the Fall of 1986. The Tunisian authorities have now decided on a number of measures with regard to the volume of domestic credit, which the Central Bank will regulate through daily intervention on the money market, now the principal source of refinancing for the banks. This orientation toward global regulation techniques means, for the banks, a larger margin of autonomy together with increased accountability. In particular, they are regaining control, with some reservations, over interest rates both for lending and borrowing. This represents a major and quite sudden evolution since up to now only long-term rates were free, while all other bank lending terms (including margins and commissions) were set by the Central Bank.

99. The move toward liberalizing banking activities is further strengthened—as part of MITAP—by the decision to mitigate two constraints that have considerably limited the autonomy of the deposit banks: (i) the requirement to obtain prior authorization from the Central Bank for any loan in excess of a certain minimum, and (ii) the arbitrary earmarking of a large portion of their deposits to medium- and long-term lending. The annual submission to the Central Bank of a complete dossier on any enterprise applying for credit above a certain amount was a requirement imposed by the Central Bank to influence the volume and, above all, the quality and selectivity of credit, through examination, inter alia, of the terms of the loan, the nature of the operations to be financed, the financial structure of the borrower, etc. The thresholds of applicability differed according to the nature and duration of the loans, which made the system very complicated. For short-term lending, by far the most important type of lending, three different categories were distinguished: (i) credits with no need for prior authorization (export financing); (ii) credits with a high ceiling below which no prior authorization was required (essentially commercial bills and lending for agriculture, mining and manufacturing); and (iii) credits with a low ceiling below which no prior authorization was required (essentially the financing of trading transactions). For medium-term lending, similar distinctions were made: (a) authorization-exempt credit (approved new investments); (b) pre-authorized credit above a certain ceiling (agricultural investments); and (c) the "other" types of pre-authorized credit, regardless of the size of the loan.

100. This procedure effectively resulted in the Central Bank substituting its judgement for that of the commercial banks in the role of risk appraisal. To reduce the Central Bank's role in this respect and to increase the accountability of the commercial banks, the Central Bank increased in February 1985 the short-term credit ceiling, from TD 600,000 to TD 1,000,000 (the lower limit remaining unchanged at TD 100,000). A much larger increase took place
on January 2, 1987, within the framework of this Loan's adjustment program: for short-term commercial bank lending the ceiling above which prior approval by the Central Bank remains required was raised uniformly to TD 5 million. Thus the system has been made considerably more simple and less burdensome: the TD 5 million ceiling now affects only about 50 enterprises, mostly from the public sector, whose situation still requires monitoring. The few private enterprises still affected by this requirement will no longer be subject to it after January 1, 1988. Medium-term lending has become completely exempt from a priori authorization from the BCT except for the negligible amount of loans destined for other than investment purposes. The small amount of long-term lending is also exempt for private borrowers, while the a priori authorization is maintained for public enterprises regardless of the size of the loan.

101. Starting in 1963, the commercial banks also had to earmark a large proportion of their deposits (except for foreign accounts) to medium and long-term lending operations, which accordingly restricted their latitude to make decisions. This proportion eventually totalled 43%: 20% in development bonds issued by the State, 5% in bonds of the Caisse Nationale d'Epargne-logement (CNEL), 18% in medium-term loans (of which 2% was reserved for small enterprises, crafts and small trades). The objectives of this scheme were to get the banks to participate more actively in investment financing.

102. The imposition of a minimum medium- and long-term lending ratio, may have been justified at a time when the institutions catering to such lending were not sufficiently developed. Now, however, with the creation of several development banks in 1981-82, it is less essential to maintain such a high and undifferentiated lending ratio. Accordingly, it was replaced on September 30, 1986 by a lower and more specific ratio, known as the "priority activities ratio," which applies only to the financing of investments in the crafts/artisan sector, the SSIs, agriculture and export activities. Initially, the new ratio is fixed at 7% for the deposits of each bank (except for certain categories of accounts): it will rise by one point per semester to reach its final level of 10% by March 31, 1988. This new measure will enable the banks to freely decide on how to allocate an additional amount of approximately TD 160 million in deposits.

103. Exchange risk guarantee. Linked to the system of credit distribution is the problem of the exchange risk. Under the Seventh Plan, Tunisia's development banks are assigned a major role in investment financing, which they cannot perform unless they borrow abroad. With the present monetary and exchange rate instability, this policy is very risky, at least for the short term and as it affects each establishment. In the past, when the banks did not borrow much, the Government generally assumed the risk, regarding this as a normal counterpart to exchange control, taking account of unforeseeable rate fluctuations and the lack of possibilities of risk coverage. Thus, it has systematically granted its guarantee to borrowings by BDET, whose SSI customers have little means of protecting themselves. BNDT has also obtained Government guarantees for its few external borrowings except for one. Up to 1981, loans guaranteed in this way were yielding gains to the Government, as the value of the Dinar appreciated in relation to the foreign exchange borrowed. In 1981, however, the situation was reversed as a result of the
strong upswing of the U.S. dollar, and has continued in this vein with the recent depreciation of the Dinar.

104. In 1985, the Government took a number of measures to handle the worsening situation. To offset the heavy losses recorded since 1981, it has provided the Exchange Equalization Fund (FPC)—until that time financed solely out of the gains resulting from exchange rate adjustments—with a constant source of income resulting from charges on final borrowers: a 0.5% commission on overdrafts, a 1% commission on development bank loans and other charges included in the Central Bank's re-discount rates. These new resources, however, will only enable the FPC to repay by the end of 1988 the TD 43.3 million in losses sustained on BDET and BNDT borrowings up to the end of 1985. These measures, therefore, remained short-term solutions dictated by the circumstances of the moment, and do not present the basis for a long-term strategy to handle the foreign exchange risk on external borrowings. In the long run, the authorities agree that the exchange risk needs to be borne by the final borrowers, if because of their size or the nature of their business, they have sufficient means of protecting themselves. Hence, the present policy to grant the banks an undifferentiated guarantee benefiting all customers is not justified. Furthermore, it incites the banks to borrow as much as possible in strong currencies, thereby profiting from lower interest rates to increase their profit margins, but at the expense of increasing the foreign exchange risk for the FPC.

105. Within the framework of MITAP, the reformed system, once a detailed study has been completed, will be improved along the following lines:

(a) The benefits of the existing FPC system will be reserved for Small and Medium Enterprises (SME) who do not have the means to protect themselves effectively; the appropriate definition of an SME will be agreed with the Government once the detailed results of the study have become available. Larger enterprises should be sufficiently well protected by their size (which can allow for diversification of risks) or by the nature of their activities (exports in particular) to carry the risk by themselves.

(b) The borrowing banks will pay the FPC a fee equal to the difference between their cost of borrowing abroad and a reference rate linked to the cost of domestic loans of equal duration: thus they will no longer be tempted to choose systematically the stronger currencies. Moreover, the income of the FPC will thus be linked to the volume and risk of the operations.

(c) Further corrective measures will be taken should a deficit in the FPC appear likely, so as to make sure that no budgetary funds need to be used to support the system. To this avail, the Central Bank will review the situation and outlook of the FPC every six months and decide on necessary changes in the level of premiums to keep the Fund solvent.

106. For its part, the Central Bank, which in January 1986 had already extended up to eight months the duration of its forward coverage for commercial operations will undertake a second study focusing on the possibility of:
(i) authorizing term coverage of debt service (principal and/or interest) in addition to trade transactions; and

(ii) improving the term coverage of exchange risks affecting foreign borrowing operations.

5. Taxation

107. The Tunisian authorities are well aware of the importance of creating an environment conducive for private enterprise, to stimulate production and job creation: in the past, they used a substantial array of tax incentives to encourage investments, which served for a long time as a model in other countries. Also, since 1982, Government had been working on a general reform of direct and indirect taxation, with three basic objectives:

(i) for direct taxes: standardization of individual and corporate taxes and some rate reductions, with the revenue decline being offset by more efficient tax administration;

(ii) for indirect taxes: institution of a single, general value-added tax, to expand the tax base and reduce dependence on imports; and

(iii) overall: streamline and simplify the system that has become very complicated over the years.

108. The IMF has expressed full agreement with these objectives after review by two special missions in May 1982 and July 1985. The review concluded that there is nothing in the existing regulations to hinder business efficiency or that should be immediately eliminated, and that perhaps, on the contrary, there were too many costly incentives. However, the tax system is excessively complicated and the rates are rather high, although they could be reduced if evasion were less prevalent.

109. As regards form, current legislation consists of a series of laws that have been promulgated over the years but never codified comprehensively. The principal texts were promulgated in 1912 (registration duties), 1932 (individual government tax—contribution personnelle d'Etat), 1945 (taxes on wages and salaries) and 1954 (tax on profits). However, they have often been amended, and many additions have further complicated the system, particularly since the temptation to establish a new general-purpose tax for every new category of expenditure has often been too strong to resist. The system thus requires a general overhaul, with the abolition of many of the minor taxes, and subsequent codification.

110. As regards substance, the tax ratio has always been high in Tunisia, but not abnormally so; it totaled 26.5% of GNP in 1984 (including social security contributions, but excluding oil revenue), i.e. slightly higher than in Morocco and slightly lower than in Egypt, to take the example of two neighboring countries. As is usual in developing countries, indirect taxes (particularly those levied on international trade) account for about two thirds of fiscal revenue. Nevertheless, direct tax rates are kept high as a
means of compensating for the many exemptions and widespread evasion. In addition, the tax structure is outdated and complicated:

- Individuals pay a combination of schedule taxes (at rates depending on the source of income) and a progressive personal income tax calculated on the remaining income. A flat rate tax is applied to owners of small businesses and craftsmen.

- Companies pay a graduated tax on their profits and dividends. The profits tax is proportional, the rate depending on the type of activity in question, to which is added a flat rate consisting of 1% of turnover. Different turnover tax systems are applied to manufacturing, consumption and services.

Since 1982, various changes have been made to simplify the system and lighten the tax burden on individuals and companies, and also to establish a uniform turnover tax. Two were particularly important:

- The 1983 Finance Law reduced the flat rate corporate profit tax from 46.5% to 44% for commercial activities and from 40.5% to 38% for manufacturing, tourism and transportation; moreover, the securities tax could be deducted from the tax payable by the holders of the securities concerned;

- The 1986 Finance Law reduced the individual profit tax from manufacturing and commercial activities from 25% to 20%, and the maximum rate of the personal income tax from 80% to 68% (with a ceiling at 60% of overall income).

In addition:

- The production tax was extended to cover the construction industry, public works and transportation (in 1984), together with tourism (in 1985) and the tax on services was increased in 1986 to bring it into line with the production tax.

Two more far-reaching reform measures that form part of the agreement with the IMF, will be implemented as part of the overall adjustment program:

- In August 1986, the Government announced that it intends to introduce a general value added tax on January 1, 1988. A bill, now under discussion, will be submitted to the National Assembly in the first quarter of 1987.

- The government also intends to simplify and consolidate the system of personal income and corporate profits taxes during the Seventh Plan and perhaps further reduce tax rates.

In its July 1985 report, the IMF estimates losses from tax evasion and avoidance at about 50% of potential direct tax revenue.
Implementation of these two reforms, which are designed to be revenue neutral, will be discussed with the IMF before the end of September 1987, during the second review of the program.

6. Industrial Employment

113. The creation of productive employment has been a high priority of Tunisia's development strategy over the last decade because, in addition to relatively high unemployment (about 14% of labor force) and underemployment, the labor force was growing at a rapid 3.3% annually. Government sought to resolve the employment problem by maintaining a high rate of economic growth and an exceptionally high investment rate. Labor emigration to Europe and to the Middle East also helped relieve some of the pressure. However, the drop in world oil prices, the decline in Tunisian oil production, and the overall slow-down in economic growth created by it, have necessitated a cut in the investment rate, and this combined with the recession in Europe and the oil producing Middle East countries has led to a further aggravation of the unemployment problem.

114. In 1983, the Tunisian Government and the Bank undertook a joint study of industrial employment, that identified an action program in six policy areas whose objectives are to reduce unemployment and underemployment as well as increasing the number of newly created jobs by reducing the cost of employment creation. Two of these areas, namely (i) the re-orientation of the overall development strategy by reforming the system of factor remuneration, and (ii) the reallocation of public investments, are being addressed under the macro-economic program underlying this Loan and the recently approved ASAL. The third area—the reform of the system of industrial promotion and the incentives framework in Tunisia—is the centerpiece of this operation. The fourth policy area deals with the institutional set-up as it relates to (i) technological acquisition, adaptation and dissemination, (ii) the roles of employers' and workers' organizations, and (iii) improved coordination between the Government institutions. These, again, are dealt with in this Loan; however, since the study's recommendations cover a long period, only the initial and immediate measures have been incorporated within the policy package supported by this operation. The fifth policy area dealt with issues of education and training reform which should more appropriately be dealt with within the framework of education/training operations. Finally, the sixth area concerns specific wage and employment issues.

115. In addition to the above study, the preparatory work for two lines of credit (Loan 2522-TUN for exports and Loan 2554-TUN for electro-mechanical industries) as well as for a second SSI project and for the industrial sector report, included visits and field surveys of many manufacturing firms, which covered among others, issues related to industrial employment and wages. Together with the joint Bank/Government industrial employment study, these field visits have formed the basis for some of the specific agreements on employment and wage policies reached with the Tunisian Government that are incorporated in the sectoral policy package and are discussed in the following paragraphs.
The proposed Loan supports an adjustment program which incorporates a reformed incentives framework favoring labor-intensive policies and a modified wage policy that (a) aims to contain any further increases in wages over the short term, (b) bases industrial wage adjustments, in the long term, on changes in productivity at the level of the industrial enterprise, and (c) aims to prevent any further increase in the high social security contribution by employers in the short term and to achieve a gradual decline in the longer term. Thus, the MITAP, in addition to the measures affecting employment and wages that are a part of the macro-economic framework on which this Loan is based, would support the following:

(i) In an effort to prevent any further increases in social security charges that help finance six separate programs, some of which are experiencing deficits while others are in surplus, the Government will study the feasibility of reallocating the total among the various programs so as to maintain the longer term equilibrium and will also review the structure of the various benefits being provided to determine if a balance between resources and expenditures is possible; if not, the Government has agreed to realign benefits with expected revenues instead of increasing the burden of social security charges on employers.

(ii) Helping enterprises to implement the policy of basing wage adjustments on changes in productivity and to take into account the financial condition of an enterprise is a priority task that the Government would like to see followed on a wider scale. The practical application of such a policy requires the assistance of experts to train Tunisians, both staff of the Ministry of Social Affairs and of selected enterprises, in this area. The Government has requested the Bank's assistance in financing the cost of such consultants for an initial phase, which is expected to cost about US$200,000.

(iii) As part of the efforts to prepare the Seventh Plan, the Government is undertaking a review of labor and employment legislation to ensure that it is sufficiently flexible to promote employment, incites entrepreneurs to hire more staff, and at the same time is not an obstacle to enterprise rehabilitation and restructuring efforts. The results of such a review would be discussed with the Bank and a timetable for action agreed upon.

7. Tourism Policy Study

With a share of about 18% of total foreign exchange receipts, tourism ranks with energy and phosphate products as one of Tunisia's major sources of foreign exchange earnings. With energy output declining and phosphate prices depressed for the foreseeable future, the optimization of this source is critical to the sustenance of Tunisia's development. Moreover, the sector is a major source of new employment, not only in the coastal area but wherever tourism can be maintained, thus contributing to the country's employment and regional development efforts. In recent years, however, its growth has been slow and erratic. Furthermore, domestic value added has remained rather low.
The main causes of slow growth and low domestic value added are four: firstly, the sector appears to suffer from too-fast an expansion of hotel capacity and this tendency seems to be continuing. The 30% increase in hotel capacity presently under construction exceeds the foreseeable demand increase of 13%-14% between 1987 and 1991. This will further reduce an already low average occupancy rate. Secondly, the low occupancy rate will further weaken the position of the Tunisian hotel industry in its negotiations with tour operators and will enable the latter to negotiate even less favorable prices for Tunisian hotel owners, thus further reducing the domestic value added from tourism. Thirdly, continued reduction in profit margins which are already depressed will force hotel managers, even more than in the past, to neglect the maintenance and renewal of their facilities and in general, reduce further the quality of their services. This leads, fourthly, to a further deterioration of the quality of services and becomes a cause for larger-income, high-spending tourists to turn away from Tunisia.

In light of the above, it appears necessary for Tunisia's tourist industry to embark on a program of consolidation. Among other things, this would seem to imply that the incentives system should provide more encouragement to renewal, proper maintenance, and proper management of existing investments, rather than to the construction of new hotels. Moreover:

(a) Tunisia would seem to have the potential to branch out and diversify into the higher quality segment of the market. So far, Tunisian tourism consists overwhelmingly of low cost, beach-based, charter-flight/package-tour arrangements which generate a rather limited value added to the country. Individual tourism is much more profitable and should be developed taking advantage of Tunisia's easy accessibility from Europe;

(b) tourists should be encouraged to spend more during their stay in Tunisia on purchases of all kinds; excursions, sports activities and other entertainment. So far, these auxiliary activities are little developed and tourists seem to spend little money over and above the actual costs of the package tour;

(c) attempts should be made to increase the low number of repeater tourists in Tunisia. This will require, most likely, an improvement in the quality of services and in the auxiliary activities.

Not enough is known, presently, about the sector to formulate such policies; this will require an in-depth assessment of the sector's problems and of the various obstacles preventing a more rapid and controllable growth. To this avail, the Tunisian authorities plan shortly to undertake a comprehensive study (see para. 133). Given the high importance of this endeavour, the Bank was willing to consider a possible participation in the financing of this study in the context of this loan; the Government, however, was confident that it had the necessary means to undertake the work without outside assistance. The study would focus particularly on:

(a) an analysis of the current incentive structure as it affects tourism, with a view to determine whether it is biased in favor of new capital-investments and against labor-intensive services and maintenance; this analysis should include an analysis of fiscal incentives and disincentives, the role of Government subsidies, and pricing and import regulations affecting the sector;
(b) an analysis of the current institutional support structure both at home and abroad, including marketing, linkage with infrastructure, the labor market, as well as the existing specialized schools and training institutions; and

(c) an analysis of prices to Tunisia and its competitors from major European destinations for all-inclusive package tours and individual tourism, versus its major Mediterranean competition.

121. The above analysis should result in a set of specific policy recommendations to Tunisian decision makers on how to:

(i) coordinate construction of new hotels with foreseeable demand;

(ii) stimulate development of auxiliary services such as sports facilities; cultural facilities (i.e. antique monuments, museums, folklore); recreational and shopping facilities (handicraft shops, tax-free shops);

(iii) stimulate better hotel maintenance and renovation;

(iv) improve the quality of hotel and other services; and

(v) promote individual tourism.

Achieving these objectives will likely require changes in the incentives structure, supported by improvements in public services and some public investments, and changes in public laws such as the tax and labor code and import regulations.

PART V - THE LOAN

A. Origin and Objectives

122. During the 1984 Annual Meetings, the Tunisian Government requested the Bank to consider the financing of a number of sector adjustment operations, beginning with two loans, one in industry and the other in agriculture, to help support continued reforms of the economy. In response, the Bank mounted in January 1985, a mission to review the industrial sector. The report of this mission was discussed with the Government in September 1985, along with a Synopsis Paper that presented the gist of the Bank’s proposals for policy changes within a consistent macro-economic framework. Government, as a result of these discussions, decided to pursue with the Bank a broad-based policy dialogue with the objective of establishing an adjustment program that would cover the period of the Seventh Plan (1987-1991) and that would be financed in phases starting with an agricultural sector adjustment loan, followed by this industrial and trade policy adjustment loan. This program was designed jointly by a Bank team and the staff of the Ministries of Planning and Finance, of Commerce and Industry, and the Central Bank.

123. The purpose of this Loan is to provide the necessary financial and technical support to the Government’s program for macro-economic reform, described in Part II, and to the adjustment program in the industrial and
trade sector described in Part IV. The Government's macro-economic and sectoral adjustment programs have been transmitted to the Bank in two letters signed by the Minister of Finance and Planning, one covering economic development (Annex IV) and the other the industrial development policy (Annex V). The sectoral reform program, including a detailed action program that covers the period from mid-1986 to 1988, was appraised by a Bank mission in October 1986 and negotiations took place in Washington, D.C. from December 19, 1986 to December 24, 1986; the Tunisian delegation was led by Mr. Tahar Ennaifer, Director General of Projects in the Ministry of Planning and Finance. A Loan Summary is given at the beginning of this report, and a Supplementary Project Data Sheet appears as Annex III.

B. Action Program Under the Loan

124. The macro-economic and sectoral adjustment programs cover the entire five-year period of the Seventh Plan (1987-1991), but the action program to be supported by the proposed loan focuses particularly on the first two years of this period. While the broad outlines of the five-year program have been discussed and agreed between the Government and the Bank, it is the shorter-term two-year slice of this program that has been developed and agreed upon in detail. Thus, a number of policy reform measures have been selected for monitoring from among all the measures agreed upon, to gauge the progress of action on policy reform. Monitoring of actions to be taken will be almost continuous but a special review would determine whether progress of implementation of the macro- and sectoral-reform programs during the period covered by the first tranche is satisfactory and on that basis, whether the second tranche of the loan should be released (paras. 139-140). Sectoral reform actions in the various policy areas selected as conditions of effectiveness or release of the second tranche of the loan are discussed below; they include actions on the new investment code, on the new system of covering the exchange risk on foreign borrowings by development banks, as well as submission to Parliament of the draft law on the VAT.

The Incentives Framework

125. Assurances were provided during negotiations that the Government will have submitted the new Investment Code to its National Assembly by the time of effectiveness of the Loan and will have adopted the new Code prior to the release of the second tranche of the Loan (para. 140). The new Code will abolish general investment licensing. It will give special incentives almost exclusively for high priority investments, primarily those exporting part of their output or creating jobs in the most underdeveloped areas of the country. They will be granted automatically provided specified criteria are met and will make no distinctions by project size or project type. Additionally, certain incentives will be available to all investments without specific approval as "common law" rights, including those outside manufacturing; they will focus on encouraging exports and enterprise creation. The main incentives to encourage exports, mostly available as "common law" rights, will be tax and duty free import of products to be processed into exports, tax free local purchases of similar products, and partial income tax exemptions for funds invested in, profits generated by, and dividends gained from export operations. The new incentives to encourage the
creation of jobs in underdeveloped areas will consist primarily of the
government bearing the cost of infrastructure on AFI industrial estates; in
addition, they foresee temporary cuts in social security charges on employers
and partial income tax exemption for funds invested in, and dividends from
such operations. There will also be minor incentives to facilitate the
introduction of new technologies and Tunisian manufacture of capital goods.
Experience with the new code, as well as the need and justification of
maintaining it, would be reviewed towards the end of the Seventh Plan.

126. For an interim period between the time investment licensing is
abolished and imports of capital goods are liberalized on January 2, 1988, a
temporary procedure, acceptable to the Bank has been established authorizing
imports of such goods for priority projects that do not qualify for special
incentives.

Institutions

127. During negotiations, assurances were obtained on the following
actions: (a) issuance of a decree separating the Approvals Committee
responsible for implementing the new Investment Code from API's Board of
Directors. This is a condition of second tranche release of this Loan (para.
140); (b) merging of CNEI's and AFI's activities and personnel with those of
API by January 2, 1988; (c) restructuring API to focus on promotional
activities by January 2, 1988; (d) merging of OCT's promotional work with
CEPEX by end 1987; (e) a detailed, concrete proposal to reduce financial
dependence of technical centers on the budget to 50% by the end of the VIIth
Plan (1991); finally, (f) submission of a concrete proposal to expand the role
of Chambers of Commerce and of UTICA before the end of 1987.

Money and Credit

128. Banking: As regards liberalization of bank.


activities, the
Government has deregulated as of January 2, 1987, all lending and borrowing
rates, with the following exceptions:

- lending rates on loans to priority activities (i.e. exports,
  agriculture, small- and medium-sized enterprises, energy saving),
  which will continue to be set by the Central Bank;

- borrowing rates on special savings accounts and the convertible Dinar
deposits of Tunisian nationals resident abroad; these will be
determined by reference to money market rates.

Banks are now free to determine all other conditions, including spreads and
fees. The monetary authorities will intervene solely in order to guarantee
positive real rates for term deposits and to set a ceiling for lending rates
well above the inflation rate so as to prevent usury.

129. The Government also raised the minimum amount for loans by deposit
banks that require prior authorization from the Central Bank (BCT) to TD 5
million, starting January 2, 1987. This new limit applies to all short-term
loans. Medium-term lending has become almost totally exempt from a priori
authorization from the BCT and so has the very small amount of long-term
lending, except for loans to public enterprises.
Exchange-Risk Guarantees: In the past, the Government has generally provided BDET and, to some extent, BNDT with exchange-risk guarantees on their external borrowings. With the likely increase in borrowings by development banks, Government could face considerable financial risks if these guarantees were not limited to small borrowers unable to cover the risks themselves, and if the banks were to continue to borrow in low interest-rate currencies that are highly likely to appreciate. In consequence, the Government has agreed to introduce, after a study has determined the most appropriate ways of doing so, the following changes to the system (para. 140):

(a) Exchange-risk guarantees granted to a banking establishment borrowing abroad should cover only loans to SMEs (see para. 105);

(b) Financing arrangements for the Exchange Equalization Fund (FPC) will be changed to ensure that the FPC would remain financially self-sufficient without any need for government subsidies. In particular, whenever there is a drawing on a new foreign loan, the borrowing banks would pay the FPC a commission equal to the difference between the cost of the loan and a reference rate which is the long-term domestic lending rate, minus an allowance for administrative costs.

(c) To further avoid the need for government subsidies, additional measures designed to increase the revenues of the FPC will be adopted any time that there is a foreseeable risk of a lasting deficit in the Fund.

Prior to effectiveness of the proposed Loan, the Government will agree with the Bank on the terms of reference of the above-mentioned study; discussion of the findings of this study and the implementation of a mutually agreed upon system will be a condition of second tranche release (para. 140). Also prior to the effectiveness of the proposed Loan, the Government will agree with the Bank on the terms of reference of a second study to be undertaken by the Central Bank on forward coverage of exchange risks in the context of the foreign borrowing policy (para. 140); the results of this study will be discussed and a mutually agreed upon system will be implemented by January 1, 1988.

Taxation

There is nothing in the existing tax regulations to seriously hinder business efficiency that should be immediately eliminated. However, the tax system is excessively complicated in all categories, and rates are relatively high; they could be reduced if the regulations were more strictly applied. The Government has decided:

(a) as a first step, to introduce a general VAT system on January 1, 1988. The submission of a draft law to the National Assembly would be a condition of second tranche release under this Loan (para. 140).

(b) to standardize direct taxes on individuals and corporations, with some reduction in rates before the end of the Seventh Plan.
Government will discuss implementation of these two fiscal reforms, which are planned to be income neutral, during the second review of the program with the IMF before the end of September 1987.

**Industrial Employment and Wages**

132. During negotiations, assurances were obtained that the Government will undertake the following actions as conditions of second tranche release under this Loan:

(i) Social Security contributions by employers will be prevented from increasing further in the short term and will be reduced gradually in the longer term without undermining the financial integrity of the existing social security system. To this avail, Government will study the feasibility of reallocating employers' contributions among the six programs covered by the social security system and will identify the actions needed to realign future benefits with the foreseeable resources of these programs. An exchange of views on the measures to be taken and on a timetable for implementation will be a condition of second tranche release (para. 140);

(ii) The policy of selective wage adjustment based upon changes in productivity and upon the financial condition of each enterprise will be pursued with the help of technical experts to be financed under the project. The focus of such assistance is to help in the practical application of this policy and to train Tunisian staff in such tasks (para. 116 (ii)). Employment of consultants to undertake this task will be a condition of second tranche release; and

(iii) The Government will review the existing labor and employment legislation so as to make sure that it is sufficiently adaptable and flexible to promote employment and does not constitute an obstacle to efforts to restructure industrial enterprises. The proposed changes resulting from this review will be discussed with the Bank before the second tranche release to determine the scope of key changes and a timetable for implementation will be agreed upon.

**Tourism**

133. During negotiations assurances were obtained that the Government will undertake a comprehensive study on future policies necessary to increase domestic resources from tourism. Agreement between the Bank and the Government on the terms of reference of this study will be a condition of effectiveness (para. 140), and the study's conclusions and recommendations would be discussed with the Bank before end 1987.

**C. Loan Administration**

134. Eligible Expenditures. The proposed Loan of US$150 million would finance (a) the foreign exchange cost of imported goods up to about US$149.8 million, using a negative list. The items not to be financed include goods financed by other sources and a specific list of excluded items, such as
military or para-military items and luxury goods such as tobacco, precious stones, jewelry, gold and nuclear reactors and parts; and (b) the foreign exchange cost of the technical assistance program that would help Government to implement its new salary policies in manufacturing enterprises, up to about US$200,000.

135. Procurement. Procurement of imports by the private sector (including public manufacturing enterprises) would be made following regular commercial practices using not less than three quotations from suppliers or manufacturers whenever possible, except when any one contract is US$5.0 million or more, in which case international competitive bidding (ICB) in accordance with World Bank Guidelines would be used. Procurement of imports by the public sector would be done by ICB, except in the case of contracts costing less than US$2.0 million each, up to an aggregate of US$15.0 million, which would be awarded on the basis of standard procedures for public sector procurement which are acceptable to the Bank. Procurement would be grouped whenever possible into packages suitable for ICB. Items which the Bank considers of a proprietary nature, expected to total no more than US$5 million, would be procured by negotiated contract, following procedures satisfactory to the Bank. Consultants helping to implement the Government's new salary policies (para. 116) would be employed in accordance with Bank Guidelines. Bidding documents, bid evaluation reports and proposed awards of contracts procured through ICB would be subject to the prior approval of the Bank. For other procurement, the Borrower would furnish to the Bank, prior to the submission of the related withdrawal application, such documentation and information as the Bank may reasonably request to support the withdrawal of funds from the Loan account in respect of such contracts.

136. Disbursement. The Central Bank would have primary responsibility for administering the proposed loan. Disbursements from the Loan account for imports would be made against 100% of the foreign cost of eligible imports. Disbursements for consultants' services would be made against 100% of foreign expenditures or 70% of local expenditures. Disbursements for contracts procured through ICB and for consultants' services would be made against fully documented withdrawal applications. Disbursements for other items would be made on the basis of statements of expenditures (SOE) from the Central Bank detailing individual transactions in a given period, together with a certification of payment of the amounts involved, and of their eligibility under the Loan. Supporting documentation for SOEs would be retained by the Central Bank, until at least 12 months after the closing of the Loan account, and made available for review to Bank supervision missions. Applications for withdrawal would be consolidated and submitted in amounts not less than US$1.0 million. In order to accelerate disbursements, a revolving fund (special account) with an initial deposit of US$35.0 million (corresponding to four months' payments expected to be made through the revolving fund) would be established at the Central Bank. Replenishments would be made either once a month or when half of the revolving fund has been utilized. The Loan is expected to be fully disbursed within 18 months of effectiveness. The Closing Date would be December 31, 1988.

137. Account and Audits. The Central Bank would maintain records of all transactions under the Loan in accordance with sound accounting practices. Not later than six months after the end of each fiscal year of the Borrower,
all accounts, including the special account (revolving fund), would be audited by independent auditors acceptable to the Bank. Audit reports would include a separate opinion with regard to the claims submitted to the Bank on the basis of SOEs and would state whether such claims have been effected in accordance with the Loan Agreement.

138. **Release of Funds and Tranching.** The proceeds of the Loan would be made available for withdrawal in two tranches, the first of US$100.0 million upon Loan effectiveness, the second of US$50.0 million when the conditions for its release have been met. Disbursement would be made on a "first-come first-served" basis. The conditions for the release of each tranche would relate to the implementation of specific measures which are crucial to the execution of the overall macro-economic and sectoral adjustment programs. Besides these measures, the Government has already demonstrated its commitment to the objectives of the macro-economic and sector programs by taking key actions in recent months; for example, currency adjustment, a first round of import and price liberalization, budget cuts, and trade and export promotion measures.

139. The **macro-economic reform actions** which would be supported and monitored under the loan are:

(a) **as a condition of effectiveness:** an approved 1987 budget reflecting the objectives referred to in Annex I to the Macro-Economic Adjustment Program, attached to the Letter of Economic Development Policy of September 1, 1986 (para. 29);

(b) **as a condition of second tranche release:** Bank confirmation of satisfactory progress in implementation of the overall macro-economic program (para. 37).

140. The **sector specific actions** to be supported and monitored under the loan are:

(a) **as a condition of effectiveness:**

(i) submission of a new Investment Code to the National Assembly reflecting the objectives referred to in the Medium-Term Industrial and Trade Policy Adjustment Program, attached to the Letter on Industrial Development Policy of January 27, 1987 (para. 125);

(ii) agreement with the Bank on the terms of reference of the studies to prepare the concrete features of the improved exchange risk guarantee scheme and on the forward coverage of exchange risks in the context of the foreign borrowing policy (para. 130);

(iii) agreement with the Bank on the terms of reference of the tourism policy study (para. 133);
(b) as a condition of second tranche release:

(i) adoption of a new Investment Code acceptable to the Bank (para. 125);

(ii) issuance of a decree establishing an Approvals Committee responsible for implementing the new Investment Code, such a committee being independent from API's Board of Directors (para. 127);

(iii) adoption of an improved system of exchange risk guarantees (para. 130);

(iv) submission of a draft VAT law to the Tunisian National Assembly (para. 131);

(v) an exchange of views with the Bank on policy changes and on a timetable for implementation of changes aimed at preventing employers' contributions to the social security system from increasing further in the short term, and reducing them gradually in the longer term, without undermining the financial integrity of the system (para. 132 (i));

(vi) employment of consultants for the technical assistance program aimed at training the staff of the Ministry of Social Affairs and of selected enterprises in the implementation of the Government's new salary policy (para. 132 (ii));

(vii) review by the Bank of a program and agreement on a timetable of changes in labor and employment legislation aimed at improving the adaptability and flexibility of labor laws (para. 132 (iii));

(viii) Bank confirmation of satisfactory progress in implementation of the overall medium-term industrial and trade policy adjustment program (para. 124).

D. Management, Coordination and Monitoring

Management and coordination of the adjustment program, including both its macro-economic and sectoral components, would be the responsibility of the Minister of Planning and Finance, with assistance from the Ministry of Industry and Commerce, and the Central Bank. Analytical and monitoring support would be provided by the Directorate-General of Planning in the Ministry of Planning and Finance. Assurances were obtained at negotiations that a semi-annual report on the implementation of the macro- and sector-adjustment programs would be provided to the Bank, followed by an exchange of views on the status between the Government and the Bank.

E. Justification and Risk

The package of macro-economic and sectoral adjustment measures is expected to have a favorable impact on economic growth in general, the allocation and use of economic resources, the balance of payments and the
public finance situation in particular. Its emphasis on decontrol, transparency of policies and avoidance of bureaucratic interference in the economy, is expected to result in a distinct improvement of the general business climate reinforced by the streamlining of the tax system under MITAP and the IMF program and the increased flexibility to be introduced into industrial employment policies. Together, this should result in higher trading and exports of goods and services, higher private investments, higher employment creation, a decline in the IOCR, a gradual decline in the balance of payments current account deficit, and in the overall budget deficit. Any comprehensive adjustment program of this size and complexity necessarily entails some element of risk. The strict limits on domestic demand might not be maintainable due to social, political and economic pressures (too rapid an increase in salaries, too rapid growth in domestic credit and money circulation and less rapid than expected reduction in the budget deficit). The growth of non-oil/non-phosphate exports might be slower than expected for exogenous as well as indigenous reasons (worse than expected world market conditions, political troubles around the Mediterranean, insufficient export incentives, excessive domestic demand). Higher than expected domestic demand combined with lower exports would put heavy pressure on the balance of payments, jeopardizing the liberalization program, particularly of imports, which is a key element in the overall adjustment process. While these risks are real and unavoidable, they are limited by: (a) the considerable amount of policy measures already taken by Government; (b) the Government's clear commitment to continue the adjustment program, as expressed in the basic policy documents underpinning the preparation of the VIIth Plan and clearly presented to the recent congress of the ruling political party; and (c) the proposed gradual approach to change, which permits the economy to adapt to the new policies steadily, but progressively within a realistic time period.

143. The sector adjustment measures are expected to have a favorable impact on sector productivity and on both the balance of payments and fiscal deficits. Some of the benefits will only be realized in the longer term; all of them, however, are vital to the process of adjustment and development. The absence of bureaucratic second guessing of investment decisions would contribute to more rational market-driven investment decisions; together with the streamlining of financial sector supervision and export and trade promotion actions, this should impact favorably on growth and the balance of payments. Institutional and employment related actions should lead to greater efficiency in the use of economic and budgetary resources. The tourism sector study should lead to reform action which in turn, should benefit the balance of payments and fiscal situation through optimization of the country's considerable tourism potential.

144. The risks facing the sectoral adjustment program relate to the length and difficulty of the process, the unpredictable developments in the external environment and the uncertainties in the response of the private sector to the program. While Tunisia's record in implementing reforms agreed with the Bank is satisfactory, the magnitude of the adjustments needed and inter-relationships between them create some risk about the pace of implementation and maintaining the integrity of the reform package. The response on the export front, specifically contingent on actions by Tunisia's trading partners and competitors and on how the private sector will respond to the changing environment, is difficult to predict with precision.
145. The design and management of the sectoral adjustment program has built-in features to minimize these risks. First, strong linkages with macro-economic actions are an integral part of the design. Second, the specific actions are to be taken over a short 12-18 month period for which uncertainty is less. Third, the phased approach to implementing the sector reform inherently permits flexibility and adjustments between phases, in light of sectoral and macro-economic developments.

PART VI - RECOMMENDATION

146. I am satisfied that the proposed Loan would comply with the Articles of Agreement of the Bank and I recommend that the Executive Directors approve the proposed Loan.

Barber B. Conable
President

January 28, 1987
Washington, D.C.

Annexes
## ANNEX I

### ECONOMIC INDICATORS

#### Table 1: Economic Indicators

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<td>GDP deflator (1980 = 100)</td>
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#### Table 2: Share of GDP at market prices (%)

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<td>78.7</td>
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#### Table 3: Average Annual Income (at constant 1980 prices)

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<td>Income</td>
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<td>Current revenue</td>
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#### Public Finance

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<td>Current revenue</td>
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<td>Capital expenditure</td>
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<td>21.5</td>
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<td>8.1</td>
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#### Other Indicators

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1/ GDP at market prices and components at factor cost.
2/ Projected years in constant prices.
3/ Including the debt amortisation.
4/ Growth rate not calculated because of negative values.

EMD 978-C
January 1987

1981/6
## ANNEX I

### Page 2 of 3

**TUNISIA - EXTERNAL TRADE**

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### PRICES

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### Composition of Merchandise Trade (2)

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### Share of Trade (2)

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<th>1975 (at current prices)</th>
<th>1980 (at current prices)</th>
<th>1985 (at current prices)</th>
<th>1990 (at current prices)</th>
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<td>Exports with Developing</td>
<td>70.8 (60.1)</td>
<td>68.7 (76.9)</td>
<td>4.9 (21.7)</td>
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**Sources:**
- IMF-IFS-C
- January 1987
## Balance of Payments Balance of Payments

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<td>Other</td>
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<td>Private</td>
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<td>Average maturity of new loans (years)</td>
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## Debt Structure

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<td>Maturity structure of debt outstanding (%)</td>
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<td>Amortization due within 5 years</td>
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<td>Interest structure of debt outstanding (%)</td>
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<td>Interest due within first year</td>
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1/ Figures may not add up due to rounding.
2/ Excluding IDA.

Source: EMCA CEIL-C

January 1987
### ANNEX II

#### THE STATUS OF BANK GROUP OPERATIONS IN TUNISIA

**A. STATEMENT OF BANK LOANS AND IDA CREDITS (As of September 30, 1986)**

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<td>Republic of Tunisia</td>
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<td>Republic of Tunisia</td>
<td>Second Fisheries</td>
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<td>Southern Irrigation</td>
<td>19.50</td>
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<td>Office des Ponts Nationaux</td>
<td>Third Port</td>
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<td>Fourth Highway</td>
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<td>107</td>
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<td>Société Tunisienne de 1'Electricité et du Gaz</td>
<td>Second Natural Gas Pipelines</td>
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<td>120</td>
<td>1983</td>
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<td>Education V</td>
<td>27.00</td>
<td>24.12</td>
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<td>121</td>
<td>1983</td>
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<td>128</td>
<td>1984</td>
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<td>21.31</td>
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<td>Republic of Tunisia</td>
<td>North West Agricultural Production</td>
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<td>Export Industries</td>
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<td>Second Electrical and Mechanical Industries</td>
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<td>Irrigation Management Improvement</td>
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<td>Republic of Tunisia</td>
<td>Gas Export</td>
<td>27.70</td>
<td>27.70</td>
<td></td>
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<tr>
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<td>1986</td>
<td>Republic of Tunisia</td>
<td>Energy Conservation</td>
<td>4.00</td>
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<td></td>
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<tr>
<td>135</td>
<td>1986</td>
<td>Republic of Tunisia</td>
<td>Fourth Urban Development</td>
<td>30.20</td>
<td>30.20</td>
<td></td>
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<tr>
<td>136</td>
<td>1986</td>
<td>Republic of Tunisia</td>
<td>Agricultural Sector Adjustment</td>
<td>150.00</td>
<td>150.00</td>
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</table>

**TOTAL**

<table>
<thead>
<tr>
<th></th>
<th>1,655.57</th>
<th>25.53</th>
<th>5.32</th>
<th>1,735.47</th>
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<tr>
<td>Of which has been repaid</td>
<td>230.32</td>
<td>10.36</td>
<td>5.32</td>
<td>246.00</td>
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<td>Total outstanding</td>
<td>1,335.25</td>
<td>64.91</td>
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<td>Amount sold</td>
<td>25.53</td>
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<td>5.32</td>
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</tr>
<tr>
<td>Of which has been repaid</td>
<td>20.21</td>
<td></td>
<td>5.32</td>
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<tr>
<td>Total now held by Bank and IDA</td>
<td>1,735.47</td>
<td>64.91</td>
<td></td>
<td></td>
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<tr>
<td>Total Rehabilitation</td>
<td>735.47</td>
<td></td>
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</table>

1/ The status of the projects listed in Part A is described in a separate report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.
2/ Not yet effective; signed on July 18, 1985.
3/ Effective on November 24, 1986.
4/ Prior to exchange rate adjustment.

10618/9
January 7, 1987
**ANNEX II**

Page 2 of 2

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### Statement of IFC Investments in Tunisia (as of September 30, 1986)

<table>
<thead>
<tr>
<th>Year</th>
<th>Obligor</th>
<th>Type of Business</th>
<th>Amount of US$ Millions</th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Loan</td>
<td>Equity</td>
<td>Total</td>
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<tr>
<td>1963</td>
<td>B.E. Nuguis</td>
<td>Agriculture</td>
<td>2.0</td>
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<td>3.5</td>
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<tr>
<td>1966/70/78</td>
<td>Société Nationale</td>
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<td></td>
<td></td>
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<tr>
<td></td>
<td>d'Investissement (now BEX)</td>
<td>Dev. Finance Co.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1969</td>
<td>C.E.P.T. Tourism (now BEX)</td>
<td>Dev. Finance Co.</td>
<td>9.0</td>
<td>2.2</td>
<td>11.2</td>
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<tr>
<td>1973</td>
<td>Société Touristique et</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Metaliks S.A</td>
<td>Tourism</td>
<td>1.6</td>
<td>0.3</td>
<td>1.9</td>
</tr>
<tr>
<td>1974</td>
<td>Industrie Chirurgique du Fluor</td>
<td>Chemicals</td>
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<td>0.6</td>
<td>0.6</td>
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<tr>
<td>1975</td>
<td>Société d'Études et de</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Développement de Boumer-Prof.</td>
<td>Tourism</td>
<td>2.5</td>
<td>0.6</td>
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<td>1985/86</td>
<td>Société Tunisienne de Leasing</td>
<td>Leasing Co.</td>
<td>3.1</td>
<td>0.5</td>
<td>3.6</td>
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<td>1985</td>
<td>Société Tunisienne de Spor</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Fuba)</td>
<td>Mining Co.</td>
<td>5.0</td>
<td>0.3</td>
<td>5.3</td>
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<tr>
<td></td>
<td></td>
<td>Textiles and Fibers</td>
<td></td>
<td>3.2</td>
<td>3.5</td>
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<tr>
<td>1986</td>
<td>SITEX</td>
<td></td>
<td>Total Gross Commitments</td>
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<td>Loan cancellations</td>
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<tr>
<td></td>
<td></td>
<td>Terminations, Repayments and Sales</td>
<td>13.6</td>
<td>1.8</td>
<td>15.2</td>
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<td></td>
<td>Total Commitments (as of)</td>
<td>8.8</td>
<td>9.7</td>
<td>18.5</td>
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<td></td>
<td>held by IFC</td>
<td>Total Unutilized</td>
<td>8.1</td>
<td>1.6</td>
<td>9.5</td>
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</table>

*\(^1\)* In addition, investments in Adeqa S.A. and Société Tunisienne Industrialisées Tunisie (BEX S.A.) were approved respectively, on June 23 and September 4, 1986, but have not yet been signed.

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1985/4
REPUBLIC OF TUNISIA

INDUSTRIAL AND TRADE POLICY ADJUSTMENT LOAN

Supplementary Project Data Sheet

Section I: Timetable of Key Events

(a) Time Taken to prepare project: About 12 months
(b) Project preparation responsibility: Government/Bank
(c) Project first identified by Bank: January, 1986
(d) Bank appraisal mission: October, 1986
(e) Negotiations: December, 1986
(f) Planned date of effectiveness: April, 1987

Section II: Special Bank Implementation Actions

None

Section III: Special Conditions

(a) Conditions of Effectiveness and Release of First Tranche (US$100 million)
   [See para. 139 (a) and 140 (a)]

(b) Conditions of Release of Second Tranche (US$50 million)
   [See para. 139 (b) and 140 (b)]
LETTER OF ECONOMIC DEVELOPMENT POLICY

Dear Mr. President:

Within the framework of preparation of the Agricultural Sector Adjustment Loan and the Industrial and Trade Policy Adjustment Loan, I have the honor to set forth below Tunisia's principal development policy goals for the period 1986-91.

After 15 years of rapid economic development, during which much economic and social progress has been made, Tunisia is currently going through a period of adaptation to the post-hydrocarbon era, a transition that is particularly difficult because of recent events such as the sharp decline in oil prices, difficulties in exporting phosphates and phosphate derivates, the rise in the price of sulfur, and the decline in Tunisian workers' remittances.

To cope with this situation, we have, as you know, adopted a strategy oriented toward the rapid growth of non-oil/non-phosphate exports, the recovery of agricultural production, and the containment of domestic demand. In this way we intend to ensure continued growth and the creation of new jobs while preserving a tolerable and sustainable external balance.

To this end, a number of measures have been implemented over the past few years, of which the following are the most significant:

- wages were delinked from the cost-of-living index in 1983 and since then the minimum wage has been increased only once by about 10%;
- the Government's investment budget was reduced by close to 1% in real terms in 1985 and by around 22% in 1986;
- a flexible exchange rate system was adopted; together with the 10% change in the exchange rate of the Dinar, announced in mid-August 1986, this made it possible to absorb the rise in the value of the dinar in relation to the currencies of partner countries and to improve competitiveness on the export markets;
deposit and lending interest rates were increased and have mostly become positive in real terms;
- the prices of products subsidized by the Caisse Générale de Compensation were adjusted, leading to a gradual decrease in compensation costs with a consequent reduction in budgetary subsidies;
- producer prices of agricultural products were increased, in particular for cereals, livestock products and olive oil, to stimulate and promote production in this priority sector;
- investment approval procedures on small and medium-scale industrial projects were simplified and decentralized;
- an export credit insurance system was established to provide security for exporters and encourage them to explore new markets;
- the export prefinancing mechanism was revised, raising the ceiling from 10 to 20% of the value of the export and extending the terms from 90 to 180 days;
- lastly, export incentives were strengthened within the framework both of the law on export industries and of the law on encouragement of the manufacturing industries.

Thanks to these policy changes, accompanied by a reduction in imports, we have been able to bring about significant improvements in the 1985 financial situation. In particular, we have achieved:

- an increase in non-oil/non-phosphate exports of 4% at constant prices, against an average of 1.5% over the period 1982-1984;
- a marked reduction in the current balance of payments deficit, which fell from 10.9% of GDP in 1984 to less than 7% in 1985;
- a reduction in inflation to 7.8% in 1985 against 8.6% in 1984 and 13.6% in 1982;
- a limitation of the net consolidated State budget deficit to a level (5% of GDP) virtually in line with the budget.

Preliminary estimates for 1986 indicate a further slow-down in the rate of inflation to about 6.6%, and a slight decline in the consolidated budget deficit to about 3.9% of GDP. However, as a result of the sharp decline in oil prices, depressed tourism demand because of political uncertainties around the Mediterranean, and the serious drought, the current balance of payments deficit is likely to worsen in 1986 to about 8.5-9% of GDP, requiring a higher than expected inflow of foreign resources.

Over the coming years the stabilization effort will be consolidated and strengthened to enable us to deal successfully with the two major problems still facing Tunisia, namely that of balance of payments equilibrium, resulting principally from the foreseeable decline in foreign exchange earnings, and that of unemployment and underemployment resulting from rapid growth in the active population.

We therefore intend to continue our efforts to curb the budget deficit and current balance of payments deficit so as to contain the external debt within limits compatible with our repayment capacity.

At this level, and although the goals of the VIIth Plan have not yet been established, we intend to introduce a development plan for the next five
years based on an annual increase in non-oil and non-phosphate exports of 7 to 8%, at constant prices, and real GDP growth of 3.5 to 4%, resulting in a gradual decline of the net budgetary deficit and a marked decrease in the current balance of payments deficit (from 10.9% of GDP in 1984 to around 6% in 1988 and under 4% in 1991).

To achieve those goals, we intend to vigorously pursue policies aimed at restricting domestic demand and promoting exports. More precisely, we intend to accelerate the policy of gradual liberalization of the economy, in particular as regards imports, prices and investments, so that by 1991 we shall have abolished most of the administrative controls in those areas. We also intend to strengthen domestic competition by bringing down import duties and reducing disparities in the effective protection levels of the various branches of economic activity, and to ensure the competitiveness of export products by pursuing a prudent and moderate wage policy and maintaining a flexible exchange rate system.

These various structural adjustment measures, which are listed in the attachment to this letter, together with an implementation schedule, should lead to a marked improvement in the general economic environment and an increase in the effectiveness of the sectoral reform measures being implemented in the agricultural, industrial and external trade sectors, or in the course of preparation in other key sectors such as public enterprises, energy, transportation, education, etc.

It goes without saying that the policy, which we have designed for the purpose of adapting our economy to the post-hydrocarbon era, will be facilitated if the Bank will give favorable consideration to our request with respect to the Agricultural Sector Adjustment Loan and the Industrial and Trade Policy Adjustment Loan, and will support our medium-term adjustment efforts with other sector loans.

We appreciate the discussions we have had with the Bank and hope to continue to exchange views in the future.

Very truly yours

/s/ Ismail Khelil

Minister of Planning and Finance
THE MACROECONOMIC ADJUSTMENT PROGRAM

1. The basic strategy underlying the Government's macroeconomic adjustment program reflects its objective of maintaining economic growth and speeding up employment creation by stimulating non-oil/non-phosphate exports, achieving a more efficient utilization of domestic resources and promoting savings through more rigorous demand management.

2. To achieve these objectives, the Government intends to pursue its course of macroeconomic policy adjustment in eight areas: wages and salaries, the exchange rate, the budget, interest rates, credit and monetary policies, and price, investment and import liberalization. The action program in each of these areas is summarized below.

3. Wages and salaries. Given the decisive role cautious wage and salary policies play in any effort to control domestic demand, improve international competitiveness and ensure more rapid employment creation; the Government decided in 1983 to delink wages and salaries from the cost-of-living index; in consequence, the minimum wage has remained unchanged during 3 1/2 years from January 1983 through July 1986, and average salaries have declined by nearly 15% in real terms during the same period. The Government will pursue these wage policies, limiting wage increases to productivity growth and to the financial situation of each enterprise.

   In July 1986, Government raised the minimum wage by 10% but it has no intention to increase the minimum wage on average by more than the inflation rate during 1986-1987. During the remainder of the VIIth Plan period, it plans to follow a minimum wage policy which ensures that the growth of the total wage bill will not exceed the growth of GDP at current prices.

4. Government Budget. Recognizing the importance of reduced budget deficits in restoring internal and external financial stability, the Government introduced a program of reducing budget deficits in 1985 and 1986. It is determined to follow through on this effort so as to reduce the consolidated budget deficit, net of debt repayment 1/, from 5% of GDP in 1985 to 1.5% in 1988 and practically to zero in 1991. In spite of declining oil revenues, the Government is determined to maintain the budgetary savings rate at around 6% of GDP, while reducing the share of public investments in GDP, particularly by cutting the Government's contributions towards public enterprise investments. The detailed measures envisaged to achieve these targets are mentioned in Annex I to this attachment.

1/ Including Chapters I and II of the Government's Budget, the Special Funds, the Treasury operations, and the non-budgeted operations financing direct investments by the Government.
5. **Interest rate policy.** Thanks to the interest rate increases in 1985 and 1986 and the drop in inflation, the Government has ensured that most interest rates are now positive in real terms. During the period of the VIIth Plan, the Government will maintain flexible interest rate policies designed to ensure positive rates on most deposit and lending operations. The exceptions will be limited to certain credits for low-income groups, such as parts of the loans granted by FOSDA, FOPROLOS, FONAPAM, FOPRODI and FODERI, and certain forms of high-priority lending such as seasonal credits, export prefinancing and the financing of renewable energy resources.

Furthermore, to improve the efficiency and viability of financial institutions, the Government intends to pursue its simplification of the interest rate structure and relaxation of existing regulations. To this avail a detailed program of action will be prepared and discussed with the Bank within the framework of preparation of the VIIth Plan, expected by April 30, 1987.

6. **Monetary and credit policy.** The Government is firmly committed to a monetary and credit policy that is consistent with declining budget deficits and investment rationalization; this implies that during 1986-91 the growth of the money supply will be kept within a range whose upper limit will not exceed the growth of GDP in nominal terms.

7. **Exchange rate policy.** The Tunisian Government is aware of the importance of this instrument in regulating external trade. Accordingly, it introduced in 1985 a flexible exchange rate system, which made it possible at first, to absorb the rise in the value of the dinar in relation to competitor-country currencies. The situation improved further in mid-August, 1986 when the exchange rate was depreciated by 10% vis-à-vis a basket of foreign currencies. This improved the competitive position of Tunisian products by about 28% compared to the situation prevailing at the end of June 1985. The Government will continue this flexible policy so as to maintain an appropriate level of competitiveness for Tunisian products. It also agrees that any exchange rate adjustments will be reflected in the administered producer prices for agricultural products.

8. **Price Controls.** The Government has for several years pursued a policy of gradual decontrol of agricultural producer prices. This policy will continue and will be extended to the manufacturing sector. In particular, the Government intends, over a period of three years (1986-88), to phase out all price controls in well-established industries where the number of domestic producers is sufficiently large to ensure appropriate competition. A detailed timetable for phasing out price controls is presented in Annex II to this attachment.

Between 1989 and 1991, the Government intends to abolish price controls in all other industries in close-coordination with the liberalization of imports, with the exception of a few key staples (such as bread, semolina and oil) of which the price must remain regulated for social reasons.

In the event of monopolistic agreements, however, the Government would reserve the right to intervene to reestablish satisfactory competition.
9. With respect to those industrial products for which the price will remain regulated over the short or medium-term, the Government intends to introduce a more flexible price control procedure on January 1, 1987 that would allow the enterprise to change a price unilaterally, by reference to agreed parameters, and to apply the new price following a reasonable time lapse, provided there is no justified objection on the part of the Government.

To this end, the Government will—with assistance by the World Bank—devise rapidly the operation formulas to be used by entrepreneurs in the various industries. These formulas must be geared to the appropriate utilization of installed production capacities and the adequate control of production costs.

10. Investment liberalization. In the context of a system of gradual decontrol of the economy, the Government intends to phase out the control (by API, APIA and the Tourism Investment Board) of investments not eligible for special incentives or benefits, in parallel with the liberalization of prices and of external trade, within the framework of a new investment incentive policy.

The Government has decided to abolish by the end of 1986 all controls on investments below DT 200,000 and on replacement investments not requiring a specific import authorization for capital equipment and not asking for special investment incentives; it intends to continue this process in 1987 and 1988 with a view to the abolition, in parallel with the overhaul of the incentive system, of the approval requirements for other well-established industries for which the number of domestic producers is sufficiently large to ensure appropriate competition.

The approval procedure will be maintained for all investment projects that are asking for special investment incentives linked to transfers of technology, regional development and exports.

In early 1989 the Government is to start on a program leading to the abolition, by 1991, of investment controls in all remaining sectors, except for investments asking for special investment incentives.

11. Import liberalization. Cognizant of the importance of import liberalization in improving domestic resource use and allocation and, in general, in helping to achieve the country's development goals over the next five years, the Government reaffirms its intention of gradually liberalizing imports. It intends to effect this decontrol by two principal means: reduction of quantitative restrictions and rationalization of import duties.

12. (a) Quantitative restrictions. In mid-August 1986 the Government abolished all restrictions on imports of raw materials and semi-finished products for companies exporting at least 25% of their turnover as well as of spare parts for use in industry, farms, hotels, hospitals, and other services. It intends to abolish before end-September 1986 all restrictions on imports for newly approved investment projects and for raw materials used in the manufacture of pharmaceutical products.

Not later than January 2, 1987, Government intends to abolish restrictions on all other spare parts and raw materials, as well as on
semi-finished products for companies exporting at least 15% of their turnover and for those that are reasonably integrated.

Not later than January 2, 1988, it plans to lift import restrictions on capital goods and semi-finished products, with the exception of a list of products which are used exclusively in poorly-integrated plants to be discussed with the Bank.

Starting in 1989, the Government will introduce a program leading to the abolition, by 1991, of the remaining quantitative restrictions, mainly those on consumer goods.

13. (b) Import duties. In line with its concern to promote exports, and to ensure greater efficiency of resource allocation, the Tunisian Government intends to gradually reduce import duties and to lessen the disparities in the levels of effective protection between the various sectors of the economy, the goal being to achieve a reasonably uniform effective protection rate of around 25% by 1991.

To this end, it aims to introduce, on January 1, 1987, within the framework of the 1987 Budget Law, the following changes in customs duties:

- a raise in the minimum duty to at least 15%;
- a reduction of all import duties to a maximum of 50%;
- reduction by 6 percentage points in all duties between 26 and 55% with a minimum not falling below 25%; with the possibility of deferring some of these reductions by up to one year after discussions with the Bank, in case a Tunisian enterprise suffers serious damage as a result of exceptionally large increases in imports and with the aim to provide that enterprise somewhat more time to adapt.

However, the Government reserves the right to introduce additional consumption taxes on products of which the local production or import is regarded as a luxury or a waste of resources, so as to absorb all or part of the loss in revenue resulting from the revision of customs duties.

It also agrees to continue this process in 1988, introducing on January 1, 1988 a new import duty reduction of 9 percentage points on duties between 26 and 50%, once again with the possibility of offsetting certain losses in revenue by consumption taxes, and over the long term to incorporate the "Taxe sur la Formalité Douanière" (TFD) into the actual customs duties, for purposes of simplification.

Lastly, the Government intends to prepare before the end of 1988 a program of further gradual tariff reductions so as to achieve the objective of a 25% effective protection rate by the end of 1991.

14. Monitoring and progress reporting. Progress on the implementation of the program described above will be monitored by the Government and reported to the Bank every six months.
The Government intends to make a sectoral and sub-sectoral allocation of investment funds within these global limits as part of the preparation of the VIIIth Development Plan. The resulting investment program will be assessed and discussed with the Bank at the time the report of the Public Expenditure Review mission will be discussed.
### Price Liberalization Time-table

**September 1, 1986**

- Building materials excluding lime, cement and sanitary appliances
- Textiles excluding undergarments and articles made out of jute
- EMI
  - car parts including batteries
  - hardware
  - TV antennas and parts
- Canned sardines
- Miscellaneous industries
  - plastic articles
  - graphic art
  - watches
  - joinery finishings in wood
  - cork articles
  - chandeliers
  - footwear and accessories
  - tannery products
  - packing materials of paper and cardboard
  - printed articles
  - small-wares

**January 2, 1987**

- EMI
  - control wire and meter transmission cables
  - electrical and telephone cables
  - refrigerators and cooking-stoves
  - boilers
- Carpentry
- Glue
- Inks
- Liquid detergents
- Tires and rubber articles
July 1, 1987

Soap excluding perfumed soap

Food products

- canned tuna
- canned tomatoes
- canned harissa
- yogurt
- cheese, excluding soft cheese
- beverages

Furniture

Fertilizer

- phosphoric acid
- superphosphate, triple superphosphate
- dicalcium phosphate
- mono ammonium phosphate, diammonium phosphate
- complex fertilizer

January 2, 1988

EMI

- sound making equipment and parts
- taps and faucets
- bicycles and motorcycles
- batteries and miscellaneous articles

Animal food

Chemical products

- paint, varnish
- perfumed soap
- detergents
- essential oils
- linseed oil
- perfumes
- insecticides and pesticides
July 1, 1988

Household articles in inox and aluminium

Copper articles

Joinery finishings in aluminium

Electrical motors and transformers

Tomato paste

Canned vegetables and fruits
LETTER ON INDUSTRIAL DEVELOPMENT POLICY

January 27, 1987

Mr. Barber B. Conable
President, The World Bank
1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

Dear Mr. President:

Further to the exchanges of views that have taken place between the Tunisian authorities and the World Bank in the course of preparation of an industrial and trade policy adjustment loan, our economic discussions and the agreements reached on a macroeconomic adjustment program, I have the honor to set out below the broad lines of our industrial development policy.

As you are aware, the manufacturing sector occupies an important position in our development strategy for the post-hydrocarbon era. This strategy gives priority to the rapid growth of exports of manufactures. At present, manufacturing accounts for 14 percent of Tunisia's GDP, roughly 20 percent of employment, and one-third of the country's exports. However, except for the phosphate processing industry and the clothing industry, which are largely export oriented, all other manufacturing subsectors are oriented essentially towards the domestic market. This situation did not present much of a bottleneck to the development of manufacturing during the seventies and early eighties when the sector was still small, possibilities for import substitution were large and domestic demand expanded rapidly, fueled by the sharp rise in oil prices and substantial wage hikes. Now, however, in the mid eighties, this strategy seems to have reached its limits: the manufacturing sector is no longer so restricted, the most obvious import substitution activities are all covered and growth of domestic demand has slowed substantially, reflecting the drop in oil production and prices.

Rapid growth of manufacturing production does depend crucially on a substantial increase in exports of manufactured goods as a means of supporting overall economic growth while at the same time generating new foreign exchange earnings to offset the expected decline in oil exports. In the circumstances, exports of manufactures and tourism will be called upon to play a key role, particularly as these are generally labor-intensive activities and so reflect also the country's priorities in this area.

We have already begun a significant adjustment effort to address these issues, and over the past two years we have endeavored to remove administrative obstacles to exports and to establish the institutional structure needed for their more rapid growth. May I refer to the following examples:

- elimination of export licenses, except for subsidized goods;
- partial elimination of export taxes;
improvements in the system for reimbursing import duties and taxes, by including the TFD (Customs Formalities Tax) in the reimbursement, by granting reimbursement at the time of customs clearance or even after export, and by opening up the possibility of reimbursing the actual exporter (who is not necessarily the importer);

improved customs arrangements for temporary admission and warehousing;

increased opportunities for export prefinancing;

extending the authorized periods for settling export transactions and repatriating the proceeds;

expanded opportunities for forward coverage of exchange risks;

liberalizing the use of accounts in convertible currencies and increasing the amounts that may be taken out of the country for business travel;

introduction of a system of export credit insurance;

establishment of a number of export companies, several of which have already begun operations;

establishment in 1985 of an export promotion fund to finance a variety of export promotion measures;

establishment of two export promotion committees, one in the Central Bank and the other in the Ministry of Commerce and Industry, to deal with day-to-day problems at the working level.

In addition, a macroeconomic adjustment program has been adopted and is being implemented. It seeks to reduce existing rigidities and create the environment needed for increased exports and optimal resource allocation. This program, as set forth in detail in the letter on economic development policy of September 1, 1986, will be supplemented and reinforced by the Sectoral Adjustment Program for the manufacturing and external trade sectors that is to be pursued under the Seventh Development Plan, as expounded in the attachment to this letter. In this regard, the Sectoral Adjustment Program will have three precise objectives:

(i) Encourage the growth of manufacturing output by making better use of existing facilities and according priority to private investment;

(ii) Encourage exports of manufactured products other than fertilizers and petroleum products;

(iii) Encourage the creation of additional jobs in manufacturing industry.

For the immediate future, the development strategy for the manufacturing sector being pursued by the Tunisian authorities seeks to improve the cost-effectiveness of existing activities and optimize the use of
existing capacities. In the longer term, it aims at promoting private investment in activities that will produce a direct economic return, given the growing scarcity of funds for investment and of foreign exchange resources. The program of short-term measures already adopted or currently envisaged — namely those designed to maintain an appropriate exchange rate and to develop the role of the market and of prices in order to ensure better allocation of resources — are entirely consistent with the longer-term strategy.

The key measures, to be taken over the next few years, relate to the implementation of a new investment code reflecting the new priorities, the liberalization of credit policies and reorganization of the institutions for promotion and support of the manufacturing sector, together with the relaxation of laws and regulations governing labor and employment.

To enable us to meet the objectives of our policies aimed at preparing the industrial sector for the post-hydrocarbon era, we hereby request you to consider granting Tunisia a loan to be disbursed rapidly to meet the needs of the industrial and trade policy adjustment program.

Very truly yours,

signed: The Minister of Planning and Finance

Ismail Khelil

Attachment
1. The Government's medium-term objectives for development of manufacturing industry are to encourage private investment in the sector, step up the expansion of exports of manufactured goods, and create a growing number of new jobs. To this end, the Tunisian authorities have already adopted an adjustment program, focusing largely on the areas of foreign exchange, wage policy, interest rates, and progressive deregulation of prices, investment and imports in accordance with the schedule set forth in the Letter of Development Policy dated September 1, 1986. This macroeconomic program, several provisions of which have already been implemented, will be supplemented and strengthened by a number of sectoral measures set forth below.

2. These measures fall into two broad categories:

(i) Improved incentives to invest, with a view to encourage private investment by relaxing controls, allowing private enterprises greater freedom of action, and creating a more favorable environment. These incentives should promote exports and create new jobs by changing the relative cost of factors of production in favor of labor.

(ii) Search for greater efficiency in the financial sector, notably through improved management of the money supply by the Central Bank; elimination of prior Central Bank authorization of individual credit operations; a more flexible interest rate policy, and improvements in the system of exchange risk coverage for external loans taken out by the development banks.

3. At the same time, the Tunisian authorities intend to continue with implementation of the program of reforms undertaken in recent years. To this end:

- administrative measures for export promotion will be strengthened further;

- the powers and responsibilities of the para-public institutions established to support and promote the manufacturing sector will be adapted to encourage private initiative;

- the wage policy that has been pursued since 1983 will be continued in coming years. The de-linking of wages from the cost of living index will be maintained, and any salary increase will be linked to productivity improvements and the financial situation of each enterprise. Other improvements will be sought by holding down social security costs and introducing greater flexibility into conditions of employment.

4. The Tunisian authorities also plan to conduct a study of tourism to identify reforms needed to stimulate the growth of a more diversified and higher-quality tourism.
A. General Liberalization Measures

5. Within the context of the macroeconomic measures that have been taken in 1986, the authorities have decided to eliminate price controls over the period 1986-88 for well-established industries where the number of domestic producers is sufficiently large to ensure appropriate competition. This list was sent to the Bank as Annex II to the letter of September 1, 1986. Over and above the products shown on that list, the authorities intend to eliminate price controls on all products whose importation is to be deregulated over the period 1987-88 and beyond. This applies to all raw materials, spare parts, capital goods and the great majority of semimanufactures.

6. Concerning those industrial products for which prices will remain regulated over the short or medium term (mentioned in the attachment to the letter of Economic Development Policy), the Government will take the necessary measures, so that by the time these products are decontrolled, abrupt price increases or decreases can be avoided to the extent possible.

7. During the period 1989-91, the last import restrictions (confined essentially to consumer goods) will be lifted except for a limited number of products whose importation will continue to be controlled for social and political reasons. The Government intends to decontrol at least one-third of these remaining imports by January 2, 1989, at least two-thirds by January 2, 1990, and everything by January 2, 1991. The lifting of price controls will proceed in parallel with the elimination of quantitative restrictions on imports.

As regards infant industries, the Government has the intention to limit specific protection measures to a maximum duration of three years from the date of completion of the project. Except in duly justified cases, this protection shall not take the form of quantitative import restrictions; and in no case shall there be a complete import ban of the product.

B. Investment Incentives

8. Within the context of the macroeconomic objectives of the Seventh Plan, the Tunisian authorities intend to modify the procedures for investment and for the granting of related benefits and incentives. To this end, the new Industrial Investment Code currently in preparation lifts all Government controls on industrial investments and confines the granting of incentives to just those few projects that correspond to the key priorities of the Nation. The new Code introduces five major changes:

(i) It is highly selective, in that special incentives can only be granted to high-priority projects meeting certain clearly specified criteria;

(ii) It eliminates the distinction between new projects and replacement and expansion projects;

(iii) It eliminates prior Government examination and approval of investments not eligible for special incentives;
(iv) It makes the granting of incentives virtually automatic once the necessary conditions have been met; and

(v) It focuses the incentives available on the basic objectives of the Seventh Plan, notably export promotion and the creation of jobs in disadvantaged regions.

9. Many of these incentives are covered by ordinary law, i.e. are granted to export enterprises independently of any prior Government authorization or approval. Export enterprises will in particular benefit from the suspension of duties and taxes on inputs, whether imported or purchased locally, and exemption from profits tax up to the value of export sales.

Other incentives will be specific in nature, i.e. will be tied to investment projects meeting certain defined criteria, namely exports, creation of jobs in disadvantaged areas, acquisition of technology, and integration. These incentives will take the following specific forms:

- Exemption from duties and taxes on capital goods for units geared exclusively toward exports. All other projects will be required to pay duties on imported capital goods. The rate of import duty on such goods has been adjusted in the 1987 Finance Law to a level providing effective protection on the order of 25%.

- Payment of the social security contribution for a period ranging from two to six years and provision of infrastructure in industrial estates at 50% to 100% of actual costs, depending on the area;

- Payment of the cost of formal and on-the-job training for technicians linked to the introduction and acquisition of new technologies.

10. The Tunisian authorities intend to review at the end of the VIIth Plan the incentives system established by the new investment code in view of the macroeconomic situation at that time.

11. The new Investment Code, which has already been the subject of many discussions with the Bank, is expected to be submitted to the Chamber of Deputies by early 1987, and it is anticipated that it will become effective no later than July 1, 1987.

As an interim measure covering the period between implementation of the new Code early in 1987 and the liberalization of capital goods imports scheduled for early 1988, the Tunisian authorities have set up a procedure under which projects that do not qualify for approval (agrément) may request authorization from the Investment Commission to freely import the capital goods required.

C. Financial Policy and Fiscal Environment

12. In order to adapt the financial system to new demands from the economy, the Tunisian authorities will continue to reform the instruments of monetary and credit policy by combining adjustment of overall controls
exercised by the Central Bank with assigned increased responsibilities to primary banks. Within the context of this reform, the Central Bank will adapt its means of intervention to the objective of keeping growth of money supply within limits compatible to overall economic growth and balance of payments equilibrium. At the same time, it will gradually relax the system of prior authorization and mandatory placement requirements to which the deposit banks are subject. Both borrowing and lending interest rates will be largely deregulated to encourage savings and promote better resource allocation. Lastly, the exchange risk coverage system for external loans contracted by the banking sector will be modified to ensure that this risk is borne by the end-user of the credit.

13. As agreed with the International Monetary Fund, the banks will from 1987 onward raise the bulk of their funds on the money market, with fixed-rate rediscounting to be available only for the priority sectors (exports, agriculture, small and medium-scale enterprises, and energy-saving). Each bank's fund-raising on the market at the daily rate will be subject to ceilings based on its deposits, with excess fund-raising attracting a penalty rate. To meet the performance criteria agreed with the IMF, the Central Bank will influence the volume of domestic credit by manipulating its intervention rates on the money market and the refinancing ceilings allowed to the banks.

14. To ensure better allocation of financial resources, bank borrowing and lending interest rates will be deregulated as of January 1, 1987, with however the following exceptions:

- lending rates for priority sectors, which will continue to be administered by the Central Bank;

- borrowing rates on special savings accounts and convertible dinar deposits held by Tunisians residing abroad, which will continue to be set by the Central Bank with reference to money-market rates. All other rates will be freely determined by the banks in response to market forces. The monetary authorities will intervene solely in order to ensure that the rates paid on term deposits are positive in real terms and to set ceilings on lending rates to prevent usury.

15. The banks will also have greater freedom in employing their funds. Two restrictions to which they had previously been subject are to be eased:

(i) The requirement that they use 18 percent of their funds for medium-term lending was replaced, effective September 30, 1986, by an initial figure of 7 percent (later to rise to 10 percent) linked to the financing of investment projects in the artisanal sector, small and medium-scale enterprises, agriculture and export industries;

(ii) The various ceilings for short-term loans above which the commercial banks have to obtain prior authorization from the Central Bank has been raised on January 1, 1987 to a uniform figure of TD 5 million. The system, thus, has been considerably simplified and easier to administer: the TD 5 million ceiling for total annual short-term loans outstanding will in practice apply to only some fifty enterprises, most of them in the public sector, whose
situation is deemed to require continued monitoring. Moreover, this requirement will be lifted on January 1, 1988 for the few private-sector enterprises still affected by this formality. Medium-term lending for the financing of Government approved investments, of investments receiving special Government incentives and of investments for handicrafts, other small enterprises and small farmers has become exempt completely from a priori authorization from the BCT. Medium-term credit for the financing of all other types of investments, would be exempt from BCT authorization after the implementation of the new industrial investment code. The small amount of long-term lending is also exempt for private borrowers, while the a priori authorization is maintained for public enterprises regardless of the size of the loan.

16. As regards exchange risks, the Tunisian authorities, mindful of the dangers of poorly spread risks or excessively generous guarantees, have already taken steps to channel resources on a regular basis to the Exchange Risk Equalization Fund and to confine the guarantees to certain development banks — essentially BDET (Banque de Développement Economique de Tunisie), specializing as it does in the financing of small and medium-scale enterprises — given the inability of borrowers to protect themselves against this type of risk.

In order to further improve the efficacy of this system, a number of modifications will be introduced as of mid-1987, reflecting the following three principles:

- The end-user of the loan will himself bear the exchange risks where his operations are on a sufficient scale to enable him to do so;

- Adoption of specific criteria governing access to exchange risk guarantees designed to restrict eligibility solely to small and medium-scale enterprises;

- Changes in the way in which the Equalization Fund is financed designed to ensure its integrity without recourse to government subsidies. Studies are in progress to examine the possibility of financing the Fund through variable commissions depending on the currency borrowed, which could reflect the difference between the cost of borrowing plus the intermediation margin and the lending rate obtaining on the domestic market.

At the same time, the Central Bank of Tunisia will be conducting studies to examine possible ways of providing forward coverage of the exchange risks bearing on different settlement currencies, with a view to limiting their impact on the balance of payments.

17. As regards the general business climate, the Tunisian authorities are aware of the need for continued improvement in order to promote investment, increase output and create new jobs.

In view of the impact of taxes on the environment for business, the 1983 Finance Law already introduced two major concessions:
- reduction in the corporation tax (proportional tax) from 46.5 percent to 44 percent for commercial activities, and from 40.5 percent to 38 percent for industrial, tourism and transportation activities;

- deductibility of income tax on income derived from securities, for the beneficiaries of such income.

Other changes have been introduced since then, affecting export companies in particular, with profits derived from export operations now being tax exempt.

For the years ahead, the Tunisian authorities are devoting their full attention to ensuring the success of two major reforms:

- introduction of a Value Added Tax on January 1, 1988;

- simplification of direct taxation by introducing, during the period covered by the Seventh Plan, a consolidated tax on individual and corporate incomes.

D. Export Promotion

18. In order to speed up the adjustment process, the Tunisian authorities have already made sustained efforts to eliminate the obstacles of an administrative nature against exports of manufactured goods. This program now having been largely completed, the authorities plan, in the course of 1987, to improve the services provided by the Customs Administration. In concert with all the government departments involved in exports, measures will be taken to gradually standardize working hours, combine services in a single location, and integrate data processing operations, so that the exporter will have to deal with only one office.

E. Institutional Changes

19. The policy of promoting exports and private investment in manufacturing industry, together with gradual deregulation of the economy, will be accompanied by a transformation of the support infrastructure in the manufacturing sector, including API1/, AFI2/, CEPEX3/, CNEI4/ and the various technical centers.

The purpose of these changes will be (i) to strengthen promotion and support activities, particularly to firms in the private sector, (ii) to reduce control and approval functions, and (iii) to encourage beneficiary enterprises to assume responsibility for a greater proportion of the cost of services received. The Tunisian authorities have decided to introduce the following specific changes during the period 1987-88:

(i) The role of API has already changed and will change further with the introduction of the new Investment Code early in 1987. To enable this agency to play its promotional role to the full and to make maximum use of the many

1/ Industrial Investment Promotion Agency; 2/ Industrial Land Agency; 3/ Export Promotion Center; 4/ National Industrial Studies Center.
years of experience gained by CNEI, the authorities have agreed to merge API, AFI and CNEI. The bulk of the combined agency’s human and financial resources will be assigned to the effort of promoting and assisting business enterprises, more particularly through project identification and preparation of sectoral studies. In addition, in order to facilitate the granting of incentives for eligible projects, API will continue to act as secretariat of the Approvals Committee (Commission de l'Agrément) responsible for implementing the new Investment Code. This Committee will be independent of API's Board of Directors, the latter focusing exclusively on supervising and guiding the agency's promotional activities.

(ii) The role of CEPEX will, for its part, be consolidated in order to make its operations more effective and reduce its expenses incurred in foreign exchange. To this end, the Tunisian authorities propose to merge the promotional work currently undertaken by OCT\(^1\) into CEPEX and to study the possibility of more closely integrating commercial attachés abroad into the organization.

(iii) The three existing technical centers which provide valued services to private and public entrepreneurs will be reorganized. The measures being considered in this regard involve providing interested enterprises with enhanced representation on the Boards of these centers and have them gradually assume a higher share of the cost of the services provided by these centers.

Should need for assistance become evident in additional sectors not yet covered by an existing technical center, the Government will consult with the enterprises concerned regarding the possibility of assigning this new task to one of the existing centers rather than increasing the number of such centers.

(iv) Lastly, the Chambers of Commerce will be reactivated as part of the policy of encouraging the private sector to assume greater responsibility for its own development, and the efforts of UTICA\(^2\) in assisting small and medium-scale enterprises and promoting exporters will be strengthened.

F. Employment and Wage Policy

20. The Tunisian authorities are pursuing two long-range goals in this area closely linked to the adjustment program:

(1) Create the largest possible number of new jobs in manufacturing industry; and

(2) Improve the competitive position of industry, more particularly of export companies.

To this end, they plan to study ways of gradually reducing the burden of social security contributions without undermining the financial integrity of the social security system. As a first step, attempts will be made to reallocate contributions among the various funds. In the longer term,

1/ Tunisian Trading Office.
2/ Tunisian Association of Industry, Commerce and Handicrafts.
the structure of benefits will be reviewed in order to ensure that a reasonable balance exists between costs and payments. In the event that resources prove inadequate, the authorities agree on the need to align benefits on the resources expected to become available rather than adding to the burden on employers. Any additional benefits (more particularly in the area of health insurance) would have to be covered by voluntary schemes.

It is understood that, in cases where the Investment Code provides incentives in the form of exemption from, or reductions in, contributions to the social security funds, these exemptions will be financed out of the government budget in such a way as to avoid any shortfall in receipts to these funds.

21. In the same order of ideas, work is in progress, as part of the drafting of the Seventh Plan, to review labor legislation to ensure that it is sufficiently adaptable and flexible to promote employment while keeping the enterprise competitive.

The results of this work, expected to be available before the end of June 1987, will be the subject of an exchange of views with the Bank.

22. In addition, in order to curb domestic demand and promote productivity, the Tunisian authorities plan to continue the policy of deindexation of wages that has been in effect since 1983. To this end, any wage increases will be tied to improvements in productivity and in the financial situation of each enterprise.

In order to facilitate the practical implementation of this policy, it would be useful to receive assistance in developing methods to measure productivity within each enterprise. A request for such assistance is currently being prepared.

G. Tourism

23. Lastly, the Tunisian authorities plan shortly to undertake a comprehensive study of tourism policies, in light of its importance for exports and job creation. It will identify inter alia the various obstacles to expansion of the tourism sector and indicate what action is needed to remedy the situation. The terms of reference of this study will be discussed with the Bank in March 1987. It will be completed by the end of 1987 and its conclusions discussed with the Bank.

H. Monitoring of Progress

24. It goes without saying that the Tunisian authorities will carefully monitor implementation of the program set forth above; they will submit a progress report to the Bank every six months.

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