The Association Agreement Between Tunisia and the European Union

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The Association Agreement between Tunisia and the European Union provides for extensive trade liberalization and enhanced cooperation in many areas. It offers Tunisia an opportunity to build on the economic progress already made and to further strengthen relations with its most important trading partner.

FOR CENTURIES, Tunisia's location has made it a natural intermediary between the Middle East and Europe, which remains Tunisia's main economic partner. In recent years, Europe has accounted for about 80 percent of Tunisia's exports and 70 percent of its imports, and European tourists and investors have contributed 90 percent of both tourism receipts and foreign direct investments in Tunisia (see chart). Nearly 80 percent of the 600,000 Tunisian migrant workers live in the European Union (EU), and their remittances provide annual foreign exchange inflows equivalent to 3–4 percent of Tunisia's GDP.

During the past decade, Tunisia has adopted an economic reform strategy aimed at establishing a market-based and private-sector-driven economy that is increasingly open to world goods and capital markets. A gradual liberalization of Tunisia's trade was launched in the mid-1980s. This was complemented by liberalization of the exchange system, which culminated in 1993 in the establishment of current account convertibility and the adoption of the obligations under Article VIII of the International Monetary Fund's Articles of Agreement. Tunisia became a full member of the General Agreement on Tariffs and Trade (GATT) in 1990 and is a founding member of the World Trade Organization.

The opening of Tunisia's economy was reflected in its growing integration into the world economy. Led by the rapid growth of its non-energy exports (see table), particularly in the textile sector, Tunisia's export share in its traditional markets (mainly Europe) increased steadily during 1985–95, and the share of exports of goods and nonfactor services in its GDP trended upward, to an average of 41 percent during 1991–95 from 35 percent during 1982–85.

In an effort to further deepen its economic and financial relations with Europe, in mid-1995 Tunisia concluded an Association Agreement with the EU. The Agreement provides for a far-reaching liberalization of trade relations, enhanced financial and technical cooperation, and close collaboration in many areas, including cultural and political matters.

For the EU, the agreement with Tunisia is part of a broader strategy aimed at deepening the EU's relations with its southern neighbors, with the objective of building a Euro-Mediterranean Economic Area. (See the article by Nsouli and others in this issue.) Agreements were recently concluded with Israel and Morocco, and others are under negotiation with other Mediterranean countries, including Egypt, Jordan, and Lebanon.

Provisions of the Agreement

The Agreement phases in free trade in industrial goods over 12 years. Under the previous trade and cooperation agreements, in effect since 1976, nearly all of Tunisia's industrial exports had free access to EU markets. (The main exemption was for certain textiles, for which a voluntary export restraint was, however, rarely binding.) Under the new Agreement, this preferential access will be preserved and extended to textiles, while Tunisia will dismantle, over 12 years, all tariff and nontariff barriers to industrial imports from the EU, subject to a number of safeguard provisions. Quantitative restrictions and tariffs on a large number of items—mainly equipment goods—will be abolished immediately after the Agreement comes into effect; for other categories of products, tariffs will be phased out over a 12-year period, although tariffs may be maintained proportional to the content of nonliberalized agricultural inputs (the "agricultural element") in certain goods.

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Comprehensive trade liberalization is not envisaged for agriculture, but the Agreement provides that the EU and Tunisia will review the trade regime for agriculture in the year 2000. For specific agricultural products, the Agreement consolidates, and in some cases improves, the existing preferential mutual access.

The Agreement goes well beyond the existing framework of cooperation by calling for a comprehensive harmonization of the regulatory framework, with a view to phasing out any practices that distort trade between the partners, such as monopolies, government subsidies, or privileges granted to public enterprises. Economic and financial cooperation is to be strengthened, particularly to support industries that will face difficulties in adjusting to the envisaged trade liberalization, promote intra-Maghreb regional integration, and enhance environmental protection. The Agreement calls for the harmonization of norms and standards (in transport, telecommunications, etc.), and of regulations and rules concerning accounting and financial services, statistics, and customs. Financial support for Tunisia's adjustment and development efforts will be provided from EU resources under the EU's Mediterranean Initiative.

In the social sphere, the Agreement calls for a dialogue on social questions and identifies priority areas for active cooperation, such as reducing immigration into Europe through regionally targeted development support for Tunisia, efforts to reintegrate illegal immigrants into their country of origin, promotion of the role of women in development, and the strengthening of basic social services, especially for women and children. The Agreement also consolidates the existing rights and obligations of expatriate workers.

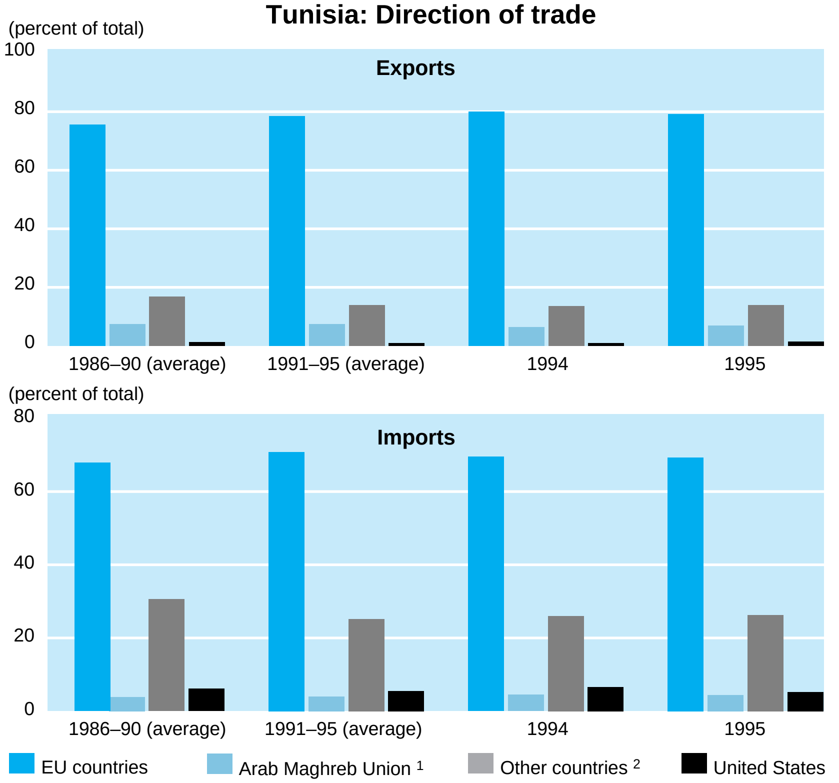
Impact of the Agreement

The Agreement will be an important step toward the integration of the Tunisian economy into the EU and the world economy as a whole. It is thus a logical extension of a decade of economic reforms that have helped diversify the economy, reduce domestic and external imbalances, liberalize trade and incentives, and strengthen the financial system.

Nonetheless, a number of weaknesses remain in Tunisia's economy. In particular, effective protection remains high in a number of sectors (e.g., textiles), and domestic industries, composed mostly of family-owned small and medium-sized enterprises, remain fragile and overly dependent on trade protection and government support. Moreover, although labor costs are relatively low in Tunisia, the lack of adequate infrastructure, the high energy costs, the shortage of industrial land, and the distortions related to both remaining price controls and cumbersome administrative regulations all hinder competitiveness. Support provided by the European Union, in accordance with the Agreement, is expected to encourage the Tunisian authorities to undertake the reforms needed to address these problems.

The Agreement is likely to have a profound impact on the Tunisian economy, although both the sectoral changes it is likely to produce and their precise timing are difficult to predict. Over the long run, gains in growth and employment from the Agreement should be derived from the reallocation of factors of production toward sectors where Tunisia has a comparative advantage and from the economies of scale associated with Tunisia's integration into a larger market. The size of such welfare gains will depend on the pace at which labor and capital are redeployed, as well as on the extent of trade creation or trade diversion, and thus on the extent of any concomitant liberalization of imports from non-EU countries. Tunisia could experience greater gains if its agricultural products obtained better access to European markets

Tunisia: Direction of trade



Source: International Monetary Fund, *Direction of Trade Statistics*, various issues.
[1] Members are Algeria, Libya, Mauritania, Morocco, and Tunisia.
[2] Includes the United States.

Tunisia: Economic indicators 1985Ð95

	1985Ð90 average	1991Ð95 average	1994	1995
	(percentage change)			
Real GDP	2.8	4.2	3.4	3.5
Inflation	7.2	5.6	4.7	6.2
Non-energy export growth (volume)	13.0	6.7	20.8	2.9
Current account deficit (percent of GDP)	-3.3	-5.1	-2.9	-3.7

Sources: Data provided by the Tunisian authorities and International Monetary Fund staff estimates.

during the transition period. A study commissioned by Tunisia's Ministry of International Cooperation and Foreign Investment finds permanent gains of 1.4 percent of GDP per year in the long run (when all factors of production are reallocated) and larger gains if liberalization is extended to non-EU imports. In the short run—when labor, but not capital, could be reallocated—gains are estimated to be negligible.

Dynamic gains may result from both the creation of greater productive capacity and productivity growth. Investment, including foreign direct investment, should increase on account of the reduction in uncertainty implied by the adoption of EU standards and regulations, the perceived "locking in" of reforms by the Agreement, and the likely acceleration of Tunisia's move to a fully market-based and open economy. The Agreement would thus enhance existing investment incentives, such as Tunisia's relatively low labor costs and its proximity to European markets. The experiences of Portugal and Spain, which attracted large inflows of foreign direct investment following their entry into the European Community, provide support for this conjecture. Other influences, however, may tend to slow capital inflows. For example, the Agreement might tilt incentives toward investing in Europe rather than in Tunisia through the "hub-spoke effect," since investors choosing Europe as a production location would gain additional export access to the Tunisian market, while firms producing in Tunisia would gain only limited additional access to European and world markets.

Productivity growth may be boosted by the erosion of domestic monopolistic rents, and the increased openness of the economy may speed up the economy's absorption of best practices and technologies from abroad, thereby raising Tunisia's long-run growth rate. In addition to trade liberalization, the envisaged adoption of common standards and the upgrading of telecommunications and transport facilities are likely to result in better access and prices for Tunisian exports and, thus, additional long-run economic gains.

Employment creation may also increase in line with Tunisia's comparative advantage in labor-intensive sectors. Reallocation of labor and capital toward these sectors of comparative advantage could entail transitional unemployment, however, since some existing enterprises in the manufacturing sector could disappear through liquidation or mergers, while others could survive only after undergoing strong adjustment.

The Agreement will have a significant fiscal impact, resulting from the elimination of import duties. The loss of tax revenue from import duties, which currently account for about a fifth of total tax revenue, is estimated to reach 3.5 percent of GDP at the end of the 12-year period, and would be even greater if tariffs on imports from non-EU countries were also dismantled. To the extent that the Agreement will result in faster economic growth, these losses may be partially offset by higher revenues from domestic taxes. Nonetheless, considerable efforts will be required to shift the tax burden to domestic sources, especially in view of the possible transitional weakening of the industrial sector. A combination of revenue and expenditure measures may be necessary to avoid a deterioration of the fiscal situation.

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As to the impact on savings, investment, and the balance of payments, the Agreement is likely to result, at least initially, in lower savings and higher investment, and thus a widening of the trade and external current account deficits. The dismantling of quantitative restrictions and tariffs may stimulate private consumption by making a wider range of consumer goods available, while investment could increase as a result of higher private capital inflows and of efforts to expand or upgrade production capacity. Furthermore, sizable investments in infrastructure will be needed over the medium term to improve the business environment and help attract larger flows of foreign direct investment.

The likely initial deterioration of the external current account will reflect an acceleration of import growth, driven by substitution effects and the increase in overall investment. Since Tunisia gains little additional access for its exports, except for a few agricultural items, the expected growth of exports will result mostly from a reallocation of resources from import-substituting production into export industries, increased investment in these industries, and productivity gains. Over the medium term, however, this could be reversed as increased competition and other effects of the Agreement stimulate faster productivity gains in the tradable goods sectors.

Conclusions

Implementation of the Agreement will imply adoption of a broad agenda for modernization and structural reforms, to facilitate the reallocation of resources to sectors enjoying comparative advantages, and to contain the transitional costs in the coming years. The industrial restructuring *(mise à niveau)* program, which is being implemented with assistance from the EU and the World Bank at a total cost of $2.5 billion during 1996–2000, should help Tunisia's private industry prepare itself for increased competition. On a more global level, greater discipline in the conduct of macroeconomic policies will be a crucial determinant of Tunisia's success in reaping the full benefits of the Agreement. Fiscal consolidation and prudent monetary policies aimed at lowering inflation to European levels, together with an adequate exchange rate policy, would help preserve financial stability and attract private capital inflows. At the same time, prudent incomes policies are needed to help keep costs under control and strengthen Tunisia's competitiveness.

Greater integration into the world economy through trade liberalization should go hand in hand with greater integration into global financial markets, including moving toward full convertibility of the dinar. Increased competition among banks, and further progress toward more market determination of the allocation of credit and interest rates will facilitate the adjustment and reallocation of labor and capital. Stock market reform has already laid the basis for growing market capitalization, and—in the context of the overall modernization of the industrial sector and the privatization of public enterprises—a greater reliance on equity financing is likely to emerge. An acceleration of the privatization program and a further liberalization of foreign portfolio investment and other capital transactions would enhance the role of the bourse and of Tunisia as an emerging market. F&D