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## African Trade Policy Centre

# Ten Years after Implementing the Barcelona Process in Tunisia: What we can learn from the Tunisian experience

By

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## Abstract

January 1, 2007 marks the eleventh anniversary of the Tunisia-E.U. Free Trade Agreement (FTA). In its short life, this agreement has instigated major changes in the Tunisian economy and has significant consequences on the conduct of Tunisian and international trade policy.

Our preliminary assessment of the impact of this agreement on the Tunisian economy shows that contrary to expectations, the structure of Tunisian imports of manufactures does not change much. Additionally, our assessment shows that trade diversion was limited to products of the first list of tariff dismantling. This is explained by the depreciation of US dollar compared to the Euro, the emergence of China and other countries in the world market, and the reform of Tunisian fiscal policy since the implementation of the agreement. In addition, the FTA was not translated in the development of a new growth regime based on a new productive sectors but it only helped the existing growth regime based on labor intensive to be more efficient. However, growth accounting analysis shows that the contribution of TFP to total economic growth is improved in the post-reform period, which indicates that the country benefited from technological transfers. Simultaneously, FDI increased since Tunisia started the liberalization of services and the country succeeded in implementing fiscal reforms by reducing over-dependence of the government's budget on tariff revenues.

# Table of Contents

- I. Introduction ..... 1
- II. The Free Trade Agreement between Tunisia and the European Union: Contents and Implementation ..... 3
- III. Literature review and lessons from past experiences on the effects of North-South Free Trade Agreements ..... 9
- IV. Assessment of the FTA between Tunisia and the European Union..... 13
- V. Conclusion ..... 26
- References ..... 27

# I. Introduction

Regional Trade Agreements (RTAs) have grown dramatically in number and importance since the early 1990's. In the last ten years, almost 200 RTAs have been notified to the World Trade Organization (WTO). Thirty-three new agreements have been notified in 2004 alone, and 20 more in the first six months of 2005. This steady growth of regional trade agreements is not expected to slow down in the near future; taking into account RTAs currently under negotiation or not yet ratified, the number of notified RTAs into force is expected to grow from 139 (July 2005) to 300 in 2008.

January 1, 2007, marked the eleventh anniversary of the Tunisia-E.U. Free Trade Agreement (FTA). In its short life, this agreement has instigated major changes in the Tunisian economy and has had significant consequences on the conduct of Tunisian and international trade policy. It now seems appropriate to ask: Has the FTA delivered what it has promised? This agreement is part of a package of economic and trade reforms implemented in the country since the mid-1980s after decades of heavy state control and intervention in the economy. In 1990, Tunisia acceded to the General Agreement on Tariffs and Trade (GATT) and became a member of the WTO on March 1995. In 1996 Tunisia began dismantling tariffs on industrial imports originating from the European Union, two years before being ratified by members of the EU in 1998. The aim of this agreement is to remove tariff and other trade barriers on a very large variety of goods by 2008. In conjunction with the Association Agreement, the EU is assisting the Tunisian government in implementing the upgrading (Mise A Niveau) program to enhance the productivity of Tunisian businesses and prepare the Tunisian economy to face competition in the global market.

It is obviously clear that the economic policy context of the late 1990s is much different than that of the early 1980s, when initial interest emerged within Tunisia's policymaking for negotiating freer trade with the EU. A fair assessment of the FTA requires consideration of this context and the goals Tunisia established for its experiment in regional integration. Accordingly, and in order to match with this new orientation of its economic policy, Tunisia has initiated a comprehensive reform program aimed at laying the foundations for a diversified and competitive economy by adapting to the new international environment on one side and cushioning the expected adjustment costs related to trade liberalization on the other side. These basic reforms, which aim at eliminating market inefficiencies and reducing state intervention in competitive activities, has affected prices, the degree of competition, taxes and public finances, the investment incentive system, the financial sector, as well as the restructuring of public enterprises through the implementation of a major program of privatization and administrative reform. At the same time, special attention has been paid to upgrading human resource to improve productivity, a necessary element for the success of the reform program.

Ten years following the implementation of the Euro-Med agreement in Tunisia, our preliminary assessment of the impact of this agreement on the Tunisian economy shows that contrary to expectations, the structure of Tunisian imports of manufactures did not in fact change significantly. Furthermore, the expected trade diversion effect, always linked to preferential agreements, was not realized. Data shows that origin of imports is not only determined by tariff structure by partner, given that many other factors can play an equally critical role in impacting the source of trade. This covers changes in relative exchange rate and overall competitiveness of trade partners. The positive aspects of the agreement cover a more sound fiscal policy, an improvement in the business atmosphere through harmonization of standards, and a higher level of national competitiveness. Overall our analysis show that the FTA did not help the Tunisian economy to implement a new economic regime based on new activities and new technologies but only helped in improving the efficiency of the existing one.

This paper is structured in the following way. The second section presents the different trade commitments undertaken by Tunisia under the Euro-Med partnership as well as the level of implementation of these commitments. The third section describes the expected effects of the Euro-Med partnership on the Tunisian economy. The description is based on theoretical analysis as well as on lessons drawn from past experiences of north-south integration. The fourth section analyses the effect of the agreement on the Tunisian economy. This analysis includes effects on growth and growth composition, productivity changes and sectoral contribution to growth, public finances, trade creation and trade diversion and FDI. The last section concludes.

## II. The Free Trade Agreement between Tunisia and the European Union: Contents and Implementation

### 2.1 Trade Provisions of the Agreement

Tunisia is one of the EU's most established trading partners in the Mediterranean region. With a total value of €13.4 billion in 2003, Tunisia ranks as the EU's 30th trade partner. The EU is Tunisia's biggest trade partner. In 2003, it accounted for 79.2% of Tunisia's exports and 73.7% of its imports. The EU initiated during the Barcelona conference in 1995, a multifaceted attempt to regionally integrate the two shores of the Mediterranean, to create a Euro-Med area that seeks to promote peace, stability and security. It is in this context that the EU has proposed a new mode of association with 10 Mediterranean countries. The Barcelona Process extends free trade across the Mediterranean region through a network of bilateral agreements between the EU and individual Mediterranean partners. This involves reciprocal liberalization on industrial products, and gradual, reciprocal liberalization in agricultural and fisheries products. Tunisia was the first Mediterranean country to sign an association agreement with the EU, in July 1995. Besides working to foster greater overall stability in the region, the Association Agreement represents a key step in advancing bilaterally towards the eventual goal of establishing a Euro-Mediterranean Free Trade Area between the EU and all its 10 Mediterranean partners.

Trade provisions of the agreement confirm the existence of free trade in manufactured goods and seek to reinforce it by initiating a dialogue in a number of related areas. Notably, these include provisions for the freedom of establishment, free movement of capital, trade facilitation and the approximation of legislation. The Agreement phases 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 the EU markets. The main exemption was for some textiles, for which a voluntary export restraint was implemented though was rarely binding. Under the new agreement, this privileged access is kept and extended to textiles, while Tunisia is committed to dismantle, over a 12 year period, all tariff and non-tariff barriers, against 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, are abolished immediately after the enforcing the agreement. In regard to other categories of products, tariffs will be phased out over a 12-year period. Regarding tariff reductions, the agreement fixes four lists of industrial products, where reductions will be achieved during a specific period (Table 1). The first list includes equipment goods and inputs for which import duties are already removed immediately in the first year of implementation of the agreement (January 1996). Imports of goods corresponding to this list amounted to 12% of the total industrial imports from the European Union in 1994. The second list essentially covers raw materials and intermediate goods, none produced locally, and they represent 28% of total imports of industrial goods from the European Union in 1994. For this list, duties are already removed gradually

over a period of five years starting from the first year of implementation of the agreement. Duties on imports of goods classified under this list were completely removed in December 2000. Concerning list 3, which covers goods that competed with domestic production, tariff reduction was planned over the whole period of implementation of the agreement (12 years). Currently, tariffs on products of this list are reduced by 92% from their initial levels before the agreement. This list covered 30% of total industrial imports from the European Union in 1994. Finally, the fourth list covers industrial products that are deemed highly vulnerable to foreign competition and for which tariff reduction was planned over the last 8 years of implementation of the agreement. This list covered about 29% of total Tunisian imports of industrial products from the European Union in 1994. A final list, or negative list, contains all other products not covered by the four lists of reduction.

**Table 1: Tariff Dismantling Schedule (in % of initial rates)**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
List 1	100	0	0	0	0	0	0	0	0	0	0	0	0	0
List 2	100	85	70	55	40	25	0	0	0	0	0	0	0	0
List 3	100	92	84	76	68	60	52	44	36	28	20	12	4	0
List 4	100	100	100	100	100	88	77	66	55	44	33	22	11	0

Source: Tunisian Ministry of Trade

Concerning agricultural trade, progressive and reciprocal liberalization in areas of mutual interest are already underway. In December 2000, the EU and Tunisia agreed on measures to further liberalize trade in agricultural products starting from January 2001 with the conclusion of a transitory agreement on trade in agricultural products. Tunisia has acquired better access to the EU market for many products due to an increase in the annual tariff quota provided by the EU to many Tunisian agricultural exports (such as olive oils, cut flowers, tomato concentrate, and oranges). On the other side, the EU has obtained improved access for vegetable oils and wheat under the preferential quotas set by Tunisia in the context of its commitments in the GATT agreement. Further liberalization of agricultural trade is being negotiated in the context of the on-going Doha Development Agenda of the WTO.

The Agreement also covers the right of establishment, the liberalization of services, and an effective protection of intellectual and commercial property rights. The Agreement goes well beyond the existing framework of cooperation by calling for a comprehensive harmonization of the regulatory framework, with a plan to phase out any practices that distort trade between trade 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, to promote intra-Maghreb regional integration, and to enhance environmental protection. The Agreement calls for the harmonization of norms and standards (in transport, telecommunications, etc.), and for regulations and rules concerning accounting and financial

services, statistics, and customs. Financial support for Tunisia's adjustment and development efforts is also envisaged.

Regarding trade in services, the commitments under the FTA with the European Union go hand in hand with the multilateral commitments under the GATS agreement. Accordingly, the World Bank (2004) claims that liberalization of trade in services is the most difficult task in the agreement for two main reasons. The first reason is that State monopolies are much more prevalent in services markets in Tunisia and as a consequence it is more complicated to remove barriers in the corresponding sectors. The second reason comes from the fact that Tunisia's commitments under the GATS are limited to only three sectors (tourism, financial services, and communications). There are no commitments in the other key services sectors, such as transport and distribution (c.f. Table 2).

**Table 2: Market Access Commitments in Tunisia by sector and GATS compared to other countries**

	Business services	Communications Services	Construction and related engineering services	Distribution services	Educational services	Environmental services	Financial services	Health related and social services	Tourism and travel related services	Recreational, cultural sporting services	Transport services	Other services not included elsewhere	Total commitments
Turkey	X	X	X				X	X	X	X	X	X	9
Morocco	X	X	X			X	X		X		X		7
Romania	X	X	X	X		X			X		X		8
Poland	X	X	X	X	X	X	X				X		10
Tunisia		X					X		X				3

Source: World Bank (2004)

The agreement also introduces financial support to Tunisia coupled with a follow-up mechanism. Financial co-operation with Tunisia takes place through the MEDA program. Between 1996 and 1999, under MEDA I, the co-operation focused on economic transition, reform and socio-economic balance,

with mainly two structural adjustment facilities and several technical assistance programs to strengthen private sector development. The funds committed in this period amounted to around € 428 million. In this context, the European Union is one of the main donors for the upgrading program (Mise a Niveau) implemented by Tunisia to enhance the productivity of domestic firms. MEDA II, which covers the period 2000-2006, is supporting the implementation of the association agreement in order to achieve the following objectives:

- Follow-up and implementation of the tariff dismantling envisaged in the association agreement for industrial products,
- Negotiations for the liberalization of trade in services,
- Trade related technical assistance, and
- Rules of origin and the accession of Tunisia to the pan-European system of accumulation.

## **2.2 Progress in implementing the association agreement**

Tunisia is making considerable progress in dismantling tariffs in the context of the Association Agreement with the EU. The implementation of the tariff-dismantling schedule under the FTA with the EU is on track. Around 55% of tariff reductions are already in place. Tariffs were totally removed for capital goods in 1996. Similarly, tariffs on raw materials and intermediate goods (list 2) have been totally dismantled since January 2000. Imports duties on the third and fourth lists have been cut by about 88% and 78% respectively by the beginning of 2006. This liberalization excludes agricultural goods as well as the agricultural components of processed food. While duties on imports originating from the EU were reduced as scheduled in the agreement, imports for some products remain subject to import licenses or quotas or also to monopoly, especially consumer goods that compete with domestic manufactured goods, such as textiles. For these products, imports are still subject to license delivered by the Ministry of Commerce specifying the product, the quantity and their corresponding amount of foreign exchange. For other goods, such as “popular” cars, imports by local distributors remain subject to a yearly quota fixed by the Ministry of Commerce for each category of cars. Additionally, imports of several other goods, such as oil products, drugs, cereals, seed oils, tobacco, alcohols, coffee, sugar, and tea, remain monopolized by state trading boards or public enterprises. This category of imports covers about 15 percent of the total import bill in 2004. Moreover, and despite the law on customs valuation adopted in 2003 for the calculation of customs taxes, which is based on the custom declarations with the necessary justifications, the Tunisian customs continues to use reference prices mostly fixed at high levels in order to compensate the loss of protection linked to the customs dismantlement process. The use of these reference prices has been highly reinforced since 2004.

For agricultural and fisheries products, a special treatment is implanted in the Euro-Tunisian agreement. Under this treatment, Tunisia granted new concessions to EU agricultural products, but with many constraining rules in certain cases. These concessions could be classified in 5 groups:

- Products that are exported in Tunisia free of tariffs, without any quantitative restriction and without any limitation of export calendar.
- Products that are exported in Tunisia free of tariffs, but with limitations in terms of quantities and calendar,
- Products that benefit from a zero tariff for a defined quota and a reduced tariff for the quantities exceeding the quota,
- Products that benefit from a zero tariff for a defined quota and a normal tariff for the quantities exceeding the quota,
- Products that benefit from a reduced tariff without any limitations of season or quantity.

Regarding trade in services, Tunisia delayed implementing its financial and communications services, surpassing the periods stipulated in the WTO agreements. Hence, this delay in making reforms in the communication and information sector is one of the main reasons behind the weak progress realized in this field in Tunisia. “Tunisie Télécom”, the public operator has been partially privatized and brought by a foreign consortium. This enterprise holds the monopoly of the fixed telephone and still managed under the supervision of the Ministry of Telecommunications. The granting of a second license to a private cellular telephone company abated shortage in services. However, it took more time than the commitment of Tunisia, vis-à-vis the WTO agreement on telecommunications in 1997.

The Tunisian financial system is dominated by commercial banks, which hold two thirds of total financial assets. State intervention is still preponderant since the State owns the three main banks of the country: the “Société Tunisienne de Banques (STB)”, the “Banque Nationale Agricole (BNA)” and the “Banque de l’Habitat (BH)”. The State holds 46% of banks’ total capital, which is high share, in spite if this share dropping by 4% in 2002 when the State transferred its shares in the “Union Internationale des Banques (UIB)” to the foreign bank, Société Générale. Foreign participation in the Tunisian banking system is weak, even in comparison with other MENA countries. It increased recently with the acquisition of the two public banks by foreign financial institutions (UIB and Banque du Sud). Generally, and since the mid-1990s, significant reforms have been undertaken to restructure the Tunisian banking sector that has been characterized by a weak appreciation of risks associated with its loans activity, which led to an excessive volume of doubtful loans. While many financial operations are liberalized since the beginning of the 1990s, the central bank of Tunisia still plays a dominant role in regulating the financial sector. Banks are still not allowed to diversify their services and are only allowed to provide services permitted by the central bank, which reduce the degree of dynamism in the financial market and the development of new services.

The most significant progress in terms of services liberalization has been realized in tourism and its related transport activities. Foreign hotel companies have been authorized to invest in Tunisia. Their involvement consists either of managing local hotels, acquiring Tunisian hotel units or building new hotels. The low price charter transport has been liberalized through the creation of new local companies and through

opening the sector to foreign companies. Despite this declared determination to open the tourism sector to foreign operators, the implementation of big international hotel chains is too weak and limited to some unities that already exist in Tunisia. Concerning the sector of air transport, it is rather a question of rent sharing between the national air company and some private companies, rather than an opening of the sector to local and foreign private competition.

As far as concessions granted by the EU to Tunisia, they allow Tunisian fishing exporters to sell freely in the European market, except sardine preparations where the EU has fixed a small quota. The agreement also grants Tunisian agricultural exports zero tariff quotas for certain products without calendar limitations, and for others with an extended period of export. The additional protocol entered into effect in January 2001, stipulates a 3% annual increase of quotas from 2002 to 2005 with higher quotas for some products (such as olive oil or processed tomatoes) and fixes a new date for further liberalization talks (January 2006).

### III. Literature review and lessons from past experiences on the effects of North-South Free Trade Agreements

#### 3.1 The Effects of North-South Integration.

Generally, free trade areas are considered the most widespread modes of regional integration in the world and the closest to full integration. Many countries have entered into trade negotiations, aimed at establishing free trade areas, or restoring and extending previous trade and economic agreements. In signing the GATT agreement in Marrakech that proved to have had a high impact on the promotion of regional integration, by introducing progressive freedom in world trade. In this respect, it led many countries to resort to regional integration agreements in the form of free trade areas, to alleviate the drawbacks, resulting from the liberation of world trade, such as the loss of their traditional markets. However, in spite of the continued increase in the number of FTAs, whether in the form of south-south, north-north, or north-south integration, other forms are still prevalent. Rather, other forms of regional integration include custom unions, common market and monetary unions. In fact, common market agreements provide the closest model to comprehensive economic integration (Chemingui and Colton, 2005).

Since the evaluation of the effects, which are brought about by the creation of free trade areas, is one of the main issues, typically raised before, in the middle, and after any agreement of regional integration, this part of the paper examines the main predicted effects of establishing a free trade area between developed and developing countries. The evaluation will be based on economic theory, which is relevant to regional integration and free trade. As for the second section of this part, it draws particular lessons from establishing free trade areas, with reference to the experiences of other pioneering countries in the implementation of such agreements.

As underlined by Lawrence (1996), the motives behind the recent integration agreements differ radically from those at the origin of regionalism. In fact, contrary to the agreements of the 1930's, 1950's, and 1960's, recent agreements are aimed at providing their members with better participation in the world economy. The recent commitments of developing countries to FTAs indicate that these countries are willing to adopt a strategy of opening their economies in order to promote exports and attract FDI, rather than substitute imports with over-protected, and often unprofitable, local production. Through regional integration, less developed countries are attempting to become more attractive to the exporting enterprises of their partner countries.

There are many reasons why it is beneficial to base foreign exporting firms in developing countries. Some of these include the: 1) creation of jobs, 2) transfer of technology and knowledge, 3) improvement

of the equilibrium rate of the balance of payment, and 4) development of downstream and upstream activities.

For more developed countries, the creation of an FTA area with less developed countries has always been an attempt to improve the competitiveness of some activities by taking advantage of low wages and fiscal exemptions, as well as other incentives. The establishment of NAFTA, for example, was mainly motivated by large US companies, especially firms with high labor costs, which believed that the establishment of a FTA with Mexico would eventually provide them with a competitive advantage. Such a redeployment of activities could not occur if tariffs and non-tariff barriers were in place and would affect capital flows and finished product trade. It appears that recent regional integration agreements are often motivated and defended by Big Business, usually multinational corporations, as they appear to be the main beneficiaries.

The intensification of international competition has caused the creation of many of the recent regional integration agreements. These agreements come at a time when access to new markets has become important to secure the success of companies. Economies can no longer limit their activities to the local level due to the rapid expansion of technological progress. As companies develop new technology, they rush to cover the fixed costs related to this innovation before competitors can access it. FTAs increase trade and consequently inflate profits so that companies can cover these costs.

Beyond the static effects of regional integration agreements (trade creation and trade diversion), these agreements are also likely to provoke dynamic effects. These latter effects were considered key to the success of these regional integration agreements and became the primary motivation for developing countries to create FTAs. These dynamic effects are caused by three main factors:

- Better technological expansion and the economies of scale in a local market stimulated by lower prices allow more resistance to face international competition
- Increased competition leads to more productive efficiency and better allocation of resources, and
- A more favorable climate for investment results from low equipment and intermediary consumption costs and the elimination of institutional obstacles preventing access to local markets.

The first expected dynamic effect of an FTA is an increased FDI flow. This could be very beneficial in many ways. Foreign firms bring capital into a country by taking part in privatization, by introducing technology, and by their knowledge of the markets. Thus, as was the case in Mexico, the prospect of an increase in FDI is an important reason to open their trade to the North.

The transfer of technology connected with international trade represents another dynamic aspect of regional integration agreements. Dessus and Eisenmann (2000) argue that these transfers of technology could follow various channels: the promotion of exports and imported inputs lead to a better quality of finished product and introduce know-how and direct investment is a bearer of new technologies. Ben

David and Loewy (1995) argue that an open trade regime increases welfare by leading to an optimum allocation of resources in production. The literature points to three main channels through which an open trade policy affects growth. These channels are investment, productivity, and government policy.

Trade liberalization creates open trade regimes that increase exposure to a worldwide stock of productivity enhancing knowledge, which generates growth. The main trade-related factor that can explain the increase in productivity is access to foreign intermediates and capital goods, as well as access to the world markets. Firms then have the opportunity to buy intermediate goods and equipment that allow them to improve their productivity. Djankov et al. (1997) have established a clear link between trade liberalization and productivity. Although the analysis is limited to the level of the firm, the results indicate that trade is an important source of total factor productivity (TFP) growth. The study finds that shifts in the pattern of imports of intermediate goods and the reorientation of export production towards global markets are positively correlated with TFP.

There is also an important relationship between FDI and productivity. Rutherford and Tarr (1997) attempt to estimate the impact of trade liberalization on the accumulation rate of capital using a general equilibrium model. They assume that the available capital stock of each country was optimal and chosen only for its return. Another source noted that if the return on capital increases after liberalization, then agents will be encouraged to invest until the marginal productivity of capital returns to its level prior to the reform (Dessus and Suwa 2000). This approach presented evidence that there is potential for new investments to be made given the implementation of an FTA, as long as the agreement leads to an increase in the productivity of physical capital.

### **3.2 Expected effects of the FTA between Tunisia and the European Union**

According to the previous section, the FTA between Tunisia and the European Union was expected to generate static as well as dynamic gains for the Tunisian economy. The static gains come from the removal of trade distortions, while the dynamic gains will be generated through more efficient trade with the European Union. The agreement should also improve the investment climate for both domestic and foreign investors through better access of Tunisian exports to the European market and through the reinforcement of the credibility of economic reforms implemented by Tunisia. Implementation of the agreement will also carry transaction costs that will be partially compensated through an increasing financial assistance from the European Union. Transaction costs concern the loss of import duties from European exporters in addition to the losses in welfare associated with trade diversion. These losses could be limited through a gradual reduction of tariffs on all sources of imports. In this respect, Jbili and Enders (1996) argue that the FTA with the European Union is likely to have a profound impact on the Tunisian economy. Over the long run, gains in growth and employment should derive from the reallocation of production factors to 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.

As far as dynamic gains are concerned, they may result in the expected improvement of production capacity and productivity level. Investment, including foreign direct investment, should increase as result of the expected reduction in uncertainty implied by the adoption of EU standards and regulations, and of the likely acceleration of the Tunisian orientation towards 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. Other influences, however, may tend to slow capital inflows. The erosion of domestic monopoly rents may boost productivity growth, and the increased openness of the economy may speed up its absorption of best practices and technologies from abroad, thereby raising Tunisia's long-run growth rate. The expected upgrading of telecommunications and transport services are likely to result in better access and prices for Tunisian exports and, thus, additional long-run economic gains.

The Agreement is also expected to have a significant fiscal impact as a result of the elimination of import duties on EU imports. To the extent that the Agreement will result in faster economic growth, these losses may be partially offset by higher revenues from domestic taxes. Regarding 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 in 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 cheaper imported capital goods, higher private capital inflows and efforts to expand or upgrade production capacity. 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 stands to gain limited additional access for its exports to the EU, except for a few agricultural products, the expected growth of exports will result mostly from a reallocation of resources from import-substituting production to 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.

## IV. Assessment of the FTA between Tunisia and the European Union

While theoretical analysis shows the potential benefits that developing countries have to earn from regional integration with developed countries, experiences in many other countries show that the impact of regional integration agreements differ in many cases from theoretical expectations. The impact of the implementation of FTAs depends on many factors, such as: intensity and structure of trade flows among the partners and the level of domestic policy reforms. For these reasons, evaluating the specific effects of the experience of each country in integrating regional free trade agreements represent a learning process in the sense that some impacts attributed to these agreements are not expressly demonstrated by past experiences and are more specific to a given country.

In what follows, a preliminary assessment of the implementation of the FTA between Tunisia and the EU is conducted. This assessment becomes possible given the progress already made in the implementation of this FTA, which started in 1996, is expected to be fully implemented in 2008. However, the result of this assessment should not automatically be attributed to the FTA, as there are many other factors influencing the Tunisian economy since 1996, such as successive domestic policies reforms and the implementation of various FTA with other partners.

### 4.1 Effects on Trade: Trade Creation and Trade Diversion

Using the COMTRADE database, we classified Tunisian imports according to the four lists of tariff dismantling as defined by the FTA agreement. The database shows the value of imports by product (HS6 level) and year. The database covers the period 1991-2004. For the purpose of comparison between pre-FTA and post-FTA periods, yearly average growth rates of imports by list and major trade partners are calculated in addition to the aggregate level of imports (all products and all partners). Results are shown in table 3 below.

At the aggregate level of imports and over the period 1991-2004, total Tunisian imports of goods from all origins at current prices show an annual average growth rate of 10.4%. However, the average growth rate of total imports experienced a net difference between the pre-FTA period and the post-FTA. In fact, during the pre-FTA period, the average growth rate of total imports is 13.2%. While in the post-FTA period, this rate decreased to 8.1%. However, the decline in annual growth of imports between the two periods involves imports from both the European Union as well as the rest of the world. During the pre-FTA period, annual growth of imports from the European Union and the “Rest of the world” was respectively 12.7% and 14.8%. In the post-FTA period, growth declined for both regions reaching a mere 7.5% for imports from the European Union and 10.2% from the Rest of the World. Accordingly and at

this level of analysis, it is clear that the FTA does not create trade but in fact reduces trade. Furthermore, the analysis at the level of total imports does not show if trade diversion occurs.

**Table 3: Annual Average Growth Rate of Imports by Origin and List in % before and after dismantling process**

	EU		Non-EU		Total	
	1991 till last year before dismantling	After dismantling till 2004	1991 till last year before dismantling	After dismantling till 2004	1991 till last year before dismantling	After dismantling till 2004
<b>Imports subject to tariff dismantling</b>						
List 1	3.4	5.7	9	2.6	5.4	4.7
List 2	14.7	7.6	17.7	10.2	15.5	8.5
List 3	11.3	8.2	16	10	12	9
List 4	15.9	7.2	13.3	14	15.5	8.5
<b>Imports not subject to tariff dismantling</b>						
List 5	16.4	1	7.4	9	14.5	2.8
Total Trade	12.7	7.5	14.8	10.2	13.2	8.1

Source: Authors' computations from COMTRADE database

Similarly, the analysis at the level of the different lists shows an irregular picture about the growth of imports from the two main partners, except for the first list. In fact, for this list, the average yearly growth rate of imports from the EU increased from 3.4% for the pre-FTA period to 5.7% for the post-FTA period. At the same time, and for the same list, imports from the rest of the world experienced a decline from 9% during the pre-FTA period to only 2.6% in the post-FTA period. Accordingly, for the List 1, a part of the increase of imports from the European Union is explained by a shift of imports from the Rest of the World for the benefit of the European Union.

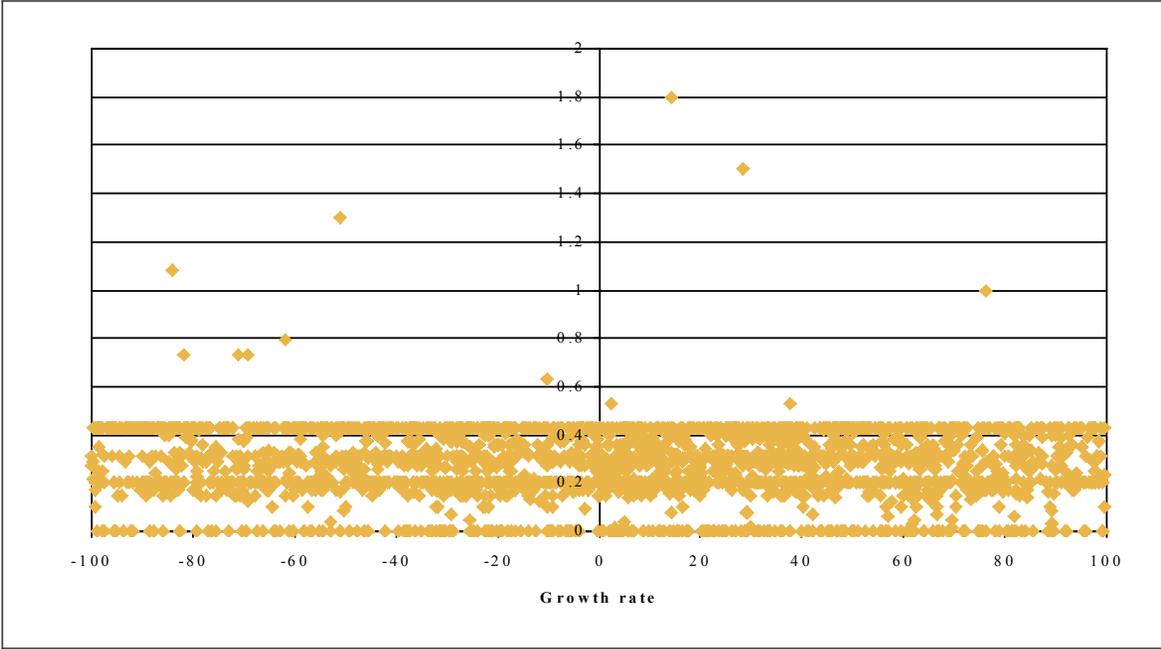
As for the three other lists of products subject to tariff dismantling, data does not show any trade diversion for the profit of the European Union, given that imports for all products under these lists coming from all origins, experienced a decline.

Although this analysis supplies a preliminary picture on the effects on trade diversion and trade creation associated with tariff dismantlement, time limits are set to the end of 2004. In fact, the post-reform period (1996-2004) only takes account of tariff dismantlement on the two first lists, whereas dismantlement on the two other lists is still in progress.

More specifically, when the relationship between initial MFN rates on Tunisian imports from the European Union and the growth rate of imports after tariff dismantling for all the 5500 products included in COMTRADE is analyzed, we found the absence of any correlation between both of them. Indeed,

figure 1 plots the average variation of imports before and after dismantling as a function of MFN applied rates. From trade liberalization, we can expect an upward tendency given that it is commonly admitted that the higher is the initial MFN rate the higher will be the tariff reduction which will induce a higher increase of imports. Nevertheless, and as shown in figure 1, this tendency is absent, which confirm our findings on the weakness of trade creation.

**Figure 1: Trend in Imports as a function of initial MFN applied rates for Tunisian Manufacturing Imports from the European Union**



Source: Authors' computations using COMTRADE (2006) and MACMAP (2001)

**4.2. Explaining the quasi-absence of trade creation and trade diversion. Two main reasons could explain the absence of trade diversion for the three lists of products subject to tariff dismantling. These include the exchange rate effect and the fiscal policy effect.**

**4.2.1 The Exchange rate effect**

Since 2001 the Tunisian nominal exchange rate was characterized by a continuous depreciation tendency against the Euro and at the same time by a sensitive appreciation against the USD. Table 4 shows that the Euro/TND ratio increased from 1.28 in 2001 to 1.61 in 2004. At the same time, the USD/TND ratio dropped from 1.439 to 1.298 during the same period.

**Table 4: Recent Trends in the Value of Tunisian Dinars in comparison with the Euro and the USD**

Currency	2001	2002	2003	2004	2005
1 dollar	1.439	1.4212	1.2877	1.2456	1.2981
1 euro	1.2877	1.3418	1.4573	1.5486	1.6126

Note: The inter-bank exchange rate

Source: Central Bank of Tunisia (2004)

Given that European products classified in List 1 and 2 are completely duty free in 2001 and by assuming their relative competitiveness against non-European products remain constant on the Tunisian market, we could expect a decrease in the share of European products in the Tunisian market as result of appreciation of the Euro vis-à-vis the USD. The exchange rate effect could then explain the drop in the European share on the Tunisian market for list 2. However, for products classified in lists 2 and 3, tariff dismantling on European products will be finalized in January 2008. Hence, their relative competitiveness against non-European products is subject to both the exchange rate effect and the tariff reduction effects. To estimate the combined effect of these two factors we compute the relative evolution of imports from the European Union in domestic currency (TNDs) of the European products in list 3 and 4 imported in Tunisia. For every product and every year, the relative evolution of the prices of European products in domestic currency can be defined by the following ratio:

$$\Delta P_{EU}^{TND}(i,t) = \left[ \frac{P_t^{EU}(i)ER_t^{EU/TND}(1+Tar_t^{EU}(i))}{P_{t-1}^{EU}(i)ER_{t-1}^{EU/TND}(1+Tar_{t-1}^{EU}(i))} \right] \left[ \frac{P_t^{Non-EU}(i)ER_t^{USD/TND}(1+Tar_t^{Non-EU}(i))}{P_{t-1}^{Non-EU}(i)ER_{t-1}^{USD/TND}(1+Tar_{t-1}^{Non-EU}(i))} \right]^{-1} \quad (1)$$

Where  $ER_t^{EU/USD}$  (resp.  $ER_t^{USD/TND}$ ) is the Euro/TND (resp. the USD\$/TND) exchange rate.  $Tar_t^{EU(i)}$  (resp.  $Tar_t^{Non-EU(i)}$ ) is the tariff applied on European (resp. non-European) product  $i$  at time  $t$ .  $P_t^{EU(i)}$

(resp.  $P_t^{\text{Non-EU}}(i)$ ) is the price of European (resp. non-European) product at factor price). If we assume the same competitiveness levels at border for products originating from the European Union and the Rest of the World and if we take into account that non-European products are not enjoying tariff reduction, this means that the same tariff level applies during all the period of analysis,  $\Delta P_{EU}^{TND}(i,t)$  can be defined as:

$$\Delta P_{EU}^{TND}(i,t) = \left[ \frac{ER_t^{EU/USD} (1 + Tar_t^{EU}(i))}{ER_{t-1}^{EU/USD} (1 + Tar_{t-1}^{EU}(i))} \right] \quad (2)$$

Where  $ER_t^{EU/USD}$  is the Euro-Dollar exchange rate at time  $t$ . We computed this index at the HS6 digit level using the MACMap database for the period 2002-2004. Table 4 displays the results of this exercise. It shows that on average, the dismantling effect is higher than the exchange effect manifested by the appreciation of the Euro vis-à-vis the USD. However, the Euro appreciation effect became higher than the dismantling effects since 2003. Accordingly, the relative price of European and non-European products increased despite the reduction of the tariffs applied on European products (cf. Table 5).

**Table 5: The Evolution of the relative price between European and Non-European Products**

	2002		2003		2004	
	Means	STD	Means	STD	Means	STD
List 3	0.944	9.365E-05	1.131	1.123E-04	1.243	1.234E-04
List 4	0.944	9.352E-05	1.131	1.122E-04	1.243	1.234E-04

Note: Standard Deviations

Source Author's computations from MACMap 2001 ITC-CEPII

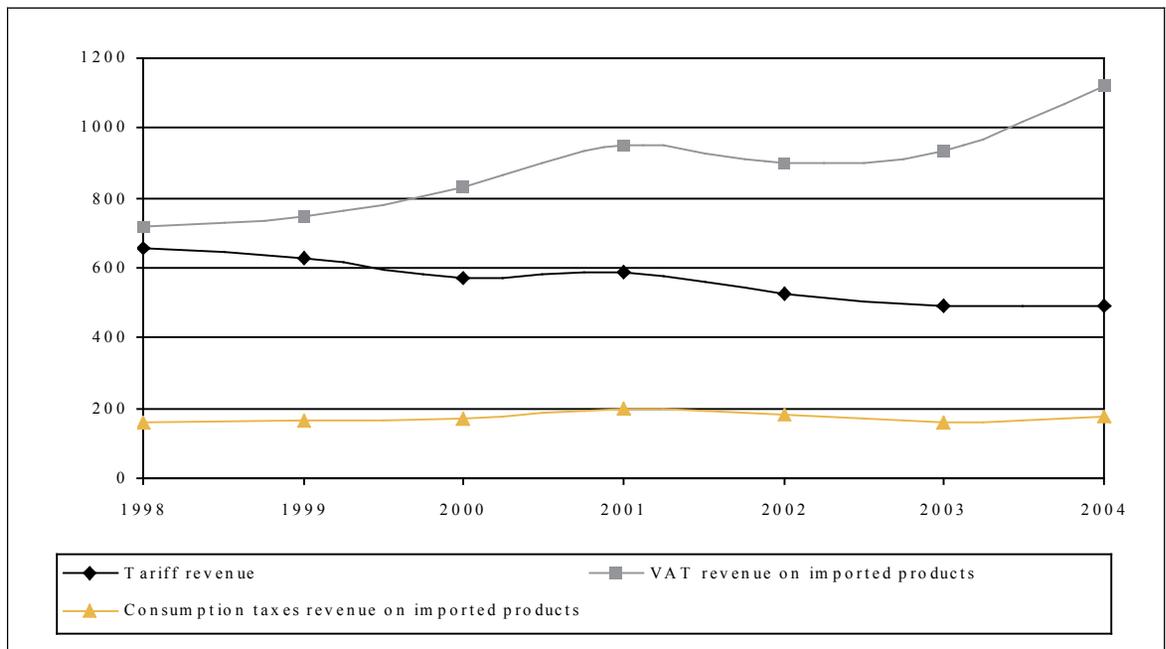
Overall, the appreciation of the European currency has reduced the trend of growth of Tunisian imports for products classified in List 2, 3 and 4. The case of products in List 1 is different given that these imports are required for the productive sectors. The increase of the domestic prices of these products is reflected in the consumer price index as a result of higher costs of production.

#### 4.2.2 Fiscal Policy Effect

Since the beginning of the implementation of the FTA between Tunisia and the European Union, the Tunisian authorities have introduced new taxes and increased the rates of others. Accordingly, the application of the value-added tax (VAT) and consumption taxes has been reinforced since 1996 for most of products covered by the FTA. Thus, for many products, consumption taxes are set at high rates (200%

for cars) for which no reduction is to be implemented given that these tariffs are theoretically applied on both domestic and imported products. For many imported products, for which there is not locally produced substitute, consumption taxes increase the level of protection. In fact, these taxes, on products and collected at the entry of the country, have almost the same distortive (or protective) effect than tariffs. Thus, Tunisian authorities have shifted border protection from using tariffs by using consumption taxes (fiscal reform is described in more details in section 5). Figure 2 shows that at the time where tariff revenue is decreasing since the implementation of the agreement, all the other indirect taxes on imported goods are decreasing.

**Figure 2: Trend on indirect taxes on imports**



Source: Authors computations from INS.

### 4.2.3 Newly Emerging trade partners

For the Tunisian economy, the FTA with Europe was in fact only one step amongst many other steps that formed the strategy for economic opening. Many other bilateral and multilateral trade agreements were signed since 1996. Tunisia has implemented the Arab Free Trade agreement in 2005. It has also signed free trade area agreements with Turkey and with EFTA in 2004. The effect of all these agreements does not appear in 2004 (year of the release of the COMTRADE database). However, all these agreements affected the structure of the Tunisian economy by reducing the share of imports from the European Union. In addition to these FTAs, and as a WTO member, Tunisia has applied MFN tariff rates to all WTO members and especially to China, who joined WTO in 2001. Table 6 shows that the market share of Chinese products has increased significantly since 2001. Accordingly, for products in lists 1 and 3, the Chinese market shares have graduated respectively from 0.6% and 0.8% to 2.3% 2%.

**Table 6: Chinese Shares in the Tunisian market**

List 1		List 2		List 3		List 4		List 5	
Before 2001	After 2001								
0.6	2.3	1	1.9	0.8	2	0.6	1.6	0.1	0.1

Source Author's computations from the COMTRADE database

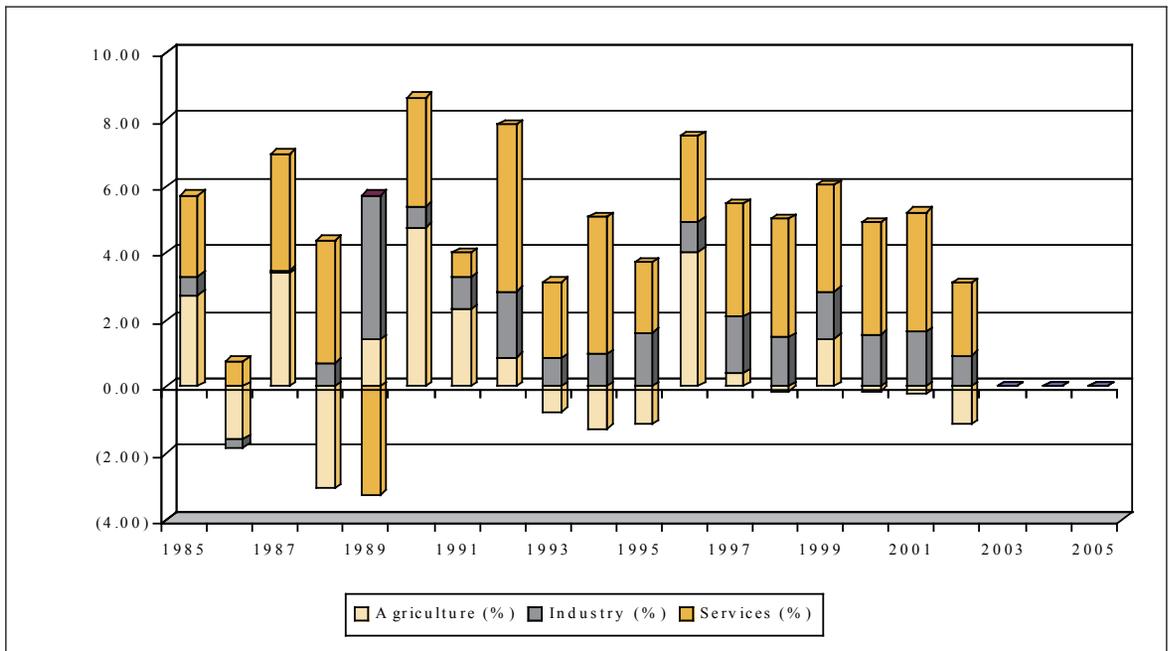
## 4.3 The Effects on Growth and Productivity.

### 4.3.1 Structure of Growth

Over the first 10-years period (1996-2005) following the implementation of tariff dismantlement, Tunisia has been able to make significant advances towards economic growth. During this period, real GDP grew at an average annual rate of 4.9% compared to an average of 3.9% per year during the pre-reform period (1990-1995). This relatively high performance in economic growth can not be attributed directly to the liberalization process, however the full dismantlement of tariffs on equipment goods and inputs could better explain part of this performance, given its direct effect on the level of competitiveness of the economy. On the other hand, the weak level of performance during the pre-reform period could explain in part the difference between the two periods. In fact, the pre-reform period witnessed the succession of years of drought as well as international political crises, mainly linked to the Iraqi situation. It is also important to point out that the post-reform period has also been marked by the events of September 11, but the amplitude of its effects on the Tunisian economy has been limited to the sectors of air transport and tourism, during a relatively short period.

Figure 3 shows that the sectoral contributions to GDP fluctuated during the whole period of the analysis. Overall and comparing pre and post liberalization periods, improvements in growth rates of sectoral GDP were observed for all the economic sectors. This shows that the trade liberalization process has been unable to accelerate the level of diversification of the economy, or even of the specialization of the country. Thus, despite this process of economic liberalization, economic growth in Tunisia continues to be sustained by two main sectors: tourism and agriculture. When these sectors realize performances, all the economy grows at a satisfying rate, but when these two sectors are in a crisis, all the economy is affected. Accordingly, explaining the relatively good performance of Tunisia in terms of growth by the liberalization process is far from being evident. Indeed, Tunisia has not been able to profit from this free trade process in order to diversify its economy. The latter remains dominated by labor-intensive activities on one hand (textiles and clothing) or by traditional activities (tourism and agriculture) on the other. Table 7 displays the trend in overall economic growth as well as the disaggregated sectoral level.

**Figure 3: Trend in sectoral contribution to growth**



Source: WDI (2006)

**Table 7: Annual Growth Rate of GDP by sector**

	1990	1995	1996	2000	2001	2002	2003	2004	1990-1995	1996-2004
Agriculture and Fishing	30.3	-9.9	29.5	-1	-2	-11	21.5	9	-1.5	3.3
Manufactured Industries	-22	9.6	2.8	6.6	6.9	1.9	0.7	4.3	5.7	4.7
Industries	2.2	5.5	3.2	5.5	5.7	3.2	0.9	4	4.4	4.3
Services	6	3.6	4.4	5.7	6	3.6	6.3	6.1	5	5.5
Real GDP	8	2.3	7.1	4.7	4.9	1.7	5.6	6	3.9	4.9

Source: WDI (2006)

### 4.3.2 Changes in sources of growth and productivity

The overall increase in factor productivity has contributed to over one-third of the growth of GDP per worker (or productivity) achieved during the post-reform period in an environment marked by control of inflation, which was reduced to only around 2.7% in 2005 (see table 7 on sources of growth) . Theoretically, if a Ramsey growth model, was considered, in the long run equilibrium, the contribution of capital deepening may be expected to decline as diminishing returns to capital deepening occurs when the country is reaching its long-term equilibrium. Labor's contribution remains almost unchanged as the productivity of labor benefits from capital deepening. Then, it may be expected that TFP's contribution will rise. Hence, improvements in the TFP cannot be even attributed to the trade liberalization process.

The growth rate of capital accumulation as well as employed labor has been almost constant throughout the three periods, leading to a constant level of growth in capital per worker (or capital deepening). In light of this trend in growth rate of capital per worker, the increase of output per worker is not surprising given the high contribution of TFP in growth.

The decomposition of economic growth between factor accumulation and productivity growth is important as the bulk of cross-country differences in growth rates of GDP or GDP per worker are not the result of factor accumulation, but of differences in TFP growth. Analyzing the role of overall productivity as a major source of output expansion is a key element of any analysis focusing on the sources of economic growth. While TFP increased at an average annual rate of 1.04 over the period 1960-2005, it increased only by 1.01 during the pre-reform period (1990-1995) and by 1.02% during the post-reform period (1996-2003). The increase in the average yearly TFP during the post-reform period has led to a decrease in the contribution of TFP to growth in labor productivity.

The distinction between technical efficiency change that arises due to variations in the method of application of inputs, and technological progress in the varying coefficient approach, offers an additional important dimension to the policy relevance of TFP . The decomposition of TFP growth into technical efficiency change and technological improvement is, therefore, useful in distinguishing innovation or adoption of new technology by “best practice” industries from the diffusion of technology. The co-existence of a high rate of technological progress and a low rate of change in technical efficiency may reflect failures in achieving technological mastery or diffusion. During the whole period of analysis (1960-2000), results of the estimation show that the average yearly change in technical efficiency was positive (1.01%). Both in the pre-reform as well as the post-reform periods, technical efficiencies were positive and growing at 1.01% and 1% per year respectively.

As far as changes in technology are concerned, it grew by 1% both over the long term and by 1.02% over the post-reform period. These results suggest that Tunisia’s economic growth during the post-reform period was attributed mainly to the growth of both technological efficiency and technology. The decomposition of TFP growth into technical efficiency change and technological improvement is, therefore, useful in distinguishing innovation or adoption of new technology by “best practice” industries from the diffusion of technology. Co-existence of a positive rate of technological progress and change in technical efficiency may reflect a success in achieving technological mastery or diffusion .

**Table 8: Contribution to Growth**

	GDP	GDP per Worker	Capital Deepening	Education augmented labor force	Factor Productivity
1966-2005	5.08	1.95	0.71	0.27	0.97
1980-1995	3.67	0.88	0.55	0.34	-0.01
1996-2005	4.8	1.89	0.78	0.45	0.66

Source: Authors’ calculations using WDI (2006) and INS (2006)

**Table 9: Change in Technical Efficiency and Technical change by economic period in Tunisia (%)**

	1960-2000	1980-1995	1996-2000
Changes in technical efficiency	1.01	1.01	1
Changes in technology	1	1	1.02
Changes in total factor productivity	1.01	1.01	1.02

Source: Authors’ calculations using estimations carried out by Isaksson (2006)

#### 4.4 Effects on foreign investments

One of the main objectives for Tunisia that have motivated the establishment of the FTA with the European Union, is to attract foreign direct investment. In addition, Tunisia launched a vast program of privatization in order to improve the participation of foreign firms in the domestic economy. This would allow the achievement of two objectives at the same time: attract foreign capital and improve the business environment by privatizing some of the largest state enterprises and giving their control to foreign groups to improve their management and ensure technology transfers. Since 1998, FDI inflows increased substantially in Tunisia mainly due to the privatization of large state firms. Total FDI inflows increased from an average value of 454 millions USD \$ per year during the period 1991-95 (2.6% of GDP) to an average of 554 millions USD \$ (2.8% of GDP) during the period 1996-2004 (Table 7).

The privatization program offers wide opportunities for foreign investors in different sectors, especially those related to infrastructure and to the manufacturing sector. Privatization was also extended to the financial and communication sectors. Overall and during the past years, privatization has significantly contributed to the increase of FDI inflows and to the compensation of FDI declines in the energy sector. Total privatization receipts exceeded 1000 Millions Dinars during the period 1996-2004. Without accounting for sales of public entities to foreign investors, FDI inflows have slightly regressed during the period 1996-2004 compared to the period 1991-1995, decreasing from a yearly average of 454 Millions USD during the period 1991-1995 to 448 millions USD \$ during the post-FTA period (1996-2004).

If we compute FDI excluding the receipts of privatization, we clearly find that Tunisia does not succeed to improve its ability to attract FDI or more specifically, new investment opportunities, mostly in the traditional sectors, as was the case in the off-shore manufacturing sector. Compared to other countries in the region, it is clear that Tunisia and Egypt are the only countries signing the FTA with Europe who experienced a decline in FDI as share of GDP (Table 10).

**Table 10: FDI Inflows to Tunisia and other MENA countries (1991-2002)**

	1991-96		97-2002		2001		2202	
	Inflows in USD Million	As % of GDP	Inflows in USD Million	As % of GDP	Inflows in USD Million	As % of GDP	Inflows in USD Million	As % of GDP
Tunisia	425	2,6	562	2,8	486	2,4	710	3,4
Egypt	714	1,4	903	1,1	510	0,6	647	0,8
Morocco	406	1,3	1242	3,6	2808	8,3	428	1,3
Jordan	4	0,1	343	8,5	100	2,3	56	1,3
Turkey	751	0,5	1302	0,8	3266	2,2	1037	0,6

Source: Chemingui and Lahouel (2005)

Data for the year 2005 show that FDI experienced a high increase in the form of new investments as well as acquisitions of public enterprises (through partial or complete privatization). Additionally, FDI in the energy sector experienced an increase compared to the previous year as a result of the government policy to increase domestic production of energy products. More recently, the year 2006 showed a new wave of FDI in the construction services. Thus, liberalization of services has increased the opportunities offered to foreign investors in the Tunisian economy by diversifying opportunities in it.

#### **4.5 Effects on public finances**

In order to assess the effect of the implementation of the free trade area with the European Union, a preliminary analysis of the structure of public revenues during the pre-reform and post-reform periods, seems very useful in order to know how Tunisia adjusts its fiscal system to compensate for losses in tariff revenues. Despite the tariff dismantling undertaken by Tunisia since 1996 under the FTA with the European Union, the share of tax revenues to GDP remains almost constant, varying between 19.9% in 1995 and 19.4% in 2004. Also, in spite of decline in tariff revenue as a percentage of GDP (from 4.5% in 1995 to 1.4% in 2004), government revenues stemming from direct taxes and other indirect taxes increased in average by 10.2% per year over the period 1995-2004. This growth in government tax revenues is mostly explained by the growth of revenues from direct taxes (13.1% average yearly increase over the period 1995-2004) and the Value Added Tax (10.6% per year between 1995 and 2004). The increase in consumption tax and other indirect taxes were less significant (7.7% and 4.2% per year respectively) during the period 1995-2004. Fiscal compensation of losses in tariff revenues are generally made through the extension of the fiscal system and a better collection rate, than through an increase of the rates of existing taxes or through the introduction of new taxes.

Given these figures, international institutions have rated fiscal adjustment in Tunisia as a success, and expectations are that future tariff reductions envisaged under the different free trade agreements will not disturb the budget balances. Furthermore, the preservation of the domestic financial balances through the control of the budget deficit, which has been limited to 3% of the GDP during the period 1997-2001 constitutes one of the main targets of the Tunisian macroeconomic policy. In fact, and in spite of the impact of the program of tariff reduction, the budget deficit is expected to continue its declining tendency according to the goals of the eleven development plans (2007-2011). Table 11 presents the recent trends in tax and public finances.

**Table 11: Tax Revenue (MD)**

	<b>1995</b>	<b>1996</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
Total Tax Revenues and its composition	3388	3597	5327	5844.5	6032.7	6230.4	6811.2
Duties and Taxes on Imports as % of total tax revenues	22.80	20.60	12.10	11.20	9.90	8.90	8.20
Value-Added Tax as % of total tax revenues	26.50	28.00	33.20	33.00	31.40	32.20	33.10
Taxes on consumption as % of total tax revenues	17.60	17.80	17.60	17.40	17.30	17.20	16.90
Other indirect taxes as % of total tax revenues	9.10	8.70	7.10	7.00	7.80	6.80	6.80
Direct Taxes as % of total tax revenues	23.90	24.80	30.00	31.30	33.60	34.90	35.00
Tariffs and Tax revenues as percentage of GDP							
Tariffs Revenue as % of GDP (%)	4.50	3.90	2.40	2.30	2.00	1.70	1.60
Total Tax Revenues as % of GDP (%)	19.90	18.90	19.80	20.30	20.10	19.10	19.70

Source: Authors' calculations using data from INS

## V. Conclusion

Since the 1970s, economic development in Tunisia was based on a combination of a led export growth labor-intensive sectors and some import substitution activities. This combination helped Tunisia in maintaining a high level of growth since the beginning of the 1970s until the mid 1980s. This policy was profoundly reformed with the adoption of the structural adjustment program and mainly in the middle of the 1990s with the progressive orientation toward more liberal economy through the conclusion of the FTA with the European Union in 1995.

Tunisia has also benefited from favorable international conditions, due notably to the restrictions imposed, by developed countries, on the imports of textile and clothing products coming from more competitive countries (such as China and India). Tunisia has also benefited from a local policy favorable to the development of the manufactured sector, which has largely contributed to the increase of exports and the reduction of unemployment. Having put stakes essentially on a single sector as a vector of industrial development, Tunisia is today facing a big challenge, namely the liberalization of international trade. With globalization, international competition has become tougher making competitiveness deficiencies more evident than in previous years.

The FTA signed between Tunisia and the European Union in 1995 that entered into effect in 1996 was seen as a vehicle for economic growth. While the literature review shows that FTA will automatically induce trade diversion, the Tunisian experience with its partnership agreement with the European Union, show that trade diversion is only limited to products of the list 1 of tariff dismantlement as results of the high depreciation of the US \$ compared to the Euro, the reform of the fiscal policy, and the emergence of other trade partners. As far as economic diversification is concerned, the FTA does not generate a sensitive re-allocation of resources and the economy is still dominated by labor-intensive activities. However, the growth accounting analysis shows that the contribution of TFP in the growth is improved in the post-reform period, which indicates that the country benefited from technological transfers. FDI increased significantly since Tunisia started the liberalization of services and the country succeed in implementing fiscal reforms by reducing the dependency of the government budget to tariff revenues. The diversification of fiscal instruments coupled with the improvement of the collection rate for the different taxes explained this success.

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