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The EU-Tunisia Deep and Comprehensive Free Trade Area (DCFTA): macroeconomic impacts and pro-developmental policy responses

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The European Union (EU) and Tunisia launched negotiations on a Deep and Comprehensive Free Trade Area (DCFTA) in 2015. So far, progress has been limited. The enhanced integration of the Tunisian economy into the EU single market involves several controversial topics. Above and beyond the elimination of tariffs in sensitive agricultural sectors, these concern in particular the liberalization of trade in services, investment and public procurement. At the same time, the negotiations take place under challenging economic, political and social circumstances within the country and the MENA region, which call for a particularly prudent approach. Our assessment of expected economic impacts points to negative GDP effects and minor employment effects in Tunisia in the short to medium term in the case of full tariff liberalization and extensive harmonisation of the regulatory frameworks. Therefore, in the negotiations, the EU should prioritize short-term benefits for the Tunisian economy, mitigate adjustments costs and pro-actively support productive development and upgrading. [1]

Ever closer EU-Tunisia trade and investment relations

As neighbours in the Mediterranean, Tunisia and the EU have long-lasting and close economic, political and social relations. These ties were already institutionalized in the 1976 Cooperation Agreement, in which the EU granted unilateral tariff preferences for most Tunisian industrial products.

In the more recent past, the EU stepped up its efforts towards closer cooperation and integration with neighbouring countries. Thus, the EU concluded an Association Agreement (AA) with Tunisia in 1995. The AA was based on three pillars: (1) reciprocal, but asymmetric, reduction of tariffs and quotas in merchandise trade, in particular in industrial goods, (2) the harmonization of Tunisia's regulatory framework including norms and standards, trade-related policies, rules on competition and intellectual property rights, and (3) enhanced cooperation on economic, social and ecological issues.

Trade relations were extended to the regional level. Tunisia is a member of the Euro-Mediterranean partnership between the EU and 11 Mediterranean countries, which aims for trade liberalization and cooperation in connection with the EU and among the non-EU members, including the establishment of coherent Rules of Origin (RoO). The EU provides political and financial assistance for Tunisia via the European Neighbourhood Policy.

Even though the EU's dominance as a destination for Tunisian exports and as a source of imports and investment has diminished in recent years, the EU remains the key partner for Tunisia. However, limited progress with respect to the harmonization of the regulatory framework in Tunisia to EU standards as well as the remaining tariffs and quota systems on agricultural products on both sides are perceived as the main obstacles to further trade and investment. With the Deep and Comprehensive Free Trade Area (DCFTA), the EU therefore has launched a comprehensive liberalization agenda focusing on the mutual elimination of tariffs and quotas, trade in services, alignment of laws and regulations as well as reduction of non-tariff barriers to trade and investment.

Key issues in the negotiations

After the start of negotiations in October 2015, only two rounds of negotiations (April 2016, May 2018) have taken place so far. The EU has presented initial texts on 15 chapters and subject matters, respectively. [2] In the following, we provide a short overview of the key areas of negotiations and the respective state of play.

Tariffs and Quotas

The EU proposes the elimination of all tariffs and quotas in the DCFTA. It should be noted, that the level of tariff and quota liberalization is already rather advanced between the EU and Tunisia. In 2016, 93.6% of the value of EU imports entered Tunisia duty free and quota free (DFQF), and 97.3% of the value of Tunisian exports enjoy DFQF access to the EU market (own calculation, based on UNCTAD TRAINS data). In total, trade weighted average duties (tariffs and quotas) amount to 1.7% in Tunisia and 0.6% in the EU.

However, certain sensitive agricultural sectors and products still enjoy substantial tariff and quota protection. This includes imports of animal and vegetable products to Tunisia, such as cereals, dairy and meat products with tariff and quota equivalents of more than 30%. In the EU, tariff rate quotas affects in particular the import of Tunisian olive oil[3]. With EU market access already widely open, the burden of a further tariff and quota liberalisation for agricultural products thus largely rests with the Tunisian side, even though Tunisia might be granted a gradual liberalisation over a ten-year implementation period (as shown also in the simulation results below).

Non-Tariff Barriers

The DCFTA will also include chapters on Technical Barriers to Trade (TBT), Sanitary and Phytosanitary Standards (SPS), customs and trade facilitation issues as well as transparency in order to enhance market access and trade between the parties. This shall be achieved by either (i) cooperation between the parties, (ii) alignment to international standards, or (iii) alignment to the EU regulatory framework. Though arguably advantageous for the Tunisian economy in the long run, the implementation of these issues will put the burden of adjustment on Tunisia, since the EU regulatory regime is either the benchmark or the EU already applies the relevant international standards.

Services and Investment

Liberalization of services targets cross-border provision of services (Mode 1) and investment (Mode 3) based on a negative list approach, and thus only excludes specified services such as audio-visual and selected air transport services. The opening of service sectors requires harmonization of sector regulations. For the DCFTA, the EU effectively demands alignment of Tunisian regulations to the EU regulatory framework in (i) computer services, (ii) postal and courier services, (iii) financial services, (iv) electronic communications, (v) international maritime transport, and (vi) tourism services. So far, the EU offer regarding Mode 4 trade in services (temporary presence of services suppliers) lacks detail and does not include independent professionals, despite the high Tunisian expectations on better access to the EU market, particularly for the ICT service providers.

The investment chapter of the DCFTA will replace the existing 17 bilateral investment treaties with EU Member States. The EU is by far the most important source of FDI, accounting for 70% of total FDI stock in Tunisia. With the current implementation of a new investment law (Loi sur l'Investissement 2016), Tunisia already expanded investors' protections, as well as investor privileges with respect to access to land and financial incentives. However, the DCFTA would enshrine this investment regime into an international legal obligation. In addition, in line with its recent policy change on investment arbitration, the EU proposes the installation of an Investment Court System to resolve investment disputes.[4]

Public Procurement

The EU proposal aims at a comprehensive opening of public procurement processes by maximizing transparency and allowing for the non-discriminatory participation in public tenders at all levels of government for both EU and Tunisian firms. The participation of EU companies in public tenders in Tunisia at a par with local companies will arguably increase competition and thus reduce costs for the public sector. However, in attracting more EU companies to compete in the Tunisian procurement market than vice versa, the effects will likely be asymmetrical. Besides, the implications of a liberalized procurement market for local economies and regional cohesion merit further attention.

Competition and State Aid

By way of extending the provisions in the 1995 Association Agreement, the EU proposes to set up independent authorities in Tunisia on competition and state aid, as well as the phasing out of privileges of Tunisian state-owned enterprises (SOEs) for instance in the extractive industries, banking and public utilities. This liberalization is demanding on the technical level as well as sensitive on the political level, given the role of SOEs for employment and economic coherence in the interior regions, specifically in the south and west of the country.

Other Issues

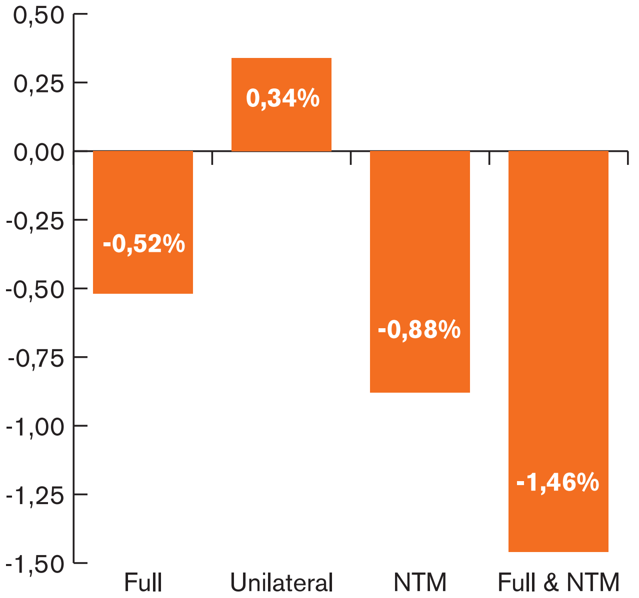
Other issues of relevance in the DCFTA negotiations include for instance disciplines on the application of trade defence instruments, limiting policy space for the trade partners, as well as potential changes to rules of origin (effects for the textile and apparel sector are discussed in detail in Grumiller 2018a, b). With further issues still being tabled in the next negotiation rounds, Tunisia faces an extensive negotiation agenda.

Estimated economic effects

Not all of the above mentioned issues can be analysed in an economic modelling exercise. Thus, the potential outcomes need to be judged in light of the current economic, social and political background and involve both quantitative and qualitative approaches. The potential effects of tariff reductions and NTM alignment on macroeconomic and sectoral variables are simulated with the ÖFSE Global Trade Model, a structuralist Computable General Equilibrium (CGE) model. We simulate four scenarios: (1) elimination of all tariffs on both sides ("Full"); (2) scenario asymmetric tariff liberalization by the EU only ("Unilateral"); (3) liberalization of NTMs ("NTM"); and (4) combination of bilateral elimination of tariffs and NTM liberalization ("Full & NTM"). With ongoing negotiations, the simulation results provide a range of potential effects based on different 'corner' negotiation solutions.

The estimated effects of trade liberalization on GDP are negative for Tunisia, when tariffs and NTMs are eliminated or lowered on the Tunisian side. Estimated effects on employment are roughly zero, due to differences in sectoral labor intensities. In these cases, negative contributions to GDP from imports exceed potential positive export and consumption effects. The impact of the DCFTA with regard to tariffs will be mainly determined by changes in the agricultural sector, where imports are still subject to significant tariffs and quotas. In the case of full tariff liberalization by the EU and Tunisia (Scenario 1 "Full"), the Tunisian sectors cereals and foods & beverages will be negatively affected by higher import competition from EU products, while only selected sectors in Tunisia (vegetable oils and vegetables/fruits) benefit slightly. Overall, real GDP in Tunisia will decline by 0.52% in the case of full tariff liberalization in both FTA partners (see Figure 1).

Figure 1: Changes in Tunisian real GDP



Source: CGE calculations

For the case of NTM trade costs, we follow a scenario design applied in the EC's Trade Sustainability Impact Assessment of the DCFTA (Ecorys 2013) in which an asymmetric reduction of trade cost equivalents of NTMs is assumed. In other words, the cost reduction associated with the harmonization of the regulatory framework for goods and services are higher for EU imports entering the Tunisian market than vice versa. This is a reasonable assumption, given that the Tunisian regulatory framework shall be aligned with the EU acquis. In the short to medium term, this higher cost reduction triggers however import competition in Tunisia with negative effects on growth and employment. Assuming further, that NTMs are rent-generating and therefore incomes of the private sector, leads to an income decline. Consequently, real GDP in Tunisia decreases by -0.88% in the "NTM"-scenario and by -1.46% in the combined scenario ("Full & NTM") (see Figure 1).

Overall, changes in imports and exports are main drivers of real GDP effects. Even though bilateral trade flows between the EU and Tunisia increase, the net trade effect is negative for Tunisia. In the combined scenario ("Full & NTM"), exports from Tunisia to the EU increase by 4.4%. Due to the dominance of exports to the EU in total exports, this lifts total exports from Tunisia by 3.1%. However, as imports from the EU to Tunisia increase by 10.6%, the result is a decline in net-exports for Tunisia. For the EU as a whole, changes in trade flows are marginal as the share of Tunisian trade in goods amounts to only 0.6% of total extra-EU trade.

Our model – in contrast to standard CGE models – shows changes in macroeconomic balances, namely the private, public and foreign balances. A full tariff liberalization leads to an increase in the public budget deficit of Tunisia of up to 1% of GDP, mainly due to the loss of tariff revenues from EU imports. Given that the budget deficit reached 6% of GDP in 2016 and 2017 and is not likely to return to balance in the near future, copying with a further increase will be challenging. Tunisia already receives macro-financial assistance from the IMF and the EU and is required to take painful steps to control the size of the deficit. In the short to medium term, trade liberalization should thus be accompanied by additional EU budget support. With respect to the long-term, EU Aid for Trade should support reforms to broaden the fiscal basis.

Difficult politico-economic conditions in Tunisia

The DCFTA negotiations coincide with a challenging period for the Tunisian economy as well as its political system. Since the Arab Spring in 2011, the country has gone through a political transition and has experienced social instability and a difficult security situation. GDP growth has slowed down significantly to around 1.2% in 2015/2016 and 2.0% in 2017, exacerbating the problems of high unemployment and the strong asymmetries in territorial economic development between the coastal and interior regions of Tunisia. The increasing deficits in the current account and the public budget finally led to macro-financial assistance by the IMF and the EU, which was associated with reforms in sensitive public sectors and liberalization programs.

After the new constitution has entered into force and the first free democratic elections in 2014, internal political stabilisation has proved complex and burdensome. A government of national unity has been formed under the leadership of the secular Nidaa Tunes party of President Beji Caid el Sebsi. The stability of the government has been disturbed by various factors, for instance by internal divisions in the largest government parties, corruption charges and the difficult economic situation. Against the background of rampant unemployment among the youth (30% among university graduates) and deep economic disparities between the rather affluent coastal and the stagnant interior regions, the liberal outlook of economic policies implemented by the government – including budget austerity and privatisations under the aegis of the IMF – has met stiff resistance from domestic stakeholders, in particular the trade unions and the younger generation.

The government has conducted public consultations on the DCFTA with employer associations, trade unions, NGOs, and academia, but has not yet presented an official comprehensive position on the negotiations. On the other hand, civil society organizations and trade unions, have been active in developing their positions regarding the agreement. In particular, the trade union federation (UGTT) and human rights organizations have voiced concerns over the potential negative social and economic effects. Thus, these actors see the DCFTA negotiations as a long-term project that needs a careful discussion and appraisal of potential benefits and costs. This process should include an independent impact assessment and full transparency in the negotiations. In the private sector, the positions vis-a-vis the agreement differ, with the agricultural sector been the most sceptical due to potential import competition after a removal of tariff barriers.

Given this panorama of conflicting views on the DCFTA, the Tunisian government will face a rather cumbersome task in forging broad support for the agreement. Nevertheless, convergence of views seems to emerge on certain substantive issues. Firstly, it is broadly shared among stakeholders that offensive interests are particularly related to RoO, certain service industries such as ICT services and the freedom of movement for natural persons (Mode 4), and secondly, that an ambitious liberalization of agriculture as well as of public procurement will be detrimental to the social and regional cohesion of the country.

Ensuring policy coherence for sustainable development is key

According to the principle of policy coherence for sustainable development, EU trade policy as well as development policy must be judged against its contribution to sustainable development as defined by the UN Agenda 2030, the latter having been adopted by the European Consensus on Development. This calls for the promotion of sustainable economic growth that is socially inclusive, respects ecological boundaries and promotes peace and democracy. Trade liberalization should thus be considered as a means to achieve these objectives. Due to different geographical conditions, economic structures, political and institutional systems, trade liberalization outcomes for individual countries differ substantially, and it must not be taken for granted that effects are exclusively beneficial, neither at the aggregate nor at the sectoral level. Given the exceptional characteristics of contemporary Tunisia, which is in the difficult and protracted process of democratic transition in a complex regional environment, the DCFTA is to be assessed in terms of its contribution to the consolidation of Tunisia as a democratic and economically prospering country in the southern neighbourhood of the EU. This calls for a particularly circumspect negotiating approach. Against this background, the proposals for the DCFTA negotiations submitted by the EU provide a number of challenges for Tunisia that deserve further scrutiny. The EU should pay particular attention to the following six issues:

1. Cater to the short-term needs of particular export sectors of the Tunisian economy: this will involve addressing three core problems in the negotiations: (i) increasing market access for Tunisian apparel exporters via a simplification of RoO. Ideally, the EU grants single transformation to apparel exports from Tunisia; (ii) facilitate EU market access for Mode 4 services suppliers, particularly from the Tunisian ICT industry; and (iii) increase EU market access for exports of Tunisian olive oil by expanding quota allowances and simplify administration of the quota system, or by abolishing the quota outright.

2. Include exemptions for sensitive sectors in the negotiations: this relates primarily to (i) certain agricultural sectors deemed essential for domestic food security, in particular grains; (ii) public procurement, where at least specific provisions need to be included to exempt public contractors at local and regional level from tendering obligations, and (iii) competition and state aid regulations, which should allow for special treatment of certain state industries in the interior regions of the country, given their overarching significance for the respective regional economies.

3. Pro-actively address adjustment costs with respect to public revenues and domestic employment: (i) given the current high level of the budget deficit, effects of tariff reductions on public budgets require policy responses in the form of additional EU budget support during the implementation period of the agreement, and support for efforts to expand and diversify the domestic taxation; (ii) effects of trade liberalization on employment in specific sectors – in particular, agricultural sectors – need to be properly addressed. In particular, EU development funds for active labour market policy and re-training need to be increased in order to improve skills and facilitate re-employment in expanding sectors.

4. Promote capacity-building in the framework of Aid for Trade: The effective use of DCFTA provisions requires the necessary capacities and capabilities of the respective actors both in government and the private sector. This is evident with regard to important Tunisian agricultural export sectors, which need capacity building and extension services with respect to e.g. conformity assessments, certification procedures as well as marketing and market intelligence services. Only upon this basis will it be possible in the medium to long term to exploit the market access opportunities offered by the agreement. EU 'Aid for Trade' programs should pro-actively support such policies for Tunisian export sectors.

5. Promote productive development and industrial upgrading: The DCFTA should strengthen upgrading opportunities in Tunisian export sectors and support Tunisia in overcoming the current specialisation profile of the economy, which is based on low-wage and low-skills integration in global and regional value chains. Detailed analysis of leading agricultural export sectors such as olive oil as well as the textiles & apparel sector, points to the need for policy interventions in two priority areas: (i) Export potentials for food products depend on investment in processing and branding activities and in quality infrastructure. . Trade policy can support upgrading both by improving market access, e.g. by eliminating remaining tariffs and quotas, and, by supporting to meet EU standards, both public SPS and private standards of lead firms in GVCs, in particular quality standards and certifications for organic products in the context of EU development cooperation; and (ii) Promotion of upgrading programmes for the textile sector is of strategic importance in the apparel sector, against the background of continuing preference erosion for the Tunisian apparel sector. This will involve investment in building-up a domestic textile sector, but also extend to other supporting services, e.g. increasing the availability of working capital for FOB production, extending affordable investment loans as well as improving the technical skills of T&A workers (see Grumiller et al. 2018a, 2018b, 2018c, for a detailed discussion).

6. Use the DCFTA's sustainability chapter for effective monitoring and evaluation: The sustainability chapter of the DCFTA demands not only adherence to labour and environmental standards, but defines an institutional structure for the governance of the agreement. This structure need to be leveraged for effective and participatory monitoring of the implementation of the agreement. This will in particular require institutional support and scaled-up funding for the civil society consultations envisaged in the sustainability chapter.

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1 This policy note builds on the results of a comprehensive study (Grumiller et al. 2018a) conducted by the Austrian Foundation for Development Research (ÖFSE). The economic assessment is based on simulations with the ÖFSE Global Trade Model, a structuralist Computable General Equilibrium model. The qualitative analysis on the negotiation process and the current context in Tunisia draw on text and data analysis, literature reviews and interviews in Tunisia. The analyses of the olive oil sector as well as the textile and apparel sector in Tunisia are summarized in ÖFSE Policy Notes, see: https://www.oefse.at/en/publications/policy-notes/

2 See: http://trade.ec.europa.eu/doclib/press/index.cfm?id=1490&serie=1106&langId=en (accessed Nov. 2018)

3 See Grumiller et al. (2018c) for details on the olive oil sector.

4 See: http://trade.ec.europa.eu/doclib/docs/2018/july/tradoc_157220.pdf (accessed Nov. 2018)

Disclaimer:
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