



TUNISIA

SELECTED ISSUES

February 2016

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SELECTED ISSUES

September 16, 2015

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Central Asia
Department**

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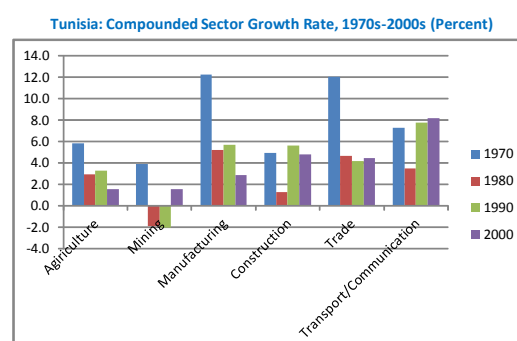
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TUNISIA'S GROWTH POTENTIAL: RECENT TRENDS, CONSTRAINTS, AND OPPORTUNITIES FOR THE FUTURE

A. Tunisia's Growth Drivers in Recent Years

Tunisia's old growth model benefitted from political and macroeconomic stability, cautious modernization and increasing trade links; the duality between the offshore and on-shore sectors supported export development and diversification. On the other hand, state capture, weak rule of law and economic duality have stymied competition, prevented a fair and efficient allocation of resources and left a legacy of cronyism and high unemployment which post-revolution Tunisia needs to address to reinvigorate growth.

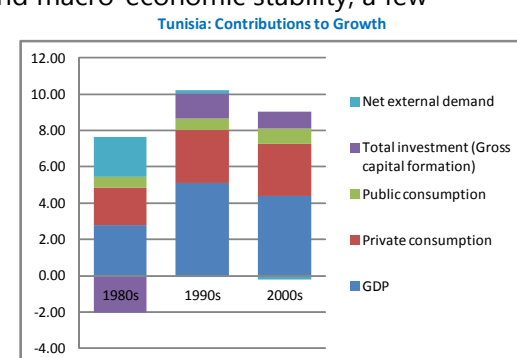
1. Tunisia enjoyed solid GDP growth rates in the run-up to the revolution of 2011, driven by the manufacturing and service sectors. Growth rates averaged 4.5 percent a year in 2000–10, after peaking at close to 5 percent annually in the 1990s. Manufacturing, distribution, transport, and communications were the main drivers of growth. However, the contribution of manufacturing and distribution to growth declined in the last decade, while transport and communication grew in importance.



Source: IMF staff calculations.

2. A stable macroeconomic environment and a gradual liberalization of trade and investment facilitated growth.

Benefitting from prolonged political and macro-economic stability, a few incremental reforms to promote entrepreneurship in light industries— and the provision of good public education and health services— private consumption and investment sustained growth in the decades preceding the revolution (with average yearly contributions to growth reaching 2.9 and 1.1 percent, respectively). While the contribution of net exports to growth has been small and negative in most years, Tunisia's trade openness¹ grew from 82 percent of GDP to 102 percent of GDP between 1990 and 2010.

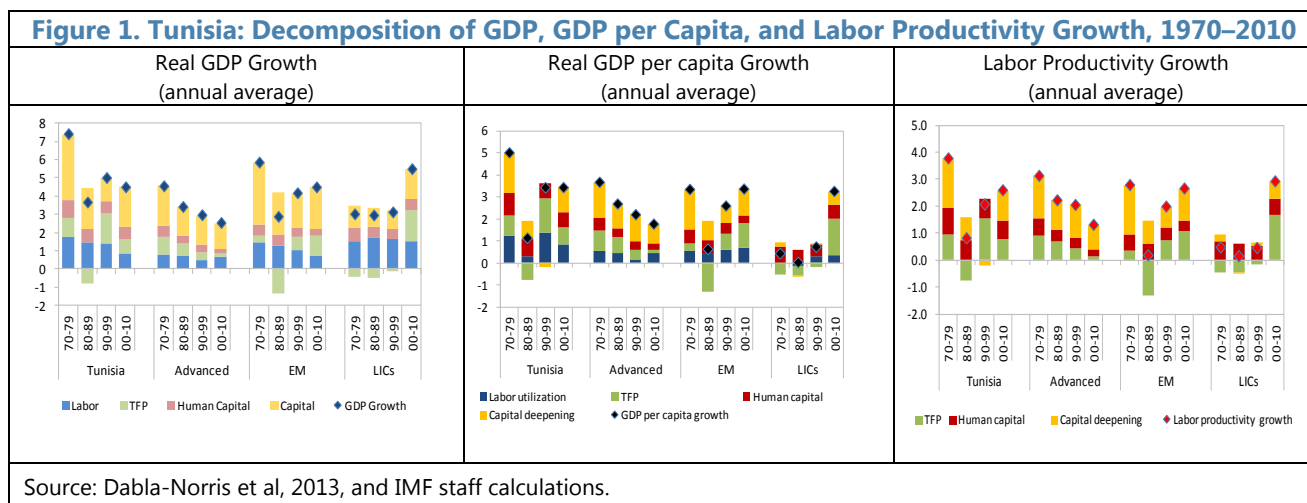


Source: IMF staff calculations.

¹ Measured as the sum of imports and exports over total GDP.

3. Labor has been gradually overshadowed by capital accumulation as the main growth driver, while productivity has been lagging.² In the past forty years, favorable demographics facilitated an increase in labor utilization, and improvements in education helped the accumulation of human capital, which in turn pushed up labor productivity. However, in more recent years, it became increasingly difficult to absorb a young and growing population in the workforce, a number of surveys³ has shown that the education system struggled to keep up with the skills demanded by employers, and labor contribution to growth has declined. Conversely, capital accumulation, partly driven by FDI, accelerated since the mid-90s, becoming the main driver of GDP growth. Contrary to other Emerging Markets and Developing Economies (EMDEs), total factor productivity (TFP) has been slowing in the 2000s, and has plunged since the onset of the global financial crisis. Its drop is at the core of the slump in growth in 2008–10 (Figure 1).

Figure 1. Tunisia: Decomposition of GDP, GDP per Capita, and Labor Productivity Growth, 1970–2010



² This analysis is based on a simple growth accounting exercise (see IMF, 2014a for details)

³ See, for example, World Bank Enterprise Survey (2013) available at: <http://www.enterprisesurveys.org/data/exploreeconomies/2013/tunisia>.

4. Productivity has slowed in agriculture and manufacturing. The decline in manufacturing is particularly worrisome because of the higher productivity and growth potential of this sector.⁴ Moreover, some critical sectors for Tunisia's economy, such as financial services and hospitality, have shown no productivity growth in the past twenty years, as state capture and heavy regulations stifled competition and, ultimately, their development.

5. Failure to reallocate resources to higher-productivity sectors weakened growth. This is confirmed by a decomposition of aggregate productivity growth into a within sector component and a "structural shift" (or "structural change") component, the latter being a reallocation of resources across sectors. Despite a trend of shifting employment and value added towards the service sectors at the expense of agriculture, the contribution of structural change to growth has been minimal between 2000 and 2010, with resource allocation biased towards slower growing sectors.

6. Product space analysis of exports confirms that structural change led to a significant increase in Tunisia's economic complexity,⁵ although the latter remains low compared to higher middle income peers (Box 1). Starting from 2000, textiles and chemical products (once a combined 65 percent of the exports basket) have been progressively losing export share (textile accounted for only 26 percent of the 2013 export basket), and have been overtaken by machinery/electrical equipment (28 percent). However, while Tunisia's economic complexity increased significantly, it remains low compared to higher middle income peers such as Malaysia,

Figure 2. Tunisia: Average Sector Productivity Growth

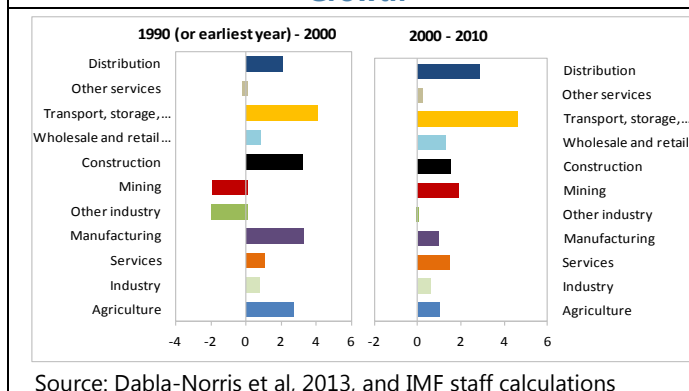
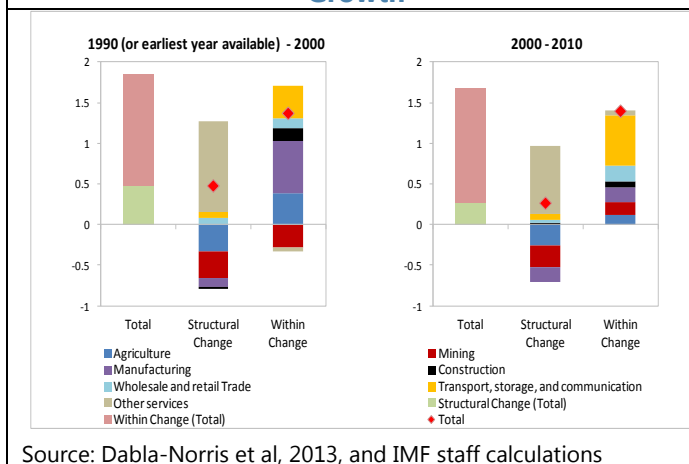


Figure 3. Tunisia: Drivers of Sector Productivity Growth



⁴ Indeed, value added per worker in agriculture is less than half than in manufacturing, and in services, it is about two thirds than in manufacturing.

⁵ The country ranking climbed from 71st in 1995 to 46rd over 125 in 2012 in the Economic Complexity Index, available at <http://atlas.cid.harvard.edu/>

and the sophistication of its main export products—measured by the Product Complexity Index (PCI)—is low compared to the world average.⁶

Box 1: Tunisia: Definitions of Concepts from Product Space Theory

Tacit knowledge: Product space theory assumes that the product of any good requires a combination of individuals’ knowledge: the know-how. This expertise is in individuals’ mind and gets refined over years of experience. The theory also assumes that as long as knowledge for producing the good is missing, the good cannot be produced.

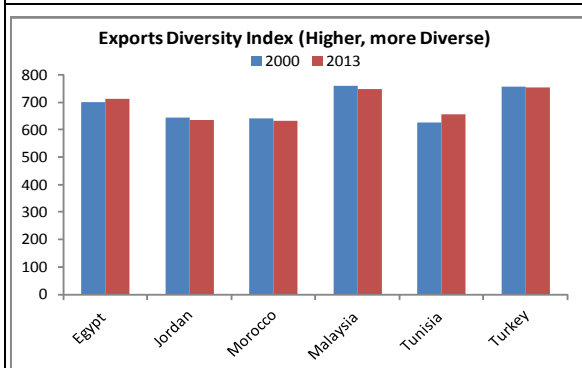
Product complexity: The complexity of a product indicates the level of sophistication of that product. The sophistication of a product is measured by the number and quality of knowledge required to produce it. The quality of knowledge is measured by the number of products that could have been produced using that knowledge. The Product Complexity Index (PCI) compares the sophistication of a product with the average sophistication of world exports products basket.

Distance between products (a) and (b): It measures the additional tacit knowledge required on top of existing tacit knowledge used to produce (a) in order to produce (b). The lesser knowledge required, the shorter the distance will be between (a) and (b).

Diversity: The Diversity Index counts the number of products exported by a given country. It reflects to some extent the existing know how in a given economy.

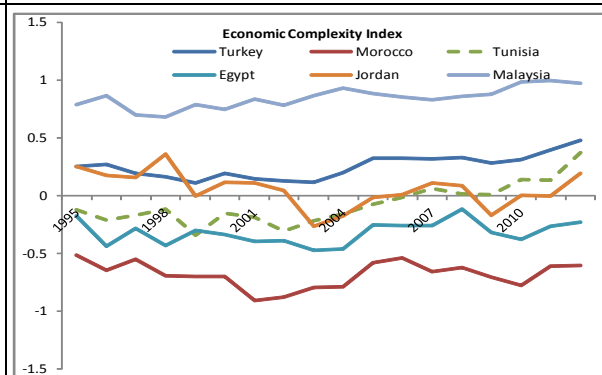
Economic complexity: Similar to the product complexity, it measures the level of sophistication of an economy based on the sophistication of exports basket. The Economic Complexity Index (ECI) measures the level of complexity of a given economy relatively to the average complexity of world economies. This comparison is done by looking at how many economies produce the most complex exports products of that given economy. The negative/positive ECI value (x) means that the country is x standard deviations below/above the world average ECI.

Figure 4. Tunisia: Export Diversity, Selected Countries



Sources: Comtrade, and IMF staff calculations.

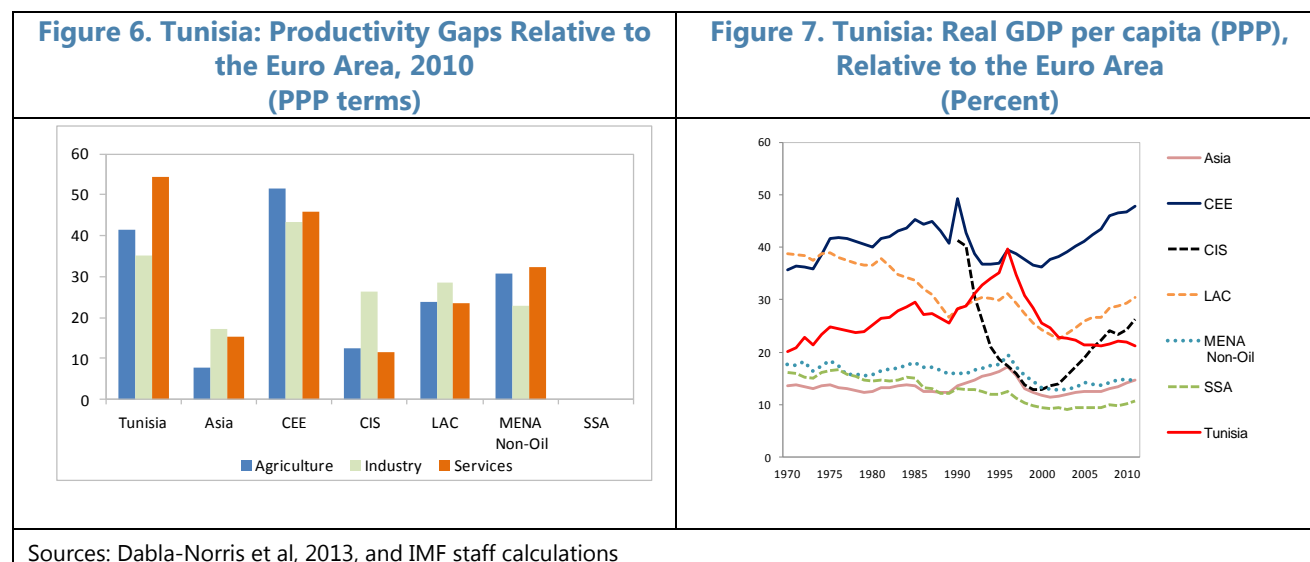
Figure 5. Tunisia: Economic Complexity, 1996-2014



Source: Atlas of Economic Complexity.

⁶ The PCI for main exports products groups are: machinery and electrical (0.63), textile (-1.74), and mineral products (-3.35).

7. The observed “productivity gaps” translate into lower standards of living. In all sectors, but particularly in services, productivity gaps widened vis-à-vis Tunisia’s main export markets in Europe, its major competitors in these markets, and other MENA economies. Anemic productivity growth translated into persistent and widening GDP gaps. In fact, after a catch-up phase ending in the mid-1990s, Tunisia’s real, PPP-adjusted GDP per capita has been declining relative to the euro area and other peer countries.



B. Binding Constraints to Growth: A Growth Diagnostic Approach

We find that Tunisia’s binding constraints to growth are the lack of access to finance, public institutions ineffectiveness and stringent labor regulations. Macroeconomic risks may also hamper growth and market failures lead to lack of competition and poor resource allocation. While these constraints are the legacy of decades of economic policies under the old regime, the political transition has brought to the fore the pressing need to address them.

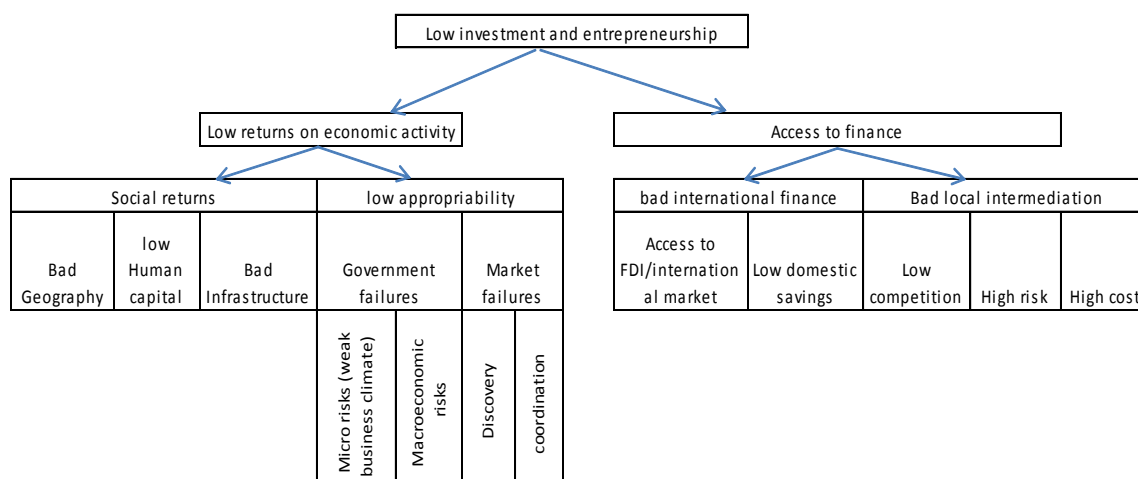
8. Lack of access to finance, the ineffectiveness of public institutions, and stringent labor regulations are the most binding constraints to growth in Tunisia. Using the diagnostic framework developed by Hausman, Rodrik, and Velasco (2009; see Box 2), which helps policymakers with limited resources to prioritize their intervention in addressing numerous growth constraints, we find that access to finance and low appropriability are the main barriers to higher private investment and entrepreneurship. Interestingly, infrastructure, geography and human capital are not binding constraints to business in Tunisia. Finally, lower macroeconomic risks and better allocation of resources to higher value industries could help boost growth prospects.

Box 2. The Growth Diagnostic Approach

The growth diagnostic approach crafted by Hausmann, Rodrik and Velasco—HRV—(2005) is an operational decision making tool for economic policymakers for main constraints identification. The theory assumes private investment and entrepreneurship are the main drivers of growth over the medium and long term. It posits that the level of investment is constrained at any point in time by a small number of specific distortions. The removal of those constraints would result into faster growth. Then, the identification of these specific obstacles called “binding constraints” is the main goal of this exercise.

The identification process of the binding constraints uses a decision tree allowing the Policy Analyst to eliminate “non-binding constraints” and to narrow down to the binding ones. It assumes that the level of private investment is the outcome of two main factors: (i) the availability of finance (supply-constrained) and (ii) the returns of economic activity (demand-constrained). The availability of finance could be constrained either by bad international finance or bad local finance. The returns on economic activity could be driven by either low social returns or low appropriability of those returns.

Differential Growth Diagnostic Tree



The HRV framework is not meant to exclude constraints but rather help to prioritize among them. The HRV approach is built on the premise that most developing economies face numerous and simultaneous constraints which need to be removed if possible. Therefore, the framework helps the policy maker determine which constraint could yield the “highest” payoff if it was removed, assuming limited time and resources available for policy implementation. Therefore, highlighting a constraint as binding does not imply that the other factors—contributing to low private investment—should not be tackled.

Lack of access to finance constrains the growth of domestic firms

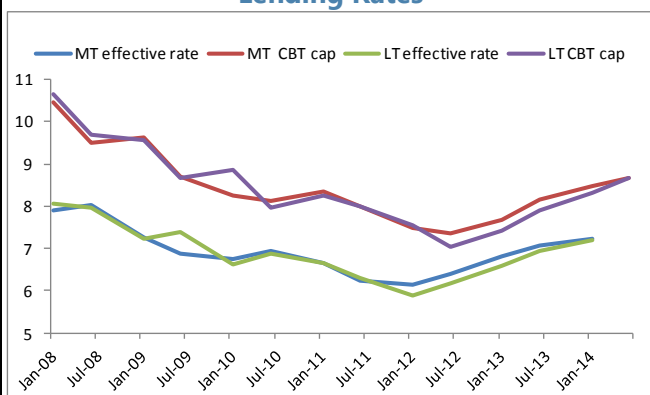
9. Access to finance for domestic firms is limited by credit rationing from domestic banks. Investors have consistently cited limited access to finance as the major constraint to business over the past decade. Yet, lending rates have not been high compared to MENA countries.⁷ The persistent gap between the actual lending rates and the existing caps on lending rates (Figure 9), as well as the positive correlation between private investment and interest rates (Figure 10) point to some credit rationing by banks, whereby banks deliberately limit credit supply to a limited pool of selected clients; another less likely hypothesis would be low returns on private investments.

Figure 8. Tunisia: Main Impediment to Business

Year of the report	2006/07	2008/09	2009/10	2010/11	2011/12	2013/14	2014/15
Access to financing	1	1	2	1	2	3	2
Tax rate	2	8	8	8	12	13	11
Tax regulations	3	6	9	9	10	7	9
Inefficient government bureaucracy	4	2	1	3	1	2	1
Restrictive labor regulations	5	3	3	2	5	6	4
Poor work ethic in national labor force	6	4	5	6	8	8	7
Inadequately educated workforce	7	10	6	5	9	14	10
Foreign currency regulations	8	9	4	4	11	11	12
Inflation	9	5	10	10	13	9	13
Inadequate supply of infrastructure	10	7	7	7	6	4	5
Corruption	11	11	11	11	7	10	6
Policy instability	12	13	12	12	4	1	3
Government instability/coups	13	14	13	13	3	5	8
Insufficient capacity to innovate						12	14
Crime and theft	14	15	14	14	14	15	15
Poor public health		12	15	15	15	16	16

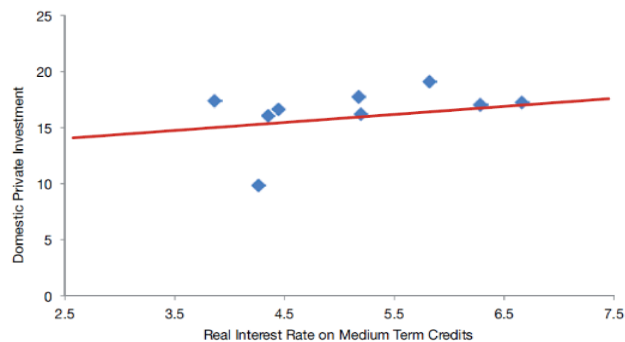
Source: Global Competitiveness Report (Schwab and Sala-i-Martin, 2014).

Figure 9. Tunisia: Official Caps and Actual Lending Rates



Source: Central Bank of Tunisia.

Figure 10. Tunisia: Correlation Between Investment and Interest Rates



Sources: WDI and Central Bank of Tunisia

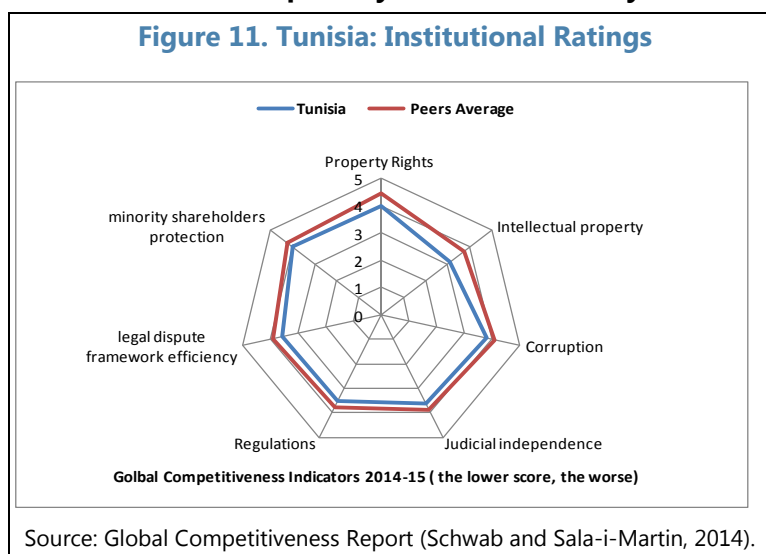
⁷ World Development Indicators, available at <http://data.worldbank.org/data-catalog/world-development-indicators>.

10. Perceived high risks—due to the lack of an appropriate and effective legal framework—have contributed to credit rationing. The perception of high risks—corroborated by high and rising non-performing loans stemming partly from lending to “connected parties” under the pre-revolution regime and the lack of information on new borrowers—and difficult collateral⁸ recovery—because of an inadequate bankruptcy law not allowing banks to quickly recoup collateral from delinquent loans and a weak judicial system—worsened banks’ reluctance to lend. High concentration risks highlight that banks appear to lend to only a few trusted customers.⁹

11. Some firms have bypassed the “access to finance” constraint through self-financing. Declining FDI inflows and shallow financial markets have left self-financing as the main financing option, despite its ineffectiveness to sustain firms’ development in the longer term.¹⁰ Not surprisingly, offshore or publicly-owned firms—which are less financially constrained because of public guarantees or foreign financing—have been the most successful in Tunisia.¹¹

Public institutions have been ineffective to protect investors.

12. Tunisia lacks effective institutions to ensure transparency and accountability. Tunisia performs poorly, below comparable peers, on corruption, property protection, and judicial independence (Figure 11). Regulatory barriers and anti-competitive practices—through excessive requirements for approval, prohibition of investment in certain sectors, and tolerance for abuse of market position—limit growth. Staff finds that the unconditional correlations between capital formation and Tunisia’s weak performance in judicial independence and corruption are high and negative.



⁸ The use of collateral, while comparable to other similar countries, has been ineffective because of inadequate bankruptcy laws, and slow out-of-court-settlements. Even when collateral is eventually recovered after a default on a loan, it takes ten years on average to do so.

⁹ According to the latest FSAP report (IMF, 2012) seven banks would have become insolvent over two years if the largest borrower of each bank were to default.

¹⁰ Tunisian Institute of Quantitative Studies and Competitiveness Report, 2012.

¹¹ World Bank, 2014, The Unfinished Revolution: Bringing Opportunity, Good Jobs and Greater Wealth to all Tunisians.

Stringent labor regulations hamper labor productivity.

13. Tunisia's labor market regulations are among the most rigid in the MENA region. The 2014–15 Global Competitiveness Survey¹² ranks Tunisia poorly on labor market efficiency, where it stands 129th out of 144 countries, driven by low women participation (134th), rigid wage determination (119th), lack of labor-employer cooperation (118th), and rigid firing and hiring practices (97th).

14. Stringent labor regulations lead to informality and low-skill jobs. For instance, termination of open-ended contracts requires government approval. Also, wages—set periodically through labor negotiations—are neither differentiated by size, regions nor productivity. Hence, firms unable to meet those regulations slip into informality (see World Bank 2014) or keep the labor size under certain limit—Tunisia has the lowest number of large firms compared to most of its North Africa peers (i.e. Morocco, Egypt).

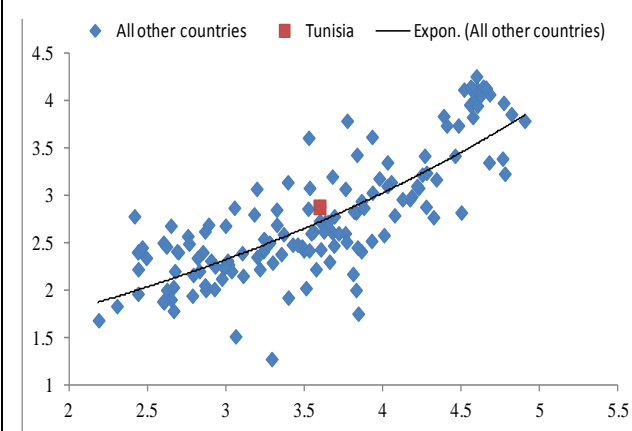
Macroeconomic risks and market failures are dragging growth.

15. Macroeconomic risks have increased after the revolution. Economic growth has remained positive, but slowed to 2 percent, not high enough to make a dent in unemployment. External and fiscal imbalances are high, with deficits and debt rising since 2010. Security challenges and social tensions cloud the near-term outlook. As a result, and despite the positive impact of the successful political transition, investor confidence has been dented and economic agents seem to be far more cautious than in the past with their investment and consumption decisions.

Infrastructure and human capital are not binding constraints to growth.

16. Social returns on investment are adequate. Tunisia's geography is an asset for its growth, reflecting its direct access to the sea and its proximity to the European market. In spite of regional disparities, Tunisia's existing infrastructure appears to be adequate relative to its income level (Figure 12). Work force availability was also found to be appropriate, with Tunisian firms ranking work force education as only the 10th most problematic issue for doing business in 2014. Yet, improving the higher education curricula could help reduce the existing skill mismatches and unemployment (currently high at 15.2 percent).

Figure 12. Tunisia: Correlation Between Infrastructure and GDP per Capita



Source: World Bank Data, LPI, 2014.

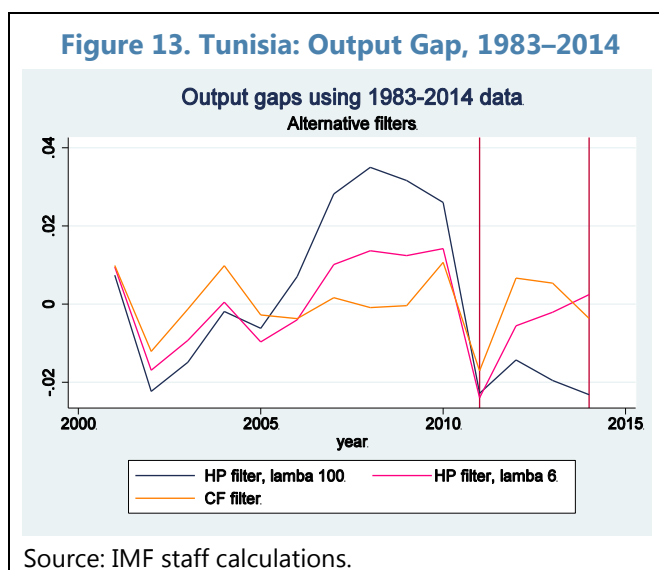
¹² Schwab and Sala-i-Martin, 2014.

C. Unlocking Tunisia's Growth Potential: Some Estimates and the Impact of Key Reforms

Removing the key long-standing constraints to private investment and entrepreneurship highlighted in the previous section would allow Tunisia to significantly increase its potential growth. Moving forward with reforms to introduce best practices in a number of additional areas would further help.

17. Potential growth in the absence of reforms would remain below the pre-revolution level.

Using the growth accounting exercise of Section I, a scenario of no reforms (keeping with current policies) would lead to a gradual pick-up in growth, which would only average 3.1 percent during 2015-20, well below its potential. This result was arrived at after assuming that the contribution of production factors (capital, labor) and total factor productivity converge back to their pre-revolution trends. Despite the slow economic transition not keeping up with the pace of the successful political transition, the evolution of the output gap does not indicate that the 2011 one-year growth collapse marked a change in the longer-term growth trend. Other empirical tests looking at potential structural breaks in the growth series confirm this finding.¹³



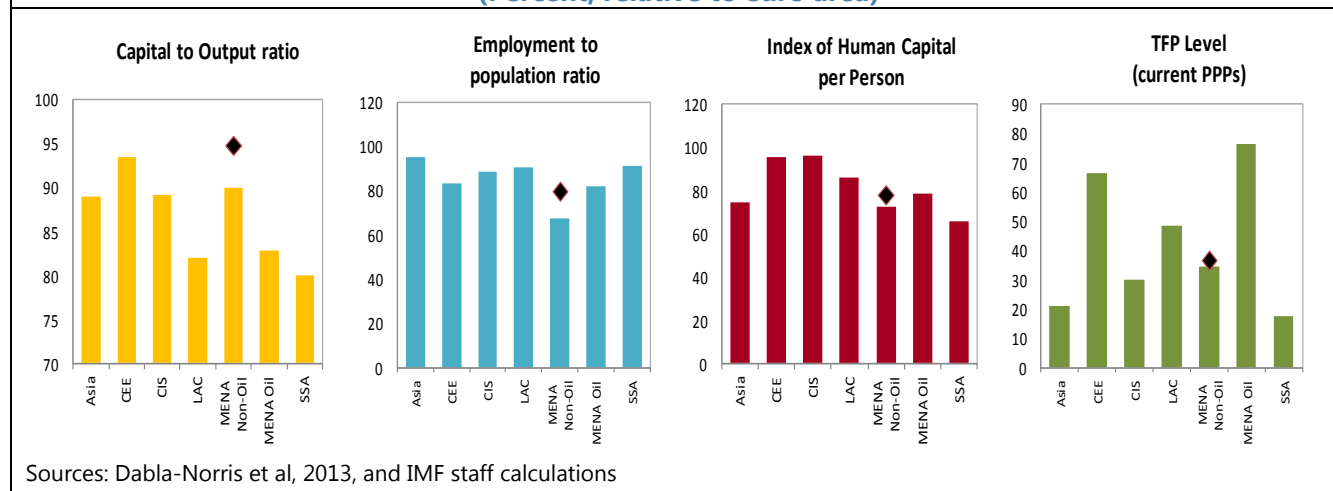
18. The existing gap in factors of production suggests significant room for improvements.

The employment to population ratio and the human capital index are lower in Tunisia than in peer countries (and only 80 percent of the euro area average—see Figure 14). Despite an adequate capital to output ratio at the eve of the revolution, a gap with the euro area and other EMDEs has likely re-opened in recent years because of low investment.¹⁴ Finally, productivity in Tunisia is only a fraction of the euro area and below emerging market peers.

¹³ We test for structural breaks in the growth series using the Olken-Jones methodology under a variety of trimming parameters and maximum number of breaks in the 1983–2014 horizon. The algorithm does not find evidence of a break around 2011 at any significance level; however, it does find a negative break during the financial crisis, reversed by a positive break in 2012. Other structural break tests confirm these findings.

¹⁴ Total investment dropped from 25 percent of GDP in 2000 down to 19.3 percent of GDP in 2014 while private investment fell from 21.1 percent of GDP to 16.9 percent of GDP over the same period (IMF staff calculations).

**Figure 14. Factor Inputs in Tunisia (Red Dot) and Other EMDEs, 2010
(Percent, relative to euro area)**



Policies to unlock potential growth

19. Based on the findings of the growth diagnostics exercise, filling the existing gap in factors of production will require: (i) appropriate financial and banking policies to increase access to finance and boost physical capital accumulation; (ii) a sound business environment to attract investors and boost long-term productivity; and (iii) a reduction in macroeconomic risks. More specifically, building also on the experience of other countries,¹⁵ reforms should focus on:

- Improving access to finance and promoting financial market development.** Policies facilitating access to financial services and enhancing legal rights are crucial. Strengthening credit information systems, including by expanding the coverage of credit registries, would enable lenders to better assess the creditworthiness of borrowers. Aligning insolvency and judiciary regimes to best international practices would also be instrumental in improving credit access and costs.
- Promoting a competitive business environment and reducing market distortions.** This requires a supportive rather than a dominant public sector, especially as state capture was a common feature of the pre-revolution economic model. Recalibrating the public sector role requires: (i) a tax reform promoting greater efficiency, equity, and simplification, and lowering bureaucratic red tape to reduce the cost of doing business; (ii) promoting the rule of law, good governance, and strengthening the judiciary to discourage corruption and cronyism; and (iii) increasing the efficiency of, and reduce protections to, state-owned enterprises, including public banks.

¹⁵ See Mitra and others (2015).

- **Reducing macroeconomic risks.** Prudent policies need to stay in place in order to continue reducing macroeconomic vulnerabilities and induce a return in investors' confidence amid a difficult external environment and rising security and social tensions.

20. Tunisia can also enhance its growth potential by adopting best international practices to improve its supply-side drivers. Applying the results of a recent cross-country study¹⁶ (Mitra and others, 2015) to Tunisia suggests that action can be taken on:

- **Policies promoting financial market development,** as they would be the most important contributors to potential physical capital growth in Tunisia through improved access to funding for investment.
- **Building a competitive business environment.** FDI promoting technology transfer, educational quality and diaspora support are important drivers of long-term productivity.
- **Improving labor market institutions and flexibility.** Better hiring and firing practices could also have a strong influence on medium-term unemployment¹⁷ (Figure 15). Over the longer-term, increased female labor force participation can also contribute to employment growth.
- **Promoting greater trade integration raises growth.** This can be achieved by lowering high tariffs and nontariff barriers, simplifying customs rules and procedures, and upgrading logistical infrastructure. In this regard, a transition toward higher value-added and sophisticated exports will be essential to reap the benefits from increased integration and connectivity.¹⁸
- **Raising public infrastructure investment.** For Tunisian business to thrive in the face of fierce international competition, public investment needs to catch up after the drop related to the political transition. Improving the quality and quantity of public capital expenditure, as well as elevating their jobs and growth impact, requires (i) more financial resources and (ii) more efficient public investment management. First, eliminating untargeted subsidies and controlling the public sector wage bill would create the fiscal space for more public investment. Mobilizing additional public revenues and promoting public private partnerships are additional options. Second, continuous efforts at improving the efficiency of public investments can be achieved through project prioritization and increased transparency in the investment cycle and budget process.¹⁹

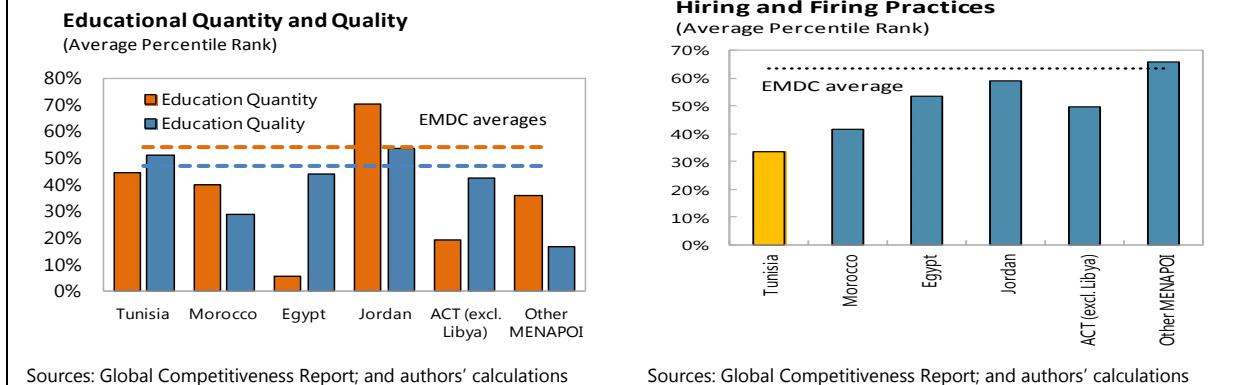
¹⁶ Specifically, three sets of cross-country regressions are performed—where the dependant variable in each of the three regressions is potential or smoothed growth in capital, labor and total factor productivity using a range of macroeconomic, structural and socio-political explanatory variables from several sources such as the Global Competitiveness Report (Schwab and Sala-i-Martin, 2014) and the IMF World Economic Outlook. For details, see Mitra and others, (2015, forthcoming).

¹⁷ Recent studies (IMF 2014a, b) elaborate on such policies for Tunisia and other Arab Countries in Transition.

¹⁸ See also Mitra and others (2015, forthcoming).

¹⁹ Mitra and others (2015, forthcoming) and Albino-War and others (2014) provide more details.

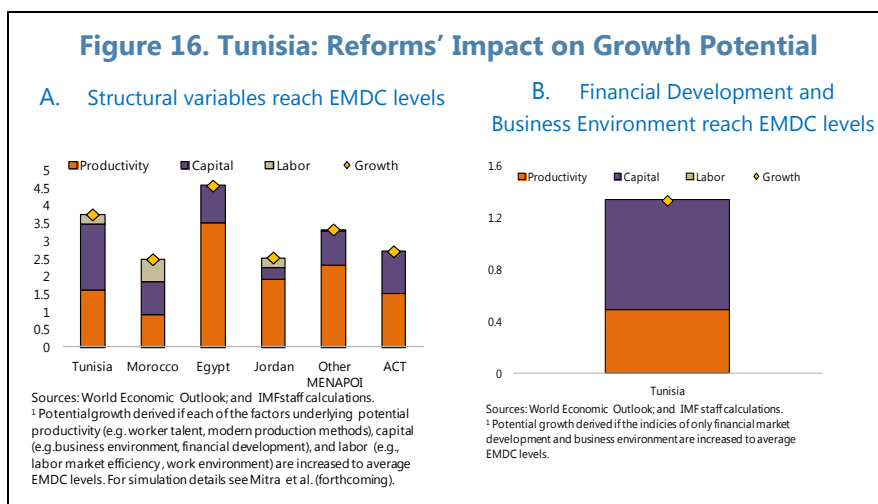
Figure 15. Selected Countries: Education and Labor Markets Indicators, 2014.



21. Staff analysis shows that reforms in the banking sector and business environment would be enough to increase growth above pre-revolution levels.

Following the methodology proposed by Mitra and others (2015, forthcoming), we find that growth could average 4.3 percent during 2015–20 if Tunisia were to reach EMDCs average levels in financial market development and global competitiveness. If Tunisia

undertook additional reforms so as to bring its underlying macroeconomic and structural indicators at the average level of the EMDEs, average growth during 2015–20 could further increase and reach an average of about 5 percent, reflecting gradual but significant improvements from capital accumulation and, to a lesser extent, from productivity gains



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