1 Overview and key policy messages

Middle East and North African governments have advanced notable reforms to improve the investment environment in the past decade. But further efforts are required to leverage investment to advance inclusive and sustainable development, and support recovery from the economic crisis provoked by the global pandemic. This chapter provides an overview of liberalisation reforms and investment climate constraints in the region, drawing out common challenges shared by the eight diverse economies. It offers an overarching reform agenda based on the main findings and policy considerations of *MENA Investment Policy Perspectives*.

Introduction

The Middle East and North Africa (MENA) has the regional market, resource and human capital potential to attract high levels of foreign direct investment (FDI). While some MENA economies have been fairly successful at attracting foreign business, FDI inflows in much of the region – including the eight economies covered in this report (MENA focus economies) – are below their potential. As are the potential benefits from greater integration within the region and with the European market. MENA governments have also been less successful than other emerging and developing economies at leveraging investment to advance sustainable development. Periods of political instability, conflict, and social and economic shocks over the past decade have negatively affected the investment climate and economic growth across the region. But the benefits of FDI have also long been constrained by structural challenges shared by the eight diverse economies, which have hindered the growth of a dynamic, competitive and rules-based private sector. The Covid-19 pandemic and the ongoing economic crisis have created further – and for some economies severe – challenges. Leveraging investment to support the economic recovery will require policymakers to address persistent challenges to competitive markets and advance policies to support more inclusive growth.

In much of the MENA region, economic activity, as well as FDI, has been concentrated in a few capital-intensive sectors, including extractive industries, real estate and construction, as well as light manufacturing. Many of these sectors not have sufficiently advanced job creation or productivity, nor have they supported the growth of small and medium-sized enterprises (SMEs), or economic activity outside of coastal and urban regions. In most MENA economies, there is a popular perception that FDI – and economic growth more broadly – has not benefited the average citizen (OECD, 2018[1]) (World Bank, 2018[2]). The eight economies covered in this report nonetheless differ widely. Some countries have had more success than others diversifying their economies and supporting job creation, while shocks, including conflict, insecurity and popular uprisings, have added substantial challenges in other economies.

MENA governments recognise that attracting more investment, with a greater developmental impact, will depend on further reforms, and all of the eight focus economies have made considerable efforts to improve the investment environment in the past decade. Some countries have already seen positive developments, including more investment in sectors that can advance job creation, exports and productivity, and more diversified sources of FDI. But further efforts are required. Structural challenges continue to constrain, to varying degrees, the investment climate in the MENA focus economies, from insufficient competition to skills shortages, inadequate infrastructure, political instability, poor governance, and weak regional integration.

Several more immediate challenges persist for investors. Investment-related regulations are not always clear or transparent, and many rules are enforced in an overly-discretionary or *ad hoc* manner. Co-ordination among government agencies in promoting and facilitating investment is often insufficient, limiting effectiveness in implementing strategies and impact on improving the business climate. MENA economies rank poorly on many measures related to business integrity and responsible business conduct. More targeted investment policies, including on tax incentives and linkages between SMEs and foreign companies, could better serve sustainable development objectives and countries' engagement in global value chains (GVCs).

Improving the investment climate will require that MENA governments make rules more transparent and less discretionary. Implementing clear, transparent and targeted strategies to attract FDI in more diversified sectors, and towards specific development aims, would help maximise the benefits of investment. Further reforms are also needed to address challenges to competition and dynamic private sector growth. These include reducing formal and informal barriers to competition, including privileges received by certain firms. This is particularly important in service sectors and infrastructure, crucial for strengthened participation in GVCs and greater regional integration.

MENA governments have demonstrated their commitment to addressing investment climate challenges, although implementing these reforms will not be quick or easy. But the stakes have never been higher. The Covid-19 pandemic and resulting economic and social shocks have added new challenges and exacerbated existing ones. Already, FDI inflows have declined sharply and projections suggest a significant economic contraction ahead in nearly all the focus economies. This will increase the risk of rising poverty, unemployment as well macro-economic and political instability across the region (UN, 2020[3]). This new reality makes it even more imperative to commit to bold reforms that will make investment work for sustainable development.

A diverse group with a common challenge: make investment work for sustainable development

Early economic reforms advanced aggregate growth

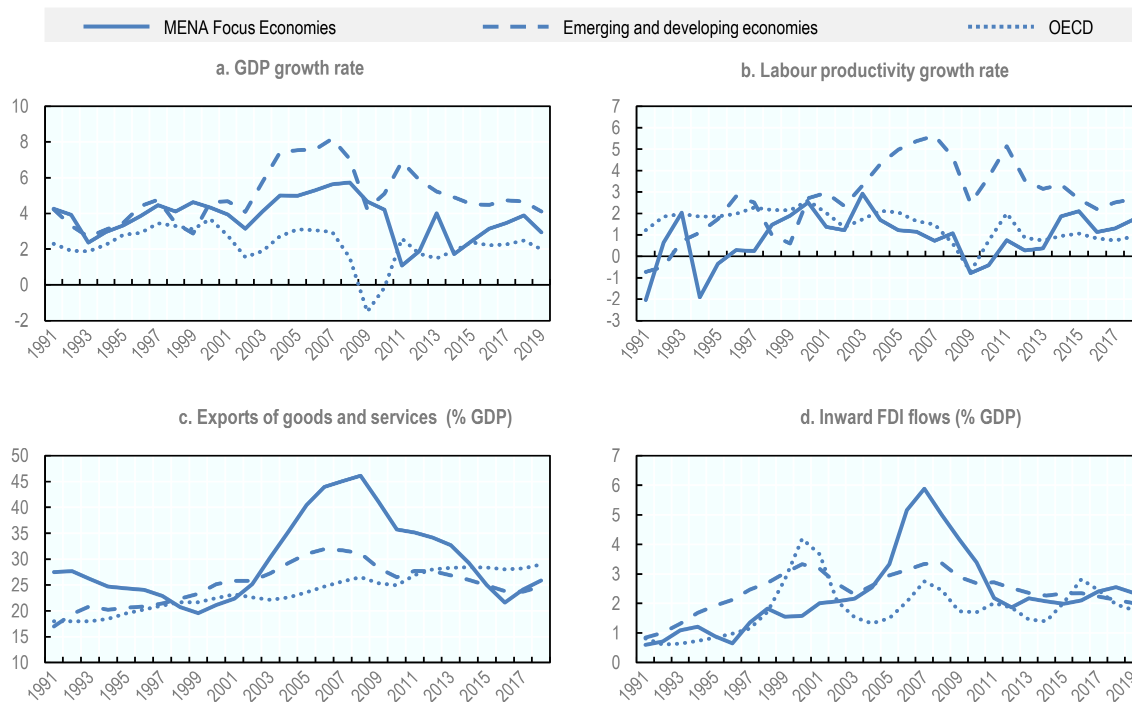
MENA governments have undergone numerous periods of economic reform. By the 1990s, most of the focus economies had advanced profound transitions from decades of predominately state-led development towards more open market economies. In Morocco, Tunisia, Jordan and Egypt, this process involved successive waves of reforms that drastically reduced state spending, privatised many state-owned enterprises and removed important barriers to trade and investment. Though less ambitious, reforms in Algeria and Libya also sought to partially open markets to foreign investors. In Lebanon, advancing private sector development, in part through open capital markets, was central to the post-civil war reconstruction strategy. Liberalisation reforms were also adopted by the Palestinian Authority after the Oslo Accords with Israel in 1993.

This process contributed to strong GDP growth in all of the focus economies, averaging between 4% and 5.4% between 1995-2007 (Figure 1, panel a). Growth was also aided by higher oil prices, which increased revenue for exporters (Algeria and Libya) and benefited energy importers through higher remittances and investment from neighbouring Gulf States. Exports also grew in many of the focus economies, and FDI reached record volumes in the years before the 2008 global financial crisis (Figure 1.1, panel c and d). On aggregate, there were initial labour productivity gains in several countries, as employment in agriculture and government services decreased (Figure 1.1, panel b).

The 2008 global financial crisis, followed by social unrest and political instability across the MENA region starting in 2010, halted many of the positive economic gains of the previous two decades. Average GDP growth across the eight economies dropped to 1.6% between 2009 and 2011. FDI plummeted, particularly in countries most affected by political upheavals (Egypt and Tunisia) or conflict (Libya). But across the whole MENA region, instability or uncertainty had a negative spill-over effect on trade and investment. In Jordan and Lebanon, conflicts in Iraq and Syria severely affected trade networks, and the influx of Syrian refugees has strained the two economies. Security concerns have affected tourism across the region. Several countries suffered from a sharp decline in exports and foreign reserves, pushing up macroeconomic risk.

Over the past decade, prior to the global health and economic crises of 2020, economic output and investment had been slowly recovering from the twin shocks of 2008 and 2011. Some countries, including Morocco and Egypt, saw noticeable increases in FDI in recent years. In the eight economies overall, FDI as a share of GDP has been comparable to other emerging and developing economies. But in many of the focus economies, inflows over the past decade have stagnated, decreased, or in the case of Libya, halted. This mirrors trends in global FDI inflows, which have been declining in the past few years, until their collapse after the Covid-19 pandemic and resulting economic crisis (OECD, 2020[4]). Investment has also remained relatively un-diversified. With some notable exceptions, the majority of FDI to the eight focus economies has consistently been concentrated in real estate, construction, mining and fuels.

Figure 1.1. Growth, productivity, exports and investment in MENA and comparator groups



Note: Variables are expressed as two-year moving averages. OECD statistics on inward FDI for 1990 to 2004 relate to unrevised BMD3 data.
Source: OECD National Accounts, OECD FDI statistics database, The Conference Board Total Economy database, IMF World Economic Outlook, UNCTAD Statistics, and World Bank National Accounts.

Further reforms are required to support a dynamic, competitive and rules-based private sector…

Supporting a durable recovery from the pandemic will require deeper reforms to address the structural challenges that have continued to negatively affect sustainable growth in the region. Even after the substantial liberalisation reforms of the 1990s and early 2000s, strong GDP growth rates, and notable expansion of trade and investment, mass social movements in 2011 confirmed that these trends did not achieve inclusive economic growth. Crucially, reforms did not create enough opportunities for the majority of the population (OECD, 2016[5]) (World Bank, 2018[2]). Explanations for the failings of pre-2011 reforms are numerous, and depend on country specificities. Progress was affected by regional developments, including civil and regional conflicts, and the global context of rising competition from Asia and Eastern and Central Europe. But a common challenge is persistent across the region: reforms did not sufficiently support a dynamic, competitive, and rules-based private sector that can generate inclusive growth.

While successive reforms reduced public sector investment and related employment in several countries (most notably in Egypt, Jordan and Tunisia), the private sector did not, and still has not, filled this gap. In the two decades before 2011, Lebanon was the only focus economy to increase private investment to above 20% of GDP. Private investment has remained at around just 10% of GDP in Egypt since the late 1990s (OECD, 2020[6]). In particular, private sector reforms did not create enough jobs for the growing labour force, and well-educated youth in particular – jobs that were previously provided by the public sector (Assaad and Krafft, 2016[7]). While GDP growth was fairly strong in the 1990s and early 2000s, the growth of the labour force was stronger, and private sector jobs did not keep pace with labour supply. With some exceptions, unemployment in the focus economies has remained static at between 10 and 20% of the labour force in the decade before 2011 – and in the decade after. Youth unemployment has consistently

averaged 30% (ILO Stat). Notwithstanding the limited ability of the private sector to generate jobs, boosting youth employment has also been constrained by considerable skills mismatches (OECD, 2016[5]).

Competitive markets have been hindered by various *de jure* and *de facto* barriers. This includes a wider legal and regulatory framework that has enabled conflicting interpretations and inconsistent application of rules. These various barriers have contributed to a dualistic private sector, dominated by a few large firms and a vast informal economy, with little room for SMEs to grow. There is also growing consensus that a key challenge to competitive markets in many MENA economies is linked to the outsized role of privileged firms in the economy. These include some state-owned enterprises (SOEs) as well as politically-connected private-sector firms.[1] Economic activity in many states has historically been concentrated in the hands of a few, and networks of patronage have benefited these firms to the detriment of growth of others.[2] Privileges granted to preferential firms can include special regulatory treatment (including selective enforcement of rules), trade protection (often through non-tariff barriers), beneficial access to credit and land, tax benefits, energy subsidies, and preference in public contracts (Atiyas, Diwan and Malik, 2019[8]).[3] In some cases, politically-connected firms have tilted regulations towards their favour and could be shielded from competition via restrictions on foreign investors.[4] Special advantages granted to certain firms has lowered aggregate productivity, employment and innovation, as well as the entry of new competitors.

Other cross-cutting factors have limited the potential for higher levels of growth and investment, and more inclusive development, in the MENA region. Good governance, including respect for the rule or law, underpins an attractive investment climate, and trust in government and public institutions – crucial for effective policy reform – is notably low in the region, particularly among youth (OECD, 2018[1]). Meanwhile, low quality infrastructure and poor logistics are limiting investment opportunities, as well as links to less-developed regions. Weak governance and low quality infrastructure, together with existing barriers to trade and investment, have also hindered regional integration – among MENA countries and with Mediterranean neighbours. Among the eight focus economies, the share of intra-regional trade in goods as a share of total trade was just 4% in 2017, a substantially lower share than for regional economic communities in West Africa (intra-regional trade among ECOWAS members is around 9%) and Southeast Asia (ASEAN intra-regional trade in goods is around 23%).[5] FDI flows between the MENA focus economies are also marginal, representing only 1% of total greenfield investment since 2003 (fDI Markets).

…and to increase the benefits of FDI to the economy and society

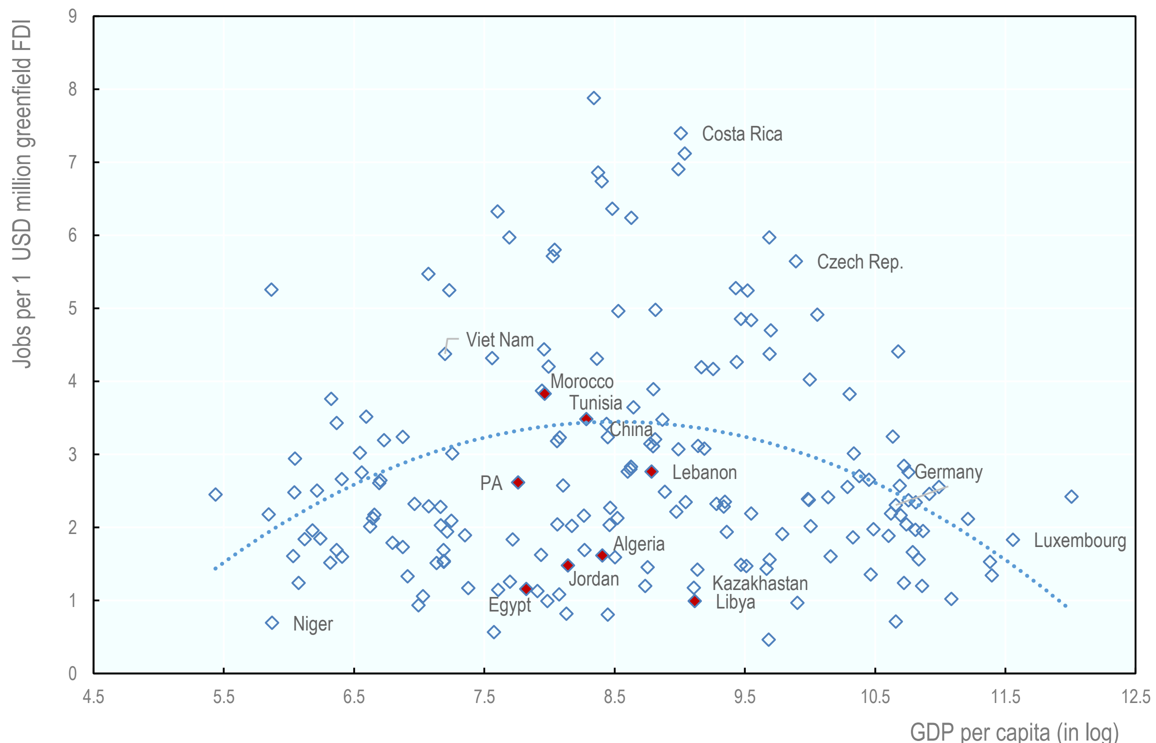
Harnessing the benefits of FDI requires, foremost, an enabling investment environment that allows firms to operate efficiently, and the aforementioned challenges to a competitive private sector have limited the potential of firm entry and growth. It also requires more targeted policies that can maximise the direct and indirect impacts FDI can have on sustainable development. Along with productivity improvements, FDI can create jobs, boost exports, spread knowledge, trigger innovation, improve living standards and, more generally, advance inclusive and sustainable development (OECD, 2019[9]). Yet, the realisation of this potential has been unequal across MENA focus economies: some have benefited more from FDI than others and, within economies, some segments of the population have been left behind.

Liberalisation reforms in the 1990s and 2000s sought to accelerate the structural transformation of MENA economies – the movement of labour and capital, including FDI, from low-productivity to high-productivity sectors.[6] While aggregate productivity initially increased, growth in higher-productivity sectors has been limited. Other developing countries, mostly in East Asia, had more success using foreign knowledge to accelerate innovation. In most MENA economies, an increase in employment and FDI in light manufacturing and some business services have generated modest productivity gains, although at varying degrees across the region – foreign manufacturers have recently contributed to the emergence of strong automotive and aeronautic sectors in Morocco. In oil exporters, FDI has remained concentrated in the energy sector, limiting economic diversification.

Growth in labour-intensive industries in Morocco and Tunisia have attracted FDI with the largest effects on job creation in the region in the last two decades, and comparable to other countries at similar stages of economic development (Figure 1.2).[7] FDI-related job creation has been weaker in other MENA focus economies. Sectors that receive the most foreign investment, including natural resources and real estate, have not created the most jobs, limiting the ability of the growing labour force to move to more productive, better-paid and higher-skilled employment.

In the past decade, some countries have made notable progress in attracting investment in a more diverse group of sectors. FDI in manufacturing has increased as a share of total greenfield investment in Algeria, Egypt, Morocco and Tunisia since 2013, compared to the years before the 2008 global financial crisis. Lebanon, Morocco and Tunisia have also seen service sectors attract a greater proportion of total FDI. But manufacturing still receives a relatively small amount of foreign investment in several of the focus economies, and the service sector even less.

Figure 1.2. FDI-related job creation and GDP per capita of MENA focus economies



Note: Greenfield FDI is defined as announced capital expenditure (capex). Number of jobs and capex are partly based on estimates between January 2003 and December 2017. GDP per capita is calculated as an average between 2003 and 2017.
Source: OECD based on Financial Times' fDi Markets database and the World Development Indicators.

FDI in tradeable goods such as natural resources or light manufacturing has helped most MENA focus economies engage in GVCs. Algeria and Libya, for instance, boosted exports of commodities while other economies relied, to varying degrees, on foreign inputs to increase their exports of manufactured products. But gains in terms of export diversification, skills upgrading and technology diffusion have been insufficient. Weak private sector competitiveness has meant domestic SMEs primarily supply low-skilled goods and services to foreign firms. In addition, linkages between foreign and domestic firms are largely confined to the developed coastal areas and urban centres of the MENA focus economies. This has helped these areas connect with global economic networks, but linkages have been weak outside these centres, which

tend to have inadequately skilled labour force and poor infrastructure, limiting the possibility for enhanced labour mobility. While regional disparities are not specific to the MENA region, they have nonetheless reinforced within-country inequality, a key factor in popular discontent in several countries.

Harnessing the benefits of investment will be key to the post-pandemic recovery

In the past decade, many MENA governments have put new or renewed emphasis on advancing reforms to foster economic diversification, productivity gains and job creation. Recognising the positive role investment can play in supporting these aims, all of the focus economies have adopted important measures to promote and facilitate investment. These reforms are explored in detail in thematic chapters of this report, and summarised below.

The imperative to advance inclusive development has perhaps never been greater. The Covid-19 pandemic, resulting supply disruptions, demand contractions and the pessimistic outlook of economic actors has precipitated an economic and social shock unprecedented in modern times. Global FDI flows fell by 50% in the first half of 2020 compared to the preceding six months, and the OECD projects world economic output to fall by 4.2% in 2020 (OECD, 2020[4]) (OECD, 2020[10]) (OECD, 2020[11]). The effect on the MENA focus economies could be even greater, as low oil prices put additional fiscal constraints on exporters, and reduce remittances, investment and direct aid from Gulf States to importers.[8] Several sectors particularly affected by the crisis, including tourism, energy and manufacturing, are critical to MENA economies. Estimates suggest economic output in 2020 contracted by -5.3%, on average, in focus economies excluding Libya and Lebanon, which face drastic recessions due to other political and security shocks. Most economies are likely to recover GDP growth by 2021 or 2022, though forecasts are subject to high degrees of uncertainty (World Bank, 2019[12]).

Investment to the eight focus economies has already been significantly affected by the pandemic. The total value of greenfield investments in the first half of 2020 was 80% less than in the first six months of 2019 (Figure 1.3). This is twice the reduction in greenfield investment in emerging and developing economies as a whole (42%), and a significantly sharper decline than experienced by OECD countries (17%) (fDi Markets by the FT). At the time of writing, recent contractions in FDI appear largely due to projects being put on hold, rather than divestments or cancellations of projects (OECD, 2020[13]).

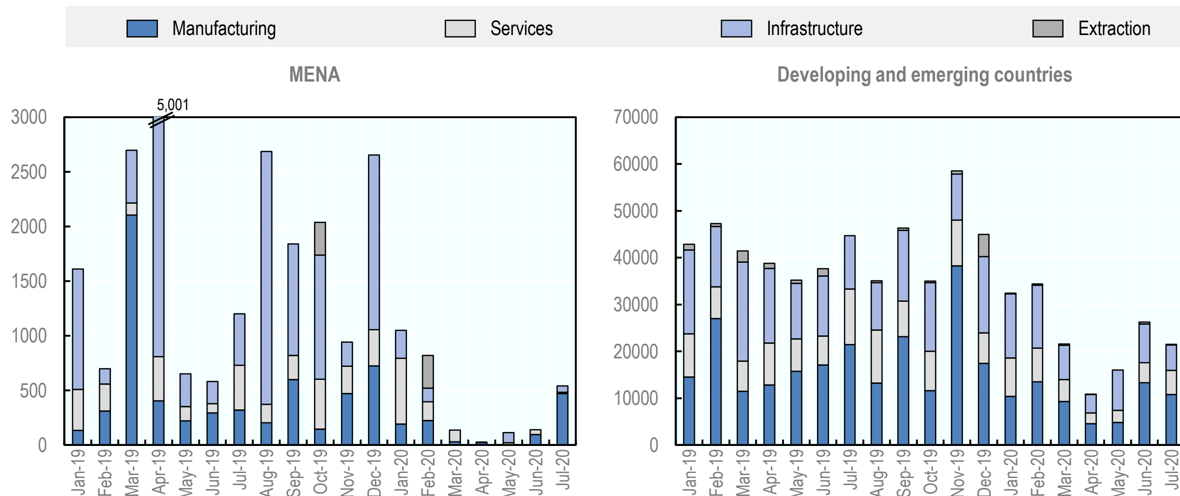
The economic contraction has added new risks and exacerbated existing ones. Before the current crisis, in all of the eight focus economies, both overall unemployment and youth unemployment were higher in 2019 than in 2010 (ILO Stat). Government crisis response measures to the pandemic, combined with a sharp decline in revenue streams, has put strong pressure on already high deficit and debt levels. The pandemic has also exposed acute vulnerabilities in food supply in some countries. In this context, any additional shocks – including the explosion at Beirut’s port in August – can be devastating.

MENA governments have put in place numerous measures to respond to the health, economic and social impacts of the crisis.[9] These include fiscal packages to support hard-hit sectors and SMEs, including through cash and in-kind transfers, deferred tax and loan payments, and reduced utility bills. Several governments have taken notable measures to target groups that usually fall outside of social safety nets, including informal and seasonal workers (OECD, 2020[14]). To respond to investors’ concerns, most IPAs in the region have refocused their services on aftercare to support and retain existing investors. Governments are also considering revising incentives policy to attract investment in sectors vulnerable to supply chain disruptions, including agriculture (OECD, 2020[13]).

These measures have been crucial to respond to the immediate effects of the pandemic. But in the medium- to long-term, many MENA governments may have to re-think investment promotion strategies, both to respond to new challenges and to harness potential opportunities. MENA economies could attract new multinational firms considering diversifying – if not shortening – their supply chains. Harnessing the positive benefits of investment will be key to the post-pandemic recovery.

Figure 1.3. Effect of Covid-19 on greenfield FDI

Announced capital expenditure, USD millions



Source: OECD based on Financial Times fDi Markets, as of 10 September 2020.

Investment policy priorities for the MENA region

Many of the MENA focus economies have accelerated reforms in recent years in an effort to attract more investment, with a higher development impact. Governments have adopted new investment legislation, eased market entry, streamlined regulations on business operations, strengthened investment promotion agencies (IPAs) mandates, and adopted policies to direct investment to under-performing regions. Some countries have already seen positive returns to reforms, including more investment in sectors that can advance job creation, exports and productivity, and more diversified sources of FDI (Chapter 2).

But many areas of the investment climate continue to pose challenges to private sector growth, limiting FDI inflows and the positive impact of investment on sustainable economic development. The eight economies are diverse; each face their own unique challenges. Several policy priorities apply to the whole region, however. The following section presents several cross-cutting themes of the report, highlighting where reforms have been made and where further progress is needed to improve the overall investment climate and realise the positive benefits of FDI.

Priority 1: Improve the clarity, consistency and transparency of investment-related rules and procedures

MENA governments have adopted numerous reforms to improve investment-related legislation

The eight MENA focus economies have adopted numerous reforms to improve investment-related legislation (Chapter 3). In particular, MENA governments have expended considerable resources and political capital to revise their investment laws. Since 2010, Algeria, Egypt, Jordan, Libya, the Palestinian Authority and Tunisia have all adopted new investment laws. These laws set conditions for market access for foreign firms, property protection guarantees, as well as other provisions relevant for investors, such as conditions for tax incentives and authority of IPAs. Though these provisions and guarantees can be

secured in other laws, the investment law is often the first point of reference for a potential investor, and can be used as a signalling devise to promote the country as an investment destination. Recent revisions to investment laws in the MENA focus economies removed some restrictions on foreign investors (Chapter 4), streamlined business registration, and reinforced and expanded IPA mandates (Chapter 6).

MENA governments have also recently revised or are in the process of amending other legislation pertinent to investors, including: commercial codes (Morocco and Lebanon), companies acts (Egypt), Public-Private Partnership laws (Jordan, Morocco and Tunisia), public procurement regulations (Algeria), as well as legislation on bankruptcy (Egypt and Morocco), competition (Egypt and Tunisia) and SMEs (Libya and PA). Establishing clear rules on market entry, business operations and contract enforcement, through investment-related legislation, are essential to attract investors.

Revisions of investment legislation can, but do not always, improve legal clarity

In some cases, however, the fast-paced rhythm of regulatory amendments may have created superfluous legislation, leading to overlaps and inconsistency. New iterations of investment laws are not always an improvement over the earlier version. Some highly publicised amendments may have been adopted to signal a new political direction, following frequent governmental reshuffles, rather than to address a clear legal gap. Frequent amendments can also hinder implementation of regulations.

In some cases, adopting new laws can add layers of complexity to the overall regulatory environment for investment, which encompasses a variety of sectoral and thematic legislation, as well as international investment treaties (Chapter 5). In many MENA countries, regulations are scattered across a wide range of laws and decrees; when designed in silos, this can create legal overlaps or loopholes, of the perception thereof, which can have a deterrent effect on investors, particularly in jurisdictions where non-commercial risks are higher than the average. For example, restrictions on foreign investors' entry and operations can involve lengthy and frequently updated positive lists (of sectors open to foreign investors), making it difficult for investors to understand prevalent rules (Chapter 4). All the focus economies grant fiscal and financial incentives through multiple pieces of legislation, decrees and executive orders, in addition to one-off agreements with firms, limiting transparency over incentives offered (Chapter 7). Similarly, regulation around procurement for infrastructure projects sometimes overlaps with older sector-specific or project-specific laws (Chapter 9).

Such overlaps and loopholes can deter investors by creating confusion, but they can also create incentives for investors to exploit uncertainty, preventing countries from reaping the potential benefits of investment. Ensuring coherence and clarity across various investment-related laws is essential. Some countries have taken steps in this direction. In Jordan, sectors restricted to foreign investors are clearly outlined in a negative list (Chapter 4), while Morocco has consolidated most of its tax incentives in its tax code, in line with international best practice (Chapter 7).

To the extent possible, international investment treaty (IIA) provisions should also be consistent with domestic laws. The MENA focus economies have entered into a significant number of IIAs, which creates an additional layer of legal obligations pertaining to the treatment of investment. Inconsistencies between IIAs and domestic laws can create room for disputes between the State and foreign investors that benefit from such treaties (Chapter 5).

MENA governments should avoid short-term fixes and ensure that no unnecessary additional layers of regulation are created when endeavouring to modernise legislative frameworks. Reducing the time gap between the adoption of new laws and their implementing regulations, and streamlining and empowering relevant institutions in charge of enforcing investment rules, are key to increase legislative efficiency. Revision of the investment treaty policy and practice should also be considered, as well as reforms that would limit exposure to investment arbitration claims.

Clarifying the regulatory framework for investment would reduce opportunities for discretionary decisions

Several MENA countries have made notable improvements to streamline regulations for investors, or ease procedures by centralising administrative steps in one-stop shops (OSS) (Chapter 6). However, the regulatory framework for investment is often not predictable or transparent. In addition to potential legal gaps and loopholes outlined above, the lack of clarity of investment-related regulations opens the door for discretionary decisions – which may be applied in discriminatory manner – or inconsistent implementation. Government authorities in most of the MENA focus economies have wide discretion to determine tax benefits investors can receive, and in some cases, which investors can enter the market, receive licences, permits and land. Specificity in laws and regulations, rather than wording that allows open interpretation by officials, helps reduce opportunities for corruption and aggressive tax planning by firms. Moreover, rules that are applied in an *ad hoc* manner across taxpayers creates unfair competition, and can deter investors.

MENA governments widely use tax and financial incentives to attract private investment and direct it into certain sectors, activities and locations (Chapter 7). Many investment incentives offered in the region are open to interpretation and discretion of implementing authorities. Often the law does not specify the length or ceiling of tax exemptions or reductions, and often conditions for receiving incentives are vague, such as broadly-defined sectors or activities "in the national interest". Some MENA IPAs have wide discretion in determining which investors receive incentives and the generosity of the benefit. Other incentives are given to firms on an *ad hoc*, contract-based manner. Investment contracts can indeed be problematic, as they can be inconsistent with the national and international legal framework and give leeway to discretionary powers (Chapter 5).

Notably, some governments in the region have reduced discretionary decisions around market entry (Chapter 4). Tunisia notably removed in 2016 a requirement that foreign investors receive approval for equity stakes exceeding 50% of a firm's capital. Libya is the only focus economy to apply economy-wide screening measures to regulate the entry of foreign investors. However, legislation in some MENA economies still imposes discriminatory approvals or criteria for admitting foreign investment in certain sectors. Screening requirements can dissuade foreign investors, as they create unpredictable and costly barriers to entry, particularly when approval criteria are poorly defined or not transparent. Approval mechanisms also impose administrative costs to governments and businesses. Ensuring effective and clear implementation of regulations governing the entry and operations of foreign investors, including by limiting excessive discretion of authorities, and implementing monitoring mechanisms, would reduce undesirable practices and help foster a more dynamic private sector.

MENA governments could enhance efforts to curb corruption across the investment process

Reducing discretionary application of rules and procedures for investors, such as those described above, would help reduce the incidence of corruption across the investment process. An investor may resort to corruption in order to enter a foreign market; obtain or retain a government contract, licence or clearance of customs procedures; get access to raw materials or foreign currency; or to receive specific incentives or tax benefits. Clear and unambiguous market entry rules and requirements are a prerequisite to reduce to a minimum opportunities for officials' discretion over the provision of licences, permits or public contracts.

Though some MENA governments have recently adopted new strategies to enhance business integrity, further reforms are required to lower the incidence of corruption in the public and private sectors (Chapter 11). The MENA focus economies rank among the bottom 50% on international indices measuring perceptions of corruption. Governments could greatly improve their image as investment destinations by showing their willingness to converge towards international standards. MENA economies can benefit from the proper implementation of the anti-corruption instruments they have adhered to, as this represents a

strong signal of convergence to international standards vis-à-vis the international community and foreign investors. Moreover, other international instruments to which MENA economies have not yet adhered can provide guidance to inspire domestic efforts to promote integrity in business transactions.

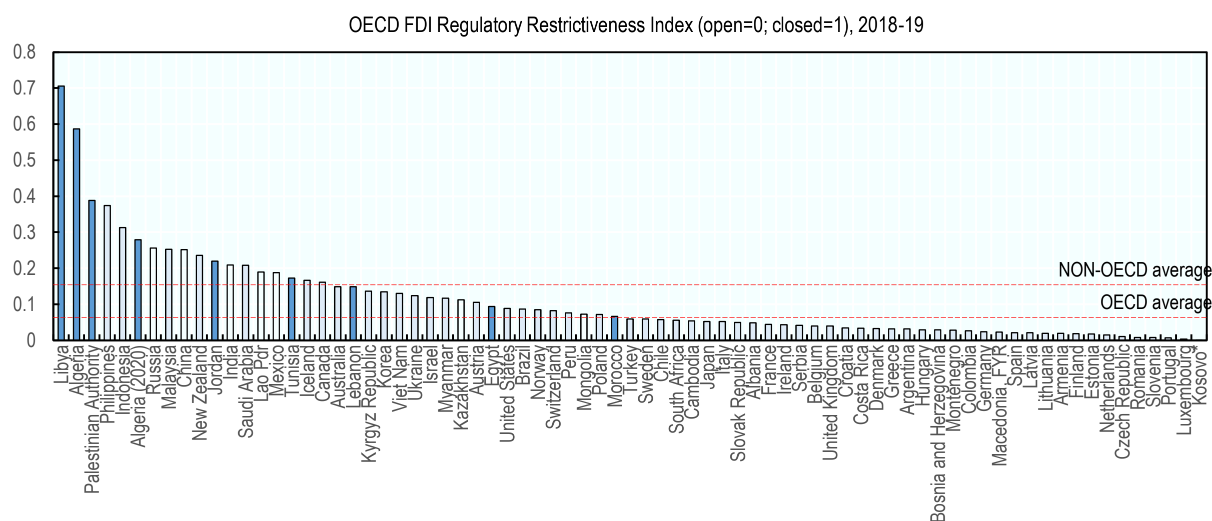
Priority 2: Advance reforms to improve competition and private sector development

MENA economies have recently undertaken meaningful liberalisation reforms

Within the wider legislative framework for investment described above, a critical issue for foreign investors is the rules governing their entry and operations. All governments impose some legal or regulatory restrictions on FDI, often in an effort to protect domestic industries or safeguard national security interests (Chapter 4). But FDI restrictions involve economic costs, which can lead to lower competition, forgone government revenue, and reduced opportunities for knowledge spillovers.

The eight MENA focus economies are on average more restrictive than OECD and many non-OECD countries covered in the OECD *FDI Regulatory Restrictiveness Index*, though there is considerable variation in the region (Chapter 4). Based on statutory FDI restrictions (those explicit in regulations or laws) as of year-end 2019, Egypt and Morocco are as liberal as OECD countries, while Libya, the Palestinian Authority and Algeria are significantly more restrictive than OECD and non-OECD peers (Figure 1.4.). Jordan, Lebanon and Tunisia impose restrictions close to the average non-OECD economy. The high scores of the most restrictive MENA economies are largely driven by horizontal restrictions applied across various sectors to all or most foreign investors. Aside from these measures, sector-specific limits on foreign equity ownership are the most prevalent forms of discrimination against foreign investors.

Figure 1.4. OECD FDI Regulatory Restrictiveness Index (MENA 2019)



Note: The OECD FDI Regulatory Restrictiveness Index only covers statutory measures discriminating against foreign investors. The implementation of regulations, restrictions related to national security, state monopolies, preferential treatment for export-oriented investors and special economic zone regimes are not considered. Data reflect regulatory restrictions as of December 2019 for the MENA8 countries and 2018 for all others.
Source: OECD FDI Regulatory Restrictiveness Index (database), www.oecd.org/investment/fdiindex.htm.

Conscious of the negative impact of some of these restrictions, several MENA governments have recently adopted significant liberalisation reforms. Jordan revoked a minimum capital requirement for foreign investors, expanded sectors open to full foreign ownership, and eased restrictions in some service sectors. Tunisia removed a screening requirement for foreign majority-owned projects. Algeria in 2020 took a major step, ending its most substantial restriction, a cap on foreign equity of 49% in all non-strategic sectors.

Reducing FDI restrictions in services could support productivity gains from competition

Remaining statutory restrictions in MENA focus economies may nonetheless be inhibiting greater volumes of FDI as well as productivity gains from competition. Like most countries, the MENA focus economies impose more restrictions in service sectors than in manufacturing (Chapter 4). These sectoral restrictions are more severe and widespread than in peer emerging and developing countries, however. Several MENA countries restrict foreign ownership in business, financial, distribution and transport services, all of which are key inputs for other sectors. Restrictions in infrastructure sectors, including maritime and air transport and construction, also tend to be high (Chapter 9). Limiting FDI in such backbone services hinders competition and productivity in these sectors and the industries that rely on them, including manufacturing, in turn holding back potential productivity gains throughout the economy.

FDI restrictions in services particularly impede the deployment of foreign investment projects that are crucial for GVC participation and strengthened business linkages (Chapter 8). Gains from GVCs in MENA focus economies have been relatively limited in terms of knowledge and technology transfers to local firms as well as engagement in higher value added activities. Further openness could help raise efficiency (and reduce input costs) in sectors dominated by large state monopolies and improve the quality and availability of services. Openness in services can be important for the competitiveness and productivity of small manufacturers throughout the MENA region. SMEs often rely more on high quality backbone services and other services provided by upstream, external providers.

Governments should consider reassessing FDI restrictions against their public policy objectives (e.g. objectives of economic diversification or participation in GVCs) and, where relevant, streamline or remove them. Where such policies are deemed necessary, ensure that they are not more restrictive than needed to address identified risks and concerns.

Wider pro-competition reforms would encourage investors' entry and growth

Several MENA governments have removed important *de jure* restrictions on market entry. But other barriers to competition may be prevalent. These include institutional or informal barriers to investment (such as excessive bureaucracy or corruption), inconsistent enforcement of statutory rules, as well as distortions caused by state ownership of key sectors, and special regulatory treatment received by certain firms.

While privatisation programmes in most of the focus economies substantially reduced the economic role of the state, state-owned enterprises (SOEs) continue to play a fundamental role in MENA economies, and are dominant in many sectors. State ownership gives rise to unique governance and regulatory risks that can prevent SOEs from creating optimal value for the economy and society. When SOEs operate inefficiently and are subject to weak governance arrangements, they can crowd out more productive private sector activity, and in the worst case, be used as tools for political patronage or for self-enrichment at the expense of society at large (OECD, 2019[15]). Many MENA SOEs benefit from special regulatory treatment, from preference in public procurement to exemption from certain laws (World Bank, 2018[16]). The OECD *Guidelines on Corporate Governance of State-Owned Enterprises* outline good practice standards on how SOEs can manage more effectively their responsibilities, thus helping to make them more competitive, efficient and transparent.

Fair competition is also hindered when private firms with influential political (and in some cases military) connections benefit from formal or informal preferential treatment. In several MENA countries, some firms have been protected from competition through non-tariff import barriers, preferential access to land or government contracts, favourable tax treatment, and non-uniform application of doing business procedures (World Bank, 2015[17]) (Atiyas, Diwan and Malik, 2019[8]) (Diwan, Keefer and Schiffbauer, 2020[18]) (El-Haddad, 2020[19]). Such crony behaviour by firms makes it more difficult for other firms to compete. All MENA governments could do more to promote competition and address the externalities associated with the prevalence of a few dominant firms, one of the main impediments to more dynamic job and firm growth in the region.

Priority 3: Target investment policy to better serve sustainable development objectives

Investment promotion activities target investment with high development impacts

Countries attract higher levels of FDI when they choose to prioritise certain types of sectors, investors or countries – through prioritisation, IPAs can better focus their resources and tailor their services. Most MENA agencies prioritise investment in certain sectors, including industries that have the potential to diversify the economy, promote regional development and reinforce their competitive position vis-à-vis other countries. This reflects an effort to find the right balance between diversifying the economy and tapping into strong domestic capabilities, an approach that is similar to OECD IPAs. The majority of MENA agencies also prioritise certain investment projects, notably those that will have a positive impact on domestic firms' production capabilities, the country's image, regional development, jobs and innovation.

MENA IPAs' have priorities that are often in line with their national development goals, although investment promotion strategies, and related objectives, are not always publicly available. The decision to prioritise often comes from the highest levels of government, but some agencies have more autonomy in selecting priority sectors that will help achieve the government's wider development goals, similar to OECD countries. Prioritising investment promotion efforts should be conducted according to a set of criteria in line with wider development objectives. The decision to prioritise should be based on carefully crafted economic rationales and transparent consultations with public agencies and with the private sector, and not only serving political agendas.

The Covid-19 pandemic and its consequences on the global economy may propel MENA agencies to revise their investment promotion strategies to support the recovery. Indeed, in response to the outbreak, MENA IPAs have re-oriented their priorities to focus on existing investors and have expanded their aftercare services. The health crisis also pushed them to innovate and develop new digital tools and services that they could consider operating permanently. Policy advocacy may become even more relevant in a context where governments are rethinking their wider economic strategies and related business climate reforms. As FDI declines, sound business environments will become even more salient for investors. IPAs are well-placed to advocate for open, transparent and well-regulated markets. Particularly relevant are the policy reflections taking place to assess the disruption of value chains and the future positioning of the MENA region within global investment networks (OECD, 2020[13]).

Investment incentives should focus on achieving specific spillovers

As mentioned above, MENA governments widely use tax and financial incentives (Chapter 7). But the costs of incentives, particularly tax incentives, can outweigh the benefits. Tax incentives may subsidise firms that would have invested without favourable treatment and can constitute a significant cost for governments in terms of revenue forgone. However, carefully designed and targeted incentives may help

correct market failures and advance certain development goals, such as supporting renewable energy or skills and technology upgrades, enhancing the positive impact of investment.

Incentives in the MENA region tend to be given to a wide range of investors. The eight MENA governments grant fiscal and financial incentives primarily to investors in agricultural, tourism and industrial sectors (broadly defined), export-oriented activities, and under-developed regions. Also common are incentives to investors that advance environmental protection, as are fiscal benefits to hydrocarbon industries. Several of the focus economies give tax breaks or grants to firms that create jobs or enhance skills. Fewer give incentives to firms that use new technologies or support technology transfer and R&D activities, unlike OECD countries.

Benefits to eligible investors are often generous. All of the eight MENA focus economies offer tax holidays – total exemptions from corporate income tax (CIT) – to investors in certain sectors and locations. Several governments have taken steps to reduce the length of tax holidays and number of firms eligible for them. But profit-based incentives (tax holidays and CIT rate reductions) remain widespread and are often easy for firms to receive, with broad eligibility requirements. Profit-based incentives, by benefiting firms that are already profitable, are more likely to be redundant than cost-based incentives.

MENA governments should consider how widely to offer tax and financial benefits, if these incentives are necessary to attract investment, and if their costs – in terms of revenue forgone and economic distortions – outweigh their benefits. Cost-benefit analysis and monitoring would help governments assess the effectiveness and efficiency of incentives. Simple tax incentive reports, identifying and describing all available incentives, their policy goal, and legal reference, is an important first step to create accountability and transparency. Replacing permanent incentives with temporary benefits would also encourage evaluation.

MENA governments should also consider moving gradually from broad-based tax holidays to more targeted, cost-based incentives in line with government priorities. The more targeted the incentive – for example to foster positive spill-overs such as skills training, innovation, and linkages to local firms – the more likely it is to reach its stated goal. Some MENA governments have begun to implement such targeted incentives, but these make up a small minority of incentives offered to investors.

Many governments in the region have added or revised incentives, or plan to do so, to respond to the economic and social costs of the Covid-19 pandemic. As governments seek swift measures to advance their economic recovery, assessments on the effectiveness and efficiency of incentives will be key to support already strained state budgets, and to ensure incentive design matches its goals.

Targeted policies and programmes can enhance SME-MNE linkages in GVCs

Leveraging FDI to integrate SMEs in global production networks can be an opportunity for the MENA region to achieve more inclusive and sustainable growth, especially in the post-Covid-19 recovery (Chapter 8). SMEs can plug into GVCs through the provision of inputs of goods and services to multinational enterprises established in their countries. This enables them to create jobs, develop skills, upgrade products and services to meet global standards, or adopt more sustainable production processes.

Foreign manufacturers in MENA countries including Egypt and Morocco are a key source of revenue for domestic suppliers. But business relationships are often limited to the sourcing of low-skilled inputs, rather than contractual arrangements for R&D or other upstream activities. Relatively low levels of SME productivity in MENA economies reduce the propensity to forge linkages with foreign firms in higher value-added segments of the supply chain. They also reduce the possibility of transfers of technology and managerial and technical expertise.

MENA governments should opt for targeted policy actions to enhance SME-MNE linkages. They could further develop business development services (BDS). This includes supplier development programmes

such as those helping SMEs to form consortia (e.g. to respond to large orders from clients), improving quality, and strengthening managerial and technical skills. Other programmes could facilitate SMEs access to resources such as finance and technology. Governments can also support business linkages through the provision of matchmaking services and the development of high-quality supplier databases. All MENA IPAs offer such services but these are often implemented on an *ad hoc* basis, and are not part of a specific, more explicit, linkages programme. IPAs could also help maintain, through intensified and digitalised aftercare services, close contact with foreign firms with established relationships with local suppliers to address temporary challenges related to disruption in GVCs resulting from Covid-19.

Strengthening responsible business conduct would help advance sustainable development goals

In an effort to attract quality investment, MENA governments could do more to promote and enable responsible business conduct (RBC) (Chapter 10). While nearly all MENA governments have adopted measures to support sustainable development, more could be done to create an environment that fosters the positive contribution of the private sector to development objectives. This includes advancing human and labour rights, reducing opportunities for corruption, and improving environmental protection in business activities and their supply chains. Governments are also encouraged to implement RBC standards in their own economic activities, through state-owned enterprises and in public procurement processes.

The notion that businesses should contribute to society is prevalent throughout the MENA region. In line with global trends, awareness and understanding of RBC in the region is growing and increasingly moving from approaches based on philanthropy and social investments towards a more comprehensive approach that looks at how core business operations affect society. Promising initiatives driven by businesses and other stakeholders could be leveraged to communicate clear expectations on RBC and support a common understanding of RBC among businesses of all sizes and types.

The impetus to promote RBC among MENA businesses is not only a social matter but also an economic one. As demands for RBC are growing, companies that participate in global supply chains must be aware of international expectations of RBC. Some of the key trading partners of the eight MENA focus economies, such as the EU, have integrated RBC principles and standards in their policies and legislations. This makes promoting RBC particularly important for MENA countries to ensure integration in supply chain networks.

Businesses that implement RBC principles and standards are also better equipped to sustain supply chain and operational shocks, and ultimately build resilience and long-term value. This is also relevant in the context of the Covid-19 pandemic and its impact on supply chains as well as occupational safety at work.

Important commitments towards RBC have been made, although approaches differ across countries. Four MENA governments – Egypt, Jordan, Morocco, and Tunisia – have adhered to the OECD Declaration on International Investment and Multinational Enterprises, thus committing to promote the OECD Guidelines for Multinational Enterprises and to establish a National Contact Point (NCP) to further their effectiveness. NCPs are agencies established by governments to promote the Guidelines, and to handle cases as a non-judicial grievance mechanism. In Morocco, the NCP has taken an active role in the promotion of RBC. In most cases though, this mechanism has been under-utilised and should be strengthened to fulfil its mandate and support the sound design and implementation of RBC policies in the region.

Governments could also leverage existing collaborative initiatives to actively promote and disseminate RBC due diligence instruments among businesses in key industries. In particular, supporting collaborative initiatives, facilitating dialogue and supporting application of the OECD Due Diligence Guidance for Responsible Supply Chains in the Garment and Footwear Sector could improve industrial relations and enhance competitiveness of the garment sector in MENA economies.

Priority 4: Strengthen good governance and co-ordination to deliver better investment policy

MENA countries have undertaken numerous reforms of their institutional framework for investment…

An effective investment policy and transparent environment for investors are grounded in good public governance and strong institutions. Notably, the regional wave of investment law reforms in the past decade has significantly revamped the institutional framework governing investment policy in the MENA focus economies. Reforms have bolstered the roles of IPAs as key bodies responsible for investment issues. Most agencies have been given organisational autonomy and regulatory power to improve the business climate, a task that is often handed to ministries in other countries (Chapter 6). Depending on the agency, this includes screening of foreign investment projects, granting fiscal incentives or delivering business licences. Morocco and, to a lower extent, Algeria and Lebanon, separate more than other focus economies investment policymaking, a mandate fulfilled by ministries, from investment promotion and facilitation.

…but clarifying responsibilities and strengthening co-ordination over investment policies continue to be priorities

Combining investment promotion and facilitation with policymaking responsibilities has given some IPAs the ability to administer regulatory procedures themselves so that they can help investors better navigate them. But investment policy is an issue requiring policy responses that do not fit neatly within any single governmental department or agency. The breadth of MENA IPAs' mandates, which has frequently evolved, means their responsibilities overlap with those of other government bodies, more than in other countries. This can generate confusion of roles and affect IPAs' credibility to voice private investors' concerns while they also regulate their operations. Such wide mandates also weigh on agencies' ability to properly achieve their mission of promoting and facilitating investment.

One priority for MENA governments is to clarify responsibilities and strengthen co-ordination over investment policy, promotion and facilitation to reduce institutional overlaps and conflicting objectives. This is particularly important in institutional settings where the IPA has numerous mandates and holds regulatory functions, which may negatively affect their ability to carry out their core investment promotion functions. Investment-related responsibilities across different government bodies and agencies need to be balanced, sufficiently funded, explicit, and mutually understood by all actors. In this endeavour, clear and targeted institutional reforms should be preferred to hastily executed reorganisations as these could create uncertainty for investors.

Inter-agency collaboration would deliver better investment policies and services

Good governance where administrations work in a collaborative manner is crucial for delivering clear and transparent investment-related strategies. In particular, crafting an investment promotion strategy requires a whole-of-government approach as investment priorities need to be aligned with other major strategies – including trade, innovation, skills, and infrastructure (Chapter 9). Such strategies are not systematically developed in a collegial manner and not always publicly available in MENA focus economies, although they help raise countries' positive image within the international business community and inform it about investment opportunities.

Whole-of-government approaches to investment policy also involve crafting strategies and programmes that improve FDI sustainability outcomes and enhance business services delivery. In most of the MENA focus economies, initiatives to help SMEs establish business linkages with MNEs lack an overarching

government strategy and tend to be scattered across different institutions (Chapter 8). But effective delivery of linkages programmes require close collaboration between IPAs, SME agencies and the private sector, among others. This co-operation is also essential to establish mechanisms to facilitate the flow of information on supply chain opportunities for both local suppliers and foreign investors. This will help address temporary challenges related to disruption in GVCs resulting from the Covid-19 pandemic.

Governments of the region so far have addressed their integrity and investment agendas independently, but inter-agency co-ordination is also essential to improve business integrity (Chapter 11). Several of the eight MENA focus economies have enacted in recent years laws and strategies to strengthen the anti-corruption framework and promote business integrity, and have established specialised anti-corruption bodies. But the links between integrity and investment call for better integrating both the policy and the institutional framework. Investment and anti-corruption agencies and policy-makers need to coordinate more closely to advance their respective agendas in a mutually reinforcing manner.

Co-ordination between various governmental bodies is also essential to manage investment disputes and set up prevention mechanisms. Investors' claims often arise from measures taken at the sub-national level or by a sectoral ministry, not always prepared and competent to deal with the issue. Dispute prevention policies also require institutional links with a leading body having a co-ordinating role (Chapter 5).

Sharing responsibilities between national and subnational bodies could improve investment promotion and facilitation outcomes

MENA governments have been seeking to attract FDI to less developed regions, but policies sometimes have failed to account that each region is unique in the way it competes in global investment networks. The majority of MENA countries have a centralised approach to investment promotion and facilitation. Around a third of MENA IPAs never contact subnational agencies and only a few consult them to integrate local development plans into their national attraction strategy. IPAs work with their own local branches, when these exist, rather than with separate regional entities. Branches provide facilitation and aftercare services and sometimes run OSS services. The Moroccan agency is the only IPA with no subnational branches. The IPA cooperates with regional investment centres, which operate under the authority of governorates and the Ministry of Interior.

Investment promotion and facilitation should strike a balance between centralised strategic decision-making and sufficient leeway for subnational agencies to exercise their power. Whether there is a network of national IPAs with local branches or a system of independent subnational IPAs, MENA governments could give subnational bodies more room to conduct investment promotion and facilitation tasks, in co-operation with the national IPA. Regional institutions often have more knowledge on local assets and challenges, and could help develop investment promotion strategies that are better suited to the local context. In Morocco, for instance, a recent reform granted regional investment centres financial autonomy and the mission to provide single window services, conduct economic intelligence, promote the regions, and offer dispute settlement services. Implementation of the reform is ongoing.

Investment facilitation entails a whole-of-government approach and digitised services

Investment facilitation is one business service that requires close co-operation between government agencies, including at the subnational level. All MENA focus economies provide a wide range of investment facilitation services, although they tend to focus on pre-establishment services and less on aftercare and retention activities. Despite considerable efforts, business registration services in the region are often defined by administrative structures working in silos.

Digitalisation can support a whole-of-government approach to investment facilitation. It lowers corruption risks throughout the business establishment process and speeds-up procedures. In addition, as shown during the Covid-19 crisis, there is a benefit to having paperless procedures to obtain relevant information,

licences or permits. Yet, progress on investment facilitation as well as digitisation of procedures lies far beyond the responsibility of IPAs. It takes a concerted government effort to implement the necessary regulatory adjustments to make public services available online. Digitisation of pre-establishment procedures will also help MENA IPAs to focus on aftercare services, which are crucial to retain investors that may be considering relocating their operations during economic recovery from the pandemic.

Dialogue with the private sector on future reforms contributes to policy legitimacy

MENA focus economies could further include the private sector in government consultations over priority reforms and next strategies. Soliciting investor views, along with those of other stakeholders, when developing or revising policies contributes to policy legitimacy and effectiveness. It also instigates an environment of trust between the government and the business community, particularly in uncertain times. MENA governments could review IPAs' board membership to ensure a more balanced representation between governmental and non-governmental stakeholders (Chapter 6). They could also establish, or reinforce when they already exist, whole-of-government public-private dialogue platforms to consult systematically with the private sector. To avoid regulatory capture by a small group of large and influential companies, private sector participation in such consultation mechanisms must be based on transparent selection criteria.

Good governance of investment policy entails transparency in the monitoring of government actions

Pressure on MENA governments to demonstrate impact of reforms has been growing in the past few years, because of tighter budgets, popular demands, and overall governmental accountability. This trend is likely to accelerate following the Covid-19 outbreak as governments are more pressed than ever to attract FDI that can make the greatest contribution to sustainable development.

To ensure accountability, governments should set up proper monitoring and evaluation mechanisms of the reforms they plan and implement to improve the business and investment climate and communicate adequately. They also need to have accurate information about their IPAs' activities and impact. For instance, MENA focus economies could better spell out their objectives and targets on investment, and equip investment promotion strategies with key performance indicators (KPIs) to raise transparency about objectives and improve monitoring and evaluation of agencies' actions.

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Notes

[1] See, among others: (World Bank, 2015[17]) (Malik and Awadallah, 2013[20]) (Cammett et al., 2015[21]).

[2] Connections to the state can be formalised by current or former members of government on board, or involve more informal connections (such as family or other close personal relationships). For more details on privileged firms and their impact on economic growth see, (World Bank, 2015[17]) (Atiyas, Diwan and

Malik, 2019[8]) (compilation of analysis on the region, Egypt, Morocco, Lebanon, Tunisia and Jordan); (Diwan, Keefer and Schiffbauer, 2020[18]) (Egypt); (Rijkers, Freund and Nucifora, 2017[22]) (Tunisia).

[3] In some countries, privileged firms have been concentrated in a few sectors, while there are indications that in Egypt before 2011, politically-connected firms were present in half of all sub-sectors. Politically-connected firms appear to be more prevalent in natural resources and service sectors, including banking, real estate, tourism, media, distribution, and telecommunications. There is also evidence that privileged firms have benefited from special treatment in light manufacturing (Atiyas, Diwan and Malik, 2019[8]).

[4] In Tunisia, prior to 2011, 64% of politically connected firms operated in sectors subject to restrictions on FDI, relative to only 36% of non-connected firms (World Bank, 2015[17]).

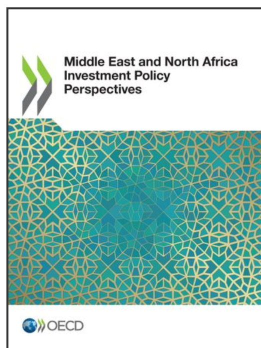
[5] Data for 8 economies author's calculation based on COMTRADE for the year 2017 (last year available for most of the economies), except for Libya, for which 2016 data was used (last available). Total trade in goods is calculated as exports plus imports. Data for ECOWAS the average share for 2016-2018 (World Bank, 2019[12]), ASEAN data from 2017 (ASEAN, 2018[23]).

[6] For a discussion on productivity growth and structural transformation in selected MENA focus economies, see for instance (Morsy and Levy, 2020[24]) and (OECD, 2020[6]) for Egypt, (Morsy, 2017[25]) for Jordan, (OECD, 2016[26]) for Libya, (OCDE, 2017[27]) for Morocco, and (OECD, 2018[28]) for Tunisia

[7] FDI can also have an indirect impact on job creation. In Jordan, for instance, FDI inflow had positive employment spillovers among domestic service providers, although it also led to a partial crowding-out of domestic firms operating in the same sector (World Bank, 2015[17]).

[8] Remittances play an important role in several of the focus economies. In 2019, remittances totalled between 10 and 16% of GDP in Jordan, Lebanon and the Palestinian Authority, and between 5 and 9% of GDP in Morocco and Egypt (World Bank Development Indicators).

[9] For details on the Covid-19 crisis response in MENA countries, see (OECD, 2020[13]) and (OECD, 2020[14]) for specific information on investment policy responses.



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