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Arab Financing for Development Scorecard

Foreign direct investment

Summary

Foreign direct investment (FDI) is a key means of international private finance, and a catalyst for job creation and economic growth. In recent years, Arab economies have undertaken meaningful reforms to improve the investment climate, with some seeing positive returns on these reforms. However, the Arab region managed to attract only 4 per cent of global FDI inflows, and remains far from exploiting its potentials, be it in terms of attracting FDI or ensuring that larger shares of their profits are reinvested within the region. Reliance on a few industries, political instability, and macroeconomic and labour market challenges continue to negatively affect investment growth. Sectors that attract the most FDI, including real estate, mining and energy, fell short of instigating transformational change or green growth. Despite accelerated job creation in services, the impact on unemployment in the region remains below global averages owing to the sectoral distribution of FDI, and the effect of a large informal sector.

The Arab region needs to include FDI as part of broader reform agenda that encompasses the pricing of externalities, rationalizing excessive and overlapping tax breaks and investment incentives, promoting competition, engaging in deeper regional integration to capitalize on nearshoring and the shortening of supply chains, revisiting thin capitalization rules, monitoring developments on the treatment of foreign income in other jurisdictions to better assess the risks and composition of FDI outflows (dividends, share-buybacks and debt repayments), aligning production patterns and incentives with the Sustainable Development Goals (SDGs), and adopting environmental, social and governance metrics to avoid green and blue washing.

The Committee on Financing for Development in the States Members of the Economic and Social Commission for Western Asia is invited to consider the global trend and regional realities outlined in the present document, and reflect on the Arab collective action needed to optimize the impact and effectiveness of FDI on the advancement of SDG outcomes.

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Introduction

1. Efforts to attract private investment in the Sustainable Development Goals (SDGs) were underway well before 2015, but progress to date has been insufficient. While there has been considerable attention placed on improving the regulatory and business environments to attract investments, it is becoming increasingly evident that these measures alone may not be enough to mobilize the necessary investments at the required speed and scale to achieve the SDGs. There is a growing consensus that government policies that support long-term decisions are needed, such as pricing externalities and phasing out harmful subsidies, coupled with adjusting corporate governance, reconsidering thin capitalization rules to address the persisting short-termism of capital, and better aligning internal incentives with the SDGs to avoid green and blue washing.

2. International private finance is not solely driven by the pursuit of the highest return, but also by the desire to reduce risks or at least be adequately compensated for them. Rising risk exposures in relation to the cost of financing explain the resulting patterns witnessed in foreign direct investment (FDI), including greenfield, mergers and acquisition, or international project finance. It is therefore vital to recognize these risks upfront to galvanize private investments, and ensure that public policies support private investment in many areas of public need.

3. FDI decisions and the behaviour of multinational corporations (MNCs) are influenced by various factors, such as market structures, capitalization rules, competition policies, and the instruments used to incentivize the delivery of public goods and services. While it is important to establish a favourable legal and regulatory environment and invest in infrastructure, there are other critical issues to consider. These include reducing political risks; promoting macroeconomic stability; implementing labour laws for decent jobs; ensuring health standards; providing access to regional markets through investment, trade and tax treaties maintained by source countries; and accounting for exogenous factors such as the terms of capital mobility, the digitization of the global economy, and the shortening of global value chains.

Foreign direct investment

Global trends and regional realities

4. In 2022, global FDI flows amounted to $1.3 trillion, a 12 per cent decline compared with 2021. The slowdown was primarily attributed to cascading regional crises, the war in Ukraine, increasing food and energy prices, and rising costs of debt leveraging. Tightened financing conditions brought about by interest rate hikes impacted international project finance and cross-border mergers and acquisitions. In 2022, the value of international project finance deals dropped by 25 per cent. This decline indicates a general decrease in investor sentiment and increased economic uncertainty. Moreover, cross-border merger and acquisition activity was 4 per cent lower during the same period. Announced greenfield projects, however, increased by 15 per cent. The largest increase in announced greenfield investments was observed in energy and gas supply, rising by more than a third to reach $181 billion as a consequence of the rise in hydrocarbon prices. Similarly, extractive industries experienced a significant surge, increasing eightfold to reach $95 billion; while basic metal products also witnessed notable growth, expanding from $12 billion to $43 billion.

5. FDI inflows to the Arab region amounted to $53.7 billion in 2022, representing 4 per cent of global FDI flows, which remains short of the record high of $88.5 billion witnessed in 2008 (6 per cent of global FDI flows). In 2022, FDI inflows to the Arab region increased asymmetrically ranging between a meagre 5 per cent in Somalia to a massive 122 per cent in Egypt.

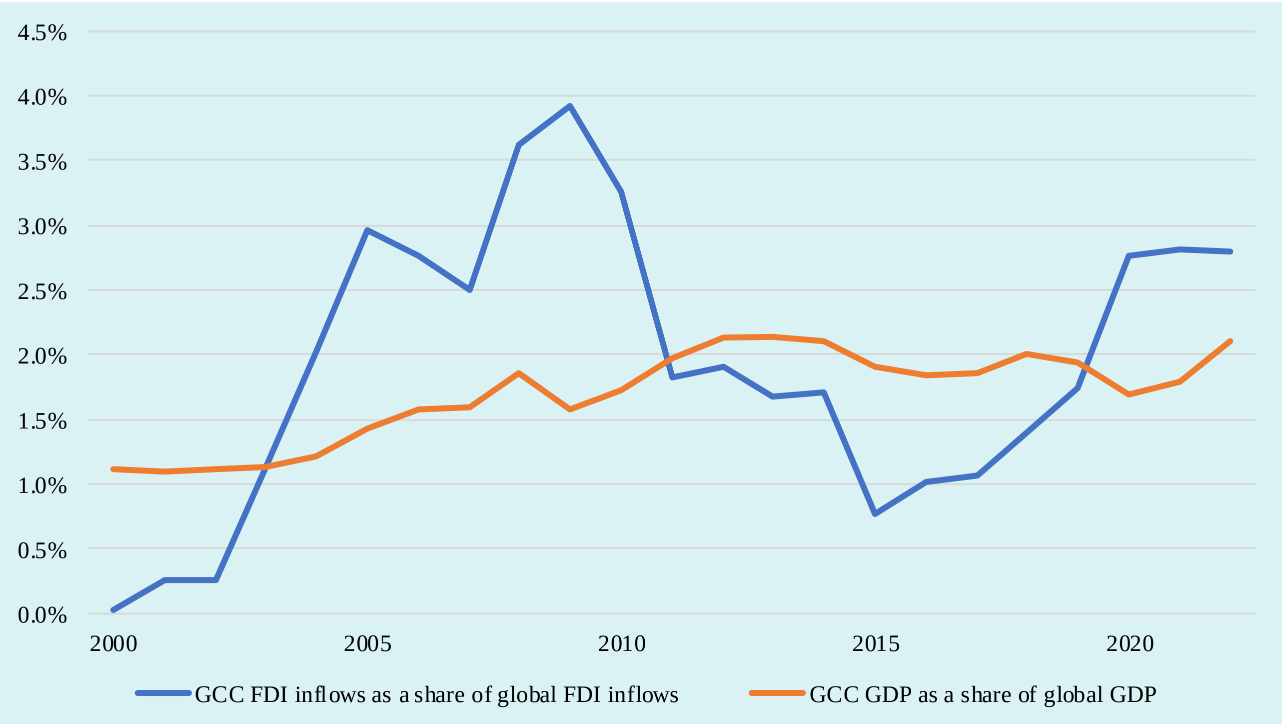
6. High-income oil-rich Arab economies witnessed an 18 per cent decline in their FDI inflows, reaching $37.1 billion in 2022. In contrast, middle-income Arab economies witnessed an 84 per cent increase of $6.3 billion in their FDI inflows, which was primarily attributed to a rise in FDI inflows in Egypt. Egypt, Morocco, Oman, Saudi Arabia and the United Arab Emirates stood out as the top five most sought-after destinations, accounting for 90 per cent of FDI received by the region in 2022. In the same year, Egypt experienced a

remarkable surge in FDI inflows, an increase of 123 per cent compared with 2021, reaching $11.4 billion. The United Arab Emirates saw a 10 percent increase in its FDI inflows, while Morocco and Oman observed a slight decline in their FDI inflows. In 2021, Saudi Arabia witnessed a significant threefold increase in FDI inflows, partly attributed to the Government's requirement for international companies to establish their regional headquarters in Saudi Arabia by 2024 to qualify for government contracts. However, the situation took a different turn in 2022, when FDI inflows to Saudi Arabia experienced a significant decline of 59 per cent, amounting to $7.9 billion.

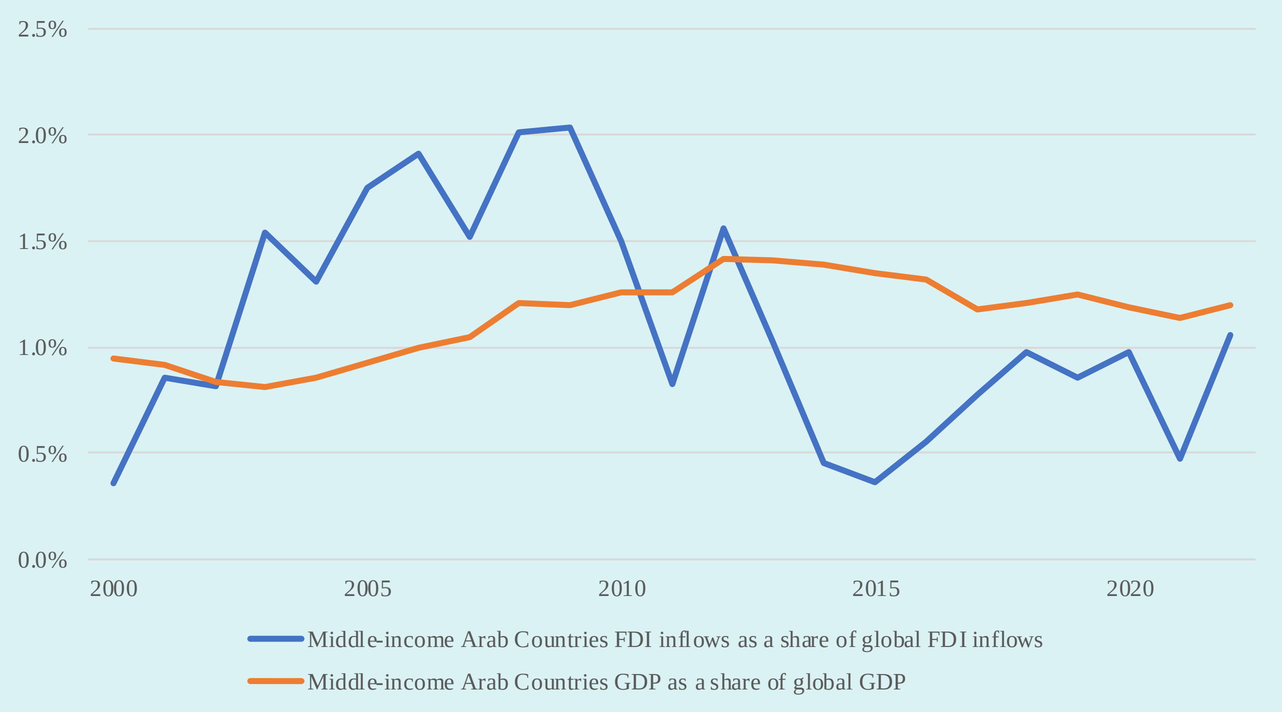
7. Over the period 2011–2022, Arab countries experienced an average annual growth rate of 2 per cent in FDI inflows. Examining FDI inflows by income groups within the region reveals that Gulf Cooperation Council (GCC) countries have surpassed their potential in FDI inflows (figure 1A), while middle-income countries are still lagging behind (figure 1B). A more detailed examination at the country level highlights that Algeria, Kuwait, Qatar and Saudi Arabia are falling behind in terms of FDI attractiveness, whereas Egypt and the United Arab Emirates have made significant strides in attracting FDI (figure 1C). While this pattern points to several Arab countries' attractiveness and untapped FDI potentials, it could also point to the region's unyielding consumption/production patterns, outdated or traditional instruments used for investment promotion, and the stagnant configuration of FDI inflows that it continues to attract. Despite the staggering 35 per cent drop in global FDI flows caused by the COVID-19 pandemic, the decline in the region was less severe at 5.7 per cent. However, this contingency is attributed to the fact that FDI inflows continue to be channelled towards traditional rentier sectors (chemicals, business services, construction, real estate and energy) that consistently fell short of instigating structural transformation. Recent reforms to improve the investment environment and galvanize inward FDI have yet to be analysed for their effectiveness.

Figure 1. FDI inflows and GDP for Arab countries, Arab middle-income countries and GCC countries as a share of global FDI and GDP, 2000–2022

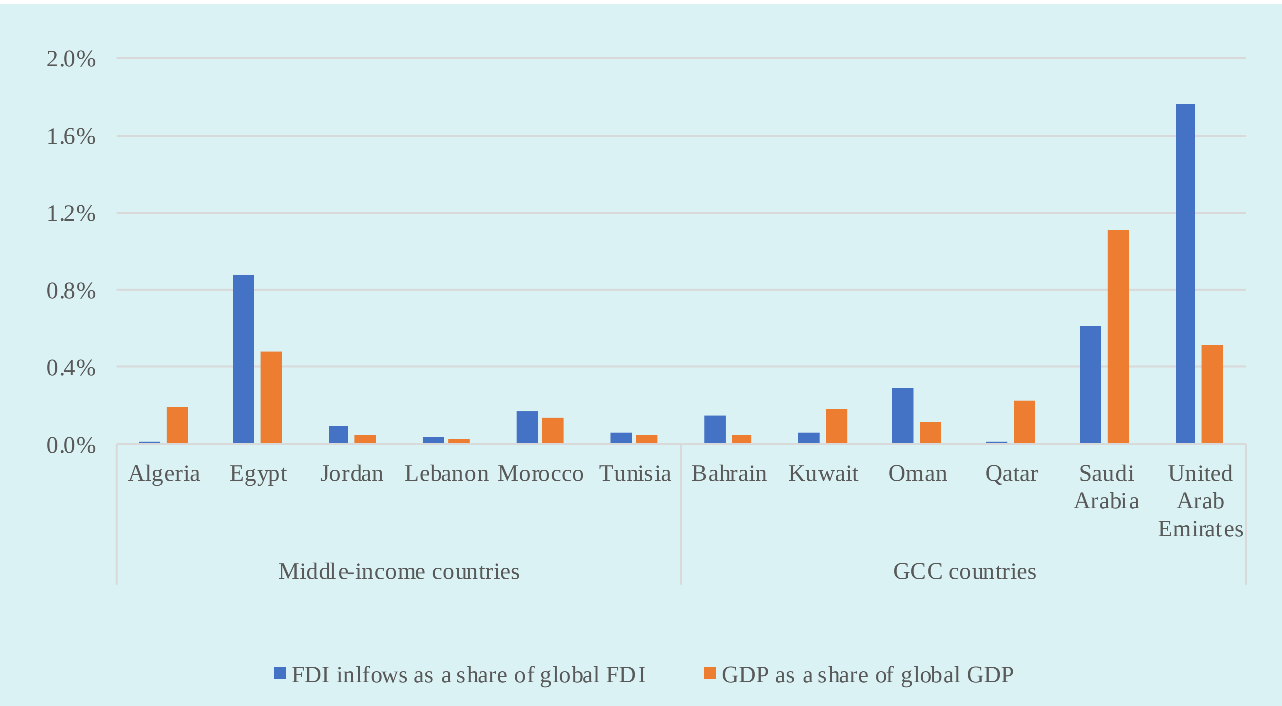
A. GCC FDI and GDP as a share of global FDI and GDP (2000–2022)



B. Middle Income Arab countries FDI and GDP as a share of global FDI and GDP (2000–2022)



C. Arab countries FDI and GDP as a share of global FDI and GDP (2022)



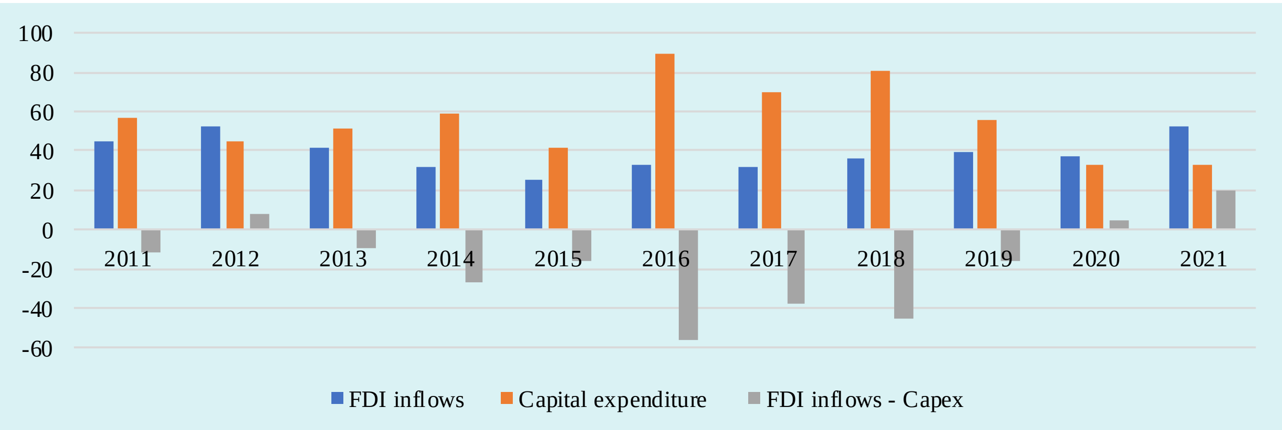
Source: ESCWA, based on data from UNCTAD, World Investment Report, 2023; and IMF, GDP, current prices.

8. Capital investments in greenfield projects hovered at around $32.8 billion in 2021 (5.2 per cent of total greenfield investments) and created 75,000 jobs in the region.[1] While capital investments in innovation-related sectors, such as software and information technology (IT) services, accounted for only 4 per cent of total capital investments received by Arab countries, these sectors generated nearly 7.6 per cent of jobs. However, apart from investments in business services and real estate, which contributed to the creation of 15 per cent and 9.6 per cent of jobs, respectively, FDI inflows to the region continue to be concentrated in capital-intensive sectors that generate fewer job opportunities. Almost half of jobs created have been in manufacturing, but the sector received only a quarter of total FDI inflows, compared with 40 per cent in countries of the Association of Southeast Asian Nations (ASEAN). Nonetheless, manufacturing has been the largest job generator for the region, where the textile sector, known for its labour-intensive nature, continues to be the highest employment creating industry.

9. In the Arab region, a $1 million capital investment resulted in the creation of approximately 2.3 jobs in 2021, primarily in service-related sectors, such as business and consumer services. The impact of FDI on reducing unemployment in the Arab region remains half of the global average. This is attributed to a stagnant sectoral distribution of FDI, which remains geared towards capital-intensive sectors that tend to generate fewer job opportunities, coupled with the prevalence of the informal sector.

10. With increased investment incentives and subsidy competition, particularly through the United States Inflation Reduction Act, and other industrial subsidy programmes introduced by the European Union's Green Deal Industrial Plan, the Made in China 2025 Strategy, South Korea and Japan, the transition to nearshoring and friend-shoring accelerated. The intensification of these geopolitical fault lines increased the risk of FDI concentration within aligned countries. The region has not been far from these developments, as intra-Arab capital investments reached $6.6 billion in 2021, a 50 per cent increase from $4.2 billion in 2020. In 2021, intra-Arab investment projects increased by 55 per cent, which constitutes 20 per cent of total capital expenditures in new FDI projects made in the region (figure 2).

Figure 2. FDI and capital investment (capex) in the Arab region, 2011–2021



Source: Dhaman, Arab Investment and Export Credit Guarantee Export Cooperation.

11. According to fDI Insights, of the $405 billion in new capital investment estimated globally in 2022, investment incentives were valued at $44.5 billion.[2] In 2022, the growth rate of capital investments was 29 per cent. However, the rate of increase in granting investment incentives was even higher, reaching 44 per cent, highlighting a more concentrated FDI market and a subsidy race-to-the bottom. Investment incentives in the region remain largely unaccounted for, since they do not appear as direct budgetary expenditures in the budget.

[1] fDi Insights, The fDi Report 2022: Global Greenfields Investment Trends, 2022.

[2] fDi Insights, The fDi Report 2022: Global Greenfields Investment Trends, 2023.

For example, it is estimated that Tunisia loses on average 2 per cent of GDP in public revenues as a lost opportunity associated with tax incentives.[3]

12. MNCs in the region operate at roughly the minimum scale that makes them profitable. Between 2011 and 2021, the Arab region returned on average $1.4 on every dollar gained in FDI inflows, effectively turning the region into a net exporter of capital. Globally, in 2017, an estimated $15 trillion in phantom investments is claimed to have been channelled to shell companies, including in some of the Arab region's financial centres. The Saudi ultimatum requiring MNCs to maintain their regional headquarters in the country is closely connected to the above-mentioned developments.

13. Mainstream economic theory suggests that FDI has a direct bearing on job creation, and capital formation with productivity gains reaped from increased competition. Empirical results, however, point to mixed effects for the Arab region. Cross-country studies reveal that the effect of inward FDI is uneven and remains contingent on several factors, including human capital, institutional quality, and financial development (figure 3). A lack of consistent findings stems from the heterogeneity of FDI along the mode of entry, the type of investment, and the relationship between foreign and domestic firms. In Morocco, for example, foreign investments in the manufacturing sector are more productive than their domestic peers, but are not associated with higher wages. In Jordan and Tunisia, foreign manufacturers have neither pushed productivity nor caused wage rises.

Figure 3. Selected determinants of FDI to the Arab region

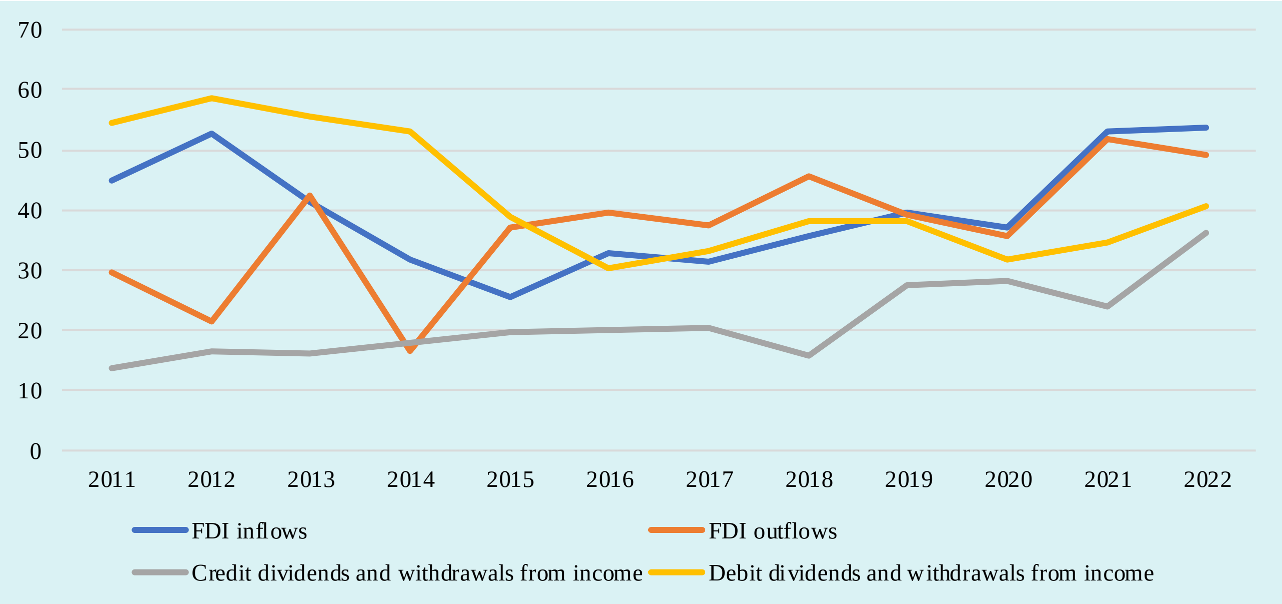
Source: ESCWA, Arab policy choices and financing opportunities in a new world tax order, 2023.

14. FDI inflows to the Arab region should be read in conjunction with outflows. Over the past five years, the region returned $1 on every $1 of FDI inflows on average. Over the period 2011–2022, the region returned 86 cents on every $1 of FDI inflows on average, indicating an increase in FDI outflows in recent years. In 2022, the region witnessed a 6 per cent decrease in FDI outflows. However, the region also witnessed lower reinvestment of foreign earnings than other regions. Moreover, over the period 2011–2022, FDI outflows from the region increased at a significant rate of 64 per cent, which stands in stark contrast to the global trend of a 6 per cent decline in FDI outflows. This considerable divergence between the regional increase and the global downturn raises pertinent concerns regarding financial outflows from the region. These flows have the potential to negatively impact domestic investment and overall economic stability within the region. Accounting for the scale of FDI outflows is crucial in assessing the overall picture of FDI dynamics in the

[3] IMF, Fair taxation in the Middle East and North Africa, 2015.

region, which seem to almost offset the FDI inflows that the region received ($53.7 billion) in 2022[4] (figure 4).

Figure 4. Investment inflows and outflows from the Arab region (Billions), 2011–2022



Source: IMF, Balance of payments and international investment position statistics.

Note: FDI inflows largely comprise the following three components: equity capital; reinvestment of earnings (not shown in figure 4); and inter-company transfers, debt and loans, and primary income on outward FDI. FDI outflows consist mainly of acquisition of assets, share-buybacks, distribution of dividends, and loan repayments.

15. Both inward and outward flows of FDI can mask various practices, such as tax abuse, profit shifting, phantom investments, and round-tripping by multinational corporations. However, it is equally important to recognize that the consistency over time in the amounts of net positive FDI inflows to the region has primacy in generating positive spillover effects in terms of human capital, knowledge transfer, and employment. These spillovers contribute to economic growth and development, underscoring the need to strike a balance between addressing potential abuses and harnessing the benefits of FDI for the region's progress. Accordingly, there is a need to strengthen sustainability disclosures and reporting requirements for large corporates to be included in a common set of sustainability metrics.

16. FDI stocks move in the same direction at relatively close margins, suggesting that aggressive tax planning is taking place: MNCs are aligning the repatriation of earnings, share buy-backs, and debt repayments (outflows) with the (re)investments in their subsidiaries (inflows). Over the period of 2011–2022, on average 54 cents on every dollar invested in Arab countries was repatriated, likely untaxed, as passive income on inward FDI. In contrast, countries of the Organisation for Economic Co-operation and Development (OECD) gain 46 cents on every dollar they invest abroad. Since 2018, Arab FDI outflows have consistently exceeded global averages.

17. Investment decisions, both along the extensive *(how much to invest)* and intensive *(where to invest)* margins, are driven by a host of structural determinants. A marginal improvement in institutional quality components (including voice and accountability, rule of law, regulatory quality, government effectiveness, political stability, and control of corruption) could lead to an increase of FDI by 22 per cent in the Arab region, while a marginal decrease in corporate income taxes by one percentage point would yield an increase in FDI of 14 per cent. The magnitude of the FDI-corporate income tax reaction in the Arab region is higher than the

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[4] Kuwait witnessed an outflow of $-25.6 billion in 2022.

OECD average (5 per cent),[5] suggesting that investments in Arab countries are likely to be mainly tax-driven. Hence, non-tax determinants of investments, which are not currently fully explored in the region, potentially have an even stronger influence on expanding FDI inflows to Arab countries.

18. According to the United Nations Inter-Agency Task Force on Financing for Development, efforts to increase private investment in the SDGs in developing countries, underway even before 2015, have not shown sufficient progress. Investment policies focused on attracting FDI need to be reviewed by strengthening SDG-aligned regulatory frameworks, developing the necessary infrastructure to support entrepreneurship, overcoming financial constraints, revisiting generous tax and subsidy programmes awarded to MNCs, improving governance models to address the persisting short-termism, and better aligning internal incentives with the SDGs.

19. Ultimately, investment promotion policy choices remain country-specific, tied to national priorities laid out in sustainable development plans, and can be supported by integrated national financing frameworks. There are several factors to consider in determining the combinations of private and public ownership, operation and financing of projects, and investments. These include whether investments will become sufficiently profitable to compensate private investors for the risks they bear; whether investments produce goods or services that will be effectively supplied by the market, or whether public intervention is warranted for social equity reasons; and whether private investors can bring efficiency gains.

20. According to ESCWA findings drawn from a series of national financing simulators, Arab high-income and middle-income countries are expected to receive $430 billion in FDI inflows by 2030, which represents a roughly 40 per cent increase in the Arab region's entire FDI stock.

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[5] OECD, Tax effects on foreign direct investment, 2008.