Making global value chains more inclusive in the MED region: The role of MNE-SME linkages

Background note prepared for the workshop "Business linkages in the MED region: Policies and tools", 17-18 April 2018, Beirut, Lebanon

This background note has been prepared for the regional workshop "*Business linkages in the MED region: Policies and tools*", taking place on 17-18 April 2018 in Beirut, Lebanon. This workshop is part of the EU-OECD Programme on Promoting Investment in the Mediterranean launched in October 2016, which aims at supporting the implementation of sound investment policies and effective institutions in the Southern Mediterranean region (MED region).

The objective of this background note is to support the policy dialogue on how to make investment in global value chains more inclusive in the MED region. The note provides trends in GVC participation of MED countries, provides preliminary measures of supply chain linkages between multinationals established in MED countries and domestic SMEs and discusses some policy options to make investment in GVCs more inclusive in the region.

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EU-OECD PROGRAMME ON PROMOTING INVESTMENT in the Mediterranean

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1. Introduction

Technical progress in ICT, the Internet, transport and other services, coupled with the development of ever more complex products made it possible for multinational enterprises (MNEs) to establish international production chains. Through investment and trade, MNEs invest worldwide and exchange intermediate products in cross-border production networks, referred to as global value chains (GVCs). They combine multiple channels – import, export, foreign direct investment (FDI), and movement of business personnel, services, data and licenses – to optimise international business strategies and enhance productivity.

Policymakers in the southern Mediterranean basin (MED) recognise the importance of trade and investment, as the two engines of globalisation, to achieve higher economic diversification, living standards and to promote job creation. They also recognise that GVCs that are more "inclusive" can only be achieved by further unlocking the barriers for small and medium-sized enterprises (SME) competitiveness. Relative to large firms, SMEs face constraints that lower their opportunities to be competitive players in the global market. GVCs can relax these constraints by providing SMEs opportunities to plug into GVCs as suppliers of MNEs invested in the region. MED economies record, however, only limited development benefits from their participation in GVCs, e.g. little opportunities to empower the local economy and enable SMEs to export, develop managerial skills, and innovate.

The objective of this background note is to initiate a policy dialogue on how to strengthen the participation of MED countries in GVC and make them more inclusive in the region. The note provided a basis for discussion for the conference "*Business linkages in the MED region: Policies and tools*", in April 2018 in Beirut, Lebanon. It is divided in three sections:

- **Section one provides trends in GVC participation of MED countries**. GVCs have been promoted as a key way for the region to achieve higher export diversification and more sustainable economic and social development. The note presents some figures on MED countries participation in GVCs and discusses the development outcomes from such participation.
- **Section two measures supply chain linkages between multinationals established in MED countries and domestic SMEs**. FDI can contribute to forging more inclusive GVCs through business linkages between foreign affiliates of MNEs established in the MED region and domestic SMEs. Business linkages refer to sales and purchasing linkages and other types of collaboration among firms. The section measures the extent and the type of linkages between MNE affiliates present in the MED region and SMEs. The measures for the region are benchmarked against Southeast Asia.
- **Section three discusses some policy options and priorities to make investment in GVCs more inclusive in the MED region**. The policy environment is a crucial ingredient for attracting foreign investment, enabling SMEs growth, and anchoring investors through deep linkages with the local economy. This section describes how institutions such as investment and SME promotion agencies could play a key role in developing deeper MNE-SME linkages. Policies such as the use of targeted and smart incentives, Special Economic Zones (SEZ), or the promotion of diaspora investment can be potentially relevant tools.

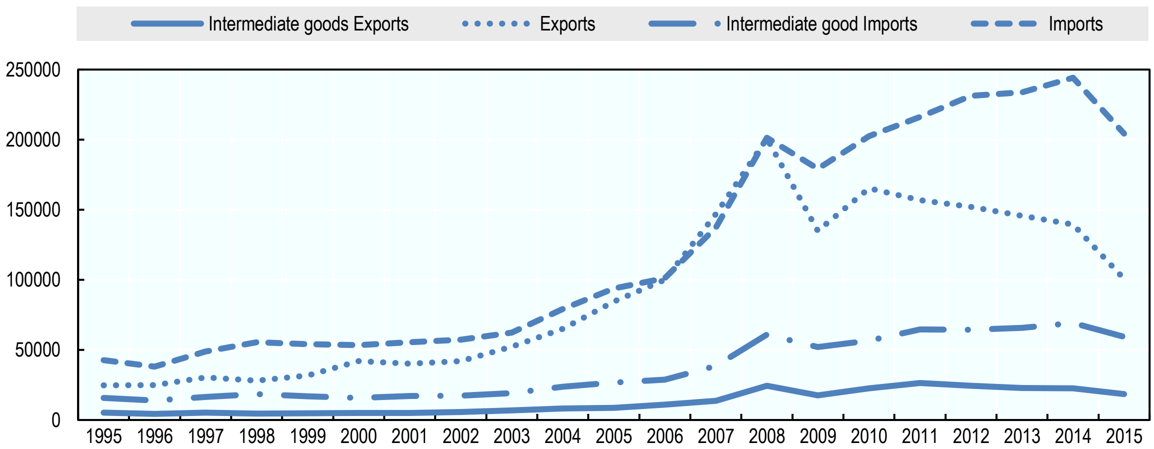
2. Trends in GVC participation of MED countries: The trade side

Countries of the Southern Mediterranean basin (MED) witnessed a sustained increase in their trade-to-GDP ratio over the last three decades. While remarkable, this surge remains moderate compared to other regions such as Southeast Asia. Trade in the MED region also considerably slowed down following the global financial crisis in 2008 (Figure 2.1). Since then, trade contracted for some of the countries and stagnated for others, particularly in the last few years of instability the region has been witnessing.

The expansion of trade in the Middle East and North Africa (MENA) region (MED plus Gulf Cooperation Council countries and Iraq), reflects to some extent a trend of over-importing compared to other regions of the world (Francis and Schweiger, 2017). In contrast, MENA countries' exports are below their potential despite the region's strategic geographic location and large market size, two key trade performance factors (Jaud and Freund, 2015). Such factors, and others, such as a common language, should also boost trade between MENA countries. Intra-regional trade is nevertheless weak and represents only 10% of total trade in the whole MENA region (OECD, 2016). The limited level of regional integration observed in the Southern Mediterranean basin suggests that trade agreements among countries of the region have not been very successful in their effort to stimulate intra-regional trade (Behar and Freund, 2011).

Figure 2.1. Trade expansion in the MED region came to halt since the global financial crisis

In USD Million



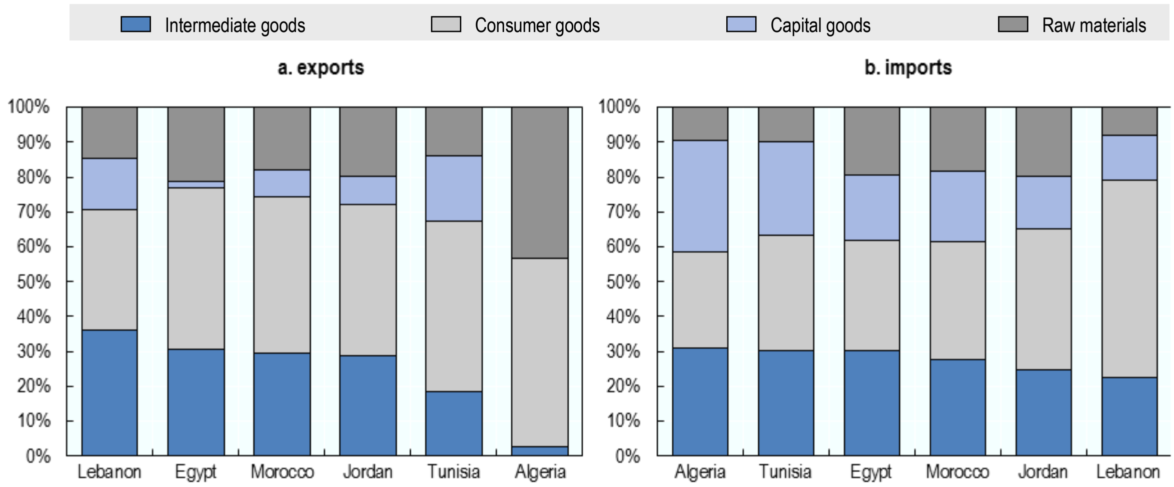
Note: The MED aggregate excludes Libya and Palestinian Authority.
Source: OECD based on World Integrated Trade Solutions Database (WITS).

The nature of trade matters for MED integration in global production networks

Beyond the magnitude of exports and imports, the nature of traded products also matters for the development of MED economies and their integration in the global economy. The export basket of the MED region is not widely diversified: hydrocarbon products account for over 90% of total exports from Algeria and Libya, for instance. Trade in services constitutes a quarter of global trade and became an increasingly important factor of global production, as most goods require services for their fabrication (Kowalski et al., 2015; IMF, 2017). However, in the MED region trade in services represented around 15% of GDP in 2016, yet there are strong disparities across countries (54% in Lebanon, 27% in Jordan, 23% in Morocco, 14% in Tunisia, and 9% in Egypt).[1] While countries of the MED region have made progress in removing barriers to goods trade, restrictions in services trade are still high throughout the region (Karam and Zaki, 2015).

Driven by impressive technological progress, the fragmentation of global production chains in the last two decades led to a surge in the trade of intermediate products. As a result, more than half of world manufactured imports are intermediate goods and more than 70% of world services imports are intermediate services (De Backer and Miroudot, 2014). This phenomenon has been a source of increased efficiency and firm competitiveness. In the MED region, the share of intermediate goods in total trade, particularly exports, increased to some extent in the mid-2000s before stagnating in the last few years (Figure 2.1). The region has become for instance a major destination for intermediates produced in South Asia (Kowalski, P. et al., 2015). Exports of intermediate products accounted for more than a quarter of total exports in MED countries between 2010 and 2015, excluding in Algeria (Figure 2.2). Imports of intermediates represented between 20% and 30% of total imports.

Figure 2.2. Trade in intermediate products in MED countries (2010-2015 average)



Note: Data for Libya and the Palestinian Authority is not available.
Source: OECD based on World Integrated Trade Solutions Database (WITS).

MED countries participate in GVCs but with limited development impact

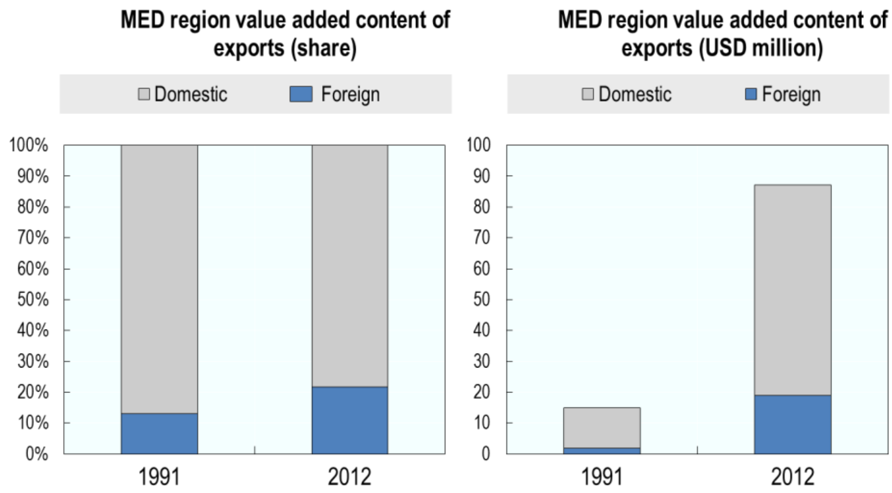
The organisation of international production, trade and investment within global value chains (GVCs), where stages of the production process are located across different countries, has become a dominant feature of globalisation. In the Southern Mediterranean basin, firms' participation in GVCs has been promoted as a key way to achieve higher export diversification and more sustainable and inclusive development. Over the last two decades, policymakers in the region focused their policies on integrating their economies in such globalised networks of trade, investment and production. As a result, some MED economies succeeded more than others in participating in GVCs. The impact of such

[1] Services trade is the sum of export and imports divided by the value of GDP. Source: World Bank, World Development Indicators database online, 2018.

participation in GVCs on economic development has been however limited, depending on countries' different compositions of export baskets or positioning in supply chains.

From the trade perspective, GVCs reflect foreign and domestic value added embedded in a country's exports (see box 2.1 for definitions). In the MED region, both foreign and domestic value added strongly increased over time (Figure 2.3). Domestic value-added, which is ultimately the part of exports that contributes to GDP, makes the bulk of value-added in exports in the MED region. Domestic value-added increased at a sustained rate between 1991 and 2012, even when the MED aggregate excludes oil producers such as Algeria and Libya. The growth rate of domestic value-added is however weaker than the one foreign value-added witnessed. Ultimately, countries may benefit from GVC participation by enjoying a smaller share of a bigger pie.

Figure 2.3. Foreign and domestic value-added in MED economies exports (including hydrocarbons)



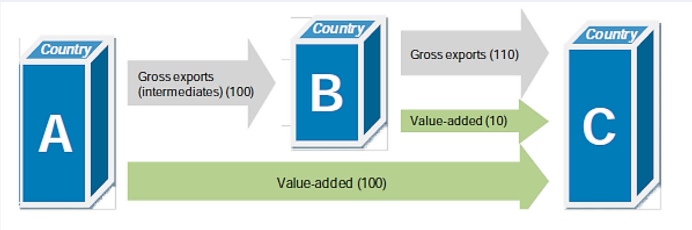
Note: The MED aggregate excludes Algeria and Libya. Data for the Palestinian Authority is not available.
Source: OECD based on UNCTAD-EORA GVC database.

Box 2.1. Measuring trade participation in Global Value Chains: Concepts and definitions

Conventional measures of international trade do not always reflect the flows of goods and services within global production chains. The international fragmentation of production has weakened the interpretability of trade data as intermediate goods and services cross borders several times on the way to their final destination. This is referred to as the double (or multiple) counting problem of international trade statistics.

Measuring Trade in Value-Added (TiVA) addresses this issue by considering the value added by each country in the production of goods and services that are consumed worldwide (see figure below). This has led to the development of TiVA statistics providing new insights on GVCs, notably the OECD-WTO TiVA database.

How trade in value-added is measured?



For country coverage purpose, this background note uses the UNCTAD EORA-GVCs database to measure MED countries participation in GVCs. The database provides the following measures, based on UNCTAD (2013):

- **Foreign value added (FVA)** indicates what part of a country's gross exports consists of inputs that have been produced in other countries. It is the share of the country's exports that is not adding to its GDP.
- **Domestic value added (DVA)** is the part of exports created in-country, i.e. the part of exports that contributes to GDP. The sum of foreign and domestic value added equates to gross exports.
- **GVC participation**: It indicates the portion of a country's exports that is part of a multi-stage trade process, by adding to the foreign value added used in a country's own exports, referred to as *backward participation*, and the value added supplied to other countries' exports, referred to as *forward participation*. Forward participation captures the extent to which a given country's exports are used by firms in partner countries as inputs into their own exports.

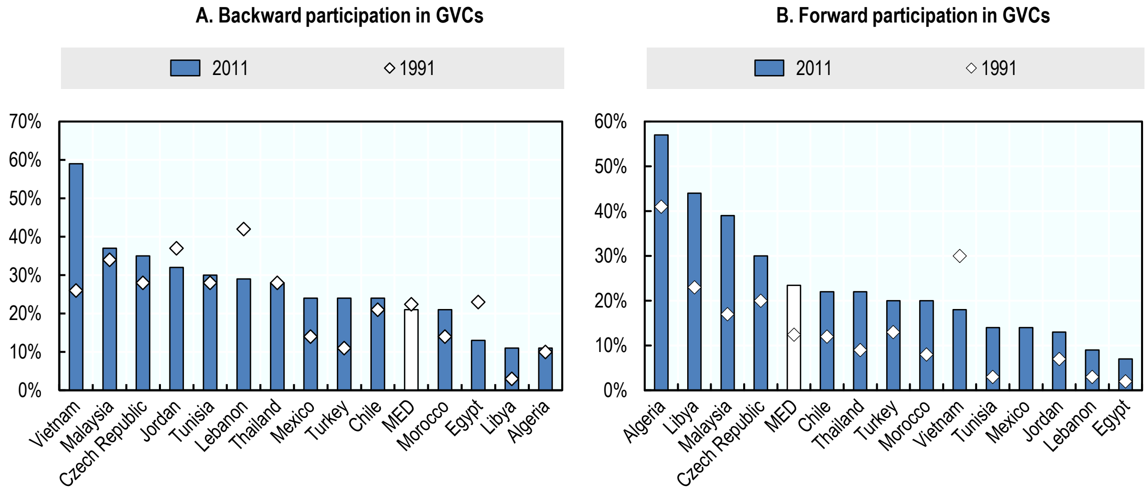
The UNCTAD EORA-GVCs database draws upon information from a variety of primary data sources, principally on national Input-Output Tables. To deal with missing data, interpolation and estimation techniques are used. The database should be therefore used with some caution when interpreting results for data-poor countries.

Source: Ahmad N. et al. (2017) ; Kowalski, P. et al. (2015); UNCTAD (2013)

Foreign value-added a share of total export (or backward participation in GVCs) indicates to which extent MED countries exports depend on imported products. In contrast with absolute figures above, the share of foreign value added did not increase over time. Within the region, backward participation in GVCs is relatively high in Jordan, Lebanon, Tunisia, and, to a lesser extent, in Morocco, as a result of more developed industrial bases, smaller geographical size, and lower reliance on primary resources (Figure 2.4, panel A). Forward participation, or the extent of linkages with foreign downstream buyers, is measured as the exported value added incorporated in third-country exports. (Figure 2.4, Panel B). In the region, the share of forward participation in total gross export is low in Egypt and Lebanon in comparison with Morocco and Tunisia. This measure can however be misleading for natural resource exporters like Algeria and Libya, as high commodity prices are driving the forward participation shares.

Figure 2.4. Participation in GVCs, MED and selected emerging economies, 2011 vs. 1991

In % of gross exports



Note: Data for the Palestinian Authority is not available.
Source: OECD based on UNCTAD-EORA GVC database.

The extent of backward and forward participation in GVCs and the positioning in the value chain may lead to different development outcomes. Overall, the developmental impacts of the participation in GVCs in the southern Mediterranean basin have been limited. MED countries succeeded only to some extent to upgrade their position in GVCs. They remain specialised in low value-added activities in these chains leading to little overall developments in terms of type of jobs and income levels. Most of their exports are also highly concentrated in a small number of export markets and sectors.

***Jordan*'s** strong presence in the garment and pharmaceutical manufacturing supply chains drives the relatively high backward participation rate in GVC. The Qualified Economic Zone (QIZ) in textile, signed with the United States in 1994, attracted large FDI inflows from Asian MNEs. These MNEs, often with multiple production locations, rapidly turned a country with a quasi-inexistent clothing industry into a leading regional garment exporter (Azmeh and Nadvi, 2014). The favourable regulatory regime in the QIZ played a key role in the location decision for Asian garment investors: It enabled them to generate rapid profits while ensuring low linkages with the host country and thus a more flexible production model (ibid). Such a business model, however, may not be promoting a sustainable participation of Jordan into garment's global supply chains. In the pharmaceutical sector, MNEs dominate the Jordan market and are present directly or through licensing, contract manufacturing, or co-marketing partnerships with local firms (Global Investment House, 2007).

Morocco and ***Tunisia*** have higher participation rates in GVCs than the average MED country. Besides textile and garment, both countries are well embedded in global supply chains of the electrical, electronic, and, to a lesser extent, ICT sectors. This participation is in large part due to geographic proximity to the EU market, even if this location also created a strong dependency towards this market**.** Morocco and Tunisia's participation in GVCs is also driven by generous incentives and trade facilitation regimes to exporting firms, such as the *offshore regime* in Tunisia (OECD, 2015). Both countries socio-economic challenges, such as territorial inequalities and high unemployment among young people and higher education graduates, have nonetheless highlighted the limited benefits of their participation in GVCs. Both Morocco and Tunisia report, for instance, a low demand for local skills in their GVC exports (UNECA, 2016). Such outcome may be due to an inadequacy between the skills supplied by young graduates and exporting firms' demand.

Egypt has relatively lower shares of backward and forward participation in GVCs than other MED economies. Larger countries, such as Egypt, may have lower backward participation because of their higher local capacity for producing specific inputs, mostly in manufactured, fuel, and food supply chains. In contrast with Morocco or Tunisia, Egypt has more diversified trade and investment partners, beyond Europe. These partners invested, *inter alia*, in the country's few SEZs, on which the government relies to foster integration into GVCs and to promote local development. One example is the SEZ of Ain-Sokhna, in the Suez Canal region, which was consists, *inter alia*, of several joint ventures with Chinese companies (UNECA, 2016). SEZs in Egypt are expected to reduce the lengthy and costly import-export procedures, which represent an important barrier for participation in GVCs. They should be nonetheless seen as "second-best" policy options and their impact on the economy should be regularly monitored (see section 4.5).

There is less information on Lebanon, Algeria, and Libya as regards to their participation into GVCs. In ***Lebanon***, the contribution of foreign value added to Lebanese exports is comparable to that of Jordan or Tunisia. Lebanon's integration in regional or global supply chains takes place mostly in financial services, the agricultural and food processing sectors. The extent to which Lebanon's exports are used by other countries as inputs into their own exports is nevertheless relatively low. Faced since a number of years with a strong influx of refugees from neighbouring Syria, Lebanon has been negotiating preferential market access with the European Union to promote EU-Lebanese trade and create job opportunities. This could play a critical role in fostering integration into more inclusive GVCs (OECD, 2016).[2] The bulk of ***Algerian*** and ***Libyan*** exports are in hydrocarbons. Such activities are in downstream sectors of the GVCs and therefore they require little foreign inputs.

While critical, there is little information on the use of services in GVCs in the MED region. With increasingly digitalised GVCs, access to high quality services – particularly telecommunications, transport and specialised business services – is becoming all the more important. Almost half of value added inputs to exports are service-sector activities, as most

[2] In Jordan, the EU-Jordan Compact signed in 2017 resulted in the simplification of rules of origin for 52 industrial categories.

manufacturers require services for their exports (UNCTAD, 2013). In fact, a significant part of the international production networks of MNEs are geared towards providing services inputs, as indicated by the fact that more than 60% of global FDI stock is in services activities (ibid). There is little data on the services sector share in gross manufacturing exports for MED economies. Evidence for Morocco and Tunisia, which are part of the OECD Trade-in Value Added Database (OECD TiVA), indicates that both countries use fewer services inputs in manufacturing GVCs in comparison with OECD member states.

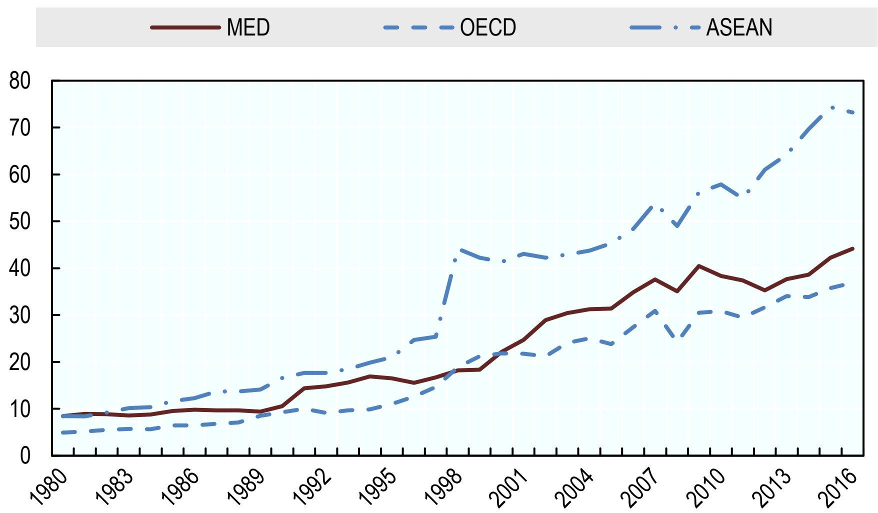
3. Investment in GVC: MNE-SME supply chain linkages in MED countries

Along with trade, the “GVC revolution” has been driven to a large extent by MNEs through Foreign Direct Investment (FDI), the other locomotive of the global economy (OECD, 2013). FDI is not only an important channel for exchanging capital across countries, it is also an important channel for exchanging goods, services, and knowledge and serves to link and organise production across countries.

FDI inflows to the MED economies witnessed a sustained increase over the last three decades, which nevertheless came to a halt at the end of the 2000s (figure 3.1). While significant, this surge was by far not unique to the MED region. In the 1990s, for instance, inward FDI for MENA represented 1.8% of GDP, compared to 2.3% and 2% in East Asia and Latin America, respectively. The situation in the MED region continued to deteriorate between 2010 and 2015: inward FDI flows to MED economies have gradually declined, while at the global level, in the OECD or in other emerging regions they have fully or partly recovered.

Figure 3.1. FDI stock increased in the last decades but came to a halt at the end of the 2000s

FDI stock (% GDP)

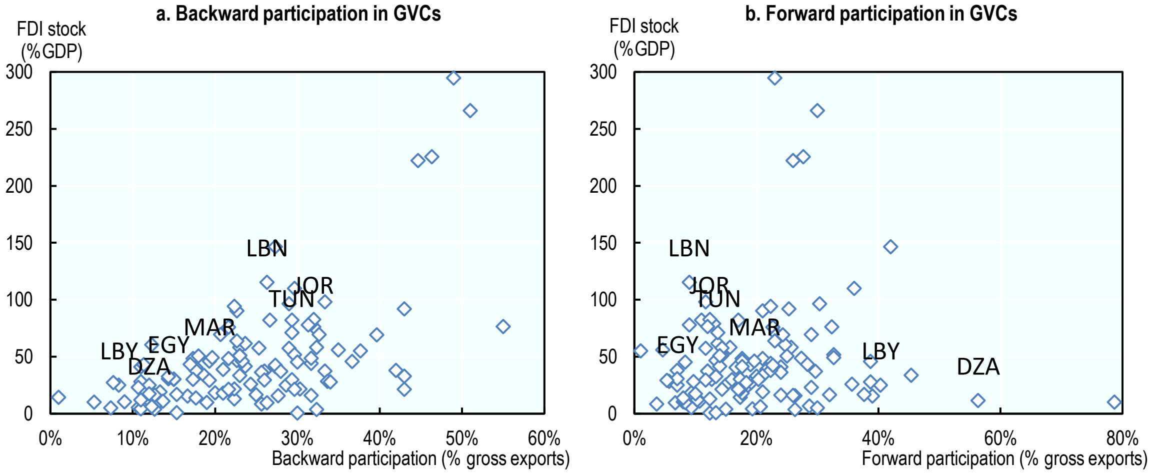


Source: OECD based on UNCTAD Statistics.

In most of the MED region, FDI inflows are concentrated in capital-intensive sectors with low job-creating potential (natural resources, real estate and construction) and, to a lesser extent, in light manufacturing (e.g. textile and garment). Since 2010, instability in the region has further skewed the sectoral composition of FDI towards the natural resources sector, which has been immune to political shocks. In contrast, FDI inflows in non-oil manufacturing and services sectors stagnated, while these sectors have a higher propensity to create jobs and promote transfers of technology and managerial know-how to host economies, making it more challenging for the MED region to participate in global value chains.

FDI have a significant association with GVC participation. With the establishment of foreign affiliates of MNEs in the MED region, investment can play a key role in fostering participation in GVCs, particularly through stronger backward linkages. Excluding resource-rich economies, MED countries with the highest FDI stock-to-GDP ratio between 2009 and 2012, such as Jordan and Tunisia, were also those that participated the most to GVCs (Figure 3.2). In contrast, Egypt has both the lowest FDI stock-to-GDP and GVC participation ratios in comparison with the other MED countries.

Figure 3.2. FDI is associated with a higher participation in GVCs in MED, 2009-2012



Note: Data for the Palestinian Authority is not available.
Source: OECD based on UNCTAD EORA GVC database, IMF BoP, and UNCTAD.

FDI pattern is strongly associated with the type and extent of GVC participation. FDI directed at establishing an export processing facility, like in Tunisia, Morocco and, to a lesser extent, Jordan, can boost backward linkages: MNEs' affiliates import large shares of intermediate products that are used in production and export (Kowalski et al., 2015). The case of Lebanon is particular as FDI stock represents more than 100% of GDP. FDI inflows attracted in the early 2000s were mostly in capital-intensive services sectors such as banking and real estate. Greenfield FDI to process raw materials, such as fuels, and observed to a great extent in Algeria and Libya, increases domestic value-added in exports as MNEs' affiliates export intermediate inputs to partner countries. In fact, the sectors that received the bulk of FDI in the MED region, e.g. real estate and petroleum activities, are also those with the least segmented supply chains (i.e. a little number of intermediate inputs are needed to produce the final good).

MNE-SME linkages in GVCs can involve multiple mechanisms

While GVCs coordinated by MNEs are responsible for most of global trade, SMEs may directly or indirectly plug into these value chains through the provision of inputs of goods and services, or less commonly, as MNEs themselves. Through their activities in home and foreign markets, MNEs account for roughly one-third of global output and between 50-60% of global exports. MNEs also source inputs and services from SMEs and larger firms in their networks of strategic partners and independent suppliers. Considering these supply chain linkages, MNEs may be responsible for up to 80% of global trade.

Foreign MNEs enjoy a performance premium over local firms across various metrics. Empirical evidence shows that MNEs are generally larger, more profitable and more productive. They also pay higher wages reflecting higher firm-level labour productivity. Furthermore, MNEs face greater pressure to conduct business responsibly, both at home and abroad, and are therefore likely to outperform local firms on a number of social and environmental performance metrics.

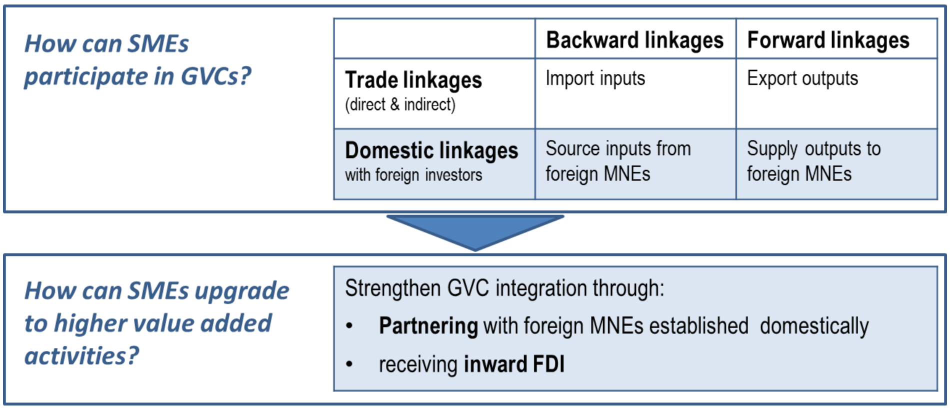
Leveraging FDI to enhance supply chain linkages with SMEs in GVCs can be an important opportunity for a more inclusive development trajectory. Given the performance premium of foreign firms over domestic ones, MNE-SME supply chain linkages are expected to result in positive impact on SMEs, depending on the extent and intensity of linkages, absorptive capacity of SMEs and the sector of activity. Linkages may enable SMEs to export, develop managerial skills, upgrade products or services to international standards, innovate, reduce costs, improve working conditions for employees, or lead to more sustainable production. Benefits of supply chain linkages for SMEs may differ if MNEs exert control and influence on SMEs (e.g. by engaging in specific contractual arrangements and support programmes, or by directly investing in SMEs), as compared to sourcing from SMEs through pure arm's length trade. Furthermore, the impact of linkages may depend on the characteristics of SMEs themselves.

SMEs access GVCs through supply chain linkages

There are multiple channels through which SMEs can participate in GVCs (OECD-UNIDO, 2018). SMEs may first integrate in GVCs via arm’s length supply chain linkages, involving the purchase and supply of goods and services. These linkages may involve trade, when SMEs directly import and export; or when they sell domestically for further processing and eventual exporting (indirect export) (Lopez-Gonzalez and Munro, 2017).

The focus in this note is on supply chain linkages that involve foreign MNEs (Figure 3.3, top box, second row). In this context, a backward linkage exists when SMEs purchase goods or services from foreign MNEs established domestically. A forward linkage exists when SMEs supply goods or services to foreign MNEs established domestically. Thus, SME integration in GVCs from the lens of linkages with foreign investors can be considered as a complementary concept to a broader framework, focusing on SME participation in GVCs via trade. The linkage with foreign investor channel could become a trade channel if inputs sold to foreign MNEs established domestically are processed and then exported.

Figure 3.3. Mechanisms of SME participation in GVCs



Source OECD based on OECD-UNIDO (2018) and Lopez-Gonzalez, and Munro (2017).

SMEs strengthen their participation in GVCs through deeper linkages and FDI

Greater involvement in GVCs occurs when SMEs forge deeper linkages beyond arm's length transactions with foreign firms (Figure 3.3, bottom box). These deep linkages essentially involve repeated interactions and greater knowledge flows. In practice, they can take many forms, including partnerships, contractual arrangements, technology licenses, franchises, research collaborations, as well as informal arrangements. Alternatively, deep linkages can arise when SMEs receive direct equity investments from foreign firms (inward FDI). Strengthened GVC participation can in some cases result in SMEs upgrading, including getting better at producing goods, moving to different tasks within the value chain, or changing the activity altogether.

MNE-SME supply chain linkages in MED: A benchmarking with ASEAN

This section measures the extent and the type of linkages between MNE affiliates present in the MED region and the local economy. The measures for the region are benchmarked against Southeast Asia, based on an OECD-UNIDO forthcoming work on MNE-SME linkages in the Association of Southeast Asian Nations (OECD-UNIDO, 2018).[3] The measures focus exclusively on the manufacturing sector. They quantify the following:[4]

1. The extent to which MNE affiliates in a MED country purchase locally-produced intermediate inputs and how much they generate a market for intermediate goods produced by local businesses.
2. The extent to which SMEs purchase intermediate inputs from foreign MNEs established in MED countries.

[3] Reference year's for the different countries are: Egypt (2013), Jordan (2013), Lebanon (2013), Morocco (2013), Tunisia (2013), Indonesia (2009), Lao PDR (2016), Malaysia (2015), Philippines (2015), Thailand (2016), Viet Nam (2015). Further information about the methodology is available upon request.

[4] From the point of view of MED SMEs, the first two represent measures of forward linkages, whereby they supply foreign MNEs established domestically with intermediate inputs, while the third represents a measure of backward linkages, whereby they source intermediate inputs from foreign MNEs established domestically.

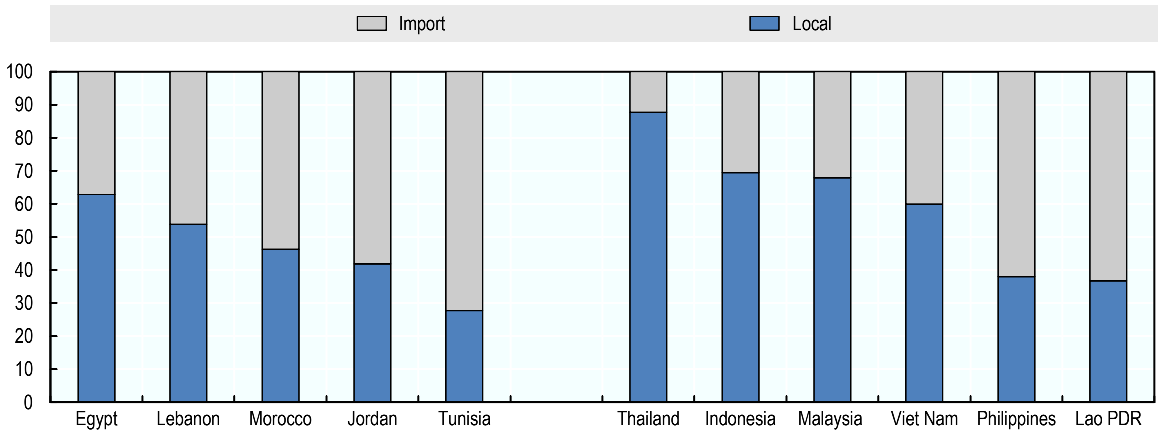
Manufacturing MNEs' sourcing of local inputs

Manufacturing MNEs' sourcing of local inputs could be higher in MED

Foreign manufacturers present in the MED region source significantly from local producers, but less than in Southeast Asia (Figure 3.4). As in Viet Nam, MNE affiliates in Egypt and Lebanon, source more than half of intermediate inputs from firms (both domestic and foreign) that produce locally. In Morocco and Jordan, this share is around 40%. The share of local sourcing by foreign MNEs established in Tunisia is less than 30%. These results mirror to some extent MED countries' GVC participation ratios previously shown. For instance, the share of foreign intermediate value-added in Egyptian export was very low, indicating possibly also a low demand for imported inputs.

Figure 3.4. Foreign manufacturers source local intermediates less in MED than in ASEAN

Foreign manufacturers' composition of intermediates sourcing, by origin



Note: The indicators in this figure include averages for manufacturing as a whole. It does not include services.
Source: OECD preliminary estimates based on OECD-UNIDO (2018) and World Bank Enterprise Surveys.

Variation between countries may be explained by differences in the sectoral structure of the economy, positioning within specific value chains, and policy factors. For instance, significant local sourcing may reflect a high local capacity for producing specific inputs, which may explain the higher share of local sourcing by foreign manufacturers in Southeast Asian countries. It may also indicate, however, higher trade barriers on the imports of intermediate inputs or on local sourcing relationships. For instance, export-only firms in Tunisia's offshore regime have little sourcing or subcontracting activities with onshore firms due to taxation and burdensome administrative custom procedures. This limits potential spillovers from the offshore regime in the Tunisian economy (OECD, 2018). The differences in shares of local sourcing by foreign MNEs may thus not indicate better integration of the local firms in production networks of MNEs established in the MED region. Nevertheless, these shares do provide a reference point on whether some linkages exist in the first place. Further analysis is required to understand the extent of linkages, as well as their intensity.

In the majority of MED economies, MNEs affiliates in manufacturing are concentrated in the food and garment sectors. Accordingly, the shares presented in Figure 3.3 often represent an average of foreign firms' local sourcing practices in these sectors. In Jordan, in addition to the food and garment sectors, MNE affiliates in the pharmaceutical and fabricated metals sectors purchase significant shares of intermediate inputs produced locally. In Egypt, foreign investors in manufacturing appear to have a diversified portfolio, from low-value added industries, such as food processing, to machinery production, a sector in which foreign manufacturers purchases of locally produced intermediates is relatively high.[5] Sourcing of intermediates in the paper industry is significant in the case of Lebanon.

MNE affiliates are a key source of revenue for MED domestic suppliers

In terms of market size, MNE affiliates in the MED region represent a vital source of revenue for local suppliers. The purchase of local intermediate goods by foreign-owned manufacturers matters for MED producers considerably more than for Southeast Asian producers (Figure 3.5, Panel A). In Lebanon, foreign-owned firms account for 75% of total purchases of locally produced intermediates. This share is between 40% to 50% in Egypt and Tunisia. In ASEAN, MNEs affiliates account at most for 20% of total purchase of locally produced intermediate products. One possible interpretation of such a difference between the two regions may be that the supply of intermediate products by local firms in MED economies is relatively limited due to lower economic diversification. Another conceivable reason may be that foreign affiliates of MNEs dominate the industry in which they are active and thereby the demand for related intermediate inputs.

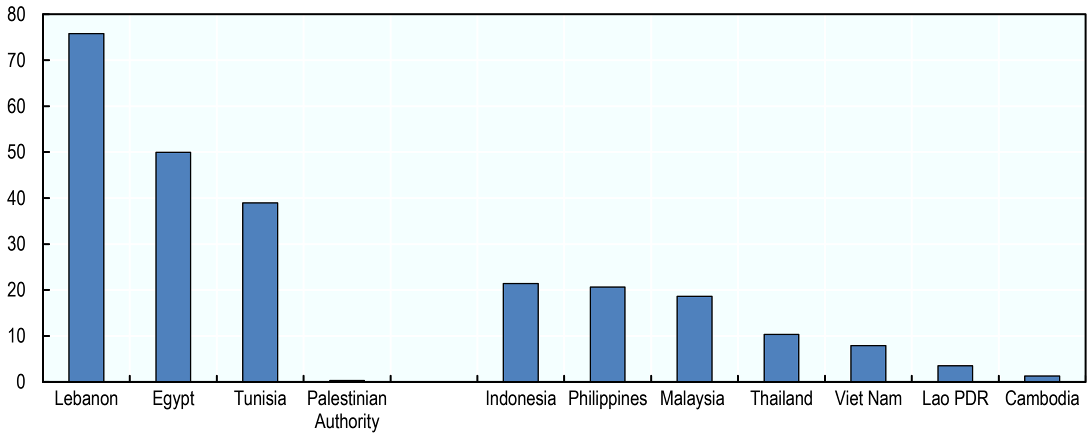
Local suppliers of MNEs can be domestic large firms, domestic SMEs, or other foreign-owned firms. In most MED economies, SMEs[6] and large firms jointly account for over two-thirds of all intermediates supplied to foreign MNEs (Figure 3.5 Panel B). The rest is supplied by other foreign-owned firms. The contribution of SMEs, specifically, varies across MED: In Lebanon, Tunisia and Egypt SMEs account for up to 40% of all inputs supplied to MNE affiliates, while in Jordan and Morocco this share is considerably lower.

As in Viet Nam or Cambodia, Jordan stands out with a relatively high share of foreign firms that supply intermediates to other foreign-owned firms (over 50%). Foreign MNEs often source from large first-tier international suppliers that are themselves MNEs for more capital-intensive and complex value chains/products (e.g. automotive) (OECD-UNIDO, 2018). From a policy perspective, different types of business linkages may have different impact on the local economy. For instance, investment that results in foreign-foreign linkages may be less effective in promoting greater inclusiveness than linkages between a foreign and a domestic firm.

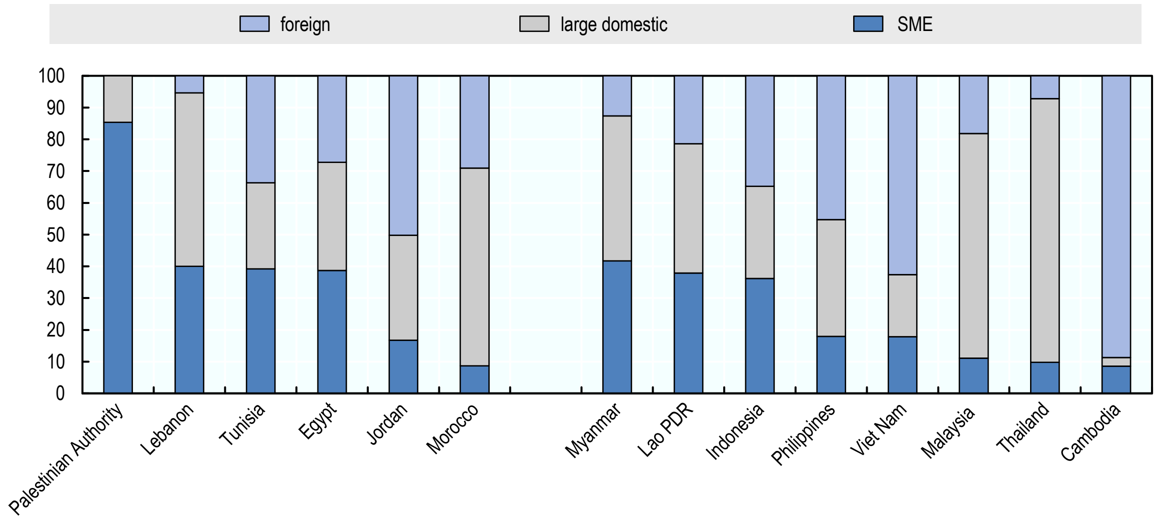
[5] There were not enough observations for Morocco and Tunisia to include firms in the machinery sector (e.g. automotive sector).
[6] SMEs are defined here as firms with less than 100 employees.

Figure 3.5. Foreign MNEs are an important market for some MED SMEs

a. Share of foreign firms in total purchase of locally produced intermediate products (in %)



b. Foreign firms' composition of domestic sourcing of intermediates, by supplier type (in %)



Note: The indicators in this figure include averages for manufacturing as a whole. It does not include services.
Source: OECD preliminary estimates based on OECD-UNIDO (2018) and on World Bank Enterprise Surveys

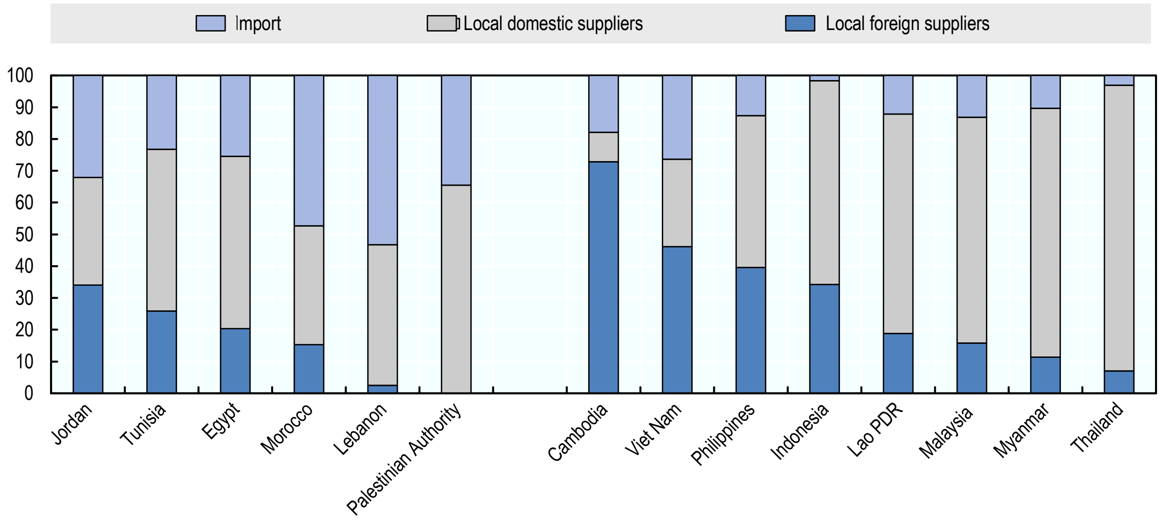
SMEs purchase only a small share of intermediates from MNE affiliates

Most MED SMEs source the bulk of their intermediate inputs from local domestic suppliers. This is particularly the case of SMEs in Egypt, Tunisia, and the Palestinian Authority, as they source from domestic suppliers more than 50% of totally purchased intermediates (Figure 3.6). These sourcing shares are lower than in most Southeast Asian economies (more than 60% in the case of Indonesia, Malaysia, or Thailand).

MED SMEs’ backward linkages, i.e. the sourcing of inputs either from foreign affiliates of MNEs or from abroad (imports), are nevertheless not negligible in some countries. SMEs source between 25% (Tunisia and Egypt) to 50% (Lebanon, Morocco) of their inputs from abroad. Sourcing from foreign affiliates of MNEs is relatively low. In Jordan, more than 30% of the inputs are sourced from foreign suppliers producing locally. This share is between 15 and 25% in Tunisia, Egypt, and Morocco. In Lebanon, while foreign affiliates of MNEs heavily depend on the inputs of Lebanese SMEs, they sell only a small fraction of their products to them (less than 5%). In contrast, SMEs in Southeast Asia source relatively more from foreign affiliates of MNEs producing locally, particularly in Cambodia, the Philippines, and Viet Nam. Southeast Asian SME also import only between 10% and 30% of their inputs from abroad.

Figure 3.6. MED SMEs purchase few locally produced foreign inputs

Domestic SMEs' composition of intermediates sourcing, by origin



Note: The indicators in this figure include averages for manufacturing as a whole. It does not include services.
Source: OECD preliminary estimates based on OECD-UNIDO (2018) and on World Bank Enterprise Surveys.

4. Policy factors to strengthen business linkages in MED countries

The policy environment is a crucial ingredient for attracting foreign investment, enabling SME growth, and anchoring investors through deep linkages with the local economy. Policymakers in the MED region recognise the importance of foreign investment linkages for local economic development, yet only few policies or programmes target MNE-SME linkages. While attracting foreign MNEs is important, it is only one part of the linkages equation. GVCs that are more "inclusive", i.e. GVCs that can benefit all segments of the populations, can only be achieved by further strengthening the overall environment for inclusive investment. Institutions such as investment and SME promotion agencies should play a leading role in this respect by developing programmes and tools that foster MNE-SME linkages. Programmes promoting Diaspora Direct Investment (DDI) can also be relevant tools for connecting diaspora investors with the local economy.

Develop investment policies that promote MNE-SME linkages

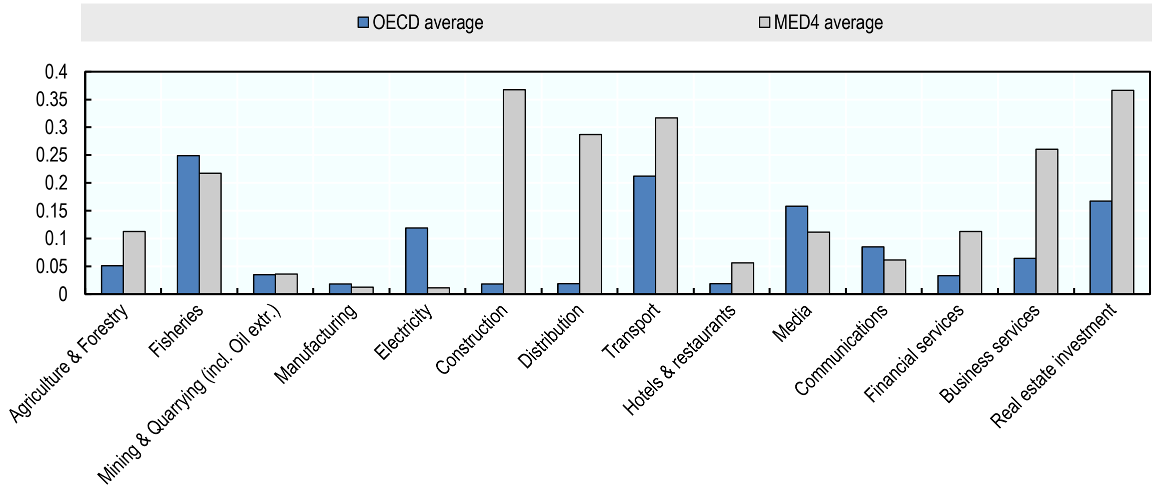
Value chain activity is sensitive to the quality of the business environment, which has been identified as one of the most important factors for enabling integration into global value chains (OECD, 2015). A wide array of horizontal and sectoral policies affects the extent to which MNE-SME linkages enhance SME outcomes in host countries.[7] Among these policy determinants, the regulatory framework for investment is a cornerstone of a policy ecosystem that can enable SME participation in GVCs through linkages with MNEs and reduce constraints for SMEs to become investors themselves. This section explores four dimensions of such regulatory framework that might, if well designed, positively affect the participation of SMEs in GVCs.

Reforming FDI restrictions in services to promote business linkages

Regulatory restrictions on FDI limit market access and thereby limit the potential for linkages between foreign investors and local SMEs. As such, reforming FDI restrictions can serve to promote business linkages (OECD-UNIDO, 2018). The pace of regulatory reform in MED countries in this regard has contributed to some extent to attracting FDI to the region. According to the *OECD FDI Regulatory Restrictiveness Index,* MED countries display moderate levels of FDI restrictions in the manufacturing sector (Figure 4.1 and Box 4.1). Outside of manufacturing, FDI restrictions remain however high in the services sectors. The *Index* indicates that FDI restrictions in sectors such as construction, distribution (wholesale and retail), transport, and financial and business services are on average higher than in the OECD.

[7] See Farole and Winkler (2014). See also Perez-Villar and Seric (2015) for a discussion on the role of institutional quality in driving interfirm linkages.

Figure 4.1. FDI in services is more restricted in MED than in the OECD area



Note: MED4: Egypt, Jordan, Morocco, and Tunisia. Data reflect restrictions as of end-December 2017.
Source: OECD FDI Regulatory Restrictiveness Index database http://www.oecd.org/investment/fdiindex.htm.

Box 4.1. The OECD FDI Regulatory Restrictiveness Index

The OECD *FDI Regulatory Restrictiveness Index* seeks to gauge the restrictiveness of a country's FDI rules. The measures taken into account by the index are limited to statutory regulatory restrictions on FDI (typically listed in countries' lists of reservations under FTAs). The *Index* does not score actual implementation of formal restrictions. Neither state ownership nor preferential treatment for export-oriented investors are scored, to the extent they are not discriminatory towards foreigners.

The *Index* covers 22 sectors, including agriculture, mining, electricity, manufacturing and main services (transport, construction, distribution, communications, real estate, financial services and professional services). Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is a simple average of individual sectoral scores.

For each sector, the scoring is based on the following elements:

1. the level of foreign equity ownership permitted,
2. the screening/approval procedures applied to inward FDI;
3. restrictions on key foreign personnel; and,
4. other restrictions, e.g. on land ownership, corporate organisation (branching).

Source: For more information on the methodology, see Kalinova, Palerm and Thomsen (2010). For the latest scores, see: www.oecd.org/investment/index.

FDI restrictions in services may impede the deployment of foreign investment in sectors such as infrastructure and logistics that are crucial for further GVC participation and strengthened business linkages. Further liberalisation could help raise efficiency (and reduce input costs) in sectors still dominated by large state monopolies and improve services efficiency and availability. Services liberalisation may be particularly important for the competitiveness and productivity of small manufacturers throughout the MED region. SMEs often rely more on high quality backbone and other services provided by upstream, external providers (OECD-UNIDO, 2018).

Establishing a smart incentives regime

Many governments recognise the potential benefits of MNE-SME linkages in GVCs and have developed and implemented targeted programmes to enhance linkages and associated benefits (often via specific financial or fiscal incentives). Despite quite limited evidence[8] (OECD, 2017) on whether these programmes are effective, or under what conditions they are effective, MED economies widely use incentive schemes (such as tax deductions and tax credits) to promote and encourage investment activities that enable economic and social spillovers and, in turn, supposedly enable business linkages (Table below). Tax deductions allow firms to subtract certain expenses (e.g. on training programmes, R&D activities, capacity building of SMEs, and environmental protection) or revenues (e.g. export revenues) from taxable income. Tax credits are similar but enable investors to use such expenses directly to reduce the amount of taxes owed.

All MED economies, to various extents, have some targeting of specific regions, either via special incentive provisions for less developed regions or additional incentives in special economic zones. In MED economies like in many countries worldwide, and mostly in developing countries, tax incentives are routinely chosen by governments to attract investment in general, and foreign direct investment (FDI) in particular, and this despite analysis indicating limited investment response to a lower tax burden relative to revenue forgone (OECD, 2015). Investment incentives are a common practice in developing countries as it is often easier to provide tax incentives than to correct structural deficiencies in the economy, for example, infrastructure or skilled labour. Tax incentives do not require an actual expenditure of funds or cash subsidies to investors and are politically easier to provide than public funds. Indeed, domestic savings, especially in emerging and developing countries, could be so low and financial intermediation so weak, that they are insufficient to finance economic expansion, effectively limiting business resources for investment. In such environments, a lower tax burden is thought to attract FDI as a source of external finance.

Certain firms may be specifically targeted to receive preferential tax treatment. Where tax relief is targeted, policy makers should examine and weigh arguments in favour of and against such treatment, and ensure that the different treatment can be properly justified. Some investment incentives have redistributive goals, for example, policies aimed at increasing investment and bolstering employment and growth in poorer parts of a country. Tax burden measures that vary considerably from one investment type to another must be explained. Policy makers want to know whether their targeted investment approach is effective in meeting its intended policy objectives (e.g. encouraging investment in disadvantaged regions), as well as to what extent the temporary character of some tax incentives (e.g. tax credits or deductions with sunset clauses) will affect the sustainability of their investment beyond the lifespan of such measures. Beyond this, efficient targeting requires accurate estimates of the amount of tax revenue forgone in order to compare the realised benefit against the costs associated with the targeted incentives. Further considerations in targeting tax incentives involve containing tax relief to targeted firms/activities only (e.g. to small businesses) (OECD, 2015).

[8] See Görg and Seric (2015) for a study of the African context.

International organisations and other institutions generally agree that more targeted approaches – both in terms of sectors and activities – should be favoured.[9] Targeted tax incentives and their effectiveness are under-researched, but some evidence supporting targeted approaches is emerging. In fact, international experience shows that targeted incentives for SME and supplier engagement, for example, have been demonstrated to be effective in other regions, such as in Malaysia and Singapore.

[9] See James (2013); See also the Report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank for an overview of options for a more effective use of tax incentives.

Table 4.1. Preliminary stocktaking of incentives types in MED and ASEAN economies

	Local sourcing promotion	Employment, training and skills, gender, diaspora	R&D and other strategic business services	Environmental protection	Real Estate/Land acquisition	High-tech/automation	Export	Import	Headquarter	Territorial/SEZs	Infrastructure
Algeria		Loans	Deduction	Loans	Deduction		Exemption	Exemption		TH/Reduction/Loans	
Egypt		Grants			Exemption/Grants		Exemption	Exemption		Exemption/Deduction	
Israel		Grants	Deduction				Exemption/Grants			Reduction	
Jordan		Grants		Exemption	Exemption	Reduction	Exemption	Exemption		Reduction	
Lebanon					Exemption					TH/Reduction	
Libya				Tax Holiday			Exemption	Exemption		Tax Holiday	
Morocco	Grants	Grants	Grants	Grants	Grants	Grants	TH/Reduction	Exemption	TH/Reduction	TH/Reduction	Grants
Palestinian Authority	Tax Holiday						Exemption	Exemption		Reduction	
Tunisia		Grants	Grants	Grants			Reduction	Exemption		Tax Holiday	Grants
Philippines							Exemption	Exemption	Reduction	Reduction	Deduction
Cambodia							Exemption	Exemption		Exemption	
Viet Nam		Tax credit	Deduction		Exemption/Reduction	Exemption/Grants		Exemption		TH/Reduction/ Reduction/Exemption	Exemption/Reduction
Laos					Exemption		Exemption	Exemption		Tax Holiday	
Malaysia	TH/Reduction/ Other financial incentives	Deduction	TH/Reduction/Other financial incentives	Reduction		TH/Reduction	Exemption			Reduction	Deduction
Thailand	Exemption	Deduction	Deduction					Exemption	Tax Holiday	Tax Holiday	Deduction
Indonesia						Tax Holiday	Exemption			Deduction/Exemption	Tax Holiday
Singapore		Deduction/Grants	Deduction/Grants			TH/Deduction	Exemption	Exemption	Reduction	Exemption	
Myanmar		Deduction	Deduction			Tax Holiday	Exemption	Exemption		Reduction	
Brunei Darussalam		Deduction		Deduction	Deduction			Exemption			

(dotted pattern)	Financial incentives
(vertical lines pattern)	Tax incentives
(diagonal hatching pattern)	Both

Source: OECD preliminary stocktaking based on national government website and on OECD-UNIDO (2018).

Providing guarantees of legal security and investor protection to support local sourcing

A cornerstone of the enabling environment for SME integration into GVCs, along with smart and targeted incentives, is the legal framework for investment. MNEs, when contemplating engaging into business linkages with local SMEs, need to be reassured that their property rights will be well protected throughout the lifespan of the sourcing contracts. Investors take into consideration the transparency and predictability of policies, as well as guarantees of legal security. Both international investors and local SMEs need to know that their rights will be respected. The ability to make and enforce contracts and resolve disputes is therefore fundamental for local sourcing conventions to function properly, and good enforcement procedures, which enhance predictability in commercial relationships by assuring investors that their contractual rights will be upheld promptly by local courts, are indeed associated with higher levels of linkages. Conversely, when procedures for enforcing contracts are overly bureaucratic and cumbersome or when contract disputes cannot be resolved in a timely and cost-effective manner, foreign investors may restrict their activities or refrain from engaging with local companies. As a result, guaranteeing good enforcement procedures or alternative dispute resolution mechanisms can serve to not only promote linkages between foreign investors and local SMEs but also to make technology transfers more likely.

Where contract enforcement is relatively poor, significant gains may be made in terms of promoting linkages with SMEs by reforming the judicial system or further providing alternative dispute settlement mechanisms. Various measures can efficiently respond to the need of modern societies for efficient and high-quality judiciary systems. They include such reforms as: adopting e-justice systems to facilitate the management of the judiciary caseload; and organising the judicial system along key areas of specialisation, e.g. by creating specialised commercial courts, IP courts, and land courts. Meanwhile, alternative dispute resolution mechanisms, including arbitration, mediation and conciliation, are increasingly used for resolving commercial and investment disputes.

Improvements in this area, as well as in the quality of the overall legal ecosystem of investors, are an important factor in driving MNE-SME linkages and should by no means be viewed as peripheral to more targeted measures. Transparent and predictable regulatory investment frameworks are particularly key for SMEs, which face more challenges in entering new segments of the economy, are less likely to have access to finance and are more vulnerable to bankruptcy risks.

Well-designed investment, bankruptcy and intellectual property rights laws and regulations are hence crucial to strengthen investor protection and contract enforcement and facilitate technology transfers, which can in turn further enable linkages between MNEs and local SMEs. International investment agreements (IIAs), although with variations in scope and content, also provide for standards of treatment of foreign investors and their investments. As such, they may provide an additional layer of security to covered investors, including by offering recourse to international investment arbitration to resolve investor-state disputes.[10] Along with dispute settlement provisions contained in the legislation and in IIAs, the adherence of all MED countries to international conventions, such as the *New York Convention on the Enforcement and Recognition of Foreign Arbitral Awards*, also

[10] OECD (2015)

provides a guarantee that contracts will be enforced smoothly, in the event a dispute is brought before an arbitral panel rather than before domestic courts.

Through both domestic laws and IIA networks that are among the widest worldwide, MED economies are progressively converging towards regulatory ecosystems that facilitate the upscaling and development linkages with SMEs. The vast majority of MED economies have recently introduced changes in their legal and regulatory investment regime, or are in the process of doing so, and have made sustained efforts to move closer to achieving a more transparent and enabling investment climate, with modern dispute settlement provisions and stronger guarantees of property rights protection. Each iteration of the investment law has been designed to address weaknesses in the existing one. The most recent laws in Jordan and Tunisia aim to streamline business registration while the recently adopted Egyptian investment law is focused primarily on providing more targeted "smart" incentives. Yet, each new legal amendment is not always in all areas an improvement over the earlier version. Frequent changes also have the disadvantage of creating temporary uncertainty for investors prior to the issuance of implementing regulations, and in some cases, legal amendments have brought about more insecurity than further legal predictability.

Box 4.2.The overall legislative framework for investment

As reflected in the *Policy Framework for Investment*, the investment environment is the sum of many different policies, as well as of the interaction among them. It cannot be reduced to one specific variable, whether the World Bank's *Doing Business* indicator or the OECD's *FDI Regulatory Restrictiveness Index*. By the same token, the overall legislative framework for investment will depend on a broad panoply of legislation, often combined in idiosyncratic ways which differ widely across countries. One of the most important laws in this respect in many emerging and developing economies is the investment law. It can cover domestic and foreign investors in one law or in separate laws and set the conditions for market access for foreign firms and offer national treatment for established investors. It can also include the provision of incentives and offer guarantees of protection of the investor's assets. These conditions could be provided in other rules and regulations, but an investment law is nevertheless often used as a signalling device to investors, particularly foreign ones, that the economy is open and accommodating to foreign investment. For this reason, an investment law is often the first point of reference for a potential investor.

Incentives may be included in the investment law or they may appear in the general tax law, as is considered good practice, although not the most common approach among MED economies. The negative list of restricted sectors might be embedded in the investment law itself or may appear in a separate decree. Market access commitments for a specific set of investors may also be established in international agreements signed by the government.

Other laws that matter for facilitating business linkages include the enterprise law, the bankruptcy law, the IP legislation and the laws and rules providing guarantees of contract enforcement. Competition law, or its absence, also determines the potential contestability of markets. Other relevant regulations for the integration of domestic SMEs into GVCs may be contained in sectoral legislation.

The protection of investors' property rights is often included in the investment law, if it exists, but more commonly in the constitution itself. An arbitration law can set out the procedures for settling disputes. In some countries, large investors in important sectors such as mining or infrastructure might sign individual contracts with the state which set out investor rights. To complement and strengthen this protective structure, governments often sign bilateral investment agreements or broader agreements which confer rights on investors from partner countries.

Going beyond this legislative and treaty structure, investors are also concerned about the issue of public governance: how these laws are actually implemented in practice and the general quality of the rule of law in the host country.

Source: Based on *Policy Framework for Investment* (OECD, 2015)

Promoting business linkages through Responsible Business Conduct

RBC principles and standards set out an expectation that all businesses – regardless of their legal status, size, ownership structure or sector – contribute to sustainable development and avoid and address adverse impacts of their operations. This encompasses impacts beyond the company itself and entails integrating and considering environmental and social issues within core business activities, including in the supply chain and business relationships.

These expectations are affirmed in the main international standards on RBC– such as the *OECD Guidelines for Multinational Enterprises* (OECD Guidelines), *the UN Guiding Principles for Business and Human Rights* (UN Guiding Principles), and the fundamental ILO Conventions – and increasingly in international trade and investment agreements and national development strategies, laws, and regulations.

Many businesses also find that responsible business is good business, in addition to ensuring that they comply with the applicable laws and meet societal expectations. Understanding, addressing, and avoiding risks material to business operations in a comprehensive way, i.e. beyond legal and financial risks, can often lead to a competitive advantage. For example, suppliers of MNEs may find that following international RBC principles and standards gives them an advantage over businesses that do not, as they are able to respond to and address concerns that may come up in risk analysis and due diligence efforts of the MNE. Additionally, recent empirical evidence shows that better standards are a positive determinant of FDI inflows.[11]

The introduction and implementation of RBC principles should therefore not be seen as mere cosmetic measures with no binding effect for both public authorities and firms operating along the value chain in the MED region. Increasing demand on businesses to go beyond a hortatory approach and apply international RBC principles and standards will affect investment in the MED region. Meanwhile, mainstreaming RBC at a government level and clearly communicating RBC priorities and expectations, including to the private sector, would help promoting linkages with MNEs, and hence maximising the development impact of FDI.

All MED governments have, in some form or another, already recognised sustainability as a development objective; however, they stand at different stages in terms of establishing and implementing policies that enable and promote sustainable investment. Five economies, namely Egypt, Israel, Jordan, Morocco, and Tunisia, are adherents to the OECD Guidelines. Nevertheless, major challenges remain in terms of establishing and enforcing an adequate legal framework that protects the public interest and creates an enabling framework for RBC. The region's continued success in attracting investment could be called into question in the medium-term if social and environmental issues affecting the business climate are not addressed.

Expectations that businesses observe RBC principles and standards cover the entire supply chain and affect suppliers and exporters. Suppliers that integrate internationally recognised environmental and social practices have a comparative advantage over those that do not as they can more easily address concerns about environmental, social, human rights or labour issues that may come up in the due diligence processes of MNEs when assessing country and supplier risks. MNEs are increasingly basing their decisions about where to do business on the ability to ensure predictable and reliable supply chains, capable of delivering effectively at the each stage (Taglioni and Winkler, 2014; OECD, 2014a: 27). It is estimated that costs of delays can be substantial for certain product categories and any delays due to, for example, labour unrests or environmental damage, contributes to those costs. (Hummels, 2007; OECD, 2014a: 27).

Governments could go beyond the promotion of RBC standards as a means to signal safe local sourcing, and use RBC as a tool for business matchmaking. RBC expectations should indeed also be included in FDI attraction efforts and may help attract MNEs that are more inclined to source locally.

One element of supplier databases and matchmaking events could be RBC. Governments could include RBC principles and standards in industry-specific training programmes as a

[11] See for example an industry-level study by Kucera and Principi (2017) that shows that stronger rights and governance have a positive effect on FDI, consistent with most prior studies, and that at the industry level, there is a larger positive effects of rights and governance on FDI for service than manufacturing industries.

way to build absorptive capacity of domestic companies and encourage business linkages with foreign investors. This could encompass everything from promotion to capacity building exercises to supporting cross-sectoral learning efforts (for example, supporting cost-sharing efforts within and among industries for specific due diligence tasks, participation in initiatives on responsible supply chain management and cooperation between industry members who share suppliers).

Additionally, training and awareness-raising with business leaders could also be useful in promoting a wider understanding and recognition of the importance of RBC. Educational institutions such as business schools can be important platforms. The authorities could make educational and training programmes more market driven by increasingly involving the private sector in human resource development policies and encouraging internal and external training by employers.

Unlock SMEs competitiveness to ensure a more inclusive GVC participation

More inclusive GVCs in the MED region can be better achieved through the development of more productive local economies. The competitiveness of the local economy not only determines MNEs investment location decisions, but also the development benefits such investments bring. Policymakers in MED countries could pursue policy reforms aimed at improving SMEs competitiveness in parallel to opening up to trade and investment.[12] Policies may entitle improving the regulatory framework, offering business development services to SMEs, or supporting the creation of industry or activity-specific clusters.

SME characteristics and performance influence their chances of becoming suppliers to foreign affiliates of MNEs and forging linkages with them. They also determine the quality and the depth of these linkages, or the ability of SMEs to absorb the capabilities and knowledge that comes through their interactions with MNEs. Technology transfers and other spill-overs are more effective when SMEs already possess a certain level of knowledge and innovative capabilities. For instance, domestic suppliers with higher human capital and technological capabilities tend to develop more knowledge-intensive types of linkages. The geographical proximity of SMEs to foreign-owned firms also increases the chances of linkages. Proximity facilitates knowledge spill-overs, especially as far as tacit knowledge is concerned (OECD-UNIDO, 2018). As foreign firms tend to concentrate in productive areas (e.g. large cities or industrial zones), not all SMEs are able to engage in linkages with MNEs, which may worsen territorial disparities.

International policy indicators of competitiveness do not rank high for MED economies, albeit some differences exist within the region (OECD/EU/ETF, 2014). The use of firm-level data can complement the picture provided by such international indicators. The share of firms involved in exports can give a good indication of firm productivity levels (figure 4.2 A). In the MED region, the largest shares of exporters are found in Tunisia, Jordan, and Lebanon, which confirms previous evidence presented in this note. In Jordan and Morocco, there are important disparities in the percentage of exporting firms between sub-national territories.

Firms that forge quality linkages with MNEs affiliates are very often also those with internationally recognised quality or environmental certifications (figure 4.2 B). Using this

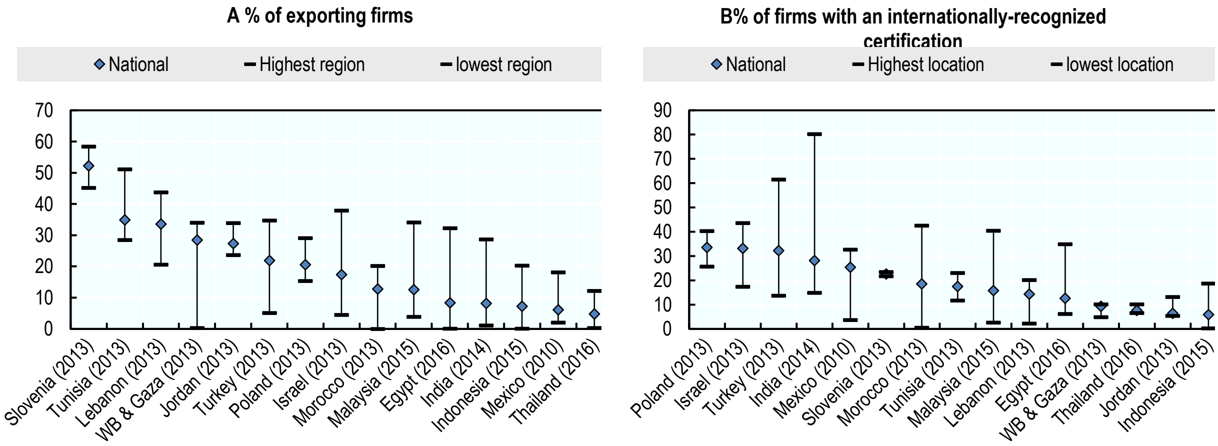
[12] The MENA SME Policy Index 2014 provides a wide range of policy recommendations to improve SMEs competitiveness, based on the policy principles of the Small Business Act for Europe (see OECD/EU/ETF, 2014).

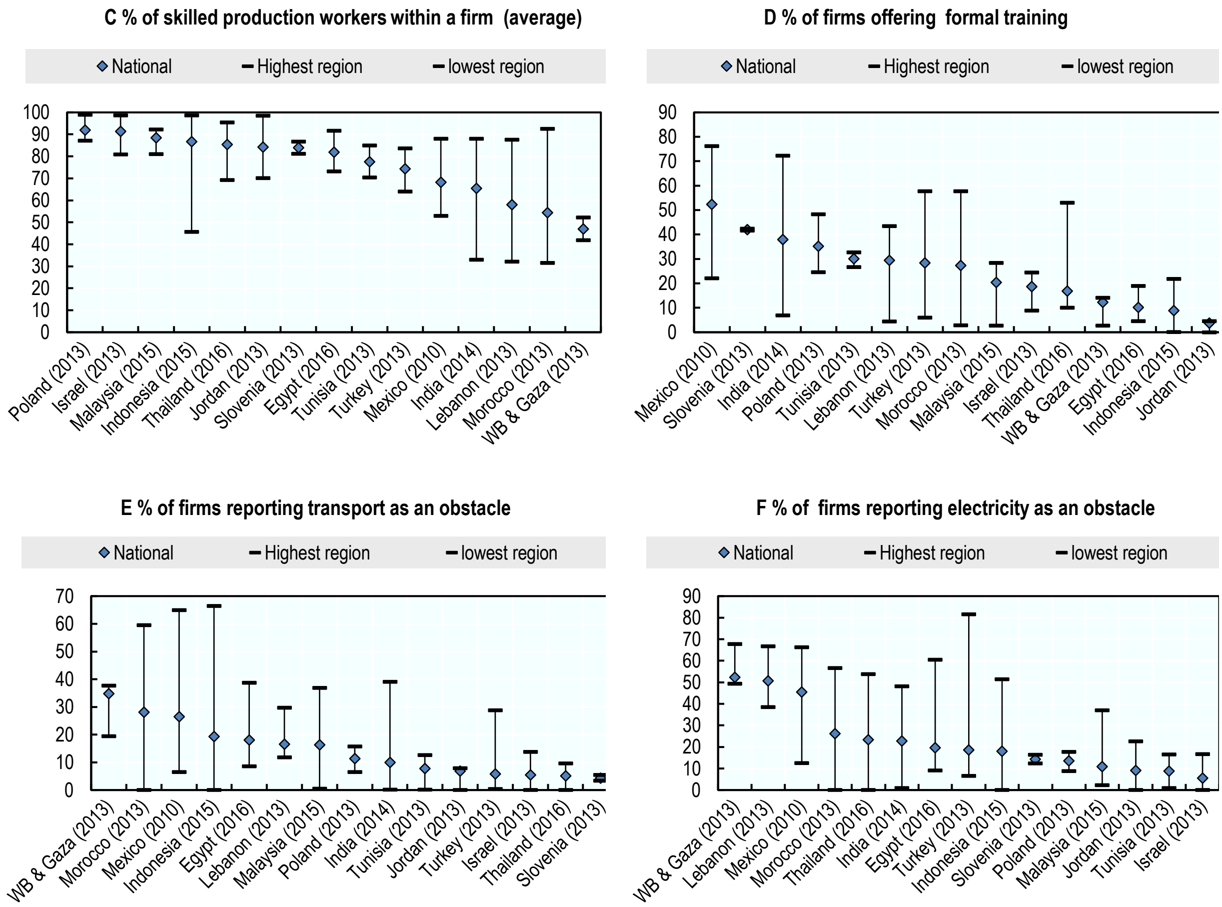
metric, Morocco and Tunisia perform the best in the region, yet below the levels of other OECD emerging countries such as Turkey or Poland. Territorial disparity in the percentage of firms with an internationally recognised quality certification is very important in Morocco and Egypt.

The capacity of domestic SMEs to “absorb” knowledge resulting from linkages with MNEs affiliates is also determined by their level of human capital and skills. In MED economies, firms in Jordan, Tunisia, and Egypt report the highest shares of skilled workers in the region, yet still in lower proportions than other emerging countries (Figure 4.2 C). Territorial disparities in the availability of skilled workers are the highest in Morocco and Lebanon. Both countries have also large spatial disparities with respect to the firms offering training opportunities to their staff (figure 4.1 D). Egyptians firms are very few to offer training to their staff, independently of the governorate in which they operate.

The quality of infrastructure (e.g. transport, logistics, electricity, etc.) is another variable that affects SMEs competitiveness and their capacity to connect with foreign MNEs affiliates (figure 4.2 E, F). Infrastructure plays also a decisive role in supporting linkages between MNEs and SMEs by reducing costs. It also helps reducing the travel and transport distance between SMEs and MNEs affiliates and therefore the quality of the linkages that could be forged. Firms in the MED region report that infrastructure is an obstacle more than in other emerging countries. This is particularly the case for firms in the Palestinian Authority, Morocco, Egypt, and Lebanon. Furthermore, there are considerable territorial disparities in the quality of infrastructure (both transport and electricity), particularly in Morocco, Egypt and, to a lesser extent, in Jordan and Lebanon.

Figure 4.2. Competitiveness indicators in MED economies and other emerging markets





Note: Number of regions included in the survey: Egypt (7), India (23), Indonesia (9), Israel (5), Jordan (5), Lebanon (6), Malaysia (5), Mexico (8), Morocco (11), Poland (6), Slovenia (2), Thailand (5), Tunisia (5), Turkey (6), and West Bank & Gaza (2).

Source: OECD preliminary assessment based on the World Bank Enterprise Survey.

Implement effective linkages and supplier development programmes

Investment Promotion Agencies (IPAs) in the MED region can play a key role in supporting MNE-SME linkages. Along with other government agencies, they could further contribute to the formulation of adequate set of linkage policies and to the implementation supplier development programmes. According to a global survey of IPAs in 2004, most IPAs with linkages programme are the lead agency for implementing business linkages policies (61% of IPAs). Remaining IPAs share that responsibility with other institutions, such as the ministries of industry, trade and innovation, or SMEs agencies and business development services providers (UNCTAD, 2006). Often, MNE-SME linkages programmes target priority sectors that are promoted by IPAs.

MED IPAs that wish to be more active in supporting the creation and forging of business linkages may need to have a clear mandate to provide investors with accurate and timely information on potential local suppliers and SMEs partners. According to preliminary results from a recent OECD mapping of MED IPAs, agencies in the region have at their disposal some tools to promote business linkages. Promoting linkages is often done on an *ad hoc* basis (i.e. not part of a specific linkages programme). All MED IPAs report offering to foreign investors' matchmaking services with local suppliers and customers (65% of surveyed OECD IPAs offer that service). Some MED IPAs offer also capacity-building support for local firms (Algeria, Lebanon, Palestinian Authority, and Tunisia). These IPAs have in common that they have also a mandate to promote domestic investment. Assistance in recruiting and training programme for local staff is only performed by a minority of MED IPAs, which is similar to what OECD IPAs report. Training local staff and companies is often carried out by other government agencies, such as SME development agencies. Co-ordination between these IPAs and SMEs agencies is therefore crucial to ensure that MNE-SME linkages policies are well implemented.

With the exception of the Jordanian and Libyan IPAs, all MED IPAs have a local supplier database that allow connecting together MNE affiliates with local suppliers. In Tunisia, FIPA, the Tunisian Foreign Investment Promotion Agency, provides matchmaking services but uses the local supplier database of the APII, the Agency for Industry and Innovation Promotion. The characteristics of the database differ however across MED IPAs. For instance, only the Lebanese and Palestinian IPAs are equipped with databases that list international and national certifications of local suppliers.

One European agency often cited as a good practice in terms of promoting business linkages is Czech Invest, the Czech IPA. The agency became one of the most successful state agencies for promoting FDI thanks to after care programmes launched in the early 1990s, such as the Supplier Development Programme, which offered both an online access to a database of local supplier in specific sectors while offering at the same time matchmaking and negotiation services (see box 4.3). Since 2000, the agency supports policies intending to foster supply chain linkages between foreign and local firms and manages the incentives aiming to enhance spill-overs from innovative firms.

Box 4.3. Czech Invest Supplier Development Programme

Czech Invest accompanied from the beginning the restructuring process of a country that underwent a deep socio-economic transformation in the 1990s. The Czech republic is a relevant example for countries confronted to the challenges of growing globalised markets while facing corruption and bureaucracy.

Czech Invest strategy was designed from its very inception to attract FDI with positive externalities and spill-overs. One issue facing Czech suppliers was their lack of competitiveness. In such case, spill-overs from MNEs to SMEs can be better absorbed domestically when the gap between local and foreign technologies is reduced. Another issue facing the agency was how to improve communication between local companies and MNEs.

To respond to these challenges, the agency launched the Supplier Development Program in 1999, with a focus on electronics, the Czech Republic's fastest growing sector and its second largest FDI sector after automotive. The Programme included several pillars, which are now part of Czech Invest work:

- **Target specific local companies to participate in training and technical assistance programs** to heighten the quality of local producers and improve their absorptive capacity.
- **Run an online database of local suppliers to ease communication between foreign investors and local suppliers**. The database serves as an effective tool for identifying and categorising suppliers in the Czech Republic and as a means of clearly presenting individual industrial sectors (electronics, IT, Aeronautic, automotive). The database is intended primarily for foreign investors entering the Czech Republic and those that are already operating there, as well as for other foreign and domestic companies that are interested in obtaining supplies from the Czech Republic. It allows also to search for suppliers according to first, second, and third tier.
- **Provide matchmaking services**. The agency helps foreign investors set up meetings with selected producers and provide assistance during negotiations, which facilitates the establishment of business relationships.
- **Provide financial intermediation for businesses expansion**. Czech Invest provides an affidavit to a lending bank or when the MNE as a partner can guarantee the contract for supplies.

Source: Benáček, V. (2010)

Promote Diaspora Direct Investment as a lever for enhanced local development

Most of MED countries have very large diaspora direct investment. Such a diaspora can positively influence the size of cross-border investment flowing to their origin countries. Empirical evidence confirms that outward FDI is positively correlated with the presence of migrants from the host country, particularly those with tertiary education (Javorcik et al. 2011, Foad, 2012). Chinese or Indian diaspora, for instance, are acknowledged to have contributed to the integration of both countries into GVCs, especially in positively influencing inward FDI (Buckley et al. 2007).

Diaspora networks positively stimulate cross border investment by reducing transaction and information costs. The less internationalised the host country, the more important the third-party connections in local networking, such as connections to the host country government and to local communities of the same ethnic origin. Diaspora direct investment has often links to both networks and can serve as an intermediary providing trust to each side to facilitate linkages (Chen et al., 2004). Initial network connections to related firms and ethnic links to diaspora play even a more important role in facilitating foreign investment in less institutionalised markets, such as in some MED economies. Diaspora investors could also better circumvent transaction challenges in remote or unstable geographical areas and provide a signal for new potential foreign investors. Publicly available information about the business climate in such areas is often scarce. As a consequence, foreign investors rely mostly on private information and mimic the decisions of already established investors (Mariotti et al. 2010; Hanafy, 2014).

Beyond their capacity to enhance cross-border investment, diaspora firms also contribute to make GVCs more "inclusive". As MNEs affiliates, diaspora firms have also higher labour productivity levels and a better export performance compared to domestic firms (Boly, 2014). Evidence from Sub-Saharan Africa reveals that diaspora investors are also more likely to establish connections with local suppliers through backward linkages than non-diaspora foreign investors (Amendolagine et al., 2013). Such evidence is also found in studies conducted on diaspora from China, Indian, and other Asian countries.

In the MED region, however, potential diaspora investors are doubtful that the local private sector would be willing and able to invest with them (World Bank, 2016). They also believe that they don't benefit from the same preferential treatment accorded to foreign investors and do not expect much support from their governments to help them invest (ibid). A recent study on Tunisia reveals that diaspora direct investors do not have more partnerships with the local private sectors than other foreign investors (UNDP, 2016). Tunisian diaspora firms are, however, more present into less-developed and rural regions, although their overall impact on jobs and wages is weaker than foreign-owned firms (ibid).

MED governments could play a stronger role in promoting diaspora investors. They can develop, in consultation with diaspora representatives, tailored strategies or programmes to diaspora members and provide more targeted incentives. IPAs can also reduce potential information costs and increase their outreach efforts to their diaspora. In the case of the Tunisian diaspora, potential investors often report not to be aware of investment incentives offered to foreign investors (UNDP, 2016). This may be the case in other MED countries.

Some programmes or initiatives to promote Diaspora Direct Investment (DDI) exist in some MED countries. For instance, the Investment Development Authority for Lebanon (IDAL), which is mandated to attract diaspora investment, developed a comprehensive strategy on attracting greater DDI. In Morocco, the government is active in attracting DDI through the Regional Investment Centres, which focus on projects by the diaspora, and the Houses of Moroccans Living Abroad, a program that provides information to expatriates returning to their country. Government/IPAs could also collect data on diaspora investors, as done for instance by the Tunisian Agency for the Promotion of Industry and Innovation (APII). Statistics on DDI should seek micro-level evidence (e.g. age, gender, and generational aspects of diaspora investors) and be comparable to non-diaspora direct investment to enable IPAs to monitor differences in trends and impacts (UNDP, 2016).

Embed specific investment regimes into a wider "inclusive" GVC strategy

MED economies participation in GVCs is in part driven by the setup of exclusive regulatory regimes such as Special Economic Zones (SEZ) (e.g. Tanger-MED in Morocco, the Suez Canal Special Economic Zone in Egypt) or special exporting regimes (offshore regime in Tunisia, the Qualified Industrial zones in Jordan). Often, these regimes are conceived with the objective of spurring new investments and trade, creating jobs and fostering economic opportunities in laggard regions. While such regimes managed in attracting investment and in fostering trade, notably by offering adequate infrastructure services and duty-free access for capital goods and other inputs, their positive impact and spill-over on the local economy is not clear-cut.

Under the right conditions, special regimes in MED countries could serve to create linkages with local suppliers, and specifically SMEs. Such regimes should be embedded into MNE-SME supply chain strategies and into wider national development objectives. SEZs, for instance, have been at the cross-road of countries' investment and local development policies. To maximise benefits, SEZs need to be equipped with an investment promotion strategy aligned with national and local economic development priorities and is coherent with national investment and trade policy frameworks.

International experience has shown that successful SEZs were firmly embedded in a wider development agenda, including strong connectivity to the rest of the economy and reduced barriers to investment, to be able to generate robust linkages with local firms (Moran, 2011). To foster backward linkages, it is also crucial to strengthen SMEs' absorptive capacity through skills development trainings, partnerships with education institutions, and better business development services. One example is the Penang SEZ, which is hosting one of Malaysia's most developed technology clusters in the manufacturing of semiconductor-based electronic components. In combination with vigorous investment promotion policies, the Penang state government established the Penang Skills Development Centre (PSDC), which was later recognized as a world-class model for partnerships between government, academia, and industry. The government also created an SME Centre to act as an incubator for SMEs, providing them with rental subsidies to help them take advantage of the facility (OECD, 2013).

International experience shows that countries using SEZs and other special regimes as a tool for local development should pay very close attention to safeguarding treatment of workers and the environment (Moran, 2011). The policy framework of special investment regimes should avoid creating an economic enclave with lower standards and norms. The framework should be applied with the same level of diligence as in the rest of the country on issues such as such as tax evasion, labour and environmental violations, and corruption (OECD, 2015).

5. Conclusion

Technical progress and lower costs of transport and communication made possible the fragmentation and geographic dispersion of production into GVCs. Firms participate in GVCs by combining trade, investment, movement of staff, and transfer of knowledge and technology, to optimise their international business strategies.

In the Southern Mediterranean basin, firms' participation in GVCs are promoted as a key way to achieve higher export diversification and more sustainable and inclusive development. Over the last two decades, policymakers in the region focused their policies on integrating their economies in such globalised networks of trade, investment and production. As a result, some MED economies succeeded more than others in participating in GVCs. Excluding resource-rich economies, MED countries with the highest FDI stock-to-GDP ratio were also those that are the most integrated into GVCs. The impact of such integration in GVCs on economic development has been however limited, depending on countries' different compositions of export baskets or positioning in supply chains.

Policymakers in the MED area recognise the importance of trade and investment, as the two engines of globalisation, to achieve higher economic diversification, living standards and to promote job creation. GVCs that are more "inclusive" can only be achieved by further unlocking the barriers for SME competitiveness. Relative to large firms, SMEs face constraints that lower their opportunities to be competitive players in the global market. GVCs can relax these constraints by providing SMEs opportunities to plug into GVCs as suppliers of MNEs invested in the region. MED economies record, however, only limited development benefits from their participation in GVCs, e.g. little opportunities to empower the local economy and enable SMEs to export, develop managerial skills, and innovate.

Leveraging FDI to enhance supply chain linkages with SMEs in GVCs can be an important opportunity for a more inclusive development trajectory. Given the performance premium of foreign firms over domestic ones, MNE-SME supply chain linkages are expected to result in positive impact on SMEs, depending on the extent and intensity of linkages, absorptive capacity of SMEs and the sector of activity. Novel indicators based on firm-level data suggest that foreign manufacturers in MED countries establish substantial upstream linkages with local producers, but less than in other emerging regions such as in Southeast Asia. In terms of market size, MNE affiliates in the MED region represent a vital source of revenue for local suppliers, considerably more than for Southeast Asian local producers. Local suppliers of MNEs are often large firms or SMEs. The contribution of SMEs, specifically, varies across MED: In Lebanon, Tunisia and Egypt SMEs account for up to 40% of all inputs supplied to MNE affiliates, while in Jordan and Morocco this share is considerably lower.

The regulatory framework for investment is a cornerstone of a policy ecosystem that can enable SME participation in GVCs through linkages with MNEs and reduce constraints for SMEs. First, regulatory restrictions on FDI, including services, limit market access and thereby limit the potential for linkages between foreign investors and local SMEs. Second, a smart and well-targeted incentives regime is often favoured by governments as one of the most efficient ways to reinforce MNE-SME linkages and to empower SMEs as investors themselves. Third, the potential of such measures can only be maximised if accompanied by a strong legal framework providing for investor legal security, predictable contract enforcement mechanisms and guarantees of property rights. Fourth, introducing

Responsible Business Conduct (RBC) principles is also key to creating the right conditions for enabling SMEs participation in GVCs.

The broader policy and institutional environment are also crucial ingredient for attracting foreign investment, enabling SME growth, and anchoring investors through deep linkages with the local economy. Only few policies or programmes target MNE-SME linkages in the MED region. While attracting foreign MNEs is important, it is only one part of the linkages equation. GVCs that are more “inclusive”, i.e. GVCs that can benefit all segments of the populations, can only be achieved by further enabling the overall environment for inclusive investment. Institutions such as investment and SME promotion agencies should play a leading role in this respect by developing programmes and tools that foster MNE-SME linkages. Programmes promoting diaspora direct investment can also be relevant tools for connecting diaspora investors with the local economy.

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