QUALITY OF FOREIGN CAPITAL: PERSPECTIVES FROM PAKISTAN’S PRIVATE SECTOR
Sustainable Development Policy Institute
January 16, 2020

Vaqar Ahmed
Ahad Nazir
Maaz Javed
Fatima Khushnud
Asad Afridi
Daheem Hayat
Mujeeb-ur-Rehman
Table of Contents

1. Introduction ........................................................................................................ 7
2. Methodology ......................................................................................................... 10
3. Trends in foreign capital inflows ......................................................................... 11
   3.1. Foreign Direct Investment ........................................................................ 13
   3.2. Foreign Portfolio Investment .................................................................... 18
   3.3. Commercial Loans ..................................................................................... 22
   3.4. Bilateral Grants .......................................................................................... 23
4. Survey Findings .................................................................................................... 24
   4.1. Perception of Foreign Investment Recipients ........................................ 24
   4.2. Perceptions of Non-recipients of Foreign Investment ........................... 27
   4.3. Future Outlook of Foreign Investment in Pakistan ................................. 29
   4.4. Removing Distortions which Prevent Competition .............................. 31
     4.4.1. The case for CPEC authority ............................................................. 32
     4.4.2. Frequent changes in rules governing special economic zones... 32
5. Policy Recommendations ..................................................................................... 33
   5.1. Need for Regulatory Impact Assessment (RIA): ..................................... 33
   5.2. Ensuring a level playing field: ................................................................. 34
   5.3. Consolidating investment promotion incentives: .................................. 34
   5.4. Progressive tax policy at federal and provincial level: ......................... 35
   5.5. Improving dispute resolution regime: ..................................................... 35
   5.6. Access to essential utilities: ................................................................. 36
   5.7. Improvements in investment diplomacy: .............................................. 36
   5.8. Track investor confidence and quality of investment: .......................... 36
5.9. Evaluate investment potential of FTAs: ................................................... 37
5.10. Encourage local industry upgrading through FDI: ............................. 37
5.11. Strengthen use of evidence in investment policy making: ............... 37
6. References .................................................................................................. 39

Annex-I: Investment Regime in Pakistan: Some legal contours .............. 44

List of Tables
Table 1: Macroeconomic Framework ............................................................... 12
Table 2: Country-wise investment focus by sector ....................................... 15
Table 3: Pakistan: Ease of Doing Business 2020 ........................................ 20
Table 4: Bilateral Borrowing by Pakistan (USD Million) .............................. 23
Table 5: Investment Incentives ..................................................................... 44
Table 6: Pakistan Investment Policy 2013 ..................................................... 47
Table 7: Laws Influencing Foreign Investment .............................................. 49

List of Figures
Figure 1: Overall foreign investment (USD Million) .................................... 13
Figure 2: FDI in Pakistan ............................................................................. 15
Figure 3: Country-wise FDI Inflows ............................................................. 16
Figure 4: Sector-wise net FDI ................................................................. 17
Figure 5: Net Portfolio Investments in Pakistan (USD Million) ................. 19
Figure 6: Net portfolio inflows by country ................................................. 20
Figure 7: Most Problematic Factors for Doing Business ............................. 21
Figure 8: Global Competitiveness Rank (out of 137 countries) ................. 22
Acknowledgments

The authors acknowledge support by SDPI’s partners in completing this study. We received technical inputs from Hammad Siddiqui, Aarya Nijat, Barada Regmi and Hafeez A. Pasha. Survey and data related assistance was provided by Shahbaz Tufail, Asif Javed, Murtaza Kazmi and Hassan Murtaza Syed. The findings were presented during 22nd Sustainable Development Conference, organized by Sustainable Development Policy Institute and partners. The authors acknowledge comments provided by the participants. We are grateful for the time and resources provided to the team by several public sector entities, including State Bank of Pakistan, Board of Investment, Securities & Exchange Commission of Pakistan, and Federal Board of Revenue.
### List of Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>BOT</td>
<td>Build, Operate, and Transfer</td>
</tr>
<tr>
<td>BRI</td>
<td>Belt and Road Initiative</td>
</tr>
<tr>
<td>CCP</td>
<td>Competition Commission of Pakistan</td>
</tr>
<tr>
<td>CPEC</td>
<td>China-Pakistan Economic Corridor</td>
</tr>
<tr>
<td>CPPA</td>
<td>Central Power Purchasing Agency</td>
</tr>
<tr>
<td>DFID</td>
<td>Department for International Development</td>
</tr>
<tr>
<td>DISCO</td>
<td>Distribution Company</td>
</tr>
<tr>
<td>E&amp;P</td>
<td>Exploration and Production</td>
</tr>
<tr>
<td>FBR</td>
<td>Federal Board of Revenue</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>FGD</td>
<td>Focus Group Discussion</td>
</tr>
<tr>
<td>FMU</td>
<td>Financial Monitoring Unit</td>
</tr>
<tr>
<td>FPCCI</td>
<td>Federation of Pakistan Chamber of Commerce &amp; Industry</td>
</tr>
<tr>
<td>FTA</td>
<td>Free Trade Agreement</td>
</tr>
<tr>
<td>FY</td>
<td>Fiscal Year</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IP</td>
<td>Intellectual Property</td>
</tr>
<tr>
<td>JV</td>
<td>Joint Venture</td>
</tr>
<tr>
<td>LNG</td>
<td>Liquefied Natural Gas</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>Merger and Acquisition</td>
</tr>
<tr>
<td>NDC</td>
<td>National Development Council</td>
</tr>
<tr>
<td>NEPRA</td>
<td>National Electric Power Regulatory Authority</td>
</tr>
<tr>
<td>Acronym</td>
<td>Description</td>
</tr>
<tr>
<td>---------</td>
<td>-------------</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>OGRA</td>
<td>Oil and Gas Regulatory Authority</td>
</tr>
<tr>
<td>OICCI</td>
<td>Overseas Investors Chamber of Commerce &amp; Industry</td>
</tr>
<tr>
<td>PBC</td>
<td>Pakistan Business Council</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and Development</td>
</tr>
<tr>
<td>SBP</td>
<td>State Bank of Pakistan</td>
</tr>
<tr>
<td>SECP</td>
<td>Securities &amp; Exchange Commission of Pakistan</td>
</tr>
<tr>
<td>SEZ</td>
<td>Special Economic Zone</td>
</tr>
<tr>
<td>SMEDA</td>
<td>Small and Medium Enterprises Development Authority</td>
</tr>
<tr>
<td>SNGPL</td>
<td>Sui Northern Gas Pipelines Ltd</td>
</tr>
<tr>
<td>SSGCL</td>
<td>Sui Southern Gas Company Ltd</td>
</tr>
<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
</tr>
</tbody>
</table>
1. Introduction

Like most developing countries, Pakistan continues to rely on foreign capital inflows as a major source of financing its public and private sector programs. Such inflows could include, but may not be limited to, foreign direct investment, foreign portfolio investment, grants or loans provided by multilateral or bilateral sources.

However, in recent past, developing economies continue to face volatility in such inflows owing to financial crises (as seen in late 1990s and 2000s), possibility of escalation in trade wars, volatile commodity prices – all making it difficult for private and institutional investors to make longer term financing decisions.

Studies show that in the early 1990s, funding through foreign private sources flowing in the developing countries contributed over 75% of external capital flows. Foreign investment was a major contributing group with its share going from less than 30% to nearly two-thirds of the total external flows by 1998 (UNCTAD, 2003). Although, a decrease in foreign investment was experienced momentarily in the early 2000s, post-2004 witnessed a new trend, i.e. the highest level of accelerated growth in FI in 2007 (UNCTAD, 2008). This pattern was of course disturbed by the global financial crisis, which also brought with it issues threatening balance of payments stability in several economies (Ahmed & O’Donoghue 2010).

Keeping in view the significant contribution of these inflows as a development funding source, understanding their effect on the macro economy and welfare is critical. Policy makers share a common perception that foreign investment remains a key element of economic growth in developing countries. Though foreign investment (and other types of capital inflows) brings about sustained welfare gains for the host country, population in general continues to be questioned by the empirical evidence (United Nations 2002).¹

¹ See also: Ahmed and O’Donoghue (2010b).
Relationship between capital inflows and other economic development ingredients such as productivity, technological spill overs, stability of interest rates and inflation, and human-capital have been extensively analysed. However, in almost all the studies, results vary, i.e. few studies depict a positive relationship while others report a negative relationship, and still others indicate no relationship at all.

Most empirical studies also anticipate a linear relationship between interest rate changes and private investment. However, the same is not true for Pakistan. The interest rates in Pakistan on several occasions in history remained in double digits, however data for the past 19 years suggests that investors’ response to policy rate movements have been mixed, i.e. neither have they always responded eagerly to lower rates nor did higher rates discouraged them from making investments.

This essentially means that the rate hike doesn’t necessarily lead to diminishing investment spending patterns in Pakistan. It may also be inferred that variables such as business confidence, energy availability and affordability, political stability, inflation, tariffs on imports, taxation, and ease of doing business play an equally critical role in influencing the private sector investment decisions. A closer analysis reveals that although the policy rate spiked from 11% to 13% in the mid-2000s, Pakistan witnessed significant investment increase in textile sector at a time when textile quotas were also eliminated.

Nevertheless, it is intuitive that hike in policy rate at times has been a key motivation for foreign portfolio inflows. There are specialised finance institutions, which in fact take ‘hot money’ where they see short-term spike in interest rates. During times of low foreign exchange reserves with the central

---


3 See also Ali (2016).

bank, Pakistan has also tried to lure such inflows. While this may have helped in the short-term to stabilize the value of local currency, however in several cases policy hikes coupled with currency volatility adversely affect the investment climate and slows down the economy during the longer term, forcing investors not to take long-term positions.

In view of the above-mentioned dynamics of capital inflows, this report aims to:

a. Analyse the overtime trends of foreign capital inflows to Pakistan by country and sector
b. Provide a brief literature review based on recent studies covering determinants of foreign capital inflows; sector-specific factors that increased probability of (these sectors) receiving foreign capital; country-specific factors that increased probability of (these countries) investing in or lending to Pakistan (e.g. see the case of US, UK, China, Saudi Arabia, Turkey, etc.); role of investment agreements and treaties and free trade agreements in promoting foreign capital inflows to Pakistan

c. Analyse the data collected by SDPI’s Centre for Private Sector Engagement with a view to highlight perceptions of local businesses regarding foreign inflows. These findings will also be validated using other available survey results (e.g. World Bank’s ease of doing business survey)

d. Provide a brief analysis of some programmes or projects based on foreign inflows to Pakistan

e. Inform if past governments may have given any preferences to investment from certain countries which deterred capital flows from rest of the world or local investors

f. Provide policy recommendations and how the regulators, federal and provincial governments can play a proactive role in creating a level playing field for all countries and foreign enterprises wishing to invest in Pakistan. We also discuss how concerns of local businesses can be addressed to create a win-win situation.
2. **Methodology**

Our methodology for addressing the above-mentioned research tasks include a detailed desk review of laws and policies in Pakistan, which have been in place to help attract investments from abroad. We also have to analyse the trends in foreign capital inflows overtime. We take note of these trends by-sector and by-country, including a discussion around what motivates private and official inflows.

We supplement this with a perception survey aimed at finding out how local private sector sees foreign capital inflows. In this regard, we have approached both, enterprises receiving foreign investment and those who do not have any such financial flows from outside of Pakistan.

To build the population list of recipient firms, the team first identified top sectors receiving foreign capital inflows. The sectors in our final list included oil & gas, chemical manufacturers and suppliers, electrical and electronic equipment supplies and services, construction supplies and services, financial business services, food and beverages, information and communication services, petroleum products and services, transportation and logistics services, power generation and distribution services and tobacco industry.

For the identification of firms within these sectors, the membership data available from FPCCI, PBC, OICCI along with registration database with SECP was used. A random sample of 50 firms was drawn. Another sample of 50 non-recipient firms was drawn from the overall business registry.

Our sample selection has some limitations. For example, within the recipient and non-recipient firms we do not differentiate between small, medium and large firms. Likewise, there is a concentration of firms from Karachi, Lahore, Rawalpindi and Islamabad. This makes the validation exercise easier with other recent surveys, for example, the World Bank’s ease of doing business survey.

---

5 In a companion study we have recently tried to explain issues of SME exporters (Ahmed and Nazir 2018).
which also takes into account Karachi and Lahore. However, in view of resource and time constraints, limitation of not taking a wider and nationally representative sample are recognized here.

All interviews were conducted in a face-to-face manner with any follow-up inquiries through other means, including phone and emails. Random data validation was carried out and accounted for 10% of the sample.

We also take a case study approach here to supplement our analysis. Case studies of select initiatives are cited or briefly discussed here with the objective to learn from instances of success and failures in working with foreign investment partners. Finally, for the validation of our initial findings, Focus Group Discussions (FGDs) on the subject were held at Islamabad, Peshawar, Karachi and Lahore.

The discussion around quality of capital inflows particularly Foreign Direct Investment (FDI) has recently gained attention of policy makers. There is an increased debate how FDI should help developing countries achieve SDGs. It is recognized that FDI quality could help support SDGs through channels of productivity and innovation, employment and job quality, skills, gender equality, and carbon footprint (OECD 2019).

3. **Trends in foreign capital inflows**

The relative interest rates, exchange rates and market size have been the main determinants of foreign investment in Pakistan (Akhtar 2006; Zahir et al. 2003). Trade openness and type of government stance also have a significant effect on foreign investment (Minhas & Akbar 2015). Hafeez (2016) also explains how productivity may be a key variable in explaining capital inflows for Pakistan.

Though the literature does focus on the effect of foreign inflows on the host country’s macroeconomic variables, the research often ignores a key aspect, i.e. impact of foreign capital inflows on the potential local joint venture partners and local businesses expected to compete with foreigners. Equally
important is to study impact on communities where projects through foreign direct investment or financial arrangements are undertaken – a key aspect which helps explain quality of capital invested (OECD 2008).

Pakistan’s current macroeconomic milieu (table 1), which has just stabilized on the back of the recently negotiated programme with the International Monetary Fund, continues to exhibit low growth in the short to medium term. It is, therefore, understood that instead of just relying on correction in macroeconomic variables to lure foreign capital inflows, the government will also require strong investment diplomacy.  

Table 1: Macroeconomic Framework

<table>
<thead>
<tr>
<th>Indicators</th>
<th>2018-19</th>
<th>2019-20</th>
<th>2020-21**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Growth (%)</td>
<td>3.3</td>
<td>2.4</td>
<td>3.0</td>
</tr>
<tr>
<td>Investment to GDP (%)</td>
<td>15.4</td>
<td>14.5</td>
<td>15.2</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>7.2</td>
<td>13</td>
<td>13.2</td>
</tr>
<tr>
<td>Tax Revenues (% of GDP)</td>
<td>11.6</td>
<td>13.7</td>
<td>15.6</td>
</tr>
<tr>
<td>Total Revenue (% of GDP)</td>
<td>14.5</td>
<td>16.4</td>
<td>18.0</td>
</tr>
<tr>
<td>Expenditure (% of GDP)</td>
<td>21.7</td>
<td>23.9</td>
<td>23.5</td>
</tr>
<tr>
<td>Fiscal Balance (% of GDP)</td>
<td>-7.2</td>
<td>-7.6</td>
<td>-5.5</td>
</tr>
<tr>
<td>Net Government Debt (% of GDP)</td>
<td>75.2</td>
<td>73.7</td>
<td>71.2</td>
</tr>
<tr>
<td>Exports fob ($ billion)</td>
<td>24.2</td>
<td>10.3 (Jul-Nov)</td>
<td>27.8</td>
</tr>
<tr>
<td>Imports fob ($ billion)</td>
<td>52.9</td>
<td>18.3 (”)*</td>
<td>52.3</td>
</tr>
<tr>
<td>Trade Deficit ($ billion)</td>
<td>28.5</td>
<td>8.0 (“)*</td>
<td>24.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Account Deficit ($ billion)</th>
<th>13.8</th>
<th>1.8 (‘‘) *</th>
<th>-5.9</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workers' Remittances ($ billion)</td>
<td>21.8</td>
<td>11.4 (Jul-Dec) *</td>
<td>23.8</td>
</tr>
<tr>
<td>Net Reserves with SBP ($ billion)</td>
<td>7.3</td>
<td>11.5 (‘‘) *</td>
<td>14.8</td>
</tr>
<tr>
<td>Gross Reserves (in months of imports)</td>
<td>1.5</td>
<td>2.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Foreign Direct Investment ($ billion)</td>
<td>1.7</td>
<td>2.1</td>
<td>3.0</td>
</tr>
<tr>
<td>External debt (% of GDP)</td>
<td>37.6</td>
<td>41.2</td>
<td>40.9</td>
</tr>
</tbody>
</table>


3.1. Foreign Direct Investment

The investment to GDP ratio stood at 15.4% in fiscal year (FY) 2019. This is low compared to peer economies. A key challenge for the governments since 2008 has been to help mobilise private investment, which as a ratio to GDP has fallen to single digits, i.e. 9.8% in FY19. The foreign investment flows did show some promise on the back of China-Pakistan Economic Corridor (CPEC) programme, however, as figure 1 exhibits, the trend has not been encouraging after FY17.

![Figure 1: Overall foreign investment (USD Million)](source: SBP)
In recent years, Pakistan has been a recipient of the inflows under CPEC - considered as the flagship and the pilot project of the Belt & Road Initiative of the Chinese government. CPEC has resulted in influx of investment from non-China sources as well during the period 2015-17. After the end of ‘early harvest program’ under CPEC, the second phase envisages development of Special Economic zones (SEZs). In FY18, the inflow of foreign investment from China amounted to USD 1.81 billion. The CPEC projects in energy, road, and ports sectors also followed financial models other than FDI (e.g. in some cases, loans were provided to the federal government or the relevant state-owned enterprises in Pakistan to undertake the project).

More recently, and due to the fears of piling overall external debt, CPEC related flows have come under scrutiny. However the government in Islamabad has argued that the share of CPEC-related loans in the overall debt volume of Pakistan is not more than 11%. Independent analysts while agreeing to this view also add that this does not include sovereign guarantees given by Pakistan’s federal government. Furthermore, during the CPEC early harvest phase, China had allowed short-term borrowing to Pakistan on commercial rates to sustain high levels of current account deficit (and meet import requirements). This includes some short-term loans; which Pakistan could only pay back after seeking new loans from alternate sources.

Pakistan has also followed a deregulation programme in several sectors having FDI potential. This has allowed other investment partners to pour in. Table 2 summarizes country-wise preference for sectors. Power, oil & gas, financial business and construction remain top investment sectors. Chinese investments in Pakistan included power sector ($1.2 billion for FY 17), construction sector

---

8 “Govt. trying to get $9bn Chinese loan for railway project at 2pc”. DAWN. December 6, 2019.
(0.8 billion USD for FY 17) and financial business (USD 306 million USD for FY 17). The financial sector also saw investment from UK, who has also invested in Oil and Gas and Power sector. In comparison, Switzerland focused its investments on the financial sector. Furthermore, the US investments in Pakistan focused on the financial, Oil and Gas, E&P and construction sectors. Mainly these investments are routed through foreign multinational firms already operating in Pakistan.

Table 2: Country-wise investment focus by sector

<table>
<thead>
<tr>
<th>Country</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>Financial Business</td>
</tr>
<tr>
<td>China</td>
<td>Power sector</td>
</tr>
<tr>
<td>USA</td>
<td>Financial Business and Construction</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Financial Business</td>
</tr>
<tr>
<td>UAE</td>
<td>Power sector and Construction</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Oil &amp; Gas</td>
</tr>
</tbody>
</table>

Source: SBP

In terms of quantum of investment by non-Chinese investors, USD 21.2 million was invested by investors from Netherlands during FY17. The inflow of investment from UK for FY18 stood at USD 185.2 million while for the US this was recorded at USD 88.6 million (figure 2 & 3). The other economies from where Pakistan could only receive sporadic inflows include Saudi Arabia, Germany, Norway, and Hong Kong.

Figure 2: FDI in Pakistan
In the past, other sectors which carried traction for investors from abroad also include textile (figure 4) and automobile. This of course also relied upon the preference of government in power and which sector it wished to liberalise. In several cases, investment inflows followed a production subsidy which was allowed to a certain sector.\textsuperscript{11} In other cases, preferred interest rates allowed to develop a certain sector prompted investor interest. However, the ambition of almost all governments in the past to attract foreign investment in export-oriented sectors of Pakistan, including textile, leather, surgical goods, sports goods, and carpets could not meet anticipated success due to factors explained later in the report.

\textsuperscript{11} For example, see Khan and Kim (1999).
Success in attracting investment also depends on variables which are sector- and time-specific. For example, investment in telecom sector was determined by market size, competition, trade openness and per capita incomes (Shumaila et al. 2006). Similarly, Muhammed et al. (2011) found that FDI in commodity producing sectors was determined by real GDP, gross fixed capital formation, foreign exchange reserves, degree of trade openness and per capita income. What such studies may not be able to capture are one-time concessions provided to certain bilateral investment partners for encouraging their investment inflows.

For example, during 2014-17, Chinese state-owned enterprises received some form of the following benefit\(^\text{12}\) from the government:

- One-time tax exemption in customs duty to import machinery
- Reduction in liabilities towards general sales tax at production and import stage

\(^{12}\) For a more extensive discussion on types of benefits provided by recipient countries in Belt and Road Initiative, see World Bank (2019).
• No competitive bidding for investment in large infrastructure projects
• Exemption from corporate taxation for certain time period
• Exemption from provincial taxes and duties for certain time period.

Such a preference allowed to Chinese enterprises irked the non-Chinese investors in Pakistan.\(^\text{13}\) This could potentially distort the level playing field. For example, overtime, the sectors which will witness significant entry of Chinese firms, may start experiencing declining interest by non-Chinese investors. This in the longer term is expected to have implications for consumer welfare. The non-Chinese investors also mention preference allowed to China under second phase of FTA, which may not be available to other countries.\(^\text{14}\) It is not clear at this point if Competition Commission of Pakistan (CCP) is looking into this matter.

### 3.2. Foreign Portfolio Investment

As Pakistan deregulated its telecom sector and a large part of its financial sector, including privatization of some commercial banks, the country saw a spike in portfolio inflows around FY07 (figure 5).\(^\text{15}\) During recent past, attractive rates in the money and capital market locally have prompted investor interest. Often time portfolio investment was also lured in the country to support falling foreign exchange reserves.\(^\text{16}\) This was done usually through maintaining a high level of discount rate. There have also been instances where during a decent

---


\(^\text{14}\) This issue has also been a concern for local business community. For example, see “5th Review of the China-Pakistan Free Trade Agreement with Recommendations for Phase II Negotiations”. Accessed via web: [https://www.pbc.org.pk/research/5th-review-of-the-china-pakistan-free-trade-agreement-with-recommendations-for-phase-ii-negotiations/](https://www.pbc.org.pk/research/5th-review-of-the-china-pakistan-free-trade-agreement-with-recommendations-for-phase-ii-negotiations/). Accessed on: January 16 2020.

\(^\text{15}\) On the experience of deregulation in, for example, telecom sector, see Imtiaz et al. (2015).

performance at Pakistan Stock Exchange, local participants (at the
exchange) invited foreign participation to increase their market share.\textsuperscript{17}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure5.png}
\caption{Net Portfolio Investments in Pakistan (USD Million)}
\end{figure}

The real economic growth, development of local financial markets and
country rating determine portfolio investment inflows (Uppal and Mangla
1996). Furthermore, a country-wise analysis reveals US to be a major
contributor of portfolio investment, in particular, short-term capital (figure 6). US
is followed by UK whose investment in capital market is often seen on the back
of attractive term structure. Participants from both countries also invest in
government T-bills and Pakistan Investment Bonds.

\begin{flushright}
\textsuperscript{17} Press release: "Increase in Shareholding Limit for Foreign Investors". March 2, 2019. Pakistan Stock Exchange
\end{flushright}
Before we move on to the next section, it is important to mention that government has grown in realisation that unless regulatory easing is expedited investor interest cannot be secured. The Prime Minister has constituted a high-level committee on regulatory reform. Investors who wish to enter fair, transparent and competitive markets pay a lot of attention to global doing business indicators (table 3) – an area where Pakistan will require concerted efforts. Pakistan’s performance on structural indicators which could enhance the efficiency of any de facto national level investment regime are also provided in figure 7 and figure 8.

Table 3: Pakistan: Ease of Doing Business 2020

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Rank out of 190 countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ease of doing Business</td>
<td>108</td>
</tr>
<tr>
<td>Starting a business</td>
<td>72</td>
</tr>
<tr>
<td>Dealing with construction permits</td>
<td>112</td>
</tr>
<tr>
<td>Getting electricity</td>
<td>123</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Factor</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corruption</td>
<td>17%</td>
</tr>
<tr>
<td>Tax regime</td>
<td>16%</td>
</tr>
<tr>
<td>Crime &amp; theft</td>
<td>7%</td>
</tr>
<tr>
<td>Inefficient bureaucracy</td>
<td>7%</td>
</tr>
<tr>
<td>Access to financing</td>
<td>6%</td>
</tr>
<tr>
<td>Inadequately educated workforce</td>
<td>4%</td>
</tr>
<tr>
<td>Foreign currency regulations</td>
<td>4%</td>
</tr>
<tr>
<td>Inadequate infrastructure</td>
<td>4%</td>
</tr>
<tr>
<td>Inflation</td>
<td>2%</td>
</tr>
<tr>
<td>Policy instability</td>
<td>6%</td>
</tr>
<tr>
<td>Restrictive labour regime</td>
<td>9%</td>
</tr>
<tr>
<td>Government instability</td>
<td>8%</td>
</tr>
<tr>
<td>Others</td>
<td>10%</td>
</tr>
<tr>
<td>Others</td>
<td>10%</td>
</tr>
</tbody>
</table>

**Figure 7: Most Problematic Factors for Doing Business**

*Source: World Competitiveness Report 2017-18*
To meet its short and long-term current account and fiscal deficit requirements, the country has resorted to commercial loans (table 4). China remains a leading source of short to medium term debt. According to various government documents, most of these loans from China were procured on concessional terms to repay past debt near to maturity.\(^\text{19}\) Since the 1990s and particularly after the first phase of privatisation, the private sector has also borrowed from abroad to meet their requirements for capacity expansion and modernisation.\(^\text{20}\)


Table 4: Bilateral Borrowing by Pakistan (USD Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>China</th>
<th>Saudi Arabia</th>
<th>UAE</th>
<th>UK</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>1,381.7</td>
<td>109.5</td>
<td>347.2</td>
<td>122.5</td>
<td>274.0</td>
</tr>
<tr>
<td>2016</td>
<td>3,435.1</td>
<td>116.0</td>
<td>44.2</td>
<td>5.6</td>
<td>34.8</td>
</tr>
<tr>
<td>2017</td>
<td>3,258.6</td>
<td>46.6</td>
<td>103.1</td>
<td>19.0</td>
<td>39.8</td>
</tr>
<tr>
<td>2018</td>
<td>2,201.0</td>
<td>59.9</td>
<td>140.1</td>
<td>86.2</td>
<td>90.7</td>
</tr>
<tr>
<td>2019</td>
<td>426.3</td>
<td>16.5</td>
<td>74.2</td>
<td>48.2</td>
<td>21.7</td>
</tr>
</tbody>
</table>

Source: Economic Affairs Division

Recently a large fiscal deficit has pressed the government to also borrow from local sources. This has prompted concerns around crowding-out of private sector. Sajjad et al. (2017) find that one percentage rise in public sector borrowing crowds-out private sector borrowing by 8 percentage points. This concern has also been pointed out by foreign firms operating in Pakistan and wishing to raise the running finance requirements locally (see also Abbas 2018).

3.4. Bilateral Grants

The strength of bilateral relations amongst countries delineates their economic relationship and this precisely explains China being the largest donor of Pakistan in recent years (Aslam et al. 2019). Grants have also played a pivotal role in the early phases of Pakistan’s history (Ahmed and Wahab 2012).

At the height of Cold War, grants were the main mechanisms of foreign economic assistance to developing countries. After 1970, these grants were gradually replaced by loans. A large part of grant inflows has arrived in Pakistan on account of infrastructure uplift and capacity building. In FY18, these grants were received for education sector (USD 64.6 million), rural

21 Short term interest rates (local and global) remain a significant determinant of private sector borrowing in the short as well as the long-run (Nadeem et al. 2016). Evidence also suggests that borrowing by the private sector was determined by foreign liabilities, domestic deposits, economic growth, exchange rate, and the monetary conditions (Kashif and Muhammed 2019).
development, government research and statistics (USD 46 million) and health sector (30.68 million USD).

Apart from China, the UK, USA, UAE, Germany, Saudi Arabia and Japan have remained top donors for Pakistan in recent times. Saudi Arabia and USA have traditionally tied grants to their strategic relationship with Pakistan.\textsuperscript{22} While Germany, UK and Japan have had long-term donor programs designed for the region, of which Pakistan is but one recipient. Many countries use their development focal agencies such as USAID, UKaid’s DFID and Germany’s GIZ to organize delivery of grants at a country-level.

The next part of this study will essentially focus on perceptions of local businesses regarding foreign capital inflows in Pakistan and if they see such inflows as an opportunity or competition and may highlight any associated concerns.

4. Survey Findings

4.1. Perception of Foreign Investment Recipients
Drivers of investment: Pakistan’s market size and labor force matter for foreign investors. Almost half of all investments are motivated by the need to access new markets (48\%) and hiring labor at lower costs (42\%). Foreign investors see a large population and demand for consumer goods attractive. Around a fifth of respondents also identified access to new talent (24\%), lower production related compliance costs\textsuperscript{23} (22\%), and sector-specific tax incentives (22\%) as key drivers of investing in Pakistan.

Types of investment: Foreign investment was mainly witnessed in manufacturing activities (33\%). This was closely followed by investments in services such as supply chain (16\%), R&D (14\%) and other support services (18\%). In the case of manufacturing activities, the interest is mostly

\textsuperscript{22} “Trust deficit is a huge constraint in US-Pakistan relations”. The News. December 8, 2019.

\textsuperscript{23} For example, compliance with environmental and labour standards.
concentrated in areas which receive some government facilitation (e.g. tax breaks or subsidized, credit and utility rates).

Local perceptions about foreign investment: By and large, respondents share a positive perception with regard to the impact of foreign investment on economic growth (48%), job creation (24%), value chain (12%) and regional trade (4%). However, a small minority of these respondents were concerned about the negative effect of such inflows on local firm growth (6%) and local firm’s ability of value chain integration (6%). Those who see possible negative effects largely belong to the small and medium enterprise (SME) sector. This segment also complains of local supply side challenges (including low labour productivity) which in turn may make it harder to compete with foreign competition – having capabilities which allow better chances of achieving economies of scale and in lesser time.

Dominant source of investment (by country): According to the recipient of foreign investment in our sample, China emerged as the largest investor in Pakistan (24%) followed by USA (12%), UK (6%) and EU region (12%). Investments from GCC countries include Saudi Arabia (6%), UAE (8%) and Qatar (2%).

Forms of investment received by the country: Majority of the investment was directed towards green field projects (38%), followed by brown field projects (36%), branch offices (30%) and M&A activities (18%). Meanwhile, some investment was also witnessed in the form of wholly owned subsidiaries (20%), JV model (18%) and build, operate, and transfer (BOT)-based projects (10%). It was informed that real estate and construction sector has now been prioritised by the PTI government, however potential foreign investors are awaiting details

---

24 Corporate Finance Institute defines this as “a type of foreign direct investment (FDI) where a company establishes operations in a foreign country. In a greenfield investment, the company constructs new facilities (sales office, manufacturing facility, etc.) cross-border from the ground up”. Contrary to this, brownfield investment is defined as “is a type of foreign direct investment (FDI) where a company invests in an existing facility to start its operations”. Details accessed from https://corporatefinanceinstitute.com/resources/knowledge/strategy/brownfield-investment/, accessed on January 16, 2020.
how they could participate in, for example, the government's housing program.\textsuperscript{25}

Impact of foreign investment on firm-level indicators: Given the idle capacity witnessed post-2010 in Pakistan’s manufacturing sector, almost all the firms witnessed positive effects of foreign investment (once it was available) on firm-level indicators, i.e. increases in turnover (66%), market share (60%) and employment (48%). Moreover, local partners also witnessed an increase in international (8%) and national (42%) geographic spread.

Has the government supported foreign investment? Out of the sample, those who claimed that foreign inflows were a result of government facilitation, majority had received some form of tax exemptions or preference. The other forms of support included relaxation in legal and regulatory matters (14%), e.g. procurement rules, financial incentives (10%) and travel and security related facilitations (8%). Within tax-related facilitation, the reduction in general sales tax on goods was cited as a key motivation, followed by reduction in corporate taxation and customs duty rates for their venture.

Fairness in attracting foreign investment: 44% of respondents expressed some level of discomfort over the government policy and indicated that investment from all countries or investors were not necessarily facilitated equally.

Impact of China-Pakistan Economic Corridor (CPEC) on Pakistan: Respondents generally feel positive about the impact of CPEC investments on economic growth (42%), job creation (12%), and regional trade (14%). The sample also includes respondents who were apprehensive about the negative effect of CPEC on growth of SMEs in Pakistan (6%\textsuperscript{26}), local job growth (18%) and potential of value chain integration (6%).

\textsuperscript{25} See “Chinese investors show interest in Naya Pakistan Housing Scheme. The Nation, October 12, 2019; “PM Imran’s housing project catches Canadian investors’ eye”. The Express Tribune, October 16, 2019; “Egyptian billionaire wants to build 100,000 units under Naya Pakistan Housing Programme: report”. DAWN, January 20, 2019.

\textsuperscript{26} 6% of respondents
Some segments of SMEs believe that a lot of those raw materials and intermediate goods which should have been sourced locally were imported from China – an argument which has been contested by the Chinese side and Pakistani government. Those who were apprehensive also remained of the view that both PML-N and PTI governments needed to do a better job of taking the local businesses on board before further liberalizing trade and investment regime with China.

Perceptions about China-Pakistan Tree Trade Agreement (FTA): Most respondents felt that the recent revisions to the FTA between China and Pakistan will alleviate the earlier concerns by the local businesses - many of which had reported reduced profits or complete shut down during the past decade due to cheaper alternatives from China. Respondents felt that the revised FTA could improve economic growth (32%), integration with Chinese value chains (6%) and strengthening of regional trade (16%).

However, in our qualitative inquiry, most respondents suggested that CPEC and FTA should not have been stand-alone negotiations. If Pakistan was to allow both trade and investment concessions to China under FTA and CPEC respectively, it would have been better to package this together under a comprehensive economic partnership agreement. This would have allowed Pakistani stakeholders to see the true value of trade and investment concessions provided to China. The information regarding such concessions should also be explicitly stated as part of the ‘tax expenditures’ statement annually shared with parliament.

4.2. Perceptions of Non-recipients of Foreign Investment

What policy support may be required to attract foreign investment? Respondents felt that they would require further support to scale up their

---

27 See “CPEC to create 700,000 more jobs in Pakistan”. The Express Tribune. January 8, 2019.
operations through foreign investment. They felt this imperative to overcome
difficulties such as non-availability of economical utilities, particularly power
and gas (18%), participation in cross-border trade (22%), and complying with
intellectual property, contractual enforcement, and foreign product
standards (12%).

The tax incentives provided should be same for foreign, local and joint venture
(JV) investors (44%).29 There should be innovation-related policy incentives30
allowed in line with peer economies (36%). Other recommendations include:
locking energy tariffs in the medium term to avoid fuel price related
uncertainties (24%), improvements desired in understanding of judiciary
regarding matters of the private sector (14%), support in getting necessary
certifications to become part of global production or buyer chains (16%) and
further revision of existing FTAs in favour of Pakistan (20%).31

Preferred destination of investment: Around 16% firms prefer investments from
China due to some tax-related incentives allowed on these ventures, followed
by Saudi Arabia, EU and USA. The top three categories where foreign
investment is desired include, manufacturing capacity, R&D and business
support activities abroad. Most of the non-recipients expressed the desire to
attract foreign investment in their existing businesses as brownfield investment,
JV and equity contribution without direct involvement. The other categories
were less preferred32.

Why your business finds it hard to attract foreign investment? Respondents
provided reasons such as recent political instability33 (54%), currency volatility

---

29 For case of energy sector in Pakistan, see Khan and Ahmed (2015).
30 For example, see Edler and Fagerburg (2017).
32 Greenfield investment, Branch office, Built-operate-transfer mode, Wholly-owned subsidiary, Joint venture with
non-host partners
33 Coupled with law and order issues faced in several locations including Karachi.
(60%), high interest rates (47%) and difficulties in dealing with taxes & tariff (46%). These findings are broadly in line with the long-term econometric study by Bano et al. (2018). During FGDs, participants also cited information barriers or inability to properly interpret the investment promotion schemes (Annex-I). Most were of the opinion that recent efforts towards macroeconomic stabilisation under the program provided by International Monetary Fund, may be accompanied by a drive to lessen the regulatory burden faced by the commodity producing sectors, i.e. agriculture and manufacturing.

4.3. Future Outlook of Foreign Investment in Pakistan
Recommended government action for attracting future investment: Non-recipients believed that government should ensure a level-playing field for all investors by revamping its taxation, regulatory and financing regime. A radical overhaul of financing regime could include measures that encourage not only the monetary contribution but also the participation of foreigners through human resources, knowledge and technology. For example, India’s investment regime was cited which has a focus on technology transfer.

Example from Bangladesh was also cited where government takes a lead in prioritizing sectors for attracting investment in current and potential export-oriented industries. For example, the Government of Bangladesh announced ‘light engineering’ as the product of the year 2020.

Pakistani diaspora living abroad has also provided recommendations on similar lines through US-Pakistan Business Council and British Pakistan Foundation. Recent incidents where Chinese investors, particularly state-

34 Also highlighted in Ahmed and Nazir (2018).
35 This was also recognized by past Governments, for example, see Planning Commission (2011).
owned enterprises from China enter Pakistani market and leave after deliverable-based operations was cited as unsustainable as it didn’t strengthen business-to-business linkages with China. Similarly, it was explained that Chinese state-owned enterprises, unlike pure private concerns, may not have an incentive to engage with Pakistan’s local business.

How can government and private sector work together to attract and host better quality foreign investment? There was a consensus that local education quality and skills are critical factors in attracting foreign investment. Moreover, for access to skills, development and cost (of acquisition) are equally important. Apart from the workforce skills, networking efforts with potential investor abroad may be expanded, digital-culture and IP rights protection regime may be strengthened to give greater confidence to foreign investor. It was felt that in recent past foreign investment followed bullish sentiments of local investors. Therefore, to address the concerns of the latter it was important to rid the tax, credit, utilities and compliance regime of any opaqueness.

Potential sectors which could receive high foreign investment in future: The majority sided with traditional sectors which are better positioned to see the interest of foreign investors, including textile, food processing, petroleum products, and power sector. The respondents found it hard to identify if any non-traditional sectors could attract investment unless the overall entrepreneurial ecosystem witnesses a level-playing field. It is interesting to note that most of the recent Chinese investment only went into secure infrastructure projects, some of which can also be defined as public goods. Most of these projects were backed by sovereign guarantees. It was non-Chinese investors, who took risk in sectors other than power sector, ports and

38 This is also discussed in Goswami (2019).
infrastructure uplift in Gwadar. Respondents attached at lot of importance to potential investments that could come in if policy interventions under Digital Pakistan Policy\textsuperscript{40} and e-Commerce Policy\textsuperscript{41} of Pakistan could be expedited. Major impediments faced while reaching out to potential investors: inability to meet expectations of foreigners (52%), secure local tax benefits, e.g. those provided under CPEC (25%) and acquiring local financing and insurance needs (23%) surfaced as the major impediments. It was cited during the focus group meetings that the most policy concessions are expected by the Chinese state-owned enterprises who already have more attractive destinations to host their capital under the BRI umbrella.

What do you fear when entering into a partnership with foreigners? Fear of hostile takeover (30%) and debt creating arrangements (29%) topped the list. The qualitative inquiry suggests that language and culture barriers with Chinese and Arab investors accentuate such fears. There was a preference to deal with investors which had origins in similar legal business structures e.g. the British Commonwealth countries. However, it was discussed that currently such countries are facing issues of their own in the wake of uncertain commodity prices, volatile financial sector outlook, Brexit, and trade wars.

4.4. Removing Distortions which Prevent Competition

The key conclusions from our focus group discussions organized in Islamabad and provincial capitals, were around economic distortions, which are strengthened due to provision of targeted concessions provided to certain investors. It was argued by representatives from multinationals working in Pakistan that there are institutional arrangements which favour investment from select region or country. Some examples of such arrangements are provided below.


4.4.1. The case for CPEC authority

While several countries participate in Pakistan’s government-to-government development projects, however in second half of 2019, a CPEC authority was approved to track and trace the progress of projects being implemented by China. While at some level, this was done to ensure to the Chinese that their investments will be expedited and will not face the usual bureaucratic hurdles seen in conducting conventional business, however this was a major discouragement for other friendly countries who continue to assist Pakistan towards development projects and witness cost and time delays at the hands of federal-provincial, and inter-provincial fragmentation of investment regulation. We were informed by representatives of diplomatic corps that potential investors from non-China origins questioned if their projects could also receive such government facilitation or a single window processing mechanism.

It is interesting to note that Pakistan’s elected parliament had opposed the formation of CPEC authority and ultimately this came in to being as a result of Presidential Ordinance, and only hours before the Prime Minister and Army Chief departed for an official visit to Beijing.\(^{42}\) The view from the private sector was that the need for this authority was not clear as during the early harvest phase of CPEC, on-time completion of projects was ensured by Ministry of Planning, Development, and Reform.

4.4.2. Frequent changes in rules governing special economic zones

It has come as a surprise to the local business associations that SEZs which were initially being governed under the SEZ Act 2012 may now see changes in their governing structure.\(^{43}\) The respondents from Balochistan and Sindh seemed

\(^{42}\) “Govt defends establishment of CPEC Authority”. DAWN. January 16, 2020.

\(^{43}\) “Laws for special economic zones under CPEC being revisited”. DAWN. September 26, 2019.
unclear as to how the government was selecting priority SEZs out of the total nine approved under CPEC.

Second, even with regard to the priority SEZs, there exists confusion around ownership-type allowed for land (e.g. lease or outright sale), and responsibility of civil works (including land development) – something which is being negotiated with Chinese counterparts, even though the law says that non-China investment will also be welcomed here. There were anecdotal claims that the Chinese firm that undertakes the civil works in these SEZs may be paid-off some of its dues in the form of land.

The ambiguity also exists around time lag which will be committed to providing utilities and other amenities in the zones. Local investors fear that preference will be given to Chinese investors and delay may be seen when it comes to provisioning of essential infrastructure for operational blocs owned by local or non-Chinese investors. The Sialkot Chamber of Commerce and Industry was the most vocal in sensitizing regarding this matter. The taxation treatment is also uncertain as Chinese enterprises are eligible for 10-year corporate income tax holiday, however local or non-Chinese investors may have to face 1.5% minimum tax being calculated on turnover.

5.  **Policy Recommendations**

5.1.  **Need for Regulatory Impact Assessment (RIA):**

Better Business Regulation initiatives at federal and provincial levels may be regarded as a priority. A strong regulatory impact assessment could reveal how select preferences allowed to certain investors could distort a level playing field. A fair and transparent investment policy may be designed at national level. The currently fragmented investment promotion incentives at the federal and provincial levels (Annex-I) may be consolidated.

Sector-specific RIA led by Competition Commission of Pakistan could demonstrate the various forms of regulatory burden in each sector, based on which Prime Minister’s Regulatory Modernization Initiative could take a lead in
rationalizing, automating or eliminating regulations that prevent good quality investment.

The preferred approach may be to take an inventory of all business-related laws, policies and regulations and make them available for public. This may be followed by validating the relevance and usefulness of all business regulations and laws through a broad-based public private dialogue. In the next step, all those regulations from the past which are not relevant or hinder investment may be eliminated (including any unnecessary documentary or compliance requirements). Finally, BOI may introduce e-compliance with all necessary regulations (including any e-payments of fees, dividends and royalties).

5.2. Ensuring a level playing field:

To start with it is important that all investors based locally or of foreign origins face same investment laws, policies, and regulations. Any preferences for a select few undermines the spirit of Pakistan’s Competition Act 2010. In this regard, tax code at federal and provincial level may also be revisited to see if any such preferences exist which will not only discourage the investors not receiving similar preference but also add to the tax expenditure. The rules regarding ownership or lease of property in Pakistan, visa, incorporation and renewal, taxation, and credit from local sources should remain same for foreign investors from all origins. The issue of double taxation in the case of potential investors from some countries needs to be addressed.

5.3. Consolidating investment promotion incentives:

The various incentive schemes are being administered by federal and provincial governments. Often investors point towards anomalies, including contradiction in investment policy or law at federal and provincial levels for certain sectors. It will be timely for BOI in consultation with provincial ease-of-doing-business units, to produce a compendium for investors which should also

---

44 A similar approach was recommended in World Bank’s presentation at 22nd Sustainable Development Conference in Islamabad on December 3, 2019, titled “Better Business Regulation in Pakistan”.


contain any region, sector, or product specific incentives. Having such an inventory of all schemes will also bring out any anomalies which need correction. There is a case for consolidating some incentive schemes. For example, a long-standing recommendation of Sialkot Chamber of Commerce and Industry has been to treat all current industry or export zones as SEZs.

5.4. Progressive tax policy at federal and provincial level:
Three major tax reforms were recommended. First, a national tax authority could better deliver tax harmonisation. Currently, all provinces and federal area have different tax types and rates. Local taxes and levies also exist, which increases compliance costs. Second, incidence of double taxation or tax competition among provinces should not hurt businesses. Finally, tax laws for all foreign and local investors should remain the same. As suggested by the IMF, no future tax exemptions may be allowed to any foreign investor without approval by parliament.

5.5. Improving dispute resolution regime:
14% of respondents believed that there is a need to enhance knowledge of judiciary at all levels regarding business priorities. The handling of issues related to high value investors from abroad by Pakistani courts was an area which requires a dialogue between the government and senior members of judiciary. Furthermore, ability to enforce contracts and related uncertainties was the reason for not receiving foreign investment inflows for 12 per cent of the respondents. It was proposed that increasing number of judges trained in business cases would help improve the case disposal rate.

---

45 See Jamali and Ahmed (2016); Ahmed and Naqvi (2016); Nazir et al. (2017).
47 For example, see “Reko Diq case: Ex-CJP’s verdict costs Pakistan $6b”. The Express Tribune, July 14, 2019.
5.6. **Access to essential utilities:**
Our respondents informed regarding the lack of utilities as a major reason behind sluggish foreign investment in export-oriented sectors. It was a matter of concern that certain enterprises could get access to utilities much faster and at lower rates. NEPRA needs to ensure that directives to install new electricity connections are processed within 15 days. While OGRA also needs to make sure that similar provisions are made within the standard operating procedures of SNGPL and SSGCL.

24% of the respondents believed that energy reforms would increase foreign investment flows into the country. Also, there is a need to expedite the implementation of Renewable Energy Policy, Integrated Energy Planning and Private permits for imports of LNG. Furthermore, CPPA needs to speed up efforts at eliminating circular debt to assist privatization of DISCOs.

5.7. **Improvements in investment diplomacy:**
11% of respondents believed that Pakistan’s Board of Investment should concentrate on mobilizing funding from Pakistani diaspora. This however requires proactive economic and trade officers at Pakistan’s embassies abroad. The diaspora has also been worried that their transfers to Pakistan should not be seen as dubious. The recent government level engagements with Financial Action Taskforce has resulted in a large segment of diaspora apprehensive of investing in Pakistan. Such issues related to optics of investment need to be addressed on priority by Financial Monitoring Unit of the federal government.

5.8. **Track investor confidence and quality of investment:**
The currently available investor confidence surveys in Pakistan do not collect information on quality of FDI indictors. In this regard, SDPI and other local think tanks could support BOI to: a) track through a quarterly survey on how FDI may or may not be influencing SDGs, and b) put in place legislative, policy, and regulatory measures which could attract FDI that supports SDGs through
channels of productivity and innovation, employment and job quality, skills, gender equality, and carbon footprint.

5.9. **Evaluate investment potential of FTAs:**
Several countries are now assessing how best to design or use FTAs as an instrument to spur FDI. There is some evidence from peer economies that FTAs may have led to increased diversification in inward FDI (across sectors).\(^\text{48}\) Ministry of Commerce and BOI will benefit from such an analysis for Pakistan as it will also serve the objective of diversification in exports, and possibility of channelling FDI in currently exporting firms.

5.10. **Encourage local industry upgrading through FDI:**
The matchmaking process between local suppliers and foreign buyers can be encouraged through a long-term vendor development program. SBP may look into the provision of working capital or fixed investment on lower rates if a firm is able to attract FDI from an entity abroad which may be willing to buy back part of the output. This measure has potential to increase export receipts as well. To start with Ministry of Industries and Production, provincial industries departments, and SMEDA could provide a priority of sectors (in consultation with FPCCI and PBC) where such an intervention may be possible.

5.11. **Strengthen use of evidence in investment policy making:**
The reform of investment laws, policies and regulations in Pakistan may be consciously informed by data and evidence. While internal monitoring and evaluation at federal and provincial boards of investment organisations can be strengthened, it is equally important to invite international investment analysts and monitoring and evaluation specialists in the investment reform space for an independent review. The learnings from such exercises will better inform and guide the government’s future reform of investment regime and strengthen (investment) diplomacy efforts.

\(^\text{48}\) From example see Cuong (2015).
6. References


Ahmed, V. and M. A. Wahab (2012). Foreign Aid in South Asia: the emerging scenario, SAGE.


instability, and political instability. Emerging Markets Finance and Trade, 55(1), 90-104.


Hafeez, A. (2016). The Impact of Productivity on Foreign Direct Investment in Pakistan: A structural VAR Analysis. PIDE.


Annex-I: Investment Regime in Pakistan: Some legal contours

Table 5: Investment Incentives

| Export Processing Zones (EPZs)⁴⁹ | 1. Developed land available on reduced / competitive rates for 30 years  
2. Duty-free import of machinery, equipment, materials and conditional vehicles  
3. Freedom from national import regulations  
4. Exchange control regulations of Pakistan not applicable  
5. Repatriation of capital and profits  
6. No sales tax on input goods including electricity/gas bills  
7. Domestic market available to the extent of 20%. Exceptions may be available  
8. Presumptive tax @ 1% will be levied  
9. EPZ units allowed to supply goods to custom manufacturing bonds  
10. Defective goods/waste can be sold in domestic market after payment of applicable duties, maximum up to 3% of total value  
11. All documents of entry and exit of goods from EPZ’s are issued free of cost on the same day basis  
12. EPZ authority facilitates in obtaining electricity, gas, telephone and water connection by coordinating agencies  
13. EPZs are exempted from all provisions of Foreign Exchange Regulation Act, 1947 and Banking Companies Ordinance, 1962 |

⁴⁹ http://epza.gov.pk/incentives/
| Special Economic Zones (SEZs)\(^{50}\) | 1. One-time exemption from customs duties and taxes on import of plant and machinery for enterprises and developers  
2. Exemtion from all taxes on income for enterprises commencing commercial production before June 13\(^{\text{th}}\) 2020 for the next 10 years for enterprises  
3. Income tax exemption for 5 years for zone developers  
4. Exemption from all taxes on income accruable in relation to the development and operation of the SEZ’s for a period of 5 years |
| Sindh investment incentives\(^{51}\) | 1. **Mineral Sector:** Exemption of customs duty on import of machinery, equipment, specialized vehicles, accessories, spares, chemicals, and consumables. For mine construction and extraction phase concessionary rate of 5% customs duty on machinery, equipment, specialized vehicles, accessories, spares, chemicals and consumables  
2. **Thar Coal Fields:** Exemption of customs duty and sales tax on import of coal mining machinery, equipment materials, spares and vehicles for site use. Exemtion from income tax on profits and gains of coal mining projects  
3. **Renewable Energy:** Exemption of customs duty on import of machinery, equipment and spares for power generation through solar, wind, micro-hydel, bioenergy, ocean, waste-to-waste and hydrogen cell. Exemption from sales and income tax on import of plant and machinery |

\(^{50}\) [https://invest.gov.pk/sez](https://invest.gov.pk/sez)  
| Khyber Pakhtunkhwa | 1. Only 5% customs duty on import of plant, machinery and equipment for manufacturing, infrastructure and social sectors  
2. Zero to 5% customs duty for services sector (including IT and Telecom) |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>4. <strong>Energy Projects:</strong></td>
<td>First year depreciation allowance of 90% of cost. Private sector power project is exempt from income tax (for duration defined). Dividends to the shareholders are taxed at reduced rate of 7.5%, then at 10%</td>
</tr>
<tr>
<td>5. <strong>Oil Exploration and Production Sector:</strong></td>
<td>Concessionary rate of customs duty and exemption of sales tax on machinery, equipment, chemicals, consumables, specialized vehicles and helicopter</td>
</tr>
<tr>
<td>6. <strong>Temporary Importation Scheme:</strong></td>
<td>Exemption of customs duty and sales tax on materials components and accessories. Prior authorization not required</td>
</tr>
<tr>
<td>7. <strong>Exemption of Interest Income:</strong></td>
<td>Exemption from taxes on interest income or loan received by non-resident person for project in Pakistan is exempt from all tax subject to certain conditions. Export finance credit is allowed at reduced interest rate</td>
</tr>
<tr>
<td>8. <strong>Head Office Exemption:</strong></td>
<td>Head office expenditure is allowed for exemption treatment for non-resident operating through a branch in Pakistan</td>
</tr>
<tr>
<td>9. <strong>Gwadar:</strong></td>
<td>Exemption from all custom duties on import of machinery, equipment for setting up of power generation, water treatment and infrastructure related projects. Concessionary rate of 5% on import of machinery and equipment for hotels and Gwadar port</td>
</tr>
</tbody>
</table>
3. Zero customs duty for agriculture sector
4. No sales tax on import of machinery
5. Tax relief in the shape of depreciation. Initial Capital Allowance has been provided as 25% of the machinery cost to all the sectors
6. Incentives for SEZs [already discussed]

<table>
<thead>
<tr>
<th>Investment Policy(^{52})</th>
<th>Exempted Gwadar Free Zone from provincial taxes for next five years</th>
</tr>
</thead>
</table>

Table 6: Pakistan Investment Policy 2013\(^{54}\)

<table>
<thead>
<tr>
<th>Policy Parameters</th>
<th>Manufacturing Sector</th>
<th>Non-Manufacturing Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Agriculture</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Infrastructure and Social</td>
</tr>
<tr>
<td></td>
<td></td>
<td>IT and Telecom Services</td>
</tr>
<tr>
<td>Govt. Permission</td>
<td>Not required except for specified industries(^{55})</td>
<td>Not required except specific licenses from concerned agencies</td>
</tr>
<tr>
<td>Remittance of capital,</td>
<td>Allowed</td>
<td>Allowed</td>
</tr>
</tbody>
</table>


\(^{53}\) [https://obortunity.org/2019/09/05/tax-exemption-laws-for-gwadar-port-free-zone-approved/](https://obortunity.org/2019/09/05/tax-exemption-laws-for-gwadar-port-free-zone-approved/)

\(^{54}\) [https://invest.gov.pk/investment-regime](https://invest.gov.pk/investment-regime)

\(^{55}\) Arms and ammunitions, High Explosives, Radioactive substances, Security Printing, Currency and Mint, No new unit for the manufacturing of alcohol, except, industrial alcohol ** Only for CAF [Corporate Agriculture Farming]
<table>
<thead>
<tr>
<th></th>
<th>Country 1</th>
<th>Country 2</th>
<th>Country 3</th>
<th>Country 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>profits and dividends, etc.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Upper limit of foreign equity allowed</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Customs duty on import of PME(^{56})</td>
<td>5%</td>
<td>0%</td>
<td>5%</td>
<td>0 – 5%</td>
</tr>
<tr>
<td>Tax relief (IDA(^{57}), and of PME)</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Royalty and technical fee</td>
<td>No restriction</td>
<td>Allowed as per guidelines – Initial lump-sum up to $100,000 – Maximum rate 5% of net sales – initial period 5 years</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^{56}\) PME: Plant, Machinery and Equipment

\(^{57}\) IDA: Initial Depreciation Allowance
| Foreign private investment (promotion and protection) Act, 1976<sup>58</sup> | 1. Under ‘investment policy 2013’, foreign investors are granted the same status as that of local and domestic investors  
2. There is no upper limit on the share of foreign equity allowed except airlines, media, agriculture and banking  
3. Notion in act shall be in derogation of any facilities or protections sanctioned by federal government  
4. Repatriation facility on profits and remittances  
5. Tax concession & avoidance of double taxation  
6. Profits earned on investment; and any additional amount resulting from the reinvested profits or appreciation of capital investment may repatriate foreign currency loans approved by the federal government and interest thereon in accordance with the terms and conditions of the said loan  
7. Remittances by Foreign nationals employed with the approval of the federal government in any industrial undertaking having foreign private investment may make remittances for the maintenance of their dependents in accordance with the rules, regulations or orders issued by the federal government or the State Bank of Pakistan. |
|---|---|
| Protection of Economic | 1. Freedom to bring, hold, sell and take out foreign currency (shall not be required to make a foreign currency declaration) including  
• Any payment from abroad for goods/services exported by Pakistan |

Reforms Act, 199259

- Any foreign exchange borrowed under section 4 of Foreign Exchange Regulations Act, 1947
- Proceeds of securities issued
- Earnings or profits of the offices or branches in Pakistan
- Any foreign exchange purchased from authorized dealer
- Cross border or inland movement of foreign currencies in cash exceeding $US 10,000 subject to equivalent ceiling by SBP

2. Immunities to foreign currency accounts:
   - Immunity against any inquiry from income tax department or other tax authority as to the source of financing of foreign accounts
   - Balances in foreign currency accounts and income shall continue to remain exempted from wealth tax, income tax and zakat.
   - Bank shall maintain secrecy regarding transactions in foreign currency accounts.
   - SBP or other banks shall not impose restrictions on deposit and withdrawal from foreign currency accounts.
   - No cash shall be deposited in an account of a citizen of Pakistan, resident in Pakistan, unless the account holder is a filer as defined in the Income Tax Ordinance, 2001

3. Incentives by the government through the statutory orders or otherwise notified shall continue to enforce for

<table>
<thead>
<tr>
<th>Foreign Exchange Regulations Act, 1947&lt;sup&gt;60&lt;/sup&gt;</th>
<th>1. It extends to whole of Pakistan and applies to all citizen of Pakistan</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>the terms specified therein and shall not be altered to the disadvantage of the investors.</td>
</tr>
<tr>
<td>4.</td>
<td>The ownership, management and control transferred by the government to any person under any law shall not again be compulsorily acquired or taken over by the government</td>
</tr>
<tr>
<td>5.</td>
<td>No foreign, industrial or commercial enterprise, and no investment in share or equity, shall be compulsorily acquired or taken over by the government</td>
</tr>
<tr>
<td>6.</td>
<td>All financial obligations, or any financial and contractual commitment made by or on behalf of the government shall continue to remain in force, and shall not be altered to the disadvantage of the beneficiaries</td>
</tr>
<tr>
<td>7. Protection of Economic Reforms Amendment Ordinance, 1999, Section 4(1) does not apply to:</td>
<td></td>
</tr>
<tr>
<td>• any foreign exchange borrowed with the permission of the State Bank of Pakistan</td>
<td></td>
</tr>
<tr>
<td>• any payment from abroad for goods exported from Pakistan, or any payment received from abroad for services rendered in or from Pakistan</td>
<td></td>
</tr>
<tr>
<td>• earnings or profits of the overseas offices of Pakistani firms, companies and banks</td>
<td></td>
</tr>
<tr>
<td>• any foreign exchange purchased from any authorized dealer in Pakistan.</td>
<td></td>
</tr>
</tbody>
</table>

<sup>60</sup> [http://www.sbp.org.pk/about/ordinance/ordinance-.pdf](http://www.sbp.org.pk/about/ordinance/ordinance-.pdf)
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>Any authorized person in writing by federal government or SBP enter any place and call for and inspect any accounts, books or other documents kept</td>
</tr>
<tr>
<td>3.</td>
<td>No person shall make payment to or for the credit of any person resident outside Pakistan</td>
</tr>
<tr>
<td>4.</td>
<td>No person shall draw, issue or negotiate any bill of exchange so that a right to receive a payment is created or transferred in favor of any person resident outside Pakistan</td>
</tr>
<tr>
<td>5.</td>
<td>No person shall make any payment to or for the credit of any person as consideration for or in association with</td>
</tr>
<tr>
<td></td>
<td>• the receipt by any person of a payment or the acquisition by any person of property outside Pakistan</td>
</tr>
<tr>
<td></td>
<td>• the creation or transfer in favor of any person of a right whether actual or contingent to receive a payment or acquire property outside Pakistan</td>
</tr>
<tr>
<td>6.</td>
<td>No person shall, except with the general or special permission of the State Bank and on payment of the fee, if any, bring or send into Pakistan any gold or silver or any currency notes or bank notes or coin whether Pakistan or foreign.</td>
</tr>
<tr>
<td>7.</td>
<td>No person shall, except with the general or special permission of the State Bank or the written permission of a person authorized, take or send out of Pakistan any gold, jewelry or precious stones, or Pakistan currency notes, bank notes or coin or foreign exchange.</td>
</tr>
<tr>
<td>8.</td>
<td>No person shall, except with the general or special permission of the State Bank,</td>
</tr>
<tr>
<td></td>
<td>• Take or send any security to any place outside Pakistan</td>
</tr>
</tbody>
</table>
| Special Economic Zones Act, 2012\(^1\) | 1. Provincial investment promotion authority shall be responsible within its province of jurisdiction while in ICT BOI shall be responsible.

2. Each provincial SEZ Authority shall, subject to the approval of BOA, establish its rules and procedures.

3. After negotiating a development agreement, the SEZ Authority concerned shall submit a final agreement for approval to the Board of Approval (BOA).

4. In case of any grievances, a developer may approach BOA directly or through the SEZ Authority and BOA shall |

---

\(^1\) [https://invest.gov.pk/sez#gallery-1](https://invest.gov.pk/sez#gallery-1)
have the authority to consider, modify or set aside any decision.

5. Enterprises shall be admitted to an SEZ by the developer in accordance with applicable zone admission criteria, the zone regulations and the terms of the development agreement.

6. The federal and provincial governments to ensure the provision of gas, electricity and other utilities at the designated point of each SEZ

7. The federal and provincial governments to ensure adequate road access to the SEZs

8. Each developer to ensure, within a particular SEZ, the supply of gas and electricity to all zone enterprises as well as the availability of all other public utilities required for such areas as envisaged in the development agreement

9. Unless provided otherwise each developer shall have the right to set up a captive electric power generation plant or install a hydel power generator of sufficient size to cater to the expected demand for electricity within a particular SEZ and to sell and distribute only the excess electricity

10. The federal and provincial governments shall, in particular, facilitate the
- issuance of licenses, permits and other approvals to zone enterprises required for their business activities
- satisfaction of customs and other export or import requirements by zone enterprises
- fulfillment of tax obligations by zone enterprises
- authorization of electronic communications and Modes of e-governance
| 11. The BOA shall make the economic impact assessment of an SEZ within 5 years from the date of agreement and within the 5 years of the operation. |