Catalysing Private Investment in Pakistan:

Leveraging the CPEC Opportunity

An Issues Paper for
The Pakistan Business Council

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ptcl hello to the future		reckitt	MASOOD ROOMI
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TCS WE MOVE YOU	Tufail Chemical Industries Ltd.	UBL where you come first	Unilever

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List of Abbreviations

APCEA	All-Pakistan Chinese Enterprises' Association
ASEAN	Association of Southeast Asian Nations
BoI	Board of Investment
BRA	Balochistan Revenue Authority
BRI	Belt and Road Initiative
CPEC-A	China-Pakistan Economic Corridor (CPEC) Authority
CPEC	China-Pakistan Economic Corridor
DISCOs	(Power) Distribution Companies
EM	Emerging Markets
FDI	Foreign Direct Investment
FES	Friedrich Ebert Stiftung
FIEDMC	Faisalabad Industrial Estate Development and Management Company
FIEs	Foreign Invested Enterprises
FMCG	Fast Moving Consumer Goods
FY	Fiscal Year
GoP	Government of Pakistan
HK	Hong Kong
ILO	International Labour Organisation
IMF	International Monetary Fund

IPPs	Independent Power Producers
KPRA	Khyber Pakhtunkhwa Revenue Authority
LMIC	Low and Middle Income Countries
MNCs	Multi-National Corporations
NADRA	National Database and Registration Authority
OBOR	One Belt One Road
OFDI	Outward Foreign Direct Investment
PBC	Pakistan Business Council
PRC	People's Republic of China
SAR	Special Administrative Region
SBP	State Bank of Pakistan
SEZs	Special Economic Zones
SRB	Sindh Revenue Board
WAPDA	Water and Power Development Authority
WB	World Bank
WEF	World Economic Forum
WIR	World Investment Report
UNCTAD	United Nations Conference on Trade and Development

Foreword

This study entitled ‘Catalysing Private Investment in Pakistan: Leveraging Chinese Investment in CPEC’ was undertaken in response to Pakistan Business Council’s overarching economic dialogue on achieving long term sustainable growth in Pakistan.

The reason for commissioning a report to study the underpinnings of a chronically low investment rate in Pakistan and to make comparisons with its peer economies, is to discover the most wanting issues, and pave the way for developing a strategy to spur productivity-enhancing and export-generating investments in the economy. The report is contextualized to CPEC investments for the reason that in the recent past, China has emerged as the leading investor in Pakistan, and the third largest investor globally, presenting a clear opportunity for Pakistan to attract private sector investments from China.

The report highlights a number of broad issues hindering investment decisions in Pakistan, ranging from political risk impeding long term investments, an unfriendly tax and regulatory regime for businesses, low labour productivity, weak intellectual property rights, uncompetitive energy prices, high logistics costs, limited comparative advantage in accessing external markets through bilateral or regional trading agreements, etc.

Furthermore, the report provides valuable insights on the challenges faced by Chinese investors, which if addressed adequately and expeditiously, will lead to opening up new investment interest by Chinese companies to relocate labour intensive manufacturing facilities from China to Pakistan, for the purpose of exporting onward to the developed world and indeed to China.

Key Takeaways

- Pakistan's overall investment rate is 'chronically' low, and has been significantly below the average for peer economies for a protracted period. The trend is similar across private investment, foreign direct investment and investment in manufacturing.

- A confluence of structural as well as institutional impediments have combined with adverse political and internal security developments since the 1990s to produce this outcome. However, there have been sporadic opportunities since the mid-2000s for Pakistan to induce greater private investment and attract efficiency-enhancing FDI, but an absence of strategic clarity and planning has hindered taking full advantage of these openings.

- Pakistan's FDI-seeking approach has been un-targeted and too general, and needs to be revamped into a more nuanced, two-tiered policy. The current strategy is liberally allowing inward FDI seeking domestic market opportunities without prioritising high-priority areas such as the export sector, advanced (including additive) manufacturing, value-added agriculture, and electronics among others.

- More recently, the China-Pakistan Economic Corridor, or CPEC, has afforded Pakistan a unique opportunity to galvanise private investment and FDI, and transform its economy. China has become the number one source of outward foreign direct investment (OFDI) in the world in 2020. It accounted for 20 per cent of the global FDI volume. Its OFDI in the Belt and Road Initiative (BRI) countries has crossed US$ 117 billion between 2013 and 2020. China is also the largest source of inward FDI in Pakistan cumulatively since 2015, accounting for over 30 per cent of the total, with an investment value of US$ 7.2 billion.

- However, despite the high volume of inward FDI from China during CPEC Phase I, Pakistan has attracted a relatively modest share of around 5 per cent of China's OFDI in BRI countries since 2015, with power generation and infrastructure projects accounting for a large share.

- The investment interest and momentum from CPEC Phase I does not appear to have carried over into Phase II as yet, or into the manufacturing sector. So far Pakistan also does not appear to have been able to successfully leverage CPEC to catalyse domestic private investment, non-CPEC Chinese investment or attract non-China FDI.

- While private investment and FDI overall face generic constraints, such as a weak macroeconomic environment and institutional framework, policy instability, inconsistent and 'predatory' tax enforcement on formal firms, and energy challenges, Chinese investors face some specific concerns. These pertain to accumulation of large payment arrears, especially in the power sector, inconsistent tax treatment, de facto exchange controls, inordinate delays in licensing approvals, lengthy and cumbersome procedures for obtaining utilities, an inflexible visa regime, and security challenges. These specific issues have sent a negative signal to Chinese investors in Pakistan, both state-linked as well as private.

- Addressing the heightened sensitivity of Chinese investors to the foregoing concerns via continuous high-level interest, as well as a 'whole-of-government' approach, is of the utmost importance to provide the requisite assurances and resolution.

- The Council of Common Interests (CCI), the constitutional body that oversees matters affecting both the Centre as well as the provinces, needs to be used more effectively in resolving many of the coordination problems CPEC investments are facing. These issues have delayed projects, increased project costs, and also increased the frustration of Chinese investors.

- Additionally, as a secondary issue, greater clarity in institutional arrangements viz. role of Board of Investment (BoI) and CPEC-Authority (CPEC-A) is also needed, to avoid duplication, lack of coordination and institutional lags.

- Imbuing a sharper strategic focus to CPEC Phase II by emphasising as well as facilitating the embedding of Pakistani exporter firms into the Chinese value chain, will be essential for its success. Pakistan should aim for 'high quality' investment that provides access to export markets, technology and capabilities, while furthering economic transformation in the FDI-targeted sectors.

- While Pakistan has opted for pursuing the Special Economic Zones (SEZs) model to set up enclaves for foreign investment, some key success factors from examples that have done particularly well in other countries appear missing. Successful SEZs have focused on specific industries, promoted clusters and agglomeration economies, and have developed strong linkages with domestic firms. In addition, they have provided a 'plug and play' environment for investors to start operations with minimum delays and hassle.

- At the same time, notwithstanding specific concerns, addressing generic, long-standing weaknesses in Pakistan's investment environment that affect all investors, foreign as well as domestic, is paramount. Setting up Special Economic Zones, even well-functioning ones, should not be the end objective of investment policy, but an element of a broader industrial policy.

- The "macro" issues which are holding back private investment in the country, and whose resolution can unlock substantial investment potential, are well known. These pertain to policy inconsistency, political instability, poor infrastructure, low labour productivity, a high effective burden of taxation and regulatory compliance, and a lack of inter-government and inter-agency coordination. A comprehensive roadmap for broad institutional and structural reform in the economy is needed more than ever.

- Specifically, on the much-mooted potential of relocating labour-intensive manufacturing from China to Pakistan, market access for Pakistan sourced goods relative to Bangladesh and SE Asian countries is poor and needs to be addressed. Moreover, the wages of labour in Pakistan will have to be, on average, 35 per cent lower than China's average wage rate, 20 per cent lower than the average wage rate in Sri Lanka, and 30 per cent lower than the average wage rate in India to be able to offer any additional advantage to an investor based on labour costs alone.

I. Introduction

The overall rate of investment in an economy lays the foundation for future growth. It is thus one of the most foundational indicators of an economy's long run growth potential. Investment by a country's private sector and direct investment by foreign firms are of particular interest in this regard. Firstly, investment in an economy by these two segments indicates confidence in the long run potential of the country, its market size and aggregate purchasing power, and confidence in the economic policies and direction-setting by a succession of governments.

In the case of foreign direct investment (FDI) in particular, the ability to attract a higher level of inward FDI usually portends that the host economy can benefit from a virtuous spiral. In the case of FDI inflows that are efficiency-enhancing, the improved competitiveness of domestic FDI-target firms can lead to attracting even more inward FDI seeking an environment of higher efficiency and productivity, especially where spillovers and strong linkages exist between foreign invested enterprises (FIEs) and domestic firms. The 'right kind' of inward FDI provides access to external markets, technology, enhanced capabilities of domestic firms, and agglomeration opportunities.

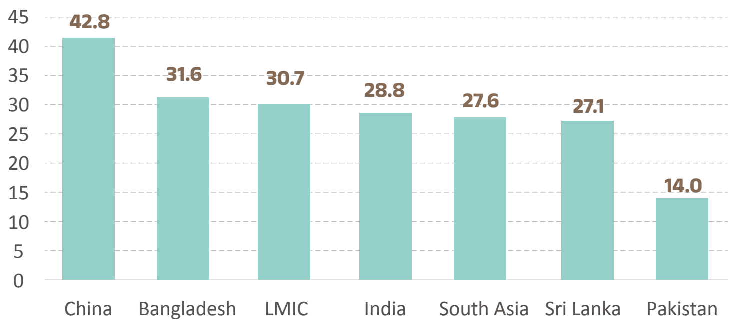
II. Pakistan's investment performance

Pakistan's overall investment rate has historically been low compared to its regional or developing peers, and has steadily declined over a protracted period. For the period 2011-20, Pakistan's fixed investment rate (gross fixed capital formation) as a per cent of GDP has averaged 13.9 per cent – almost exactly half of the average for South Asia at 28.2 per cent. By comparison, the average for the cohort of all low and middle income countries (LMICs) is 31 per cent for the same period (see Figure 1).

Using a longer timeframe of 25 years, from 1995 to 2019, the country's fixed investment rate has averaged 15.1 per cent, as compared to 28.1 for South Asia and 29.3 per cent for low and middle income countries over this period. The numbers suggest a moderate decline from an already low base for Pakistan, long run stability in South Asia's investment rate, and an acceleration for low and middle income countries overall.

Figure 1: Overall investment rate of select economies

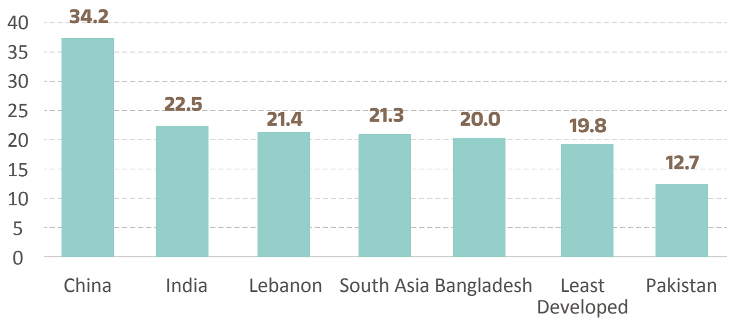
As % GDP, 2019



Source: World Bank data

Figure 2: Investment by private sector

As % GDP, 1995-2019 average



Source: World Bank data; author

Fixed investment by the private sector over a 25-year period, between 1995 and 2019, has averaged 12.7 per cent of GDP in Pakistan – a full 40 per cent lower than the average for South Asia as a whole over this period (at 21.3 per cent of GDP). After hitting a peak of 15.3 per cent in 2006, fixed investment by the private sector in Pakistan declined to 10.6 per cent of GDP by 2020 (Figure 2).

Interestingly, South Asia as a whole also witnessed a decline in the rate of fixed investment by the private sector over this period, almost of the same magnitude as Pakistan, with the investment rate easing to 21 per cent of GDP in 2020 from a peak of 25.5 per cent of GDP in 2007. Prima facie the main reason for the apparent co-movement appears to be the downturn induced worldwide by the Covid-19 pandemic. However, if there are any other reasons for the synchronized downturn, and whether there is any longer term correlation between the two, remains unclear.

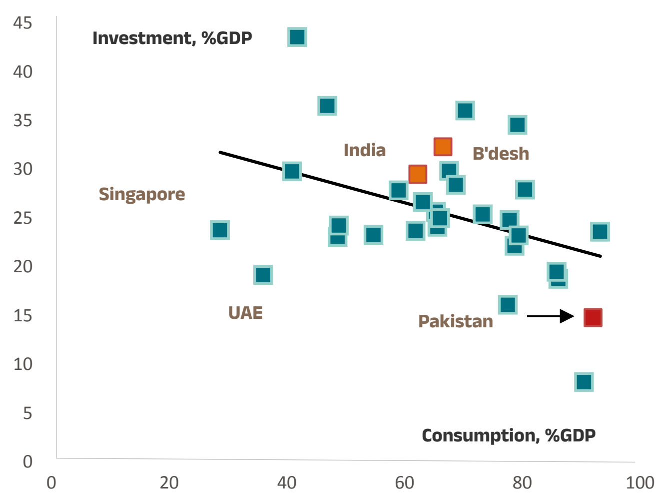
The low overall investment rate in Pakistan is a function of several factors operating over this period, including political instability, internal conflict, an intensifying energy crisis, as well as a series of macroeconomic crises. However, it is also a consequence of a low domestic savings rate and its corollary, a high level of consumption. Domestic savings and investment rates are highly positively correlated across economies, with causation generally running from savings to investment, in line with economic theory. Hence, Pakistan's low domestic savings rate can substantially explain its low investment rate, with other compounding factors.

Table 1: Savings and investment rates in select EM

As % of GDP	Saving	Investment
China	44	44
Bangladesh	36	32
Indonesia	31	32
India	30	29
Turkey	26	26
Sri Lanka	25	27
Vietnam	22	24
Egypt	15	18
Pakistan	12	14

Source: World Bank data

Figure 3: Consumption and investment in EM



Source: World Bank data; author

A feature of Pakistan's long run investment scenario is the relatively low levels of FDI that the country has attracted, barring a few years in the mid-2000s and then again between 2016 and 2021, coinciding with the start of the China-Pakistan Economic Corridor 'Early Harvest' phase. Examining data for 2019, to wash out the effects of the Covid-19 pandemic, reveals that Pakistan attracted inward FDI of US$ 2.2 billion, equivalent to 0.8 per cent of its GDP.

Inward FDI into Pakistan for 2019 represented just 3.9 per cent of the total FDI inflows in absolute terms into South Asia as a whole. By comparison, India attracted inward FDI worth US$ 50.6 billion in 2019, the equivalent of 1.8 per cent of its GDP – accounting for nearly 90 per cent of all FDI inflows into South Asia.

Inward FDI into South Asia in 2019 amounted to 1.6 per cent of the region's combined GDP, while lower-middle income countries attracted FDI inflows of 2 per cent of GDP.

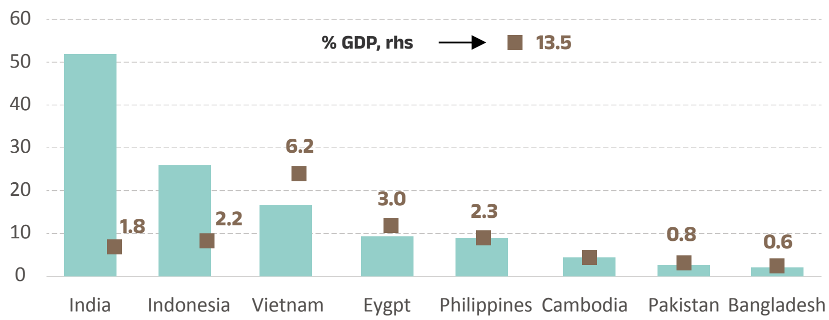
Figure 4: FDI inflows into Pakistan

US$ million, gross

Source: SBP data

Figure 5: FDI inflows in selected EM economies

US$ billion + % GDP, gross, 2019



Source: World Bank data; author

With the commencement of on-ground work on CPEC Phase 1 in 2015, FDI inflows from China accelerated, and accounted for a significant portion of inward FDI into Pakistan. Between 2015 and 2021, inward FDI from China has totalled over US$ 7.2 billion, accounting for a full 33 per cent, or one-third, of the overall FDI inflows into Pakistan over this period. The other main source countries for FDI into Pakistan during this period were: UK (US$1.7 billion, 7.8% of total), US (US$1.4 billion, 6.6%), Netherlands (US$1.3 billion, 6.1%), UAE (US$1.3 billion, 6.1%), Hong Kong (US$1.24 billion, 5.7%) and Norway (US$1.21 billion, 5.5%).

Table 2: Main source countries for inward FDI, 2015-21 cumulative

		US$ bn	% of total
1.	China	7,234	33.1%
2.	UK	1,707	7.8%
3.	USA	1,444	6.6%
4.	Netherlands	1,330	6.1%
5.	UAE	1,322	6.1%
6.	HK	1,240	5.7%
7.	Norway	1,207	5.5%
8.	Switzerland	694	3.2%
9.	Japan	482	2.2%
10.	Turkey	361	1.7%

Source: SBP; author

Over a 25-year period, from 1995 to 2019, inward FDI into Pakistan has averaged US$ 1.8 billion annually, or 1.2 per cent of GDP. Given the size of Pakistan's economy and its population, the level of inward FDI appears to be below 'potential', especially when investment from China under CPEC is stripped out from the more recent data.

Another striking feature of the overall investment performance of Pakistan over the long run is its sectoral composition. Unlike the experience of many other developing countries, investment in manufacturing has remained low, both in terms of private sector investment as well as FDI. This is closely allied with, as well as reflects, the slow structural transformation of the economy. The share of the agriculture sector in GDP and employment has not fallen as sharply as in peer economies, while the modest decline that has taken place has not been diverted to manufacturing or industry, but to services.

Table 3: Structural transformation

Share in GDP, change 1990-2016 (%)

	Agriculture	Industry	Services
Bangladesh	-18.0	8.1	9.9
China	-18.0	-1.2	19.3
India	-12.7	-2.8	15.5
Malaysia	-6.6	-3.9	10.4
Philippines	-12.3	-3.6	15.9
Sri Lanka	-18.5	3.3	15.2
Thailand	-4.2	-1.4	5.6
Pakistan	-1.3	-5.8	7.2
Lower middle income	-11.1	-2.0	13.4
South Asia	-12.2	-2.3	14.4

Source: World Bank (data); author

Table 4: FDI by sector

US$ million

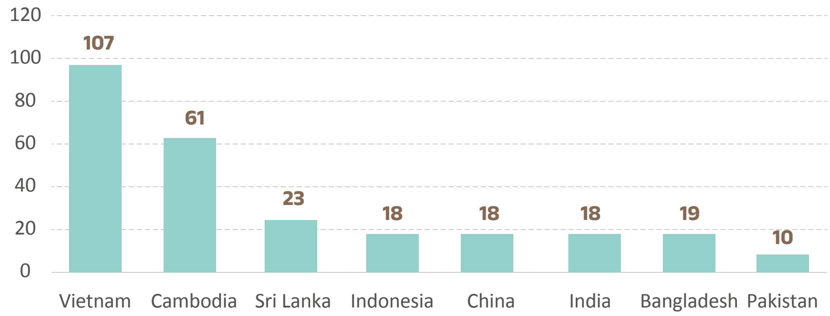
		Total		
	SECTOR	Inflow	Outflow	Net FDI
1	Power	4,390	1,147	3,243
	of which: Coal	2,663	848	1,815
	Hydel	992	30	961
	Thermal	736	269	467
2	Financial Business	1,938	444	1,494
3	Communications	1,836	1,055	781
4	Oil & Gas Explorations	1,482	59	1,423
5	Food	791	147	644
6	Trade	592	150	442
7	Electrical Machinery	468	7	461
8	Electronics	454	161	293
	of which: Consumer/Household	425	161	264
9	Chemicals	379	192	187
10	Petroleum Refining	377	180	197
	Total (1-10)	**13,131**	**3,702**	**9,429**
	Total (overall - all sectors)	**15,738**	**4,729**	**11,010**

Source: SBP; author

As a result, the share in overall GDP of Pakistan's manufacturing sector (as well as industry more broadly) has been declining, as has the share of the export sector. Unlike Pakistan's developing country peers, exports account for 10 per cent of GDP. By comparison, Bangladesh's exports (goods and services) are at 19 per cent of GDP, India's 18 per cent and Sri Lanka's 23 per cent of GDP.

Figure 6: Size of export sector

As % GDP



Source: World Bank data; author

Corresponding to the foregoing, the inward FDI into Pakistan has predominantly been domestic market-oriented. Unlike the case of China, South Korea, Taiwan or Vietnam, where a significant proportion of inward FDI flowed into the export sector and produced a substantial contribution to the host country's exports, the primary motivation for attracting inward FDI into Pakistan by different governments since the 1990s appears to have been to not only plug infrastructure gaps but also as a means of balance of payments inflow.

The absence of a strategic design and motivation in the country's FDI policy has translated into Foreign Invested Enterprises (FIEs) contributing a negligible amount to exports (around 1 per cent in estimates by UNCTAD from the early 2000s), compared to over 60 per cent at its peak in the case of China.

Box 1: **Are FDI outflows rising?**

An interesting insight from the data on FDI inflows and outflows in the case of Pakistan is presented in **Table 5.** The data indicates that from 2001-2 to 2007-8, the outflows to inflows ratio remained steady at around 6 per cent (on a 3-year moving average basis), increasing rapidly thereafter to a peak of 50 per cent by 2014-15. It has declined since then to a range of 31-37 per cent between 2018-19 and 2020-21. This ratio implies that, on average, the duration of inward FDI (or its "tenancy" in the country) has declined to only approximately 3 years, from around 20 years in the mid-2000s.

Table 5: FDI inflows and outflows (US$ million)

	Inflow	Outflow	Net	Outflow/Inflow	3 yr MA
2001-02	509	25	485	5%	...
2002-03	849	51	798	6%	...
2003-04	1,024	75	949	7%	6%
2004-05	1,584	60	1,524	4%	6%
2005-06	3,716	195	3,521	5%	5%
2006-07	5,402	262	5,140	5%	5%
2007-08	5,645	235	5,410	4%	5%
2008-09	4,479	760	3,720	17%	9%
2009-10	3,184	1,034	2,151	32%	18%
2010-11	2,270	635	1,635	28%	26%
2011-12	2,099	1,278	821	61%	40%
2012-13	2,665	1,209	1,456	45%	45%
2013-14	2,847	1,149	1,699	40%	49%
2014-15	2,843	1,809	1,034	64%	50%
2015-16	3,256	863	2,393	27%	43%
2016-17	3,111	704	2,407	23%	38%
2017-18	3,495	714	2,780	20%	23%
2018-19	2,785	1,423	1,362	51%	31%
2019-20	3,322	725	2,598	22%	31%
2020-21	3,026	1,163	1,863	38%	37%

Source: SBP (data); author

While there is no immediate explanation as to why FDI outflows are rising in relation to inflows, one possible explanation could relate to the nature of FDI inflows that Pakistan is attracting. A significant portion of the inward foreign investment has flowed into the services sector (including telecommunications), where profit margins are typically high and payback periods lower than in manufacturing for example, or into power generation.

Even in the case of power generation, the sovereign-guaranteed US dollar-indexed returns equivalent to 17.5 per cent Internal Rate of Return (IRR), or a Return on Equity (ROE) of typically 27-30+ per cent, produce high returns with a relatively short payback period.

In overall terms, based on the reported stock of FDI as of June 30, 2021 of US$ 28.9 billion, and repatriated profits and dividends in FY21 of US$ 1.49 billion, the indicative "yield" on foreign direct investment works out to around 5.2 per cent in US$ terms. It is worth noting, however, that since this calculation is based on repatriated profits/dividends, and not on total profits (including retained profits), it is an under-estimation of the total profitability of FIEs in Pakistan.

What explains Pakistan's low overall investment rate?

Various studies, investment climate assessments, business confidence surveys, and academic papers over the years have attempted to list the main impediments to investment by the private sector in Pakistan. As stylised fact, two factors that explain secular trends in the investment rate of an economy are the long run rate of economic growth and the domestic savings rate (discussed in a previous section).

The country's economic growth has been sporadic and halting, with each growth spurt lasting less than 4 years. Based on a 10-year moving average, Pakistan's annual GDP growth has exactly halved since the 1960s, from 7.2 per cent in 1962 to 3.6 per cent by 2020. Given the anaemic growth performance, the weak investment response from the private sector is hardly surprising.

The rate of economic growth and private investment are mutually reinforcing – a higher GDP growth rate over a prolonged period leads to a stronger investment response from the private sector, which in turn, boosts the rate of growth of the economy. Notwithstanding the stylised role of growth and domestic savings in explaining the investment rate in an economy, a number of specific factors have also been in operation going back to the 1990s in the case of Pakistan, and appear to have exerted an influence in suppressing private investment.

These factors include inter alia:

- A weak institutional setting, which has resulted in:
  - Political uncertainty
  - Policy instability
  - Poor economic management, including, but not limited to, implementing policies with anti-export and anti-manufacturing bias, signing free trade agreements (FTAs) without proper study that proved inimical to domestic firms, remaining on IMF programs for prolonged periods with their focus on austerity and anti-growth policies.
  - Inordinate delays/lags in policymaking + inconsistent implementation
  - Coordination failures between different levels of government
  - Contract enforcement issues
  - Cumbersome and time-consuming dispute resolution mechanisms and processes
  - Weak intellectual property rights protection
  - A convoluted and cumbersome tax regime with uneven enforcement (creating a "tax arbitrage" between formal and informal firms, in favour of the latter)
  - Prevalence of smuggling and rampant under-invoicing
  - A heavy regulatory burden for formal firms

- Difficulty in procuring land for commercial use in many urban centres, issues with obtaining clean titles, cumbersome land development/building control procedures, and relatively high per square foot price.

- Un-harmonized, multiple provincial food and environmental standards instead of unified national standards.

- A low supply of skilled labour/low worker productivity (see Box 4 for a more detailed discussion).

In general, and at a broad level, the foregoing conforms to findings in the published literature on the link between private investment and the strength of the institutional framework of a country (see Box below).

Box 2: **Effects on private investment of the institutional setting**

In the presence of political instability and policy uncertainty, "political risk" is deemed to rise, resulting in new investment in a country attracting higher risk premiums. This has the twin effect of raising the required financial return on capital for new projects, while shortening the investment horizon and required payback period for investors.

Investor perceptions of a high-risk scenario alters — as well as constricts — the portfolio of projects that a potential investor would look at, thus, potentially lowering the overall investment envelope of a riskier country as well as affecting the "quality" of investment undertaken. Pakistan's low and declining investment rate compared to its peers bears testimony to this. The increasingly higher and sovereign-guaranteed nature of returns demanded by private investors for large greenfield investment is also indicative of the same phenomenon.

The design and application of Pakistan's tax policy has exacerbated over a period of time the business as well as investment environment. An excessive burden of taxation on large, formal businesses is increasing "informality" in the economy, while the availability of a large tax arbitrage in capital gains on trading on the equity markets and in real estate are shifting investment away from manufacturing and the real economy to less productive areas, such as secondary trading.

In addition, the dysfunctional tax system has not been generating enough tax revenue for the state to be able to support the required level of public investment in infrastructure or to avoid "crowding out" of the private sector from the credit markets. Both of these developments have had a detrimental impact on new private investment.

Widespread smuggling, under-invoicing of imports and mis-declaration as well as the absence of state enforcement against counterfeit goods and violations of intellectual property rights has also hurt domestic manufacturing. With an anti-export policy bias coupled with a progressively import-friendly regime in place since trade liberalization began in the 1990s, import penetration has increased sharply. This process has also been exacerbated by Pakistan's signing of a Free Trade Agreement (FTA) with China that was implemented from 2006.

On a related note, one feature that can be expected to be prominent in countries with market characteristics but a weak institutional framework is "crony capitalism". Politically-connected insiders are given rents via choice licenses and contracts by the government or are beneficiaries of privatization of state assets or sale of state land at throwaway prices, etc. This has the twin effect of engendering pervasive allocative inefficiency in the economy while stifling competition and the processes that lead to greater competitiveness.

Numerous examples can be found in Pakistan's history of industrialization where a combination of subsidized bank credit, preferential access to foreign exchange for imports, a regime of regulatory forbearance and write-offs of bank loans led to a spurt of new "investment" — often with imported plant and machinery that was heavily over-invoiced as a conduit for capital flight. With no real equity invested in the projects thus set up, the sponsors had little or no incentive to run the projects efficiently or competitively. Over a period of time, these marginal investments became unsustainable.

Issues such as these have hurt the overall competitiveness of Pakistan's economy.

Source: *Institutional Reforms in Pakistan – The Missing Piece of the Development Puzzle;* FES (2017)

Within the institutional framework, Pakistan's convoluted tax system is a weak link that dis-incentivises new investment and generates large deadweight losses for the economy (see **Special Section**).

Special Section: Disincentives and large deadweight losses of Pakistan's tax system

The country's tax system is characterised by low collection, a narrow overall tax base, split tax bases between the Centre and the provinces, a lack of efficiency and large horizontal as well as vertical inequities.

The tax system has, over a period of time, worsened the business as well as investment environment. An excessive burden of taxation on large, formal businesses is increasing "informality" in the economy, while the availability of a large tax arbitrage is shifting investment away from manufacturing and the real economy to less productive areas.

In addition, the country's dysfunctional tax system has not been generating enough tax revenue for the state to be able to support the required level of public investment in infrastructure or to avoid "crowding out" of the private sector from the credit markets. Both of these developments have had a detrimental impact on new private investment. Hence, for efficiency as well as equity reasons, an overhaul of the national tax system is imperative.

Currently, the cost of compliance in terms of time, effort as well as cost to businesses of paying taxes in Pakistan is very high. According to data from the World Bank's Doing Business database, Pakistan ranked 161 overall in the "paying taxes" indicator as of 2018 (see **Table**).

Table 6: Ease of paying taxes

Country	Payments (# per year)	Time (hours per year)	Paying Taxes rank
Turkey	10	170	26
United Arab Emirates	5	116	30
Rwanda	9	91	38
South Africa	7	210	54
Thailand	21	229	68
Malaysia	9	174	80
Indonesia	26	191	81
Kenya	24	180	94
Vietnam	6	384	109
India	11	252	115
Sri Lanka	36	129	142
Bangladesh	33	435	151
Pakistan	**34**	**283**	**161**

Source: World Bank

The low overall rank on the "Paying Taxes" indicator, is an indication of a complicated tax system with a convoluted tax code compounded by enforcement and compliance challenges.

The current tax system in effect dis-incentivises firms to formalise, encourages informalisation, and discourages informal firms and SMEs to grow in size (or to fragment further). In addition, the tax system impedes the transition of family-owned local businesses into professionally managed listed companies and the formation of group structures via multiple taxation of inter-corporate dividends and full offset of group losses.

The net result of the country's tax policies is that they have in-built a lack of competitiveness into the economy as firms are unable to benefit from economies of scale via consolidation, acquisitions or even organic growth. This situation, in turn, also serves to discourage inward foreign direct investment (FDI).

An added complication for businesses has arisen post-18th amendment from the split assignment of tax bases.

The way forward

The country's main tax bases are assigned in the 1973 Constitution in a split manner between the Centre and the provinces. This did not pose a jurisdictional issue as the tax handles (income tax, sales tax on goods, urban immoveable property tax, excises, motor vehicle tax etc.) were well defined. However, since the 18th amendment in 2010, and the assertion by provinces of their right to impose "independently" a sales tax on services, coordination issues as well as the cost of doing business in the country have increased.

As a result, provinces have imposed different rates of sales tax in a "race to the bottom", the Centre as well as the provinces have encroached on each other's tax bases by defining "goods" and "services" in amorphous and self-serving ways leading to litigation, businesses are required to pay sales tax on both "origin" as well as "destination" basis, as well as file multiple sales tax returns, and input tax adjustments are either disallowed, disowned or delayed by provinces.

The net result for businesses operating nationally across provincial borders is a significant increase in the cost of doing business and a disincentive to invest. As part of tax reforms, a national tax harmonisation effort is underway which envisages resolving definitional as well as jurisdictional conflicts. However, it is proceeding at a glacial pace since provinces, especially Sindh, do not wish to give up their share of revenue that is accruing under the status quo.

As a first-best option, a modern, integrated (goods as well as services), nationally-administered Value Added Tax should be aspired to, to avoid on an on-going basis the definitional as well as jurisdictional conflicts the current system has spawned.

While the foregoing are common factors that affect all investors, whether domestic or foreign, certain factors are either of exclusive concern to, or carry greater weightage for, foreign investors. These include:

- Perceived high country risk (political, devaluation)
- Strength of the intellectual property rights regime
- Exchange regulations/restrictions in operation, whether de facto or de jure, on commercial remittances (profits and dividend repatriation, transfers/other payments to head office or affiliated concerns, franchise fees etc.)
- Availability of a skilled workforce
- A strong regime for the protection of overall property rights as well as for contract enforcement
- Simple, clear and effective dispute resolution mechanisms and processes

These issues among other important ones are explored in the following section.

III. Gauging Pakistan's Attractiveness for FDI

Overall, the locational choice of foreign direct investment (FDI) is driven by a "standard" set of factors. The decision by an investor to make cross-border investments in factories and businesses is motivated by one of the following reasons (see Box below):

- Resource-seeking FDI (seeking natural, physical or human resources)
- Market-seeking FDI (seeking domestic, adjacent or regional markets)
- Efficiency-seeking FDI (seeking to exploit economies of specialization and scope across or along value chains)
- Strategic-asset-seeking FDI (to advance a company's regional or global strategy or link into foreign networks of created assets, such as technology, organizational capabilities and markets)

Box 3: **Determinants of Inward FDI**

A considerable amount of published literature, spreading over four decades or more, exists on determinants of foreign direct investment (FDI), whether influencing the decision of investing firms or determining the attractiveness of a particular country as a target. A sub-set of the literature deals with the motivation of firms to prefer a specific mode of entry for their FDI.

According to Factors Affecting FDI Intentions of Investors: Empirical Evidence from Provincial-Level Data in Vietnam, published in The Journal of Asian Finance, Economics and Business (2021): With regard to the determinants of FDI, according to a review of FDI theories proposed by Faeth (2009), there have been numerous theoretical models and econometric studies, including early studies of determinants of FDI (Robinson, 1961; Wilkins, 1970); determinants of FDI according to the neoclassical trade theory (MacDougall, 1960; Kemp; 1964); ownership advantages as determinants of FDI (Vernon, 1966; Buckley & Casson, 1976); aggregate variables as determinants of FDI (Scaperlanda & Mauer, 1969); OLI paradigm

(Dunning, 1979, 1980); theories of horizontal and vertical FDI (Markusen, 1984; Helpman, 1984); determinants of FDI according to the Horizontal FDI, Vertical FDI and Knowledge-Capital Model (Markusen, 1997; Markusen & Venables, 1998); determinants of FDI according to diversified FDI and risk diversification models (Rugman, 1975; Hanson et al., 2001) and policy variables as determinants of FDI (Bond & Samuelson, 1986; Black & Hoyt, 1989; Haufler & Wooton, 1999).aradigm (Dunning, 1979, 1980); theories of horizontal and vertical FDI (Markusen, 1984; Helpman, 1984); determinants of FDI according to the Horizontal FDI, Vertical FDI and Knowledge-Capital Model (Markusen, 1997; Markusen & Venables, 1998); determinants of FDI according to diversified FDI and risk diversification models (Rugman, 1975; Hanson et al., 2001) and policy variables as determinants of FDI (Bond & Samuelson, 1986; Black & Hoyt, 1989; Haufler & Wooton, 1999).

Among them, Dunning's OLI paradigm (1979, 1980) is one of the most preferred models that explain FDI and the location decision of multi-national enterprises (MNE) by combining ownership, location, and internalization advantages of the host country as determinants of FDI. **Ownership advantages** refer to the competitive advantages of the MNE engaging in FDI, which derive from the possession of proprietary technology or other unique intangible assets, making them more powerful than domestic firms. **Location advantages** refer to a certain location that can provide firms some specific advantages, such as the favorable tax treatments, lower production and transport costs, lower risk, and so on. **Internalization advantages** refer to the firm's ability to internalize its activities, and thus reducing its transaction costs.

Corresponding to these three advantages, Dunning (1980, 1996) has also indicated four main types of FDI categorized by the motives behind the investment decision, which are:

1. Resource- seeking FDI (seeking natural, physical or human resources);

2. Market-seeking FDI (seeking domestic, adjacent or regional markets);

3. Efficiency-seeking FDI (seeking the rationalization of production to exploit economies of specialization and scope across or along value chains), and

4. Strategic-asset-seeking FDI (to advance a company's regional or global strategy or link into foreign networks of created assets, such as technology, organizational capabilities and markets).

Adapted from: Factors Affecting FDI Intentions of Investors: Empirical Evidence from Provincial-Level Data in Vietnam; The Journal of Asian Finance, Economics and Business. Volume 8, Issue 4.
Available at:https://www.koreascience.or.kr/article/JAKO202109554061298.view?orgId=kodisa

Historically, Pakistan's approach to FDI has been predicated on the underlying assumption that its locational advantage (as the "gateway to Central Asia" and next door to the Middle East) and domestic market size will ensure, along with generous fiscal and non-fiscal incentives to foreign investors (including firm-specific incentives), that it becomes an attractive destination for foreign investors. However, this somewhat myopic view taken by policymakers did not result in any meaningful inflow of FDI, and prevented an appreciation of the impediments. The belated recognition has also prevented a timely policy response.

In fact, the behaviour over a period of time of a sub-set of foreign investors – MNCs operating in the fast-moving consumer goods (FMCG) and the pharmaceuticals sectors in Pakistan – should be illustrative on this front. These MNCs invested in production facilities in the country a few decades ago, and supplied a mostly locally-manufactured product range to the domestic market (albeit using imported raw materials). Over the course of time, however, particularly from the 1990s onwards, these MNCs – especially in the pharmaceuticals sector – gradually wound down domestic production and replaced it with cheaper imports from regional production facilities.

A key lesson here is that despite "low wages" and "locational advantages", even an important sub-set of domestic market-seeking FDI has migrated away due to the rising cost of doing business in the country, especially in the manufacturing sector.

To better position itself as an attractive location for inward FDI, not just for market-seeking investment but more so for efficiency-seeking investment that intends to take advantage of Pakistan's low wages and locational advantages to shift production to the country, Pakistan needs to evaluate its standing on the following critical factors:

- Availability and quality of physical infrastructure
- Access to regional markets
- Availability of a sizeable pool of skilled, productive labour
- A 'plug and play' environment for investors with regard to approvals/regulation, land, utilities
- A simple, arms-length and 'light-touch' regulatory and tax regime
- An easy hassle-free visa regime

A few of the dimensions listed above that are crucially important for foreign investors are discussed in the following sections.

Quality of Pakistan's Human Capital

Pakistan has the 4th largest labour force in Asia, consisting of 71 million people. However, despite its size, it compares poorly with its regional peers in terms of skills structure, level of education, mean years of schooling and productivity indicators (see **Box 4**).

In terms of skills structure, Pakistan's labour force is predominantly unskilled or semi-skilled. This fact is reinforced by the level of education of the civilian labour force. According to labour force statistics from the Pakistan Bureau of Statistics, 9.15 per cent of the civilian labour force has a bachelor's degree or higher. A full 40 per cent is illiterate, while a further 45 per cent has an educational level of less than higher secondary (i.e. less than "Intermediate" pass) – see following **Table.**

Table 7: Educational level of civilian labour force

Percentage distribution of Civilian Labour Force		
Population	**100%**	
Civilian Labour Force	44.3%	
of which:		
Literate (%):	60%	Cumulative:
No formal education	2%	2%
Pre-Matriculation	29%	31%
Matriculation	13%	45%
Intermediate	6%	51%
Degree & post-graduate	9%	60%

Source: Labour Force Statistics (2017-18), PBS

The low educational attainment is reflected in the mean years of schooling in Pakistan. At 5.2 years (as of 2018), it compares unfavourably with Bangladesh's 6.1 years, India's 6.5 years, Sri Lanka's 10.6 years, and Vietnam's 8.2 years (see **Table 8**; data sourced from UNDP's Human Development Report database).

Table 8: Mean years of schooling of population

Country	No. of years
Bangladesh	6.1
China	7.9
India	6.5
Indonesia	8.0
Iran	10.2
Pakistan	**5.2**
Sri Lanka	10.6
Thailand	7.8
Tukey	8.1
Vietnam	8.2

Source: UNDP

According to the World Bank, "Human capital—the knowledge, skills, and health that people accumulate over their lives—is a central driver of sustainable growth and poverty reduction." Its Human Capital Index (HCI) provides "a new definition of human capital and quantifies the contribution of health and education to the productivity of the next generation of workers." According to the HCI for 2020, Pakistan stood at 143rd from the top in the ranking, and 31st from the bottom behind the poorest African countries. The only Asian country it scores better than is Afghanistan, and that too moderately (see Table below). The gap between Pakistan and each of its South Asian peers, as well as Vietnam, is substantial.

Table 9: Human Capital Index

Country	HCI score	HCI rank
Bangladesh	0.464	123
Cambodia	0.492	118
China	0.653	45
India	0.494	116
Indonesia	0.540	96
Iran	0.593	75
Pakistan	0.406	114
Sri Lanka	0.598	71
Thailand	0.609	63
Turkey	0.649	48
Vietnam	0.690	38

Source: World Bank

The foregoing indicators feed into how productive the labour force is. Not surprisingly, Pakistan does very poorly on this count (see below). The advantage of abundance of low wage labour is completely wiped out without productivity; ultimately, it is unit labour cost that a foreign investor uses as a metric to compare the competitiveness or otherwise of producing in one country compared to another.

Box 4: **Pakistan's productivity problem**

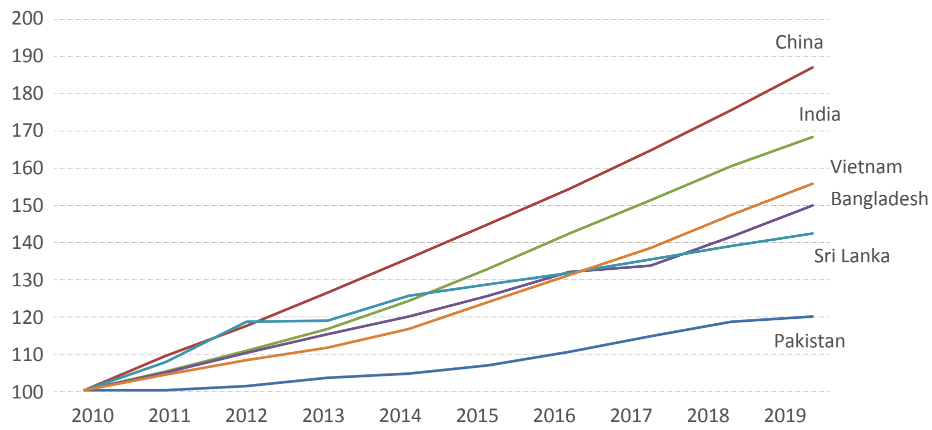
Based on estimates of productivity differentials from the International Labour Organisation (ILO), Pakistan has the weakest productivity growth among a sample of regional countries (see **Table 10**). Over a ten-year period between 2010 and 2019, Pakistan recorded an increase in productivity of 20 per cent, less than one-fourth that of China and one-third that of India over the same period. Bangladesh's productivity growth over the same period was 25 per cent higher than Pakistan, according to ILO estimates.

Table 10: Productivity growth estimates 2010-19

	Pakistan	China	India	B'desh	Sri Lanka	Vietnam
2010	**100**	**100**	**100**	**100**	**100**	**100**
2011	100	109	105	105	108	104
2012	101	117	111	110	119	108
2013	103	126	117	115	119	111
2014	105	135	124	120	125	117
2015	107	145	133	125	129	124
2016	110	154	142	132	132	131
2017	115	164	151	134	135	138
2018	119	175	160	141	139	147
2019	**120**	**186**	**168**	**150**	**142**	**156**

Source: ILO

Figure 7: Productivity growth estimates 2010-19



Source: ILO

The implications of low productivity relative to regional peers are significant not just for economic growth but potentially for the investment rate as well as its nature. Lower relative productivity negates the locational advantages of low-cost labour in an economy since unit labour costs remain high despite low wages. Hence, based on estimates from the International Labour Organisation (ILO) on productivity differentials, the wages of labour in Pakistan will have to be, on average, 35 per cent lower than China's average wage rate, 20 per cent lower than the average wage rate in Sri Lanka, and 30 per cent lower than the average wage rate in India to be able to offer any additional advantage to an investor based on labour costs alone (see **Table 10** and **Figure 7** above).

Physical infrastructure

The backbone of domestic commerce as well as international trade are the transportation, energy, utility, telecommunications and ports of entry/exit networks that exist in a country. A higher volume of trade and commerce can be supported by "denser" and better quality networks of roads, highways, railways, ports, airports and power infrastructure etc.

According to the World Economic Forum's Global Competitiveness Index 4.0 (2019 edition), Pakistan ranked 105th out of 141 countries in terms of provision and quality of physical infrastructure. By comparison, China ranked 36th, Sri Lanka 61st (highest in South Asia), India 70th, ahead of Vietnam at 77th. Somewhat surprisingly, Bangladesh was ranked lower than Pakistan on this score, at 114th.

Table 11: Ranking on quality and availability of physical infrastructure (select)

	Rank	Score
Singapore	**1**	**95.4**
China	36	77.9
Sri Lanka	61	69.2
India	70	68.1
Vietnam	77	65.9
Iran	80	64.8
Pakistan	105	55.6
Bangladesh	114	51.1

Source: GCR 2019 (WEF)

Under the first phase of CPEC, the bulk of the investment has been directed towards improving Pakistan's physical infrastructure, primarily along three areas: roads/highways, power, and Gwadar port. Despite the massive Chinese investment in these areas, Pakistan has not been able to reap the full benefits of the up-gradation in its infrastructure. This is due to the confluence of two main factors:

- The "circular" debt issue preventing full utilisation of the newly-installed power generation capacity
- Low utilisation of Gwadar port

A fourth critical element of CPEC Phase 1 was up-gradation of the main rail artery of the country under the ML-1 project. This project is stalled for various reasons, but once completed, it will be an important driver for improved connectivity between the ports in the south of the country with the markets in the north and beyond to Afghanistan and Central Asia. Additionally, the ML-1 project will provide for a more cost-efficient mode of transportation for freight compared to the existing use of highways.

Energy

Within overall physical infrastructure, energy plays an important role. Below-requirement and variable supply of energy, in addition to higher tariffs especially for industry relative to countries in the region, is also a crucial factor that disadvantages exporter-firms or FIEs from relocating production to Pakistan.

Table 12: Comparison of industrial electricity tariffs

US cents/kWh	Domestic		Commercial		Industrial	
	Range (US c/kWh)		Range (US c/kWh)		Range (US c/kWh)	
Pakistan	1.3	15.4	12.4	15.9	11.8	12.5
India	4.2	11.2	8.4	11.9	10.9	...
Bangladesh	4.1	12.6	10.8	...	6.8	...

Source: Report on the Power Sector, Committee for power sector audit, circular debt resolution & future roadmap, GoP; March 2020

While firms associated with five main export sectors have been receiving subsidised electricity and gas in line with regional tariffs, all other firms are subject to the higher domestic tariffs. In addition to higher tariffs, most firms, especially in manufacturing, have to make significant capital investment in back-up/stand-by or captive power generation.

Logistics

Logistics is defined by the Cambridge English dictionary as "the careful organization of a complicated activity so that it happens in a successful and effective way". This encompasses different activities and actors across the entire supply chains of businesses in a country.

A country's logistics infrastructure builds upon the physical infrastructure, and covers a merchandise goods clearance eco-system (efficient customs procedures, trained and equipped customs staff, bonded warehouses, clearing and forwarding agents, tracking and tracing mechanisms), transportation fleets, warehousing facilities, specialised storage facilities (cold storage chains, grains silos etc.), courier services etc.

The World Bank produces a Logistics Performance Index (LPI) to measure the relative ranking of each country on the state of the logistics infrastructure. According to the World Bank, "[T]he logistics performance index (LPI) is the weighted average of the country scores on the six key dimensions:

1) Efficiency of the clearance process (i.e., speed, simplicity and predictability of formalities) by border control agencies, including customs;

2) Quality of trade and transport related infrastructure (e.g., ports, railroads, roads, information technology);

3) Ease of arranging competitively priced shipments;

4) Competence and quality of logistics services (e.g., transport operators, customs brokers);

5) Ability to track and trace consignments;

6) Timeliness of shipments in reaching destination within the scheduled or expected delivery time."

Pakistan ranks a lowly 122nd on the LPI overall, the lowest among its South Asian comparators (see **Table**). Significant gaps and shortcomings compared to its regional peers appear in customs, infrastructure, tracking & tracing as well as timeliness. In international shipments and logistics competence Pakistan fares better than Bangladesh and Sri Lanka. However, in all parameters, it lags substantially behind South Asia's best-performing country on the LPI – India – which ranks 44th globally, not too distant from Vietnam at 39th.

The silver lining on this front is, however, that the launch of the Pakistan Single Window Initiative will address some of the deficiencies in clearance of inward and outward shipments by removing bureaucratic overlap and digitization.

Table 13: Logistics Performance Index (LPI) rank for selected regional countries (2018)

Country	LPI Rank	LPI Score	Customs	Infrastructure	International shipments	Logistics competence	Tracking & tracing	Timeliness
Vietnam	39	3.27	41	47	49	33	34	40
India	44	3.18	40	52	44	42	38	52
Sri Lanka	94	2.6	79	85	112	109	78	122
Bangladesh	100	2.58	121	100	104	102	79	107
Pakistan	**122**	**2.42**	**139**	**121**	**97**	**89**	**136**	**136**

Source: World Bank

Market access

Another important consideration for a foreign FDI investor with regards to relocation of production to a new country could be access to regional markets. Hence, in addition to the state of physical infrastructure and logistics, connectivity with regional markets and preferential access become important factors as well.

External Market Access Through Trade Agreements/Duty Free Access: A Snapshot

Country	Pakistan	Bangladesh	Vietnam	Cambodia	Laos	Key Take-aways for Pakistan
China	Yes	Unilateral access to 96% of items	Yes	Yes	Yes	Pakistan, with just 40% of items eligible for duty free access into China is at a disadvantage to others
USA	Some (GSP)	No	No	No	No	Most textiles are excluded from products elgible for GSP status into the US
EU/UK	GSP+	EBA*	Under EU FTA -Duty-free in 3-7 years	Removed from EBA	EBA	Parity with Bangladesh and Laos but Vietnam likely to overtake in time under its FTA. Cambodia removed by EU from GSP+ status
ASEAN	Ltd to some items into Malaysia and Indonesia	No	Yes	Yes	Yes	Not comparable to Vietnam, Cambodia and Laos
Australia/NZ/Canada	No	Yes (LDC)	Yes	Yes	Yes (LDC)	Pakistan at a disadvantage
Japan	No	Yes (LDC)	Yes	Yes	Yes (LDC)	Pakistan at a disadvantage
South Korea	No	Yes (LDC)	Yes	Yes	Yes (LDC)	Pakistan at a disadvantage
CPTPP	No	No	Yes	Yes	No	Pakistan at a disadvantage
RCEP	No	Considering	Yes	Yes	Yes	Pakistan at a disadvantage
Eurasia (Russia, Central Asia)	No	No	Yes	Yes	No	Pakistan at a disadvantage
*EBA - Everything But Arms for LDC countries						

Source: Pakistan Business Council (PBC)

The bottom-line from the above snapshot is that Bangladesh with its least developed country (LDC) status, and SE Asian countries by virtue of ASEAN and other trade agreements enjoy a comparative advantage in tariffs over goods exported from Pakistan into contested export markets.

There is thus significant scope for Pakistan to improve access to regional markets and trading blocs by negotiating more, and better, free trade agreements (FTAs) and preferential trade agreements (PTAs). Even with China, Pakistan does not enjoy parity with Bangladesh in market access, reflecting in part how even its most important FTA was poorly negotiated.

A final perspective: "economic complexity"

From the rich literature on the subject of the key determinants for FDI decisions with regard to the cross-border relocation of production by MNCs, two findings stand out:

- The presence of industrial clusters and agglomeration economies, and other MNCs, is a key determining factor

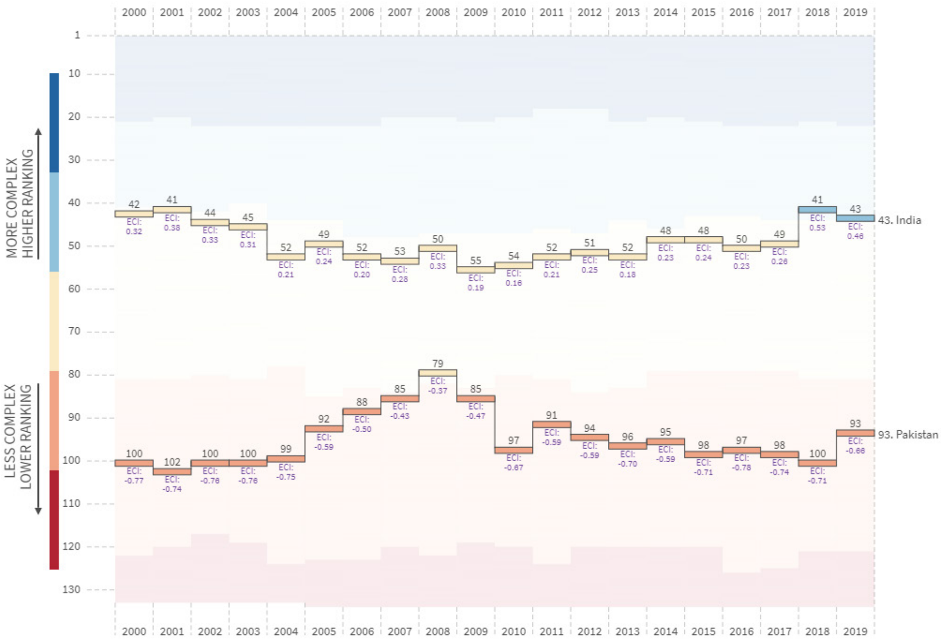
There is systematic evidence suggesting that multinationals are attracted to clusters of economic activities in their own and in closely related industries and activities (Glickman and Woodward, 1988; Head and Ries, 1996). The total number of industrial enterprises in a country, is expected to significantly attract FDI since the existence of industrial clusters signals a set of favorable conditions for foreign investors such as the presence of local suppliers, specialized labor and infrastructure (He, 2022). According to Coughlin, Terza and Arromdee (1991), the density of manufacturing activity was one of the most important factors in location decisions of foreign firms in the US during 1981-1983.

Head, Ries, and Swenson (1995), examined the location choice of 751 Japanese FDI and observed strong agglomeration effects at the industry level. Agglomeration economies may work between domestic and foreign firms as well as among multinationals only. Foreign firms have imperfect information of foreign potential sites. Therefore, they rely on the presence of other multinational firms to uncover the unexpected profitability of each location (Head et al., 1999). Moreover, MNEs prefer to interact with other foreign firms rather than with domestic firms if the perceived quality of the locally produced services and goods does not meet the needs of the firm.

Adapted from: *Factors Influencing the Choice of Foreign Direct Investments Locations in the Romanian Regions;* Aniela Raluca Danclu, Vasile Alecsandru Strat. Published by Elsevier Ltd. 2014.

- As countries upgrade their national production structure and move towards greater specialisation and product "complexity", they are more likely to attract FDI. At the same time, there appears to be bi-directional causality between FDI and economic complexity; i.e. attracting FDI can accelerate the step-up in economic complexity. In short, FDI can set up a positive feedback loop.

Given its focus on low value-added and less complex products, it is not surprising that Pakistan ranked 93rd in the Harvard Growth Lab's Economic Complexity Index for 2019. India ranked 43rd, Bangladesh 105th, Sri Lanka 75th and Vietnam 56th.



Source: Atlas of Economic Complexity, Harvard Growth Lab

As such, FDI policies, especially those aimed towards attracting "higher quality" investment and "moving up the ladder", cannot be viewed in isolation.

CPEC affords a unique opportunity to address the impediments and bottlenecks in attracting a higher volume of FDI that is not just focused on Pakistan's domestic market, but on using the country as a production base for exports to regional countries.

IV. Recent trends in China's outward FDI

After remaining as one of the top destinations for inward FDI for several years, China has recently emerged as the top source of outward FDI (OFDI) as well. According to the 2020 Statistical Bulletin of China's Outward FDI, issued jointly by the country's Ministry of Commerce, the National Bureau of Statistics and the State Administration of Foreign Exchange, OFDI from China amounted to US$ 153.7 billion in 2020, not only placing it as the number one source country in the world for FDI, but also accounting for over 20 per cent of the global investment (FDI) volume.

Table 14 below lists the ten largest source countries for outward FDI (flow) in 2019, prior to the Covid-19 pandemic, while **Table 15** lists the top ten countries with the largest stock of outward FDI as of 2020.

Table 14: Major OFDI source countries
US$ billion, 2019

		US$ billion
1.	Germany	139.3
2.	China	136.9
3.	United States	93.6
4.	Netherlands	84.9
5.	Canada	78.9
6.	Hong Kong	53.2
7.	Singapore	50.6
8.	British Virgin Islands	44.2
9.	France	38.7
10.	Luxembourg	34.5

Source: UNCTAD

Table 15: Stock of OFDI by select countries
US$ billion, 2020

		US$ billion
1.	United States	8,129
2.	Netherlands	3,798
3.	China	2,352
4.	United Kingdom	2,055
5.	Japan	1,982
6.	Germany	1,977
7.	Canada	1,964
8.	Hong Kong	1,954
9.	France	1,722
10.	Switzerland	1,629

Source: UNCTAD

In terms of capital stock of OFDI, China is now ranked third in the world behind the United States and the Netherlands, with total OFDI stock of US$ 2.58 trillion.[2] According to China's official statistics, the country's OFDI covered 189 countries and regions around the globe, representing over 80 per cent of the world.

Hong Kong SAR remained by far the largest destination for OFDI from China in 2020, accounting for 58 per cent of the flow (US$ 89.2 billion). The other major destinations for OFDI from China were ASEAN countries, EU and the US (**Table 16**).

Table 16: Main destination of China's OFDI

2020

	Flow (US$ bn)	% of Total
Hong Kong SAR	89.2	58.0%
ASEAN	16.1	10.4%
EU	10.1	6.6%
US	6.0	3.9%
Australia	1.2	0.8%
Russia	0.6	0.4%
Total	**123.1**	**80.1%**

Source: Statistical Bulletin of China's Outward FDI 2020

By the end of 2020, over 27,500 Chinese investors had set up 44,400 enterprises in different countries around the world, with an overwhelming number (58.5 per cent) within Asia, followed by North America and Europe (**Table 17**). The total overseas assets of Chinese enterprises amounted to USD 7.2 trillion at the end of 2019.

Table 17: Number of Overseas Chinese-invested enterprises by region

2020

Region	Number	% of Total
Asia	26,000	58.5%
North America	6,000	13.5%
Europe	4,600	10.4%
Africa	3,500	7.9%
Latin America	3,000	6.7%
Oceania	1,300	3.0%
Total	**44,444**	**100%**

Source: Statistical Bulletin of China's Outward FDI 2020

[2] There is a slight discrepancy between China's official statistics on OFDI flows and stock for 2019 and 2020, as compared to figures in UNCTAD's World Investment Report 2020. The figures quoted in this section have been taken from China's official statistics and may differ slightly from the Tables which use data from WIR/UNCTAD.

In terms of target sectors of OFDI from China, the investment flowed into Leasing & Business Services, followed by Manufacturing and the Wholesale & retail sector (**Table** below).

Table 18: Target sectors for China OFDI
2020

	Amount US$ bn
Leasing and Business Services	41.8
Manufacturing	20.0
Wholesale and Retail	16.1
Information Transmission, Software and Information Technology Services	6.7
Other	5.9
Construction	5.2
Mining	5.0
Production and Supply of Electricity, Heat Power, Gas and Water	2.8
Real Estate	2.7
Transportation, Storage, Post	2.7
Agriculture, Forestry, Animal Husbandry and Fishery	1.4

Source: Statistical Bulletin of China's Outward FDI 2020

China’s FDI in BRI countries

China’s investment in Belt and Road Initiative (BRI) countries has grown steadily since 2013. According to official data, China’s total direct investment in the countries along the Belt and Road amounted to US$ 139.5 billion between 2013 and 2020.

Pakistan’s share in China’s OFDI in BRI countries since 2013 stood at 5.1 per cent, with total gross inflow of FDI into Pakistan from China amounting to US$ 7.1 billion over this period.

A total of US$ 22.5 billion was invested by China in countries along the Belt and Road Initiative in 2020, which accounted for 14.7 per cent of China's overall OFDI for the year. The OFDI by China in BRI countries witnessed a year-on-year increase of 20.6 per cent despite the COVID-19 pandemic, according to official data.

According to the data, more than 10,000 enterprises have been set up so far in countries along the Belt and Road, with the OFDI stock standing at US$ 179.5 billion by the end of 2020, accounting for 8.6 per cent of China’s total OFDI stock.

More recently, during 2020 and 2021, official Chinese data suggests that the main beneficiaries of China's OFDI in BRI countries have been the following:

- Singapore
- Indonesia
- Bangladesh
- Vietnam
- Malaysia
- Thailand
- Kazakhstan
- Saudi Arabia
- UAE
- Laos

V. Taking Advantage of Recent Trends in Chinese OFDI

As noted in the previous section, China's Outward Foreign Direct Investment (OFDI) has increased rapidly in the past few years, and it now ranks as among the top sources of FDI globally. The recent momentum in OFDI from China appears to be driven by several factors, including investments linked to the OBOR/BRI ambition. Overall, the OFDI appears to be driven by the standard set of factors determining such investment (see **Box 3**), which include the following:

- Resource-seeking
- Market-seeking
- Efficiency-seeking
- Strategic-asset-seeking FDI

However, recent trends indicate that OFDI from China also appears to be motivated by one further reason: to avoid punitive tariffs and import restrictions imposed by the US on US$ 550 billion worth of Chinese products since 2018.

As a result of the expanded retaliatory action by the US targeting a large list of Chinese products and entities, US buyers appear to have moved orders to non-China based supplier countries. From a preliminary assessment of the relevant trade data, it appears that some degree of trade diversion has occurred from China to other Southeast Asian countries since the start of the trade frictions.

In addition, Chinese manufacturers also appear to have moved some part of their capacity offshore to avoid the "Made in China" label, most notably to countries in Southeast Asia such as Vietnam, Thailand, Indonesia and Malaysia. Smaller countries in the region, such as Cambodia and Laos, also appear to have received significant amounts of Chinese FDI. More recently, the Chinese OFDI "wave" motivated by this reason appears to be landing on the shores of Bangladesh – though it is difficult to disentangle the motivation to take advantage of lower wages and high productivity in textiles and apparel in the South Asian country from avoidance of the "Made in China" label by Mainland PRC manufacturers.

A third leg of this trend of potential offshoring from China involves US companies with manufacturing operations on the Mainland. With trade tensions between the US and China elevated, and a widening regulatory crackdown in China coupled with high uncertainty regarding China's policies towards some sectors such as Technology, it is possible that many China-based US and other foreign-domiciled companies may seek to relocate at some stage to neighbouring countries in the region. [3]

Nevertheless, the trend of offshoring by Chinese manufacturers to avoid the "Made in China" label is one that presents a significant opportunity for Pakistan. This opportunity (of attracting Chinese manufacturing looking to relocate offshore to regional countries) is centred around textiles and apparel. However, a range of other industries are potential targets for relocation if the right environment is created, from auto parts and light engineering, to mobile phones handset assembly/manufacture.

However, to be able to position itself as a serious contender for Chinese FDI, particularly in manufacturing, Pakistan will need to address specific areas of weakness. The manufacturing eco-system for truly large scale operations that Chinese manufacturers expect to conduct is missing. The essential ingredients for running manufacturing operations at scale include:

- Reliable supply chains centred around industrial clusters producing a wide range of raw materials and intermediate products
- Physical infrastructure connecting ports and suppliers to factories and markets in a timely and efficient manner
- Logistics infrastructure (transportation, warehousing/storage facilities etc.)
- Reliable and affordable supply of utilities
- A large pool of technically qualified and skilled workers

Two unique "cultural" factors that prima facie appear to be big impediments to relocation of manufacturing operations by Chinese firms to Pakistan, is the perception regarding the security situation as well as the rise of religious zealotry in the country. The security issue is self-explanatory, especially with the targeting of Chinese nationals involved in CPEC projects in a number of cases, culminating with the terrorist attack in Dasu in July 2021 that killed 10 Chinese engineers.

The second issue has surfaced with the killing of a Sri Lankan factory manager in Sialkot in December 2021 by a mob inspired by religious zealotry. The brutal killing, though the first of its kind and one-off, has very likely served to strengthen the perception that Pakistan is a dangerous place for foreigners, making it harder to position it as a safe and profitable destination for FDI.

To counter these impediments, Pakistan has created a special security division for protection of Chinese projects and personnel. This fact needs to be highlighted by Pakistan in China as part of a media campaign that also promotes Pakistan's soft image and culture, while underscoring its locational advantages, especially for western China, along with its profitability potential. However, before embarking on a concerted promotional campaign in China along these lines, Pakistani authorities must seek to address and resolve the very real concerns of Chinese companies and investors already operating in the country.

[3] However, according to the findings of a recent survey of American businesses in China conducted by the American Chamber of Commerce in China, 83% of respondent firms said they were currently not considering relocating manufacturing or sourcing outside of China.

VI. Specific Issues faced by Chinese Investors

While clear opportunities exist for Pakistan to attract a greater share of China's substantial OFDI, this is contingent on not only addressing the impediments to investment in the macro-environment, but very specifically, resolving the list of concerns and issues facing Chinese investors already on the ground in the country.

According to the All-Pakistan Chinese Enterprises' Association (APCEA), the representative body for Chinese-invested enterprises in the country, a total of 202 Chinese firms are registered and operating in Pakistan. These include firms that have been set up in Pakistan pre-CPEC, as well as those that entered post-launch of CPEC.

To ascertain the main issues and challenges being faced by Chinese-invested enterprises in Pakistan, the Pakistan Business Council collaborated with APCEA in conducting a sample survey of the larger businesses operating in Pakistan across a range of sectors.

A total of 16 large Chinese corporates were surveyed, with 6 of the respondent firms associated with the power sector (electricity generation), 3 operating in oil and gas (E&P as well as services), 3 involved in infrastructure projects, and 1 each in financial services, mining, engineering and auto assembly.

Brief details regarding the sample are contained in Table 19.

Table 19: Respondent companies by sector

Total respondent companies	No.	% of sample
Total respondent companies	**16**	100%
by Sector		
Power sector	6	38%
Infrastructure	3	19%
Oil & Gas	3	19%
Financial services	1	6%
Engineering	1	6%
Mining	1	6%
Auto	1	6%

Based on the responses received to questions put to the responding firms, and background interviews and discussions with relevant stakeholders, the following main concerns have been highlighted:

- **Long delays in receiving contractual payments**, was cited as the foremost issue affecting the operations of Chinese firms invested in Pakistan, with 38 per cent of the respondent firms listing this among their principal challenges. The contractual payments ranged from capacity payments to IPPs by CPPA-G, interest on accumulated arrears, liquidation damages, to the agreed compensation by Wapda to the victims of the terrorist attack in Dasu.

  In the surveyed sample of 16 firms, 4 reported payment arrears and stuck up amounts (as per their view) amounting to Rs 169.7 billion (around US$ 912 million at the prevailing exchange rate).

- **Taxation-related issues** were the next most frequently-listed concern for the Chinese firms. 25 per cent of respondent firms cited “arbitrary”, “inconsistent” and “unfair” application of tax code by both FBR as well as Sindh Revenue Board, Balochistan Revenue Authority and KPRA. Notices and large tax demands, reopening retroactively of “settled” cases, frequent audits including for same tax year in some cases, and withholding of tax refunds were the most common concerns.

- **Security issues** as well as localised law and order concerns were listed by 25 per cent of the respondent firms. These concerns were highlighted mainly by Chinese firms operating in remote areas of Sindh, Balochistan and the northern parts of the country.

- **Delays in granting licensing approvals** or one-time tariff adjustment, with a cumbersome and long-drawn approvals procedure for utilities (electricity, water, gas) was next among the main issues faced by Chinese investors. This concern was at par with visa issues and de facto exchange controls, with approximately one in five respondent firms listing these as among their main challenges of operating in Pakistan.

- **Contractual non-performance** by project executing agencies and on-going contract disputes were raised by 2 companies each.

- **Poor infrastructure quality** and the slow pace of connection approvals for utilities in Rashakai Special Economic Zone were cited by one large Chinese firm.

Based on the reported concerns and issues, the following specific measures need to be taken expeditiously by Pakistani authorities to mitigate the challenges faced by Chinese firms operating in the country.

- **Clearance of payment arrears**

Non-payment of large outstanding amounts due to Chinese firms operating mainly in the power sector is not only a contractual violation that is severely impacting the cash-flow of the affected firms as well as their ability to transfer profits and dividends to their head offices in China, but has implications for the financial credit standing of the companies involved. This in turn affects their ability to borrow cheaply, and to conduct further investment. It also has ramifications for Pakistan's sovereign credit standing.

As such, resolving this issue, no matter how difficult and intractable, should be accorded the highest priority. The main measures the government and its agencies need to take include:

- Prioritise release of all overdue payments to Chinese firms in the shortest possible time, according to a mutually agreed schedule
- Establish Revolving Account by CPPA-G for payment to IPPs as per contract
- Release as lump sum all interest due on delayed payments
- Expedite payment of compensation for victims of Dasu terrorist attack

Given that the government as well as its agencies are revenue-constrained, floatation of sovereign-guaranteed bonds by Wapda specifically to clear outstanding dues to Chinese investors in the power sector should be considered ('CPEC bonds'). The bond issuance could take the form of a serial issuance, where a new series of bonds is launched annually to pay the outstanding amounts owed to Chinese firms. The coupon/interest payment should come from ring-fenced Wapda revenue from CPEC projects, such as the Suki Kinari and Dasu hydropower projects. Till such time as this revenue stream becomes available, the federal government should earmark funds from the budget.

To make the bonds attractive to invest in by financial institutions, mainly commercial banks, the value of investment in the proposed "CPEC bonds" should be counted in the banks' reserve requirement.

Principal government agencies involved: CPPA-G, Water and Power Development Authority (Wapda), Ministry of Power, SBP, Ministry of Finance GoP.

Coordinating body/agency: CPEC-Authority; Board of Investment

- **Making the approvals regime more responsive**

  A less complicated issue to resolve involves the cumbersome and time consuming approvals procedures business face, from regulatory approvals to obtaining manufacturing licences or approvals for utility connections. Procedural delays in each case are the norm. So far, despite the lapse of several years, Pakistan has been unable to provide a 'plug-and-play' environment for investors in SEZs, with regard to utilities (electricity, water, gas).

  Key actions to be taken:

  - Expedite licensing/regulatory + utility connection approvals
  - Get provinces to fully own the investment agenda as they benefit from employment and economic activity

  Principal government agencies involved: Respective DISCOs/Water and Power Development Authority (Wapda), Ministry of Industries, Sui Northern Gas Pipelines Ltd., Sui Southern Gas Company Ltd..
  Coordinating body/agency: CPEC-Authority; Board of Investment; Provincial Investment Authorities/Departments

- **Introducing a more flexible visa regime for Chinese businesses**

  Chinese businesses are facing delays in visa processing for their overseas employees, especially in case of extension of work visas, as well as an inflexible visa regime where visa validity is for a relatively short duration and does not cater to multiple visits. Applications for work visa extension can take a minimum of 4 weeks (working days) to process as per NADRA.

  Key action to be taken:

  - Provide a more liberal visa regime for Chinese investors in addition to fast-track processing. Under this regime, visa processing for first time business visitors should be limited to a maximum of 48 hours, while previous visa holders with expired visas should be given facility of obtaining 2 year, multiple-entry business as well as work visas at the main airports of entry.
  - Work visas issued currently are single entry, and are initially granted up to 3 months extendable further up to 2 years. This should be eased to validity of 2 years in initial issuance, with multiple entry.
  - Processing time for work visa extension should be reduced to 1 week from current 4 weeks, with a reduction in documentation required.

  Principal government agency/agencies involved: Ministry of Interior, NADRA, FIA
  Coordinating body/agency: CPEC-Authority; Board of Investment

Relaxing exchange controls/requirements

Chinese respondent firms have reported severe difficulty in not only repatriating profit and dividends to the mainland head office in foreign exchange, but, more importantly, in making contractual debt repayments. The latter is a serious issue as not being able to make timely debt repayments not only affects the financial standing and credit-worthiness of the companies involved, curtailing their ability to borrow, but reduces the willingness of other Chinese or non-Chinese foreign firms from investing in Pakistan.

In addition, the large devaluation of the Rupee since 2018, and the constant pressure on the currency, is disrupting the operations planning of the Chinese companies, while severely reducing their profitability in foreign exchange (Chinese Yuan) terms.

Key actions to be taken:

- Allow Chinese companies to conduct foreign exchange hedging
- Permit Chinese companies to hold foreign debt repayment reserves in foreign exchange

Principal government agency involved: SBP
Coordinating body/agency: CPEC-Authority; Board of Investment

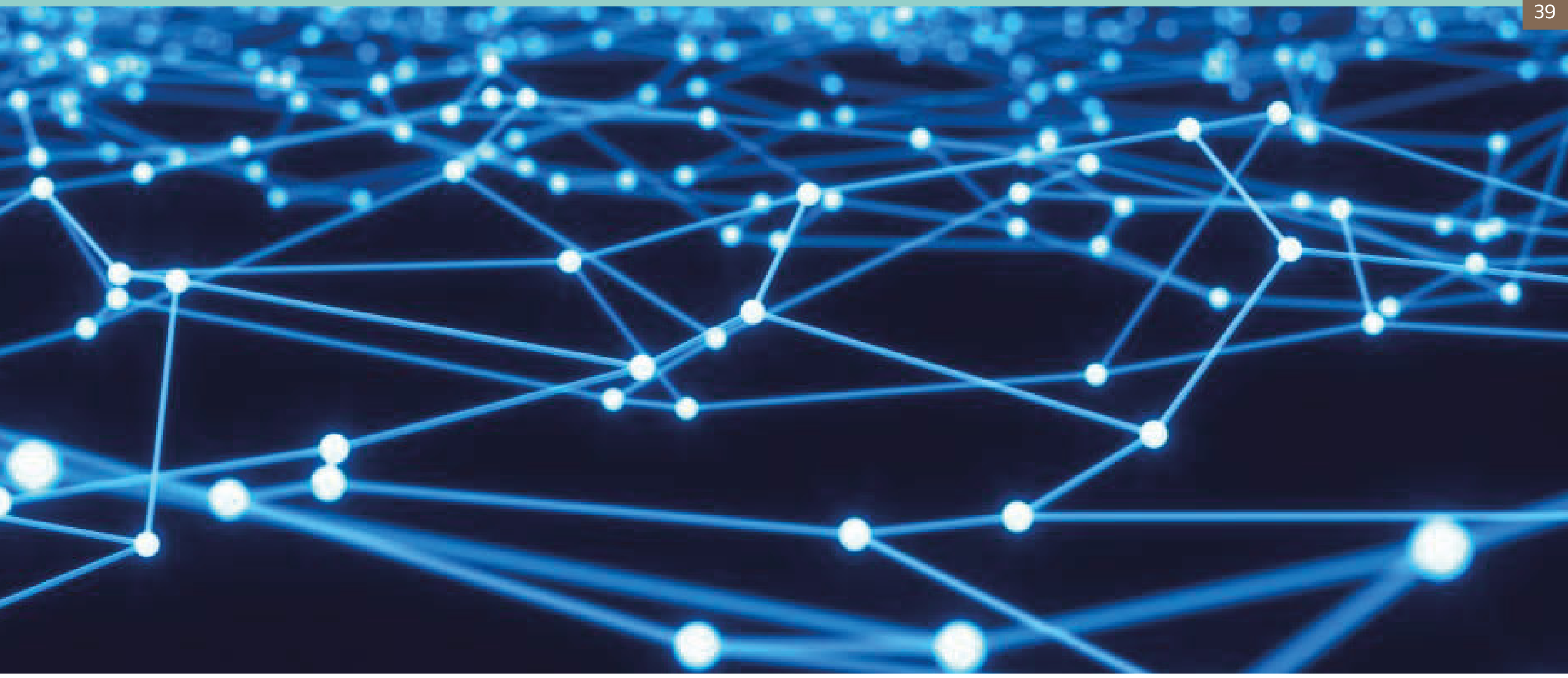
- ### Resolving tax issues

Unreasonable tax treatment by FBR/provincial tax authorities, inconsistent application of tax law, issuance of retroactive notices for past and closed transactions, multiple tax audits within one tax year, and long delays in payment of refunds are the main issues being faced by Chinese companies with regards to Pakistan taxation.

Key actions to be taken:

- Allow Chinese companies to conduct foreign exchange hedging
- Hold foreign debt repayment reserves in Fx

Principal government agency involved: FBR, SRB, BRA, KPRA
Coordinating body/agency: CPEC-Authority; Board of Investment



VII. Overall Policy Recommendations

Pakistan needs a comprehensive roadmap for galvanising not just CPEC-related FDI from China, but more broadly, inducing an investment response from all private investors, including domestic ones. Some of the recommendations of the report are as follows:

- Overall, private investment and inward FDI face generic constraints, such as a weak macroeconomic environment and institutional framework, policy instability, inconsistent and 'predatory' tax enforcement on formal firms, and energy challenges. These impediments can only be addressed via an over-arching roadmap of economic reform that encompasses institutional and structural reforms.

- Chinese investors in particular face some specific concerns. These have been highlighted extensively in the report. Addressing the heightened sensitivity of Chinese investors to the expressed concerns via continuous high-level interest, as well as a 'whole-of-government' approach, is of the utmost importance to provide the requisite assurances and resolution.

- At the same time, the Council of Common Interests (CCI), the constitutional body that oversees matters affecting both the Centre as well as the provinces, needs to be used more effectively in resolving many of the coordination problems CPEC investments are facing.

- As a secondary issue, greater clarity in institutional arrangements viz. role of Board of Investment (BoI), CPEC-Authority (CPEC-A) and the provinces is also needed, to avoid duplication, lack of coordination and institutional lags.

- A sharper "strategic" focus needs to be imbued to CPEC Phase II. The primary objective should be to emphasise, as well as facilitate, the embedding of Pakistani exporter firms into the Chinese value chain. Pakistan should aim for 'high quality' investment that provides access to export markets, technology and capabilities, while furthering economic transformation in the FDI-targeted sectors.

- A clear and comprehensive strategy to ensure positive spill-overs from the investment in CPEC Phase II to the rest of the economy is needed. A 'shotgun' approach, focused more on multi-activity Special Economic Zones (SEZs), rather than a targeted one focused on clusters, high-quality investments or exports, appears to have been followed. In addition, the SEZ approach should be embedded within a wider national industrial policy to make it more effective.

- Pakistan's FDI-seeking strategy has been un-targeted and too general, and needs to be revamped into a more nuanced, two-tiered policy. The current approach is liberally allowing inward FDI seeking domestic market opportunities without prioritising high-priority areas such as the export sector, advanced (including additive) manufacturing, value-added agriculture, and electronics among others.

  A two-track approach will prioritise "high value" FDI that, for example, provides access to Pakistani products to export markets, or embed the country's exporter firms into regional value chains, or provide for transfer of technology and/or technical knowledge. The most liberal incentives should be reserved for such high-priority FDI, while purely domestic market opportunity seeking FDI should be provided less-liberal incentives with clear sunset clauses. The revised Free Trade Agreement with China will by 2030 offer duty-free access to 70% of HS lines from Pakistan. This is a valuable opportunity for Pakistani businesses to cater to what will then be the world's largest market.

Conclusion

Pakistan's overall investment rate is 'chronically' low, and has been significantly below the average for peer economies for a protracted period. The trend is similar across private investment, foreign direct investment and investment in manufacturing.

The China-Pakistan Economic Corridor, or CPEC, has afforded Pakistan a unique opportunity to galvanise private investment and FDI, and transform its economy. However, the investment interest and momentum from CPEC Phase I does not appear to have carried over as yet into Phase II to the extent hoped. So far Pakistan also does not appear to have been able to successfully leverage CPEC to catalyse domestic private investment, non-CPEC Chinese investment or attract non-China FDI.

To be able to do so, addressing the specific concerns of Chinese companies and investors already operating in Pakistan should be the foremost priority. Although resolving these concerns and myriad impediments involve improved coordination between different tiers as well as agencies of government, a whole-of-government approach should be brought to bear given the large potential pay-offs.

To induce greater overall private investment, on the other hand, will require determined and concerted measures across a broad front, involving institutional and structural reforms. The experience of developing countries that have been successful in ramping up private investment, including FDI, both quantitatively as well as qualitatively, suggests that private investors are induced by the strength of a country's institutional framework as much as by the quality of its physical infrastructure. The starting point should be for the country's policymakers to produce a credible and comprehensive roadmap for institutional and structural reforms and embark upon it without delay.

Appendix

Investment dashboard

Labour & Conversion Cost	Unit	Pakistan	Bangladesh	Vietnam	Cambodia	Laos
Labour & Conversion Cost						
Monthly Minimum Wage	US$/Month	120-140	95	195	194	104
Electricity	US Cents/KWh	9 for 5 export sectors	9	8-12.5	15.9	13.2
Gas	US$/MMBTU	6.5 for 5 export sectors	4.06	varies by industry	N/A	N/A
Diesel	US$/Ltr	0.8	0.93	0.84	0.93	1.12
Size of Domestic Market	Pop Mn	220	165	98	17	7
Corruption Perception Index (Transparency International)	Lower the better of 140 rated	140	147	87	157	128
Logistics Performance Index	Lower the better	122	100	39	98	82
Fully Operational SEZs		Work in Progress	88 of which 29 private sector run	18	54	12
FDI 2020	$	1.8 Bn	1.5 Bn	5.8 Bn	3.6 Bn	5.1 Bn
Dietary/Cultural Affinity with China		Least	Least	Most	Most	Most
Security Conditions						
Security Threats Index 2021						
- Rank on security amongst 173 countries (higher the better)		25	39	126	57	117
- Index (10 is most insecure)		7.9	7	3.9	6.4	4.4
Travel Advisories by Western Countries (ex-Covid related)		Heightened alert-essential travel only. Travel to KP and Baluchistan not advised.	General care advised	General care advised	General care advised	General care advised
Restrictions on Family Postings by Multilaterals and Diplomatic Community		Gradually opening up	None	None	None	None

Source: The Pakistan Business Council

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