Improving Pakistan's Investment Climate:
Lessons from Select Peer Countries

The Pakistan Business Council

January 2024

Improving Pakistan's Investment Climate:

Lessons from Select Peer Countries

The Pakistan Business Council (PBC)

January 2024

The Pakistan Business Council
FOSTERING ECONOMIC GROWTH

About the author:

This report has been prepared for Pakistan Business Council by Mr. Sakib Sherani of Macro Economic Insights.

Mr. Sherani has extensive public policy experience. He has been a member of several Prime Ministers' Economic Advisory Councils and its equivalents since 2004. He has also served as Principal Economic Adviser to the Ministry of Finance, Government of Pakistan. In this position, he was a core member of the government's economic reform team, has negotiated with the IMF and the multilateral institutions, and been a member of the Revenue Advisory Council dealing with tax and FBR reform, as well as the Panel of Economists of the Planning Commission.

He also has high-level experience in financial institutions, capital markets, the development sector and not-for-profit entities.

Disclaimer

The findings, interpretations and conclusions expressed do not reflect the views of the Board of Directors and Members of The Pakistan Business Council or the companies they represent. The views, projections and forecasts contained in the report are solely of the author, and should not be attributed to The Pakistan Business Council. Although every effort has been made to crosscheck and verify the authenticity of the data, The Pakistan Business Council, or the author(s), do not guarantee the data included in this work. For any queries or feedback regarding this report, please contact hareem@pbc.org.pk.

The Pakistan Business Council: An Overview:

The Pakistan Business Council (PBC) is a research-based business advocacy platform established in 2005. It is now supported by over 96 private sector local and multinational businesses with significant investment in and long-term commitment to sustainable growth of the country. They come from 14 countries, have leading roles in 17 major sectors of the formal economy, generate 40% of annual exports, contribute a third of Pakistan's total tax revenues and employ three million. Their combined sales represent every 9th Rupee of Pakistan's GDP.

PBC's major objectives are to advocate polices that lead to creation of jobs, value-added exports and reduction in import reliance through improved competitiveness of manufacturing, services and the agriculture sectors. It also promotes formalization of the economy.

PBC's over-arching theme, ***"Make-in-Pakistan"*** consists of three pillars: ***"Grow More/Grow Better"***, ***"Make More/Make Better"*** and ***"Serve More/Serve Better."*** Its evidence-based advocacy is backed by over a hundred studies to date through its full-time research team, supplemented by collaborative research with renowned industry experts and economists. Through its **Centre of Excellence in Responsible Business (CERB)**, PBC works to build capacity and capability of businesses beyond its membership, to adopt high environmental, social and governance standards. PBC holds conferences, seminars and webinars to facilitate the flow of relevant information to all stakeholders in order to help create an informed view on the major issues faced by Pakistan. Through its presence in Islamabad and Karachi, it works closely with relevant government departments, ministries, regulators and institutions, as well as other stakeholders including professional bodies, to develop consensus on major issues impacting the economy.

PBC is a pan-sectoral, not-for-profit, Section 42 entity. It is not a trade body, therefore, it does not advocate for any specific business sector. Rather, its key advocacy thrust is on easing barriers that thwart competitiveness of businesses in Pakistan. Further information on the PBC is available on: www.pbc.org.pk.

The PBC's Founding Objectives

- To provide for the formation and exchange of views on any question connected with the conduct of business in and from Pakistan.
- To conduct, organize, set up, administer and manage campaigns, surveys, focus groups, workshops, seminars and fieldwork for carrying out research and raising awareness in regard to matters affecting businesses in Pakistan.
- To acquire, collect, compile, analyze, publish and provide statistics, data analysis and other information relating to businesses of any kind, nature or description and on opportunities for such businesses within and outside Pakistan.
- To promote and facilitate the integration of businesses in Pakistan into the World economy and to encourage in the development and growth of Pakistani multinationals.
- To interact with governments in the economic development of Pakistan and to facilitate, foster and further the economic, social and human resource development of Pakistan.

The PBC Member Companies

Jazz

JS BANK

Jubilee

K&N's

KE

KHAADI

LIBERTY

LIPTON
Teas and Infusions

LOTTE

LUCKY CEMENT

MACPAC FILMS

MAHMOOD GROUP

Martin Dow

MASOOD ROOMI

mayfair
The little joys of life

MEGA
MEGA CONGLOMERATE

National FOODS

NAVEENA
GROUP

Nestlé
Good food, Good life

NIMIR

OLP

Packages Limited

PEPSICO

PSL
PAKISTAN SERVICES LTD.

PSX
PAKISTAN STOCK EXCHANGE LIMITED

ptcl

reckitt

SAIF GROUP

Sapphire

Servis

Shan

SICPA

SIEMENS

Soneri Bank

SOORTY

SPEL
Synthetic Products Enterprises Limited

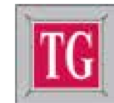
Standard Chartered

systems

TAPAL

TATA PAKISTAN

TCS
WE MOVE YOU

Tetra Pak
PROTECTS WHAT'S GOOD

TG

TOYOTA
INDUS MOTOR COMPANY LTD

TPL

TTE

Tufail

UBL
where you come first

Unilever

Young's

The PBC Affiliates

Table of Contents

EXECUTIVE SUMMARY ---------- **2**

INTRODUCTION ---------- **4**

I. PAKISTAN'S INVESTMENT LANDSCAPE ---------- **5**

II. THE INVESTMENT CLIMATE ---------- **9**

Macroeconomic environment ---------- 10

Political instability ---------- 15

Policy uncertainty ---------- 17

Human capital development ---------- 20

Physical infrastructure ---------- 21

Energy ---------- 21

Logistics ---------- 22

III. GAUGING PAKISTAN'S ATTRACTIVENESS FOR FDI ---------- **24**

IV. COMPARING PAKISTAN'S INVESTMENT CLIMATE ---------- **31**

Egypt ---------- 31

Bangladesh ---------- 34

Indonesia ---------- 35

Vietnam ---------- 37

Pakistan ---------- 41

V. OVERALL POLICY RECOMMENDATIONS ---------- **44**

REFERENCES ---------- **46**

List of Figures

Figure 1: Overall fixed investment rate, select economies ---5

Figure 2: Investment vs GDP per capita---5

Figure 3: Fixed investment by private sector in Pakistan ---6

Figure 4: Contribution to GDP growth (in percentage points) ---7

Figure 5: Consumption-investment rates in EM --- 10

Figure 6: Top location-specific factors for FDI decision--- 25

Figure 7: FDI inflows are higher in countries with lower Regulatory Risk--- 26

Figure 8: Ranking of Emerging Markets by appeal to foreign investors --- 27

List of Tables

Table 1: Investment rates of select developing countries at similar level of GDP per capita to Pakistan ---8

Table 2: Savings and investment rates in select EM--- 10

Table 3: IMF programs under different governments 1988-2022--- 11

Table 4: Number of governments since 1988 and average tenure --- 16

Table 5: Educational attainment of civilian labour force --- 20

Table 6: Comparison of industrial electricity tariffs --- 22

Table 7: Logistics Performance Index (LPI) rank for selected regional & peer countries (2023) --- 23

Table 8: Pakistan's institutional indicators --- 27

Market access of Made-in-Egypt products is enhanced by multiple trade agreements--- 32

Table 9: Pakistan versus comparator economies--- 42

Table 9: Pakistan versus comparator economies cont'd ...--- 43

Abbreviations

AfCFTA	African Continental Free Trade Agreement
APTA	Asia-Pacific Trade Agreement
ASEAN	Association of Southeast Asian Nations
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral, Technical and Economic Cooperation
BIT	Bilateral Investment Treaty
BoI	Board of Investment
BPC	Beauty and Personal Care
BRI	Belt and Road Initiative
COMESA	Common Market for Eastern and Southern Africa
CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index
DISCOs	Distribution Companies (power)
EBA	Everything But Arms
EM	Emerging Markets
EVFTA	EU-Vietnam Free Trade Agreement (EVFTA)
EVs	Electric Vehicles
EU	European Union
FCY	Foreign Currency
FDI	Foreign Direct Investment
FES	Friedrich Ebert Stiftung
FIEs	Foreign Invested Enterprises
FMCG	Fast Moving Consumer Goods
FTA	Free Trade Agreement
FY	Fiscal Year
GAFTA	Greater Arab Free Trade Area
GoP	Government of Pakistan
GSP	Generalised System of Preferences
HDI	Human Development Index
ICT	Information and Communication Technology
ICSID	International Centre for the Settlement of Investment Disputes
IMF	International Monetary Fund
IPEF	Indo-Pacific Economic Framework for Prosperity
IPPs	Independent Power Producers
IPR	Intellectual Property Rights
JV	Joint Venture
LDC	Least Developed Country
LF	Labour Force
LMICs	Low- and Middle-Income Countries
LPI	Logistics Performance Index
LT	Long Term
MENA	Middle East and North Africa
MNCs	Multi-National Corporations
OBOR	One Belt One Road
OFDI	Outward Foreign Direct Investment
PBC	The Pakistan Business Council
PBS	Pakistan Bureau of Statistics
PML-N	Pakistan Muslim League-Nawaz
PPP	Pakistan People's Party
PPP (GDP)	Purchasing Power Parity
PRC	People's Republic of China
PTA	Preferential Trade Arrangement
PTI	Pakistan Tehreek-i-Insaaf
QIZ	Qualifying Industrial Zone program
RCEP	Regional Comprehensive Economic Partnership
RMG	Ready Made Garments
SAFTA	South Asian Free Trade Area
SBP	State Bank of Pakistan
SEZs	Special Economic Zones
SIFC	Special Investment Facilitation Council
SoEs	State-Owned Enterprises
TCC	Tethyan Copper Company
TIFA	Trade and Investment Framework Agreement
TIPs	Treaties with Investment Provisions
WB	World Bank
WEF	World Economic Forum
WIR	World Investment Report
WTO	World Trade Organization
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme

EXECUTIVE SUMMARY

- Pakistan's ability to attract investment, whether domestic or foreign, has been far below potential, and far lower than regional peers, for a long period of time. Pakistan's fixed investment rate, at 11.9 per cent of GDP in 2022-23, is less than half of the regional average for South Asia (27.8 per cent of GDP), and 60 per cent lower than the average for the low- and middle-income cohort.[1]

- For its GDP per capita in nominal US dollar terms, Pakistan's "predicted" fixed investment rate should be 25.4 per cent of GDP – more than twice the current level. If Pakistan had been able to generate, from 1980 onwards, an investment rate that was close to the average for a select sample of high-performing developing country peers, the size of its economy today would have been 60 per cent larger – at Rs 133.4 trillion instead of the present Rs 84.7 trillion.

- At the prevailing exchange rate, this would have amounted to the country's GDP being higher by US$ 167 billion, or by almost two-thirds. In other words, the size of Pakistan's economy would potentially have been slightly over US$ 518 billion, instead of US$ 340 billion currently. This highlights the opportunity cost of not addressing over a long period the investment climate issues bedeviling the economy.

- Comparing Pakistan with a select group of "regional" peers, including Bangladesh, Indonesia Vietnam and Egypt, shows that the divergence in the domestic investment rate as well as quantum of inward FDI generated is stark. Bangladesh's investment rate is 32 per cent of GDP, the highest in South Asia, while inward FDI amounts to 0.8 per cent of GDP (twice Pakistan's level). Egypt's figures stand at 15.2 per cent and 2.9 per cent of GDP respectively, Indonesia's 29.1 per cent and 1.7 per cent of GDP respectively, and Vietnam's 31.7 per cent and 4.4 per cent of GDP respectively.

- These countries have been selected on the basis of their relative success in attracting FDI as low- and middle-income developing countries, having some characteristics similar to Pakistan, providing useful lessons on which set of policies and institutions generate a higher chance of success in attracting investment, and for being among potential targets of investment interest by large-sized Pakistani businesses.

- Pakistan's long run, below-par performance with regards to investment extends across all forms of fixed capital formation: investment by the public sector, private investment, as well as foreign direct investment. Manufacturing and the export sector in particular are not attracting the levels of investment required to support the country's growth ambitions.

- This situation is not new, and its persistence indicates long-standing systemic and structural issues with the country's investment climate. These issues have been periodically highlighted by business associations, investor forums, international consultancies, think tanks and academic researchers, as well as multilateral development institutions, but have failed to elicit a timely, sustained, holistic or concerted response from policymakers since the 1990s.

- Political instability has been identified by foreign investors as well as domestic firms as the top constraint to the business environment in Pakistan. Domestic firms identified access to finance, tax rates, corruption and electricity supply as the next biggest constraints they face, according to the World Bank's 2023 Enterprise Survey. For large firms (with 100+ employees), tax rates and corruption were the top two constraints.

- Political instability and macroeconomic uncertainty lower the overall investment rate in an economy, and, over a protracted period, distort the investment incentives and choices of investors. With lower levels of predictability, resources are allocated to investments with shorter payback periods and higher returns – and are increasingly required to be backed by sovereign-guarantees as well as fiscal incentives. Prospects of sovereign-guaranteed super normal profits in a handful of sectors affects the efficient allocation of overall investment resources in the economy.

1 Comparable data for South Asia and low- and middle-income cohort as of 2021.

- This situation has been reinforced by the design of tax policy. Tax policy and its enforcement have encouraged informalisation in the economy by creating a large tax arbitrage between the formal and informal sectors, further distorting investment choices.

- Improving Pakistan's investment climate requires a holistic, back-to-basics approach across a wide front. Investment policies should aim for improving the overall investment environment via deep-rooted and wide ranging structural as well as institutional reforms, with a focus on domestic firms, rather than be tailored to the specific needs of a smaller pool of foreign investors. Domestic firms achieving scale in operations and becoming viable partners for foreign investors is a tried and tested route most dynamic and successful emerging markets have taken in improving the competitiveness of domestic businesses as well as attracting foreign investment.

- *Ad* hoc and tactical approaches such as creating different "classes" of investors by according preferred status to some over others, may assist in easing the short run foreign exchange constraint faced by the economy. However, such approaches belie a "financing" reflex as opposed to an "adjustment" mindset. In the longer run, these constructs may do more harm than good by setting up perverse incentives and creating unintended consequences.

- Given that there is path-dependence in the constraints to investment, the unaddressed challenges cannot be resolved in the short run, and will require a concerted and sustained reform effort anchored by a whole-of-nation consensus, and implemented across several consecutive governments.

- An immediate entry point for enhancing inward FDI into the country, however, is the China-Pakistan Economic Corridor (CPEC) Phase II. If Pakistan is better able to leverage the "CPEC opportunity", it can still attract higher investments initially from mainland China, and subsequently from other regional investors. Unfortunately, the window of opportunity on this front appears to be closing.

Date of completion: January 16, 2024

INTRODUCTION

Pakistan's fixed investment rate, at an average of 13.8 per cent of GDP for the ten-year period 2013-22, is inadequate to support the growth and development aspirations of a burgeoning population. To understand the factors behind Pakistan's low investment rate, both domestic as well as foreign, the Pakistan Business Council commissioned this report.

The Investment Climate report covers the following main areas:

- It provides an overview of Pakistan's investment performance, historically as well as for the more recent period, both in terms of private investment as well as inward foreign direct investment (FDI).

- It examines the country's investment climate from the perspective of private domestic investors as well as foreign investors, and attempts to highlight the key issues and bottlenecks in generating overall private investment closer to Pakistan's potential.

- The report compares Pakistan's investment climate with a select group of "regional" peers, including Egypt, Bangladesh, Indonesia and Vietnam. These countries have been selected on the basis of their relative success in attracting FDI as low- and middle-income developing countries, having some characteristics similar to Pakistan (Egypt, Bangladesh, Indonesia historically), providing useful lessons on which set of policies and institutions generate a higher chance of success in generating investment, and for being among potential targets of investment interest by large-sized Pakistani businesses (Egypt, Bangladesh, Indonesia specifically).

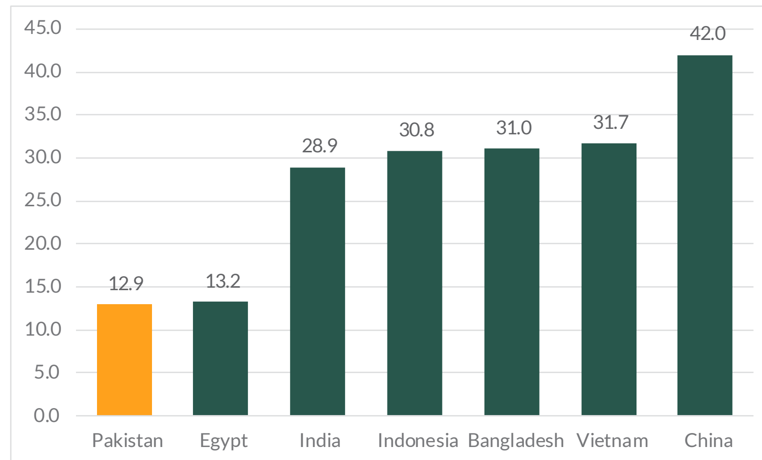
- The report also examines the merits as well as demerits of special investment facilitation vehicles such as the SIFC, as opposed to the strengthening of existing institutional mechanisms and adoption of more generic measures to improve the overall investment climate for all investors.

- A set of policy recommendations is provided at the end.

I. PAKISTAN'S INVESTMENT LANDSCAPE

Pakistan's fixed investment rate is chronically low. At 12.9 per cent of GDP in 2021, it was less than half of the regional average for South Asia (27.8 per cent of GDP), and 60 per cent lower than the average for the low- and middle-income cohort (see **Figure 1**). It has since declined further to 11.9 per cent of GDP as of 2023.

Figure 1: Overall fixed investment rate, select economies



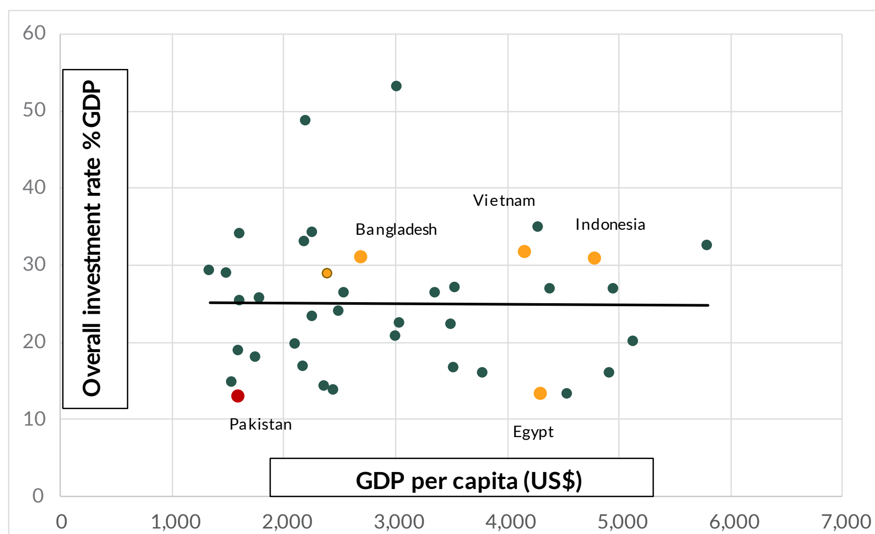
As % GDP, 2021

Source: World Bank data

The country's investment rate has been significantly below the average for peer economies for a protracted period, with the trend similar across private investment, foreign direct investment as well as investment in manufacturing. For the twenty-year period 2002-21, Pakistan's fixed investment rate (gross fixed capital formation) has averaged 14.7 per cent of GDP – almost exactly half of the average for South Asia at 29.3 per cent. By comparison, the average for the cohort of all low- and middle-income countries (LMICs) was 29.4 per cent for the same period.

Pakistan's under-performance relative to its income cohort with regards to the rate of fixed investment in the economy is depicted in **Figure 2**. For its GDP per capita in nominal US dollar terms, Pakistan's "predicted" fixed investment rate should be 25.4 per cent of GDP – more than twice its current level.

Figure 2: Investment vs GDP per capita

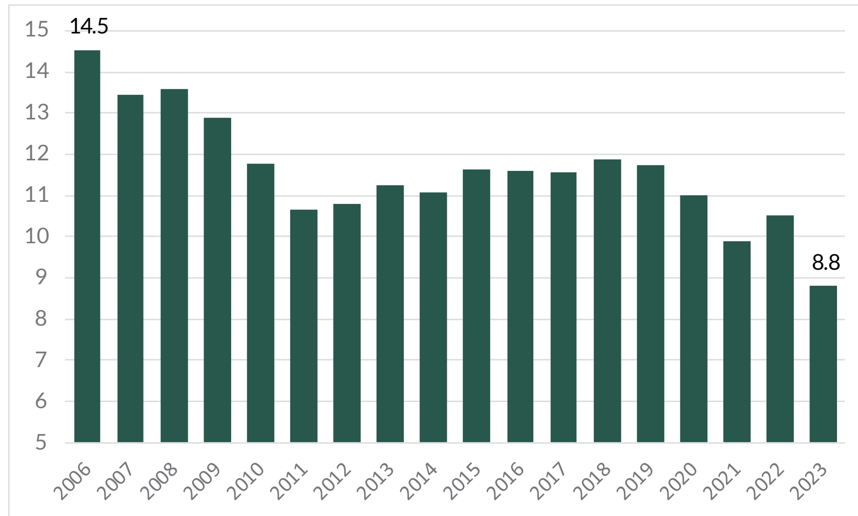


Source: World Bank data; author

Not only has Pakistan's overall investment rate been historically low compared to its regional or developing peers, but it has steadily declined over the decades from an already-low base – especially in the case of fixed investment by the private sector. After hitting a peak of 14.5 per cent in 2006, fixed investment by the private sector in Pakistan declined to 10.5 per cent of GDP by 2022, before falling further to 8.8 per cent as of 2023 (**Figure 3**).

By comparison, there has been an acceleration in the investment rates by the private sector in low- and middle-income countries over the same period.

Figure 3: Fixed investment by private sector in Pakistan
(as % GDP)



Source: World Bank; Ministry of Finance

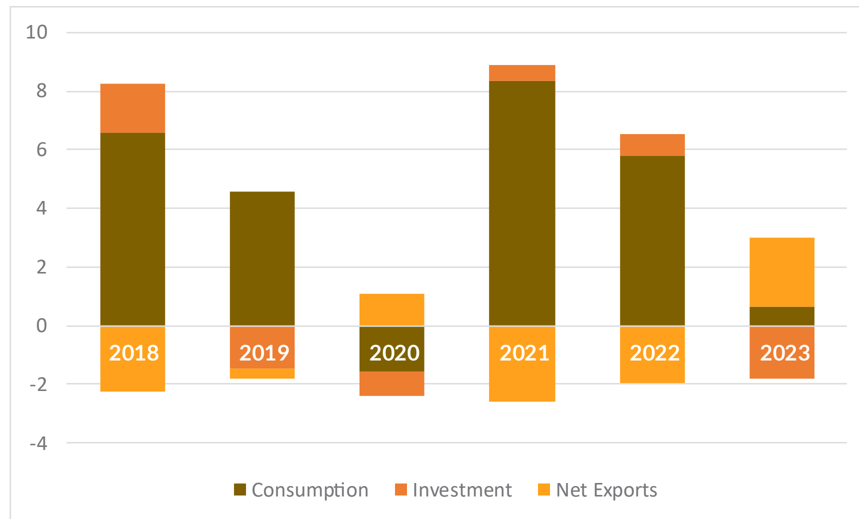
The decline in fixed investment by the private sector since 2006 is partly explained by the deteriorating internal security situation in Pakistan in the wake of the "war on terror". However, as noted earlier, the country's low fixed investment rate has been a feature of its economic performance well prior to the war on terror.

As mentioned, Pakistan's fixed investment rate is low across all major categories - private investment, gross fixed capital formation by the public sector, foreign direct investment as well as investment in manufacturing. Of greatest concern from a long run growth perspective is the low contribution of the private sector in overall fixed investment, and the retrenchment from even this low base.

Clearly, such low investment rates do not provide the foundation for sustained long run economic growth.

Not surprisingly, the low investment to GDP ratio in the case of Pakistan gets reflected in the negligible contribution of investment to overall GDP growth (see **Figure 4**). The low-investment, high-consumption driven nature of GDP growth for Pakistan differentiates the "quality" of its growth experience from its rapid growth peers (see **Figure 5**).

Figure 4: Contribution to GDP growth (in percentage points)



Source: Ministry of Finance

An illuminating way to highlight Pakistan's abysmally low overall fixed investment rate in relation to its growth potential and aspirations, is to compare the quantum of gross fixed capital formation some of today's developing country success stories were generating when their per capita income was at a level similar to Pakistan's current per capita GDP.

Table 1 presents the gross fixed capital investment rates of a number of developing countries that achieved relatively short transitions from low income to middle income based on sustained, rapid economic growth.

Table 1: Investment rates of select developing countries at similar level of GDP per capita to Pakistan

Country	Year	Total fixed investment	FDI
		As % GDP	As % GDP
Pakistan	2023	11.9	0.4
Bangladesh	2016	30.2	0.9
China	2004	39.5	3.5
Egypt	2007	20.9	8.9
India	2015	28.7	2.1
Indonesia	2006	24.1	1.3
Malaysia	1979	26.4	2.7
Thailand	1990	40.4	2.9
Vietnam	2010	35.2	5.4

Source: World Bank; UNCTAD

The data highlighted in **Table 1** is a stark reminder of how far Pakistan's overall investment rate is from what is required for sustained long run growth. Clearly, under-investment of this magnitude in the productive sectors of the economy over a protracted period must have imposed some costs. What has been the opportunity cost the country has incurred in terms of foregone growth?

A crude estimate is as follows. If Pakistan had been able to generate, from 1980 onwards, an investment rate that was close to the average for a select sample of high-performing developing country peers (see Table 1), at 30.7 per cent of GDP, the size of its economy today, under certain assumptions, would have been 60 per cent larger – at Rs 133.4 trillion instead of the present Rs 84.7 trillion.

At the prevailing exchange rate, this would have amounted to the country's GDP being higher by over US$ 167 billion, or by almost two-thirds. In other words, the size of Pakistan's economy would potentially have been slightly over US$ 518 billion, instead of US$ 340 billion currently. This highlights the opportunity cost of not addressing over a long period the investment climate issues bedeviling the economy.

II. THE INVESTMENT CLIMATE

What is the Investment Climate?

The set of location-specific factors shaping the opportunities and incentives for firms to invest productively, create jobs, and expand.

IMF Finance & Development, March 2005

Given the centrality of investment as a foundational building block for sustained economic growth, it is important to understand what is holding back investment in Pakistan, whether by domestic private investors or foreign investors.

The low overall investment rate in Pakistan is a function of several factors operating over this period, including political and macroeconomic instability, internal conflict, an intensifying energy crisis, and skewed investment incentives provided by the poor design of tax, trade and exchange rate policies.

However, at its core, it appears to be a function of poor macroeconomic management by different governments over a long period of time – with development priorities remaining unaddressed for decades. These priorities, which have provided the building blocks for long run economic growth and development of successful, rapidly developing countries include:

- Macroeconomic stability
- A stable and predictable policy environment
- A safe and stable security environment
- Human capital development
- Provision of requisite physical infrastructure for businesses
- Promoting ease of doing business
- Export-oriented policies
- Institutional strengthening, especially with regards to institutions of economic governance
- An equitable and fair tax regime, with low and predictable taxes

Macroeconomic environment

The macroeconomic environment has an important bearing on business conditions in a country, and ultimately on investment sentiment. Within the macroeconomic environment, important considerations for investment include the domestic savings rate, the rate of inflation and domestic interest rates, and the level of fiscal and monetary discipline.

Looking at the macroeconomic building blocks for growth and investment, an important requisite is a domestic savings rate that is sufficient to support investment in the economy. Domestic savings and investment rates are highly positively correlated across economies, with causation generally running from savings to investment, in line with economic theory.

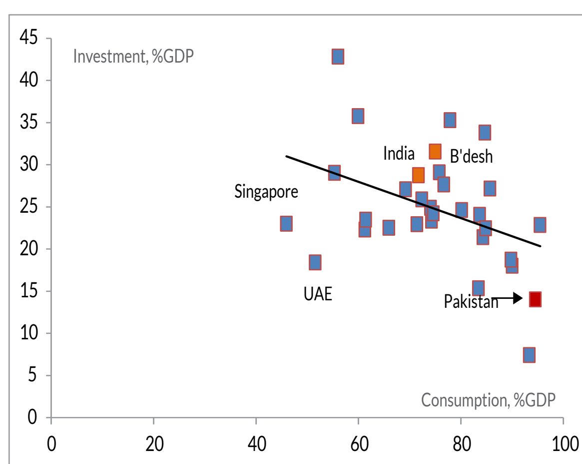
Even within peer developing countries, Pakistan has an unusually low domestic savings rate and, as a corollary, a high level of consumption (see **Table 2** and **Figure 5**).

Table 2: Savings and investment rates in select EM

As % GDP	Savings	Investment
China	44	43
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 5: Consumption-investment rates in EM



Source: World Bank data; author

This mismatch between domestic savings and consumption has led to ballooning external current account deficits causing frequent balance of payments crises. **Table 3** lists the number of times the country has had to take recourse to the IMF since 1988 – under all manner of governments.

Table 3: IMF programs under different governments 1988-2022

Government of:	No. of IMF programs	"Amount borrowed (SDRs millions)"
PPP	6	6,103,015
PML-N	4	4,860,110
Gen. Musharraf	2	1,326,420
PTI	1	4,268,000
"Pak. Democratic Movement (PDM): PML-N, PPP + 12 party coalition"	1	2,250,000*

*Total amount approved under SBA.

Source: IMF

The country's prolonged, but halting, engagement with the IMF has had deleterious effects on its economic management and investment climate. The periodic availability of Fund resources even after serial non-performance on agreed reforms by successive governments provided a strong *moral hazard*, thus diluting the impulse to reform.

Reinforcing the adverse consequences of the moral hazard were weaknesses in IMF program design that set up unintended consequences and perverse incentives that have dogged Pakistan's economic environment (see **Box**).

Box: IMF program design issues – avoiding perverse incentives and unintended consequences[2]

Despite Pakistan's protracted engagement with the IMF, spreading over 23 Fund programs and spanning several decades, there is little to show for in terms of core structural problems having been addressed meaningfully. While the lack of commitment to reform of different governments over this extended period is an obvious cause, flaws in IMF program design have also contributed substantially.

The first problem appears to be too much focus on "stabilisation" and not enough on structural as well institutional reform. Almost by definition, there is a fundamental disconnect between the structural nature of Pakistan's challenges and IMF policy prescriptions that have to be fitted into a one- to two-year time frame of a front-loaded program. The 'need for speed' sets up perverse incentives and negative feedback loops — leading to serious unintended consequences that undermine rather than help progress on reforms.

A case in point is the lynchpin of program conditionality — that relating to tax collection. In almost all IMF programs dating back to the 1990s, indicative quarterly targets on tax collection were set. This produced an unintended consequence. Rather than providing the incentive — and space — to innovate and change its flawed model, the IMF program design gave no bandwidth or incentive to FBR to widen the tax base or reduce administrative inefficiencies. On the contrary, FBR staff was incentivised to overtax the already documented formal sectors of the economy to meet quarterly targets. This not only left the large informal sector untouched (documenting which should be a key tax policy objective), but increased further the 'tax arbitrage' between formal- and informal-sector firms, increasing the incentive for medium and small formal-sector firms to *informalise.*

This outcome has been the exact opposite of what Pakistan's tax reform objective dictates. Apart from the revenue leakage, informal-sector firms typically do not invest in building economies of scale, nor do they invest in training and productivity improvement of their workforce. For obvious reasons, informal-sector firms are rarely recipients of foreign direct investment as well. Hence, the wider economic consequences of IMF conditionality on the tax front include not just more strain on formal-sector firms, and an erosion of the tax base in the longer run, but worst of all, a loss of competitiveness for formal-sector firms. And this loops back to a small, and declining, export base — the primary cause of Pakistan's balance-of-payments problem in the first instance.

The effect of the foregoing has been to create a "negative feedback loop" wherein:

2 / Adapted from Sakib Sherani (2021), *A redesigned programme* https://www.dawn.com/news/1624828. Also included in PBC's report *Understanding Pakistan's Polycrisis – and Navigating A Path Forward* (August 2023).

Negative Feedback Loop created by IMF program design

Short run revenue mobilization focus (+ pro-cyclical policy mix)

No "base capturing"

+

Low Growth

Over-taxing formal sector/existing base

Increase in 'Tax arbitrage' => Incentive to informalise

Erosion of tax base

Loss of tax revenue

More tax collection pressure on FBR

Source: *Sakib Sherani*

Similar *negative feedback loops* have been inadvertently created in the energy sector, where constant tariff adjustments without governance improvements have led to erosion of revenue and potential loss of high-value customers, and also in the case of mandating large increases in the SBP policy rate in a situation where interest payments already consume over 100 per cent of net federal revenue.

Hence, in crafting a policy response to Pakistan's current economic crisis, it is imperative that policymakers as well as the IMF ensure the following:

- A proper balance is found between short run macro-stabilisation and structural reform. A greater emphasis on *structural conditionality* instead of short run quantitative targets would be more productive in achieving the ultimate goal of making Pakistan's economy more resilient and less-reliant on periodic injections of external official capital.

- Program targets are sufficiently back-loaded to allow for achievement of structural conditionality.

- The emphasis of any incremental tax effort is on the informal, undocumented and non-taxpaying sector and other lightly-taxed sectors, including those within the purview of provinces such as agriculture and real estate. The formal, documented and tax-paying sector should be insulated from new tax measures to the extent possible.

- Given the possibility of challenging conditions for the bank sector over the next few years, banks in particular should be protected from arbitrary taxation measures in order to allow them to further build their capital buffers.

- Fiscal consolidation is achieved via a balance between additional revenue mobilisation (from untaxed and lightly-taxed sectors) and expenditure rationalisation plus re-prioritisation. Privatisation of loss-making state-owned enterprises under a framework that provides relevant safeguards should be a key element of the overall fiscal consolidation strategy.

- A holistic review should be conducted of the overall impact of all reform measures (including changes to the taxation regime, energy prices etc.) on formal sector firms to assess burden sharing between the formal and informal sector.

- Adjustment of administered prices, especially in energy, is done in tandem with improvements in governance to avoid a negative feedback loop whereby the cycle has to be repeated ad infinitum.

Political instability

A feature of Pakistan's economic landscape since the late 1980s in particular, has been the environment of political and internal instability in the country. As shown in **Table 4**, Pakistan witnessed 22 governments in 33 years since 1988, including caretaker administrations. Excluding caretaker administrations, there were 12 elected governments over this period, with an average tenure lasting 2.2 years.

The frequent change of governments, mostly via quasi-constitutional measures, resulted in an environment of not only political uncertainty for investors, but a high degree of policy discontinuity as well (see next section). This level of political instability has resulted in "entropy", which is the exact antithesis of long-term stability investors require.

Cross-country experience with similar conditions of political and economic instability have shown that they invariably result in capital flight – which in other words is a form of *negative investment* in the country. Various estimates indicate that Pakistan has experienced significant net capital flight since the 1990s.

Another effect of instability and entropy is that it distorts the investment portfolio choice and incentives of investors. It leads to an increase in the required rate of return for investment projects, and reduces the payback period. Prima facie it also incentivises over-invoiced projects where sponsors replace their equity either completely or partially upfront.

This, in turn, affects the nature of projects that are selected for investment, requiring sovereign guarantees and fiscal incentives in the form of guaranteed take-or-pay contracts and/or US dollar-indexed returns, among other incentives. Since the government has offered these incentives and guarantees either for specific projects, or by sector, or for a class of investors, it distorts the overall investment environment.

Investment in Pakistan's power sector under conditions of such sovereign guarantees is a case in point. In response to Pakistan's various power policies since 1994, the bulk of the private investment took place in power generation, leading to surplus installed capacity and the creation of the circular debt problem.

Table 4: Number of governments since 1988 and average tenure

	Prime Minister	Party	From	To	Tenure		
					Days	Months	Years
1	Benazir Bhutto	PPP	02-Dec-88	06-Aug-90	612	20	1.7
2	Ghulam Mustafa Khan Jatoi	Caretaker					
3	Nawaz Sharif	PML-N	06-Nov-90	18-Apr-93	894	29	2.4
4	Mir Balakh Sher Mazari	Caretaker					
5	Nawaz Sharif	PML-N	26-May-93	08-Jul-93	43	1	0.1
6	Moin Qureshi	Caretaker					
7	Benazir Bhutto	PPP	19-Oct-93	05-Nov-96	1113	36	3.0
8	Malik Meraj Khalid	Caretaker					
9	Nawaz Sharif	PML-N	17-Feb-97	12-Oct-99	967	31	2.6
10	Mir Zafarullah Khan Jamali	Caretaker					
11	Chaudhry Shujaat Hussain	PML-Q	30-Jun-04	26-Aug-04	57	1	0.1
12	Shaukat Aziz	PML-Q	28-Aug-04	15-Nov-07	1174	38	3.2
13	Muhammad Mian Soomro	Caretaker					
14	Syed Yousaf Raza Gillani	PPP	25-Mar-08	25-Apr-12	1492	49	4.1
15	Raja Pervez Ashraf	PPP	22-Jun-12	24-Mar-13	275	9	0.8
16	Mir Hazar Khan Khoso	Caretaker					
17	Nawaz Sharif	PML-N	05-Jun-13	28-Jul-17	1514	49	4.1
18	Shahid Khaqan Abbasi	PML-N	01-Aug-17	31-May-18	303	9	0.8
19	Justice (Retd) Nasir-ul-Mulk	Caretaker					
20	Imran Khan	PTI	18-Aug-18	10-Apr-22	1331	43	3.6
21	Shehbaz Sharif	PDM	11-Apr-22	14-Aug-23	490	16	1.3
22	Anwaar-ul-Haq Kakar	Caretaker					
	Number of years 1988-2022				**33**		
	No. of elected govts.				**12**		
	Average tenure of elected govt.				**815**	**26**	**2.2**
					days	**months**	**yrs**

Source: National Assembly of Pakistan; author

Policy uncertainty

"Economic theory suggests that when investors incur fixed and irreversible setup costs, uncertainty about the local conditions—especially policy uncertainty—will have a dampening effect that reduces investors' response to new investment opportunities (Bernanke 1983; Bloom 2009; Dixit 1989)."

Global Investment Competitiveness Report 2019-20, World Bank.

Closely related to political continuity is the issue of policy stability. Pakistan has witnessed major reversals in announced policies designed to attract investment in sectors such as autos, power generation, including renewable energy, steel and pharmaceuticals to name a few (see **Box** below).

As a result of abrupt and arbitrary changes in policies and terms of investment, the country has also been involved in international arbitration cases brought by foreign companies that have invested here. The two most high-profile and recent cases have involved the Tethyan Copper Company (TCC) and its investment in the Reqo Diq mine in Pakistan's Balochistan province, and Karkey Karadeniz Elektrik Uretim A.S. of Türkiye's setting up of a rental power plant.

In all, Pakistan has been involved in 12 cases since 2001 as a respondent state in international dispute settlement forums, according to UNCTAD's Investment Dispute Settlement Navigator. These disputes have involved investors from Australia (1), Türkiye (4), Saudi Arabia (1), Kuwait (1), Italy (2), Switzerland (1), Mauritius (1), and UK (1).

Box: Examples of arbitrary and abrupt policy changes

- **Group Taxation:** introduced in FA 2007, group taxation led to establishment of several holding companies and flotation of subsidiaries on the stock exchange. However, it was withdrawn in 2016, reintroduced in 2019 and withdrawn again in 2021, with the result that holding company shareholders now suffer multiple levels of taxes as dividends flow from subsidiaries to them

- **Independent Power Producers:** Financial returns in US$ for the life of the projects were sovereign-guaranteed in various Power Policies of the Government of Pakistan (GoP), attracting an estimated over US$ 19 billion cumulatively in investment in power generation since 1989.

  However, unable to perform its obligations under the agreements due to being cash strapped, GoP began re-opening and renegotiating the underlying Power Purchase Agreements in 2020. At the same time, IPPs have faced severe cashflow issues due to their liabilities not being promptly settled under the PPAs.

- **Tax Credit on Investment in Plant:** A tax credit of 10% of the amount invested in plant and machinery was allowed to qualifying companies via Section 65B of the Income Tax Law in 2010. The provision was to be a part of the law till June 30, 2021. The tax credit was reduced to 5% in 2019 and completely withdrawn from 2020, before expiry of its term.

- **Inflation related adjustment in price of drugs:** The 2018 drug pricing policy permitted increase in price of drugs to the extent of 70% of the change in CPI. This was reversed in the following year (2019) with the result that several MNCs have left Pakistan as their operations became unfeasible.

- **Captive Power Generation:** Through supply of cheap gas, the government encouraged large consumers, including exporters, to establish at substantial cost of their own, captive generation plants to overcome the power generation shortfall. GoP policy now, however, requires captive power plants to buy electricity from the DISCOs, effectively making the capital outlay on the captive power plants a deadweight investment.

- **Tuwairqi Steel Mills:** A multimillion US$ project involving a joint venture (JV) between a Saudi group and Korea's largest steel producer POSCO, with an annual import substitution potential of Rs. 100 bn, was denied supply of natural gas at the committed subsidy of Rs. 5 bn per annum post-commercial operation, leading to suspension of production and the filing of an international arbitration case against Pakistan.

- **Tethyan Copper:** A multimillion US$ copper and gold mining project awarded to Chile's Antofagasta was forestalled due to denial of extension in lease, leading to award of damages by ICSID (International Centre for Settlement of Investment Disputes) of US$ 5.9 bn against Pakistan.

The recognition of investors' property rights and the enforcement of these in a predictable and efficient manner is of utmost importance to investors, especially foreign investors. For this reason, the *legal and regulatory environment* was among the top 3 factors considered by foreign investors when making decisions regarding location of FDI, according to the results of a survey of international investors published in the World Bank's *Global Investment Competitiveness Report 2019-20*.

In a more recent survey of global investors conducted in 2022 by the global management consultancy firm Kearney, *Transparency of government regulations and lack of corruption* was cited as the top most factor taken into consideration by foreign investors in making their investment decision (see page 30 for details).

Box: 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 liberalisation 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 licences 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 subsidised 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; Sakib Sherani (FES 2017).

Human capital development

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**). Another striking feature in the case of Pakistan, is the abysmally low female participation rate in the workforce, at only 23 per cent compared to 61 per cent for Bangladesh, 44 per cent for Egypt, 68 per cent for Indonesia, and 78 per cent in the case of Vietnam, according to the World Bank.

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 5: Educational attainment of civilian labour force

Percentage distribution of Civilian Labour Force		
Population	100.0%	
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 (data sourced from UNDP's Human Development Report database).

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. The gap between Pakistan and each of its South Asian peers, as well as Vietnam, is substantial.

The foregoing indicators feed into how productive the labour force is. Not surprisingly, Pakistan does very poorly on this count (see **Box: Pakistan's productivity problem** in PBC's issues paper *Catalysing Private Investment in Pakistan: Leveraging the CPEC Opportunity, May 2022*). 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.

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.

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 combination 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 Foreign Invested Enterprises (FIEs) from relocating production to Pakistan.

Table 6: 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 the five main export sectors have been receiving subsidised electricity and gas in line with regional tariffs in the past, these have been withdrawn since 2022 under IMF loan conditionality. 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 7**). 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 38th globally, followed by Vietnam at 43rd.

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

Table 7: Logistics Performance Index (LPI) rank for selected regional & peer countries (2023)

Country	LPI Score	Rank						
		Overall LPI	Customs	Infrastructure	International shipments	Logistics competence	Tracking & tracing	Timeliness
India	3.4	38	47	47	22	38	41	35
Vietnam	3.3	43	43	47	38	53	41	59
Egypt	3.1	57	59	55	43	65	72	35
Indonesia	3.0	61	59	59	57	65	65	59
Sri Lanka	2.8	73	84	89	75	81	65	59
Bangladesh	2.6	88	101	108	91	81	105	87
Pakistan (2018)	2.4	122	139	121	97	89	136	136

Source: World Bank

III. GAUGING PAKISTAN'S ATTRACTIVENESS FOR FDI[3]

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

- 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)

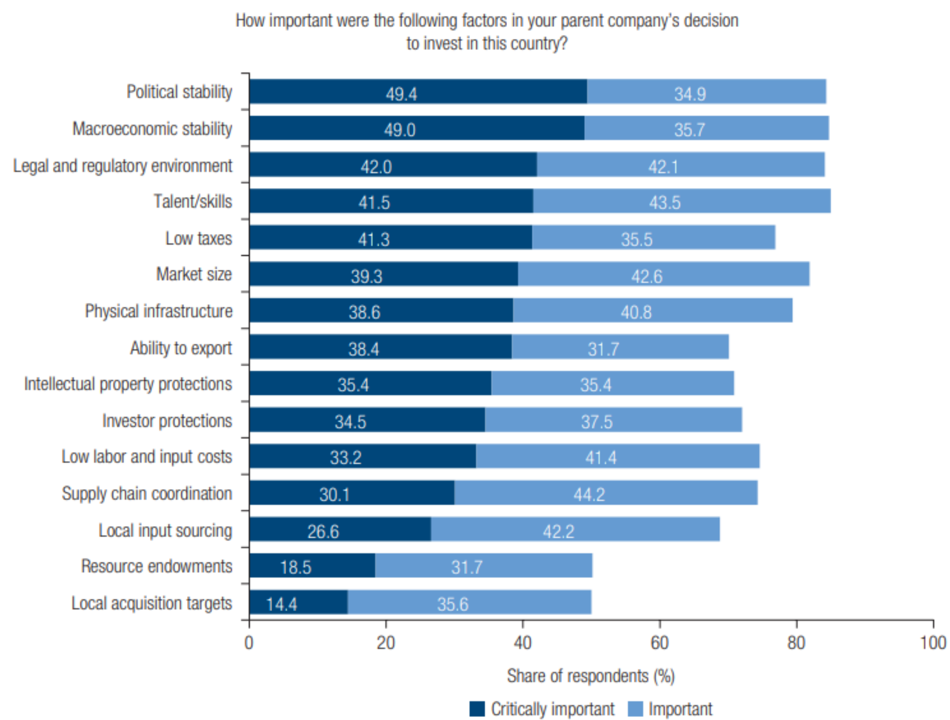
What location-specific factors drive the investment decisions of foreign investors? According to the results of a large-sample international survey conducted for the World Bank's Global Investment Competitiveness Report 2019-20:

"Foreign investors said that supportive political environments, stable macroeconomic conditions, and conducive regulatory regimes are their top three investment decision factors— even more important than low taxes, low labor and input costs, or access to natural resources."

Political stability was ranked as the number one consideration by a majority of responding foreign investors, with almost exactly half (49.4 per cent) listing it as "critically important". This was followed closely by **Macroeconomic stability**, with 49 per cent of respondents listing it as "critically important". In third place was the **Legal and regulatory environment**, with 42 per cent of respondents listing it as "critically important" (see **Figure 6**).

3 Some portions of this section have been adapted from PBC's report Catalysing Private Investment in Pakistan: Leveraging the CPEC Opportunity, May 2022.

Figure 6: Top location-specific factors for FDI decision



Source: Computation based on 2019 GIC Survey.
Note: Affiliates of multinational enterprises (MNEs) were surveyed in 10 middle-income countries: Brazil, China, India, Indonesia, Malaysia, Mexico, Nigeria, Thailand, Turkey, and Vietnam. FDI = foreign direct investment.

Source: Global Investment Competitiveness Report 2019-20, World Bank

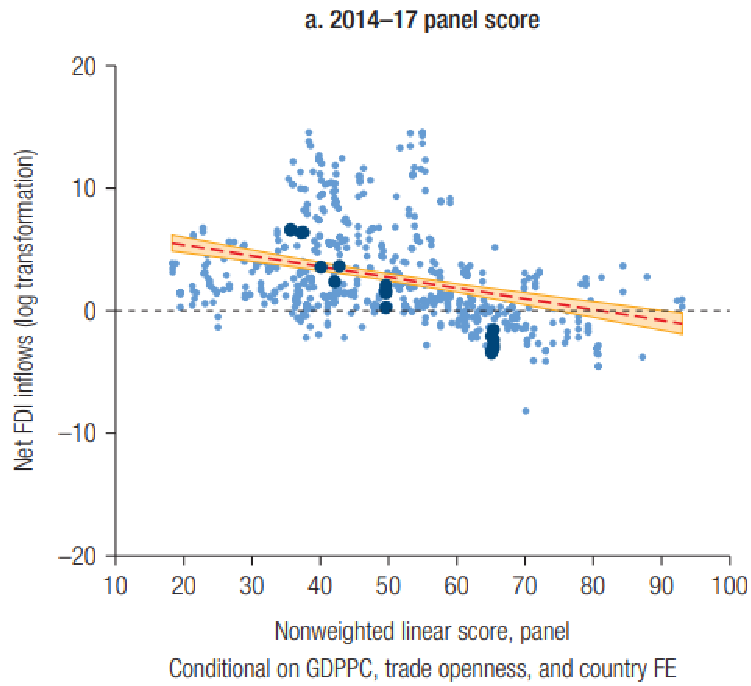
The legal and regulatory environment is especially important for larger firms. On average, large firms rank it as their top investment consideration, according to the World Bank.

These findings are largely consistent with the results of other large-sample surveys conducted by global management consultancy firms such as Kearney. In the results of a survey of global investors published in the 2023 Kearney FDI Confidence Index, *Transparency of government regulations and lack of corruption* continued to be cited, as in past years, as the top most factor taken into consideration by foreign investors in making their cross-border investment decision.

According to the World Bank's Global Investment Competitiveness Report 2019-20, "[t]he effect of regulatory risk on FDI is sizable and comparable in magnitude to the investment-enhancing effects of trade openness in the same regression models."

"Evidence at both the country and investor levels suggests that regulatory risk—as measured in this framework—matters for investment decisions. First, at the country level, higher regulatory risk is correlated with higher risk premia measured by other indexes. Second, higher regulatory risk is associated with lower FDI inflows (see **Figure 7**). Consistent with this result, investor data lend support at the microeconomic level to the negative relationship found between regulatory risk and FDI. To test the relationship between a host country's regulatory risk and foreign companies' investment entry and expansion decisions, the report uses a dataset of over 14,000 parent companies investing in nearly 28,000 FDI greenfield and expansion projects across 168 host countries between 2014 and 2016. Estimations from this investor location decision model suggest that regulatory risk can deter MNEs from entering or expanding operations in a country."

Figure 7: FDI inflows are higher in countries with lower Regulatory Risk

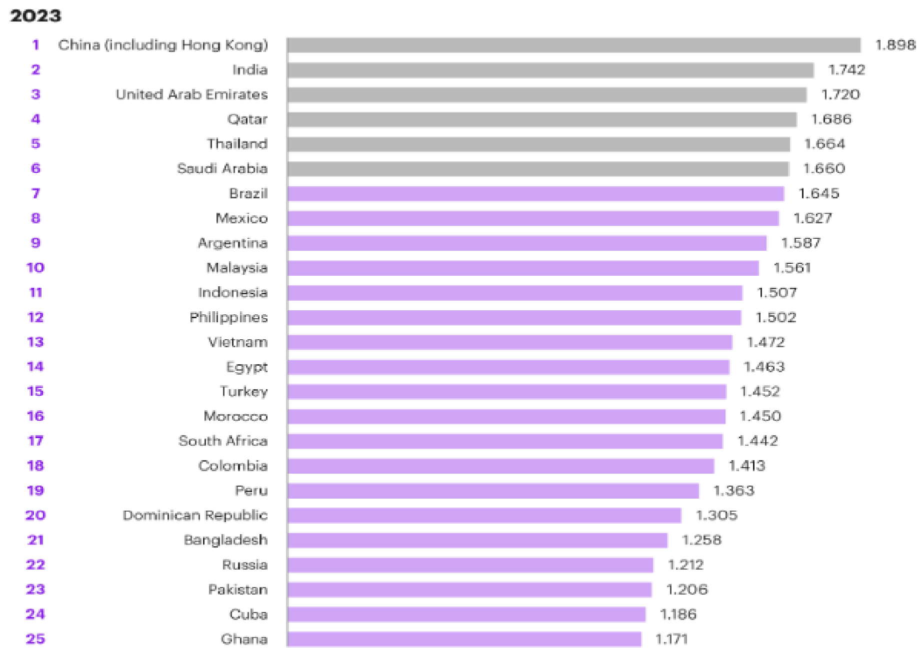


Source: Global Investment Competitiveness Report 2019-20, World Bank

Keeping the findings from large-sample surveys of global investors in view, where does Pakistan rank in terms of "attractiveness" as an investment destination for foreign investors?

According to the 2023 FDI Confidence Index published by Kearney, Pakistan ranks 23rd out of 25 Emerging Market countries ranked for their appeal for foreign investors. China, India, UAE, Qatar and Thailand make up the top 5 emerging markets for foreign investor attraction, while Bangladesh, Russia, Pakistan, Cuba and Ghana bring up the bottom 5.

Figure 8: Ranking of Emerging Markets by appeal to foreign investors



Source: 2023 Kearney FDI Confidence Index

It is important to note that the factors that are considered of primary importance for FDI appeal are almost all "institutional" factors – political stability, macroeconomic policy, the legal and regulatory environment. These are areas where Pakistan does particularly poorly, and needs to focus its reform effort on to enhance its appeal to a wide set of domestic as well as foreign investors.

According to the results of the Worldwide Governance Indicators published by the World Bank, Pakistan's percentile rank on key indicators of institutional quality are as follows:

Table 8: Pakistan's institutional indicators

Institutional Indicators	
	Percentile Rank*
Control of Corruption	23
Government Effectiveness	29
Political Stability/Absence of Violence	7
Regulatory Quality	20
Rule of Law	25

*Rounded. As of 2022.

Source: World Bank

A percentile rank in the Table above roughly translate into the percentage of countries Pakistan is higher than for the particular indicator in question. Hence, Pakistan's percentile rank of 23 for *Control of Corruption* means that it scores better than 23 per cent of the countries in the sample. Similarly, a percentile rank of 7 for *Political Stability/Absence of Violence* indicates that Pakistan ranks better in this area than 7 per cent of the countries in the sample. Another way to look at this result is that 93 per cent of the countries in the world rank higher than Pakistan in this indicator.

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 unaddressed factors.

Box: The SIFC initiative

To bridge the country's foreign exchange constraint, and to move away from dependence on the IMF, the government and the military leadership have crafted a plan to attract foreign direct investment (FDI) from friendly countries in a focused manner. The construct is called the *Special Investment Facilitation Council (SIFC)*, and appears to be modelled on the Special Investment Council formed by Egypt in 2016. The plan is to initially target inward FDI in 4 "core" sectors, namely: agriculture, minerals and mining, IT, and energy. A fifth sector, defence production, has also been listed as a potential growth driver.

These sectors have been chosen on the basis that they are "low hanging fruits" and where there is potentially strong interest by investors from Saudi Arabia, UAE, Qatar and some other GCC countries. The institutional set-up of SIFC aims to ensure speedier decision making and lower *inside-outside* lags in project approval and execution via improved intra-government coordination and fast track implementation.

After initial expectations that the SIFC initiative will generate a significant quantum of inward FDI in a relatively short period of time, thus playing a substantial role in the economy's turnaround, more recent official estimates indicate that inward FDI of around US$ 5 billion could be realised over the next 1-2 years.

While the SIFC initiative is well-intentioned and well-executed, it is not the right approach if a broad, holistic view is taken, in the author's opinion. The reasons for this determination are as follows:

- The SIFC initiative appears to be a tactical response to Pakistan's deep-rooted investment climate challenges, rather than a strategic approach. Private investment as well as inward foreign direct investment in the country have been stagnant or declining for decades. Significant factors cited have included inter alia political instability, policy inconsistency, low quality of governance, weak property rights and contract enforcement, poor infrastructure especially energy supply, and an unstable internal security situation. Without fixing the underlying causes of Pakistan's poor overall investment climate, attracting fresh investment will be an uphill task.

- This foundational challenge is exemplified by Pakistan's inability to turn the China-Pakistan Economic Corridor (CPEC) into a "game changer" due to myriad planning, coordination, implementation, security and payment issues. Focusing on improving Pakistan's state capacity via a strengthened institutional framework is a higher pay-off strategy in the longer run.

  On a related note, it is unlikely that non-Chinese investors are not aware of the challenges CPEC investors have faced, and continue to face, despite their status as "most preferred" investors in an initiative regarded as special by both the countries involved. The in-country experience of investors, whether domestic or foreign, but especially the latter, gets telegraphed in the investment community and gains high visibility. Negative experiences especially have a degree of permanence, shaping investor perceptions for a long period of time.

- The foregoing discussion leads to another fundamental problem with special-purpose investment structures and vehicles such as CPEC and SIFC. When preferential carve-out structures and policy packages are tailored to specific groups of investors, rather than be available to *all* investors via a level playing field and the same investment climate, then the government is essentially creating different "classes" of investors with differing rights and treatments. This goes against the grain of first-best policy, and does not appear to lead to a sustained increase in inward FDI that is broad-based. (This issue was first raised in PBC's report *Catalysing Private Investment in Pakistan: Leveraging the CPEC Opportunity, May 2022*. It has been reiterated subsequently by both the IMF as well as the World Bank.)

- The SIFC structure and mandate of pursuing investment in "strategic" or "core" sectors runs the risk of introducing perverse incentives and unintended consequences. Most of the sectors the SIFC is focusing its initial efforts on, barring IT, are *resource-extraction* or commodity producing industries. Pakistan needs efficiency-enhancing FDI that upgrades the international competitiveness of its exporter firms, provides market access, as well as creates opportunities for knowledge and skills transfers etc.

- The focus on basic industries signals that the SIFC structure and policy framework is meant to raise foreign exchange in quick time, rather than to catalyse a structural transformation in the economy. So far, the SIFC modus operandi appears that of a transactional body, not a transformative one.

- SIFC's ability to deliver on its initial promise is being hampered by "mission creep" on one side, and low institutional bandwidth in terms of ability of line ministries and agencies to deliver, on the other.

- The planners of SIFC are also likely to be disappointed with its results for another reason. They appear to have under-estimated the *inside-outside* lags associated with the execution of mega-projects, particularly in a fragmented institutional setting such as Pakistan where several line ministries, federal as well as provincial governments, and myriad agencies are involved.

  In addition, apart from the realisation being slower than expectation, the quantum of inward FDI realised is usually substantially lower than the initial commitments, especially in terms of balance of payments support. A significant amount of committed FDI is either in kind (non-cash) in the form of machinery or technical and services support, or is clawed back via fiscal as well as non-fiscal incentives taken from the host-government.

- One potential problem with inward FDI under the SIFC framework is something which Pakistan paid little attention to in the formulation of CPEC projects, and appears to have largely ignored to its peril once again. This pertains to the currency mis-match involved in foreign funded or invested projects that generate revenue streams in local currency. While the initial FDI boosts the host country's external account, the repatriation of Fx-denominated payment streams over the life of the project prove to be a significant drain on the country's foreign exchange reserves.

- A final issue pertains to what is known as the Dutch disease. If the SIFC initiative yields results as per its initial ambition, with substantial inward FDI in the identified core sectors, it could lead to an unwanted situation – with an exchange rate appreciation in real terms, which, if it were to materialise, would begin to undermine the country's export sector. This is a challenge which many countries have experienced in the past, particularly those that had success in generating foreign exchange from resource extraction industries.

In summary, there appear to be foundational issues which have not been carefully considered in the formulation of the SIFC initiative and which need to be re-examined.

IV. COMPARING PAKISTAN'S INVESTMENT CLIMATE

While examining Pakistan's investment climate on a stand-alone basis has its uses, comparing it with a "peer" group of countries that have been either, successful in attracting inward FDI, on the whole, or are viewed by Pakistani-domiciled businesses as potential destinations for investment, has greater utility.

In line with the two criteria listed above, this report compares Pakistan with four rapidly growing developing countries that have become "go-to" destinations for inward FDI (barring one of the selected countries, which has been chosen because it has a robust domestic investment rate). These countries span the developing world from Southeast Asia to South Asia and Middle East/North Africa, and based on anecdotal evidence and interviews, have been the subject of investment interest at some stage by large Pakistani firms.

The selected countries include Egypt, Bangladesh, Indonesia and Vietnam. Brief pen sketches of each country's economy and investment climate are presented below.

Egypt

With a population of 109 million, Egypt is the largest Arab country in the world. At US$ 477 billion, its economy is the second largest in Africa. Per capita income amounted to US$ 4,295 in 2022, or US$ 15,096 in PPP terms. The economy depends heavily on agriculture, tourism, toll revenue from the Suez Canal, and worker remittances from Egyptians working abroad - mainly in Saudi Arabia and the Gulf countries.

Industry accounts for 32.7 per cent of GDP, with textiles, food processing, chemicals, pharmaceuticals, hydrocarbons, construction, cement, metals, and light manufactures constituting the main sub-sectors. Transit fees from the Suez Canal provided over US$ 9 billion in FY2023 (1.9 per cent of GDP), while tourism receipts amounted to US$ 13.6 billion (2.9 per cent of GDP).

Poor economic management has dogged the economy for decades, with the country making several approaches to the IMF for bail-outs since 2013. The private sector is considered to be inefficient and under-performing by most standards, with the overall fixed investment rate in the economy at around 15.2 per cent of GDP. The military has a very substantial influence as well as footprint in the economy.

Inward FDI more than doubled in 2022, spiking to US$ 11.4 billion, or the equivalent of 2.4 per cent of GDP, making Egypt the largest FDI destination in Africa.

The services sector of the economy attracted the bulk of the FDI, with financial services, information and communication technology (ICT), tourism, real estate, and business outsourcing services the main FDI-receiving sub-sectors. Egypt has also attracted sizeable foreign investment in renewable energy.

The principal country sources of FDI into Egypt in 2021, according to the Lloyds Bank trade portal, were UK, Belgium, USA and UAE. More recently, Saudi Arabia has emerged as a significant source of FDI into Egypt.

According to a 2023 report by the investment consultancy Kearney, Egypt ranked as the 14th most attractive emerging market for FDI, out of 25 ranked.

Egypt offers a fairly open investment regime for foreign investors. In many sectors, there is no legal difference between foreign and domestic investors. A principal advantage for Egypt as an investment destination is its trade linkages with major world and regional markets, including the US and EU. A web of regional and US- and EU-specific trade agreements provide Egypt with substantial preferential market access, making it an export hub for Europe, the Middle East, and Africa.

Egypt is a party to more than 100 bilateral investment treaties, including with the United States. It signed a Trade and Investment Framework Agreement (TIFA) with the United States in July 1999. Egypt is a member of the World Trade Organization (WTO), and is an active member of several trading blocs and arrangements via participation in multiple FTAs, such as the African Continental Free Trade Agreement (AfCFTA), and the Greater Arab Free Trade Area (GAFTA).4

Egypt joined the Common Market for Eastern and Southern Africa (COMESA) in June 1998. Egypt's Association Agreement with the European Union (EU) entered into force on June 1, 2004, providing immediate duty-free access of Egyptian products into EU markets.

Egypt is also a member of the Agadir Agreement with Jordan, Morocco, and Tunisia, which relaxes rules of origin requirements on products jointly manufactured by the countries for export to Europe. Egypt also has a Free Trade Agreement (FTA) with Turkey in force since March 2007 and an FTA with the Mercosur bloc of Latin American nations.

In 2004, Egypt and Israel signed an agreement to take advantage of the U.S. Government's Qualifying Industrial Zone (QIZ) program. The purpose of the QIZ program is to promote stronger ties between the region's peace partners and to generate employment and higher incomes, by granting duty-free access to goods produced in QIZs in Egypt using a specified percentage of Israeli and local input. Under Egypt's QIZ agreement, Egypt's exports to the United States produced in certain industrial areas are eligible for duty-free treatment if they contain a minimum 10.5 percent Israeli content.

The country's participation in multiple Free Trade Agreements positions it as a key regional trade and production hub. Apart from reduction in trade barriers and harmonization of regulations, these agreements facilitate the import of raw and packaging material at lower prices, making Egypt an appealing destination for foreign manufacturers to produce goods in the country and supplying them to the region and beyond.

Market access of Made-in-Egypt products is enhanced by multiple trade agreements

Ship to:		COMESA	EFTA	Egypt	European Union	Russia	Saudi Arabia	Turkey	UAE	Algeria	Morocco	Tunisia
Ship from				EG	EU	RU	SA	TR	AE	DZ	MA	TN
Egypt	EG	COMESA	EG-EFTA		EG-EU	EEU DCTA	GAFTA	EG-TR	GAFTA	GAFTA	EG-MA	EG-TN
Russia	RU			...		...						
Saudi Arabia	SA		GCC-EFTA	GAFTA		EEU DCTA	...		GCC	GAFTA	SA-MA	GAFTA
Turkey	TR		TR-EFTA	TR-EG	TR-EU	EEU DCTA		...			TR-MA	TR-TN
UAE	AE		GCC-EFTA	GAFTA		EEU DCTA	GCC		...	GAFTA	GAFTA	GAFTA
Algeria	DZ			GAFTA	DZ-EU	EEU DCTA	GAFTA		GAFTA	...	DZ-MA	GAFTA
Morocco	MA		MA-EFTA	GAFTA	MA-EU	EEU DCTA	GAFTA	MA-TR	GAFTA	GAFTA	...	MA-TN
Tunisia	TN		TN-EFTA	GAFTA	TN-EU	EEU DCTA	GAFTA	TN-TR	GAFTA	GAFTA	TN-MA	...

COMESA: Common Market for Eastern and Southern Africa; EFTA: European Free Trade Association; GAFTA: Greater Arab Free TradeArea; EEU: Eurasian Economic Union; DCTA: Deep and Comprehensive Free Trade Area.

4 This section has been sourced from the 2023 Investment Climate Statement of the US State Department.

As a result of the combination of the fore-mentioned factors, many large MNCs have invested in Egypt making it their sourcing hub for other markets. These MNCs include: -

Unilever: There are two manufacturing sites developed by Unilever in Alexandria and The 6th of October City, Egypt through which food, laundry and personal care products worth Euro 85 million are exported to KSA, Dubai, Africa, Turkey, Russia and Libya. Furthermore, Unilever has invested Euro 50 million for capacity expansion of these two plants to increase production and export of laundry powders and soap bars.

P&G: With at least two production facilities in the country, Egypt is a major export hub for P&G in detergent products and diapers. Annual export volume of these product lines in 2019 was estimated at around Eur 155 million. The Pampers facility built in Egypt in 2009 serves as a global export hub for the company, while Egypt is the sourcing hub for P&G for the entire African continent for laundry products.

Nestle: With at least 3 manufacturing sites in Egypt, and a planned expansion announced in 2019 for instant coffee and bouillon for the export market, Nestle generates annual export of around Eur 65 million from its Egyptian operations, mainly from export of its instant noodles brand Maggi.

L'Oreal: The company has a manufacturing presence in Egypt since 2011 for beauty and personal care (BPC) products, mainly shampoos and hair dyes covering several of its fast-selling brands. It is believed that over 85 per cent of the volumes produced in Egypt are exported, mainly to the MENA region.

Coca Cola: The US multinational corporation operates one of its 2 facilities in Africa in Egypt, producing concentrates. It had announced plans in 2019 to invest Eur 460 million, mainly for exporting concentrates to MENA and rest of Africa.

Despite these advantages and appeal for foreign investors, however, according to the 2023 Investment Climate Statement of the US State Department's Bureau of Economic and Business Affairs:

"[...] investors continue to face obstacles, including excessive bureaucracy, lack of transparency, uneven enforcement of laws and regulations, difficulties accessing foreign currency to repatriate profits or import goods, a shortage of skilled labor, cumbersome customs procedures, corruption, and intellectual property issues."

According to the results of the World Bank's Enterprise Survey 2020 for Egypt, the top 10 business environment constraints reported by domestic firms were:

Constraint		% of reporting firms
1.	Tax rates	24%
2.	Political instability	17%
3.	Corruption	15%
4.	Practices of informal sector	9%
5.	Access to finance	8%
6.	Tax administration	6%
7.	Business licenses and permits	6%
8.	Customs & trade regulations	5%
9.	Electricity	3%
10.	Inadequately educated workforce	2%

Source: World Bank

Bangladesh

Bangladesh is the eighth largest country by population and one of the fastest growing economies in Asia. It has achieved impressive milestones over the past decade in its economic trajectory. It is now the 35th largest economy in the world in nominal US dollar terms, and overtook India in 2019 in GDP per capita. In 2021, Bangladesh crossed US$ 1 trillion in GDP in PPP terms, making it one of 31 countries to do so.

The country's spectacular growth has been powered by apparel exports. In 2022, Bangladesh exported readymade garments amounting to US$ 45 billion, accounting for 7.9 per cent of world exports. Along with exports, Bangladesh's economy is now increasingly investment-driven as well. The overall fixed investment rate was 32 per cent of GDP in 2022, the highest in South Asia.

Inward FDI into Bangladesh has remained relatively low, however, given its economic rise and potential. Nonetheless, there has been a noticeable spike in foreign investment in 2022, with FDI inflows rising to a near-record level of US$ 3.5 billion as per UNCTAD data.

According to the 2023 Investment Climate Statement of the US State Department's Bureau of Economic and Business Affairs:

"Bangladesh has 31 bilateral investment treaties with 29 countries. The U.S.-Bangladesh Bilateral Investment Treaty entered into force in 1989 and accorded U.S. companies in Bangladesh the same treatment as local companies.

Bangladesh has joined several regional trade and economic agreements including the South Asian Free Trade Area (SAFTA), the Asia-Pacific Trade Agreement (APTA), and the Bay of Bengal Initiative for Multi-Sectoral, Technical and Economic Cooperation (BIMSTEC).

Bangladesh has a Preferential Trade Agreement with Bhutan, is negotiating with Nepal and Indonesia, and is considering a Comprehensive Economic Partnership Agreement with India. The Government has broad plans to deepen economic ties with nations of Latin America. Bangladesh signed Avoidance of Double Taxation Treaties with 36 countries including: the United States, China, and India."

The top 10 business environment constraints reported by domestic firms, as per the World Bank's Enterprise Survey 2022 for Bangladesh, were:

	Constraint	% of reporting firms
1.	Electricity	21%
2.	Access to finance	17%
3.	Corruption	13%
4.	Practices of informal sector	10%
5.	Tax rates	9%
6.	Inadequately educated workforce	8%
7.	Tax administration	5%
8.	Business licenses and permits	5%
9.	Political instability	4%
10.	Customs & trade regulations	3%

Source: World Bank

Specifically for "large firms", i.e. reporting firms with 100+ employees, the top 3 constraints listed included: 1. Electricity; 2. Corruption; 3. Customs and trade regulations.

Indonesia

Indonesia is the 6th largest economy in the world in purchasing power parity (PPP) terms, the 4th largest in Asia, and the largest in Southeast Asia. The size of its economy in PPP terms was measured at over US$ 4 trillion in 2022. With a population of around 280 million, Indonesia is the fourth most populous country in the world.

A commodity-rich economy, Indonesia has recorded steady rates of economic growth over a fairly long period of time, with relatively low and stable inflation. According to the World Bank, GDP growth for 2023 is estimated at 5 per cent, with consumer price inflation at under 4 per cent.

Agriculture accounts for approx. 14 per cent of GDP, industry 41 per cent, and services 45 per cent of GDP. Its main agricultural commodities include oil palm fruit, rice, maize, sugar cane, coconuts, cassava, bananas, eggs, poultry, and rubber. Its main industries include petroleum and natural gas, textiles, automotive, electrical appliances, apparel, footwear, mining, cement, medical instruments and appliances, handicrafts, chemical fertilizers, plywood, rubber, processed food, and jewellery.

Indonesia is a major tourist destination, with tourism receipts pre-Covid amounting to an estimated US$ 18.4 billion in 2019.

As a regional economic powerhouse, Indonesia attracts significant FDI inflows. According to UNCTAD, inward FDI into Indonesia in 2022 amounted to US$ 21.9 billion, or around 1.7 per cent of GDP – well above the average for East Asian economies of 1.2 per cent of GDP (excluding high income countries).5 The overall fixed investment rate in the economy was 29.1 per cent of GDP as of 2022.

The base metals and mining sectors attracted the bulk of the FDI, with Singapore, China, Hong Kong, Japan and Malaysia as the major sources of FDI.

Indonesia established a sovereign wealth fund (Indonesian Investment Authority, or INA) in 2021 to attract foreign investment in government infrastructure projects in sectors such as transportation, oil and gas, health, tourism, and digital technologies.

According to the 2023 Investment Climate Statement of the US State Department's Bureau of Economic and Business Affairs, foreign investors in Indonesia *"find that restrictive regulations, legal and regulatory uncertainty, economic nationalism, trade protectionism, and vested interests complicate the investment climate. Foreign businesses may be expected to partner with Indonesian companies and to manufacture or purchase goods and services locally … Investors cite corruption as an obstacle to pursuing opportunities in Indonesia.*

[…] Some U.S. investors describe the investment climate as much improved over the past decade, but point out that, other barriers remain, including bureaucratic inefficiency, delays in land acquisition and the tendering process for infrastructure projects, weak enforcement of contracts, and delays in receiving refunds for advance corporate tax overpayments. Investors worry that new regulations are sometimes imprecise and lack stakeholder consultation."

To further improve the investment climate, the Indonesian government issued the *Omnibus Law on Job Creation* in October 2020 to amend dozens of prevailing laws deemed to hamper investment. The Omnibus Law repealed the Negative Investment List, and has introduced a risk-based approach for business licensing, simplified environmental requirements and building certificates, tax reforms to ease doing business, more flexible labour regulations, and the establishment of a priority investment list. It also streamlines the business licensing process at the regional level.

5 According to Indonesia's Ministry of Investment (BKPM), however, the country attracted record inward FDI of US$ 45.6 billion in 2022. The discrepancy between UNCTAD and Indonesia's official data remains unreconciled.

Indonesia currently has 26 bilateral investment agreements in force. Indonesia is a member of the *Association of Southeast Asian Nations* (ASEAN). In November 2020, 10 ASEAN Member States and five additional countries (Australia, China, Japan, Korea and New Zealand) signed the *Regional Comprehensive Economic Partnership* (RCEP), representing around 30 percent of the world's gross domestic product and population.

According to the 2023 Investment Climate Statement of the US State Department's Bureau of Economic and Business Affairs, Indonesia is actively engaged in bilateral FTA negotiations. Indonesia recently signed trade agreements with Australia, Chile, Mozambique, the European Free Trade Association (Iceland, Liechtenstein, Norway, and Switzerland), and South Korea. Indonesia is currently negotiating Bilateral Trade Agreements with the European Union, United Arab Emirates, Canada, and other countries.

The United States and Indonesia signed a Trade and Investment Framework Agreement (TIFA) in 1996. Indonesia is a member the Indo Pacific Economic Framework (IPEF). In May 2022, the United States launched the Indo-Pacific Economic Framework for Prosperity (IPEF) with Australia, Brunei Darussalam, Fiji India, Indonesia, Japan, the Republic of Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, and Vietnam.[6]

The top 10 business environment constraints reported by domestic firms, as per the World Bank's Enterprise Survey 2023 for Indonesia, were:

	Constraint	% of reporting firms
1.	Access to finance	29%
2.	Crime, theft, disorder	15%
3.	Political instability	11%
4.	Corruption	10%
5.	Practices of informal sector	7%
6.	Tax rates	6%
7.	Labour regulations	4%
8.	Inadequately educated workforce	3%
9.	Transportation	3%
10.	Business licenses and permits	3%

Source: World Bank

For large firms (with 100+ employees), *crime, theft and disorder* was the topmost concern, followed by *political instability* and *access to finance*.

6 Source: The *2023 Investment Climate Statement of the US State Department's Bureau of Economic and Business Affairs.*

Vietnam

Vietnam has become an economic powerhouse since its transition to a market economy in the 1990s. It is an export-led economy, with the export sector accounting for over 90 per cent of GDP in 2022, as per World Bank data. Export receipts amounted to US$ 371 billion in 2022, compared to less than US$ 20 billion in 2000 – an increase of a multiple of circa 20 in twenty-two years.

The other stand out feature of Vietnam's impressive economic performance is the level of inward FDI it attracts. According to UNCTAD, inward FDI into Vietnam amounted to US$ 17.9 billion in 2022, or 8 per cent of the c.US$ 222 billion inflow into Southeast Asia as a whole. This level of FDI into Vietnam was the equivalent of 4.4 per cent of its GDP.

The rate of overall fixed investment in Vietnam was recorded at 31.7 per cent of GDP in 2022, as per World Bank data.

According to the 2023 Investment Climate Statement of the US State Department's Bureau of Economic and Business Affairs:

"Foreign direct investment (FDI) continues to be of vital importance to Vietnam as an economic growth driver. The government has policies in place that are broadly conducive to FDI, particularly for enterprises engaged in export-oriented manufacturing. Factors that attract the interest of foreign investors include political stability, strong economic growth, a young and increasingly urbanized and educated population, competitive labor costs, a growing number of trade agreements, and an affordable, stable power supply."

On Vietnam's moves towards greater trade openness and investment linkages via increased market access, the Investment Climate Statement notes:

"Vietnam's recent moves forward on free trade agreements (FTA) make it easier to attract FDI by providing better market access for Vietnamese exports and encouraging investor-friendly reforms. The EU-Vietnam Free Trade Agreement (EVFTA) entered into force August 1, 2020. The UK-Vietnam Free Trade Agreement entered into force May 1, 2021. The Regional Comprehensive Economic Partnership (RCEP) entered into force January 1, 2022, for 10 countries, including Vietnam."

It also notes challenges in Vietnam's investment climate:

"[...] Despite having a relatively high level of FDI net inflows as a percentage of GDP compared to regional peers, Vietnam faces some significant challenges with its investment climate. These include widespread corruption, the entrenched position of state-owned enterprises (SOEs) in certain sectors, regulatory uncertainty in key sectors, a weak and opaque legal regime, poor enforcement of intellectual property rights, a shortage of skilled labor, restrictive labor practices, and slow government decision-making processes."

The top business environment constraints in Vietnam, as reported by domestic firms via the World Bank's Enterprise Survey, were not available beyond 2016.

Box: Country-specific characteristics – summary

Bangladesh: Narrow Sectoral Reliance

The Bangladeshi economy has grown rapidly in the past decade *with annual GDP growth rates consistently above 6 %* placing it among the fastest growing economies in Asia. Yet there are challenges, some related to sectoral concentration and others to political uncertainty and labour rights. The country is presently under an IMF programme in anticipation of a running down of its foreign exchange reserves.

Economic growth and foreign exchange earnings are mainly driven by the Ready-Made Garment (RMG) industry and remittances, primarily by semi-skilled labour in the Middle East. *The RMG sector* accounts for more than 80 per cent of export earnings and employs over 4 million workers, 60 per cent of whom are women, mainly from rural areas with little or no education. The success has made Bangladesh the world's top exporter of RMG along with China, but the sector's role in creating employment has started to decline with increased automation. Also, the country's low wage advantage is proving difficult to sustain and international buyers are now even more demanding of compliance with labour and safety laws. Despite the strong political influence of the textile sector in the parliament, the government is finding it difficult not to support demands for higher wages. On implementation of labour laws, it has hitherto taken a pro-employer stance. The pharmaceutical sector has grown significantly and is becoming one of the growth industries with exports to more than 125 countries, including the US and EU markets. Like Pakistan, Bangladesh is facing challenges with its power sector, with rising tariffs and increased supply interruptions.

In its *international relations,* the Government of Bangladesh has successfully leveraged its geo-strategic importance to obtain duty-free access for 96% of HS lines into China without an FTA. As Bangladesh graduates from LDC status, compliance with the human and workers' rights covenants will be of increasing importance to maintain the preferential access to EU markets through the current Everything But Arms (EBA) or future Generalised Scheme of Preferences-Plus (GSP+), that is key for the RMG sector and thus for the Bangladeshi economy.

Bangladesh's infrastructure, including transportation, energy, and communication networks, is inadequate to support the country's rapid economic growth. The country is highly vulnerable to the impacts of climate change, including rising sea levels, floods, and cyclones. These natural disasters can cause significant damage to infrastructure, agriculture, and livelihoods, affecting the country's economic growth and development.

Vietnam: Role of Samsung in driving FDI

Foreign Direct Investment (FDI) has played a pivotal role in shaping Vietnam's export-oriented economy. Over the past few decades, Vietnam has emerged as a prominent manufacturing hub in Southeast Asia, largely driven by the influx of FDI. Samsung Electronics, the South Korean multinational conglomerate, plays a pivotal role in Vietnam's exports, contributing significantly to the country's economic growth and development. Vietnam has emerged as a key manufacturing hub for Samsung, with the company establishing several production facilities in the country over the past few decades.

Samsung's presence in Vietnam has transformed the country's export landscape. Vietnam has become a major exporter of electronic goods, primarily smartphones and components, thanks to the Korean conglomerate's manufacturing operations. In 2021, Vietnam's total exports reached $336 billion, with Samsung accounting for approximately 20% of the country's total exports.

Samsung's manufacturing facilities in Vietnam produce a wide range of electronic products, including smartphones, tablets, televisions, and home appliances. The company has invested heavily in research and development in Vietnam, establishing state-of-the-art production lines and employing a skilled workforce. Samsung's commitment to innovation and quality has enabled Vietnam to become a competitive player in the global electronics market.

The presence of Samsung in Vietnam has also created numerous job opportunities for the local population. The company directly employs over 170,000 people in Vietnam, making it one of the largest private-sector employers in the country. Additionally, Samsung's supply chain involves thousands of local businesses, fostering the growth of small and medium-sized enterprises in Vietnam.

Samsung enjoys a well-established global distribution network and market access in various countries, which provides Vietnamese produced goods a ready market. Samsung's investment in Vietnam also provided a good model for its competitors such as LG and others to emulate.

Indonesia: Taking Control of Mineral Wealth

Over the past three years, Indonesia has become one of the vortices of competition for access to the minerals that are critical to powering global economies, especially advanced industrial countries that are looking for strategies to guarantee critical mineral supplies from outside China.

The International Energy Agency (IEA) has reported that mineral production and processing is concentrated in three big producer countries, which has the potential to cause supply vulnerability due to political instability, geopolitical risks, and possible export restrictions. For example, rare earth elements are controlled by China, the United States and Myanmar; while lithium is controlled by Australia, Chile, and China; and nickel is controlled by Indonesia, the Philippines, and Russia.

The Indonesian state is increasingly confident in its efforts to move forward with the national industrialization agenda as set out in the 2015-2035 National Industrialization Development Master Plan. An export ban policy to increase the added value of production has been in place since then. This change in national economic policy aims to transform Indonesia from an exporter of raw materials to an exporter of highly competitive products through downstream industry, particularly those based on natural resources. The economic transformation agenda is outlined in the Narrative of the 2019-2024 National Medium-Term Development Plan (RPJMN).

With large reserves of nickel and several critical minerals for EV battery production, Indonesia's strategy to ban export of mineral ores aims to take a more important role in supply chain for global electric battery production, in particular for electric vehicles (EVs).

Egypt: Benefiting from Preferential Market Access

Egypt enjoys preferential market access to the European Union (EU), the United States (US), Africa, and the Gulf Cooperation Council (GCC) countries through various trade agreements and arrangements. These agreements provide Egyptian exporters with reduced or eliminated tariffs, quotas, and other trade barriers, making it easier and more cost-effective for them to export their goods to these markets.

EU: Egypt has a long-standing trade relationship with the EU, dating back to the 1970s. The EU is Egypt's largest trading partner, accounting for over 25% of its total trade. The EU-Egypt Association Agreement, signed in 2001, established a free trade area between the two parties, gradually eliminating tariffs on most industrial goods and agricultural products. This has seen some MNC's relocate their manufacturing from more expensive countries in Southern Europe.

US: Egypt and the US have a bilateral trade agreement, known as the Trade and Investment Framework Agreement (TIFA), which was signed in 1999. The TIFA aims to promote trade and investment between the two countries and includes provisions for reducing trade barriers and enhancing cooperation in various economic sectors. Additionally, under the Qualifying Industrial Zones scheme, goods manufactured with a certain level of Israeli component enjoys duty free access.

Africa: Egypt is a member of the Common Market for Eastern and Southern Africa (COMESA), a regional trade bloc comprising 21 African countries. COMESA seeks to promote economic integration among its member states by eliminating trade barriers and fostering cooperation in various areas, including trade, investment, and infrastructure development. Egypt, by virtue of its lead role in the African continent will also benefit from an AfCTA - the African African Continental Free Trade Agreement (AfCFTA) among 54 of the 55 African Union (AU) member states. Several large MNCs are now sourcing their African needs from larger factories in Egypt.

GCC: Egypt has trade agreements with individual GCC countries, including Saudi Arabia, the United Arab Emirates, and Kuwait. These agreements aim to enhance trade and economic cooperation between Egypt and the respective GCC countries, providing preferential market access for Egyptian exports.

Overall, Egypt's market access to the EU, US, Africa, and GCC countries plays a crucial role in promoting its exports, diversifying its economy, and attracting foreign investment.

Pakistan

Pakistan is the fifth most populous country in the world, and the 42nd largest economy. After posting impressive growth rates till the 1980s, its economic performance has floundered, and has been marked by weak growth and boom-bust cycles.

Unlike the rapidly developing economies of many of its peers in South and Southeast Asia, Pakistan did not capitalise on the wave of globalisation the world economy witnessed from around 2000 onwards. Its export growth has been amongst the lowest among its peers, and at less than 10 per cent of GDP, the export sector remains a small component of the economy. The tepid export performance is a reflection of myriad issues affecting the international competitiveness of the country's firms, including weak incentives for firms to formalise, the inability to generate sufficient domestic investment or attract FDI, and non-availability of requisite and sufficiently skilled human capital.

As noted earlier, the country's overall fixed investment rate is well below levels needed to generate sustained economic growth. Total fixed investment in 2022-23 amounted to 11.9 per cent of GDP, while fixed investment by the private sector was 8.8 per cent of GDP. Inward FDI amounted to 0.4 per of GDP, well below the average for South Asia as a whole.

According to the 2023 Investment Climate Statement of the US State Department's Bureau of Economic and Business Affairs:

"While Pakistan has a nominally open foreign direct investment (FDI) regime, it is a challenging environment for investors. The government implemented additional duties and restrictions on imports in 2022 and delayed approvals of letters of credit and repatriation of proceeds due to foreign reserve and balance of payments concerns. Many foreign investors have reported they are considering suspending or scaling back operations in Pakistan due to these measures. [...] Dispute resolution processes are lengthy, enforcement of intellectual property rights (IPR) is weak, taxation is inconsistent and often disproportionately targets international investors, and regulations vary across the federal, provincial, and local levels of government."

The top 10 business environment constraints reported by domestic firms, as per the World Bank's Enterprise Survey 2022 for Pakistan, were:

	Constraint	% of reporting firms
1.	Political instability	27%
2.	Access to finance	15%
3.	Tax rates	12%
4.	Corruption	11%
5.	Electricity	8%
6.	Access to land	7%
7.	Customs & trade regulations	6%
8.	Business licenses and permits	3%
9.	Practices of the informal sector	3%
10.	Transportation	2%

Source: World Bank

Specifically for "large firms", i.e. reporting firms with 100+ employees, the top 3 constraints listed were:

1. Tax rates
2. Corruption
3. Political instability

Political instability was a common constraint listed by all 3 categories of firms surveyed.

Table 9 maps Pakistan's comparative standing on key parameters that foreign investors consider. It compares Pakistan with Bangladesh, Egypt, Indonesia, and Vietnam.

Table 9: Pakistan versus comparator economies

		Bangladesh	Egypt	Indonesia	Vietnam	Pakistan	Source	Year
Economy, demographics:								
Size of economy - nominal	US$ bn	460	477	1,319	409	375	World Bank	2022
GDP per capita - nominal	US$	2,688	4,295	4,788	4,164	1,597	World Bank	2022
GDP per capita - PPP	US$	7,398	15,096	14,658	13,461	6,351	World Bank	2022
Population	Mn	171	111	276	98	241	World Bank	2022
Size of labour force	Mn	74	31	137	56	79	World Bank	2022
LF to overall population	%	43%	28%	50%	57%	33%	World Bank	2022
Women participation rate	%	61%	44%	68%	78%	23%	World Bank; PBS (Pakistan)	2021
Median age of population	Years	29.2	24.1	32.1	32.7	22.7	CIA Factbook	2022
Est. size of middle class	Mn							
Economic structure:								
Exports	% GDP	14.7%	10.1%	22.1%	90.7%	8.3%	World Bank	2022
Imports	% GDP	19.2%	16.7%	18.0%	87.8%	19.0%	World Bank	2022
Economic complexity	Rank	101	67	64	61	94	Harvard Growth Lab	...
Global competitiveness	Rank	104	92	50	66	109	World Economic Forum	2019
Economic globalisation index	Rank	179	135	124	92	169	Swiss Institute of Technology	2020
Quality of human capital:								
Human Development Index (HDI)	Rank	129	97	114	115	161	UNDP	2023
Human Capital Index	Rank	123	115	96	38	144	World Bank	2020
Mean years of schooling	Years	7.4	9.6	8.6	8.4	4.5	UNDP	2022
Human flight & brain drain index*	Rank	36	102	82	111	80	The Fund for Peace	2023
**Higher rank = greater displacement*								
Quality of physical infrastructure:								
Overall ranking	Rank	114	...	...	77	105	World Economic Forum	2019
Logistics Performance Index (LPI)	Rank	88	57	61	43	122	World Bank	2023

Note: Shaded cells represent "worst" score in indicator

Table 9: Pakistan versus comparator economies cont'd …

		Bangladesh	Egypt	Indonesia	Vietnam	Pakistan	Source	Year
Market access/Investment treaties:								
No. of FTAs in force	No.	5	9	16	15	10	Asia Regional Integration Centre	2022
No. of PTAs + GSPs in force		26	19	9	11	19	Int'l Trade Centre (ITC)	2022
No. of Bilateral Investment Treaties (BITs)	No.	5	115	2,219	67	53	UNCTAD	2022
Treaties with Investment Provisions (TIPs)	No.	…	15	370	28	7	UNCTAD	2022
Institutional framework:								
Fragile States Index	Rank	41	50	98	118	31	The Fund for Peace	2023
1 = most fragile								
Political stability	Rank	160	163	135	100	180	World Bank	
Control of corruption	Percentile rank	16	26	38	46	23	World Bank	2022
Rule of law	Percentile rank	30	43	45	48	25	World Bank	2022
Government effectiveness	Percentile rank	23	34	66	59	29	World Bank	2022
Regulatory quality	Percentile rank	18	25	59	36	20	World Bank	2022
State legitimacy index	Rank	58	35	112	50	63	The Fund for Peace	2023
Higher rank = lower legitimacy (1 = least legitimacy)								
Est. size of informal economy	Rank	83	50	108	132	58	Medina and Schneider; IMF (2018)	
Higher rank = larger informal economy								
Investment attractiveness:								
Sovereign credit rating - FCY LT (S&P)	Rating	BB-/ Neg	B-/ Stable	BBB/ Stable	BB+/ Stable	CCC+/ Stable	S&P	
Investment rate	% GDP	32.0%	15.2%	29.1%	31.7%	13.4%	World Bank	2022
FDI inflow	US$ mn	3,480	11,400	21,968	17,900	1,339	UNCTAD	2022
FDI inflow	% GDP	0.8%	2.4%	1.7%	4.4%	0.4%	UNCTAD	2022
Kearney FDI Confidence Index - EM	Rank	21	14	11	13	23	Kearney	2023

Note: Shaded cells represent "worst" score in indicator

All the areas where Pakistan ranks the "lowest" among the comparator peer group (i.e. worst) have been shaded in blue.

The key findings that stand out from the mapping are that Pakistan does poorly in the following areas:

- Measures of strength of the institutional framework, such as Political Stability and Rule of Law
- Quality of human capital
- Physical infrastructure
- International competitiveness
- Overall investment attractiveness
- External trade linkages/market access

V. OVERALL POLICY RECOMMENDATIONS

Pakistan needs a comprehensive roadmap for 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 political instability, a weak macroeconomic environment and institutional framework, policy uncertainty, 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.

- Improving the investment climate requires a holistic, *back-to-basics* approach across a wide front. *Ad hoc*, tactical approaches such as according "preferred" status to different groups of foreign investors, and effectively creating different classes of investors with discriminatory implicit as well as explicit provisions, incentives and "rights", may be helpful in the short run to ease the country's foreign exchange constraint. In the longer run, however, these constructs are likely to do more harm than good by setting up perverse incentives and unintended consequences.

- Investment policies should aim for improving the overall investment environment via deep-rooted and wide ranging structural as well as institutional reforms, with a focus on domestic firms, rather than be tailored to the specific needs of a smaller pool of foreign investors. Domestic firms achieving scale in operations and becoming viable partners for foreign investors is a tried and tested route most dynamic and successful emerging markets have taken in improving the competitiveness of domestic businesses as well as attracting foreign investment.

- To improve the overall investment climate, areas to focus on include *inter alia* political and macroeconomic stability, human capital development, quality of physical infrastructure and key facets of the institutional framework. At the same time, comparator countries appear to benefit substantially from deeper trade linkages and market access.

- A key priority area for institutional and structural reform should be the country's tax regime. Tax policy as well as administration are burdening formal sector firms with higher costs of doing business through predatory taxation and excessive compliance costs, especially with regard to the unharmonized, multiple jurisdiction sales tax. The widening tax arbitrage between formal and informal sector firms is an impediment to the growth of the formal sector, and hinders fresh investment, including FDI.

- 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, electronics, and the IT sector, among others. The SIFC's emphasis on "core" strategic sectors aims to address this to some extent, but still focuses too much on commodity-producing sectors and resource extraction industries.

- A two-track approach to FDI will entail the country prioritising "high value" FDI that, for example, provides access to Pakistani products to export markets, or embeds the country's exporter firms into regional value chains, or provides 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.

- Pakistan must leverage CPEC Phase II. A sharper "strategic" focus needs to be imbued to CPEC overall. 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 building industrial 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.

- To improve the responsiveness of different tiers of government to investor concerns, and provide for a coordinated approach, existing constitutional bodies such as 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 investors, both domestic as well as foreign, face.

REFERENCES

1. World Investment Report; UNCTAD (2023).

2. 2023 Investment Climate Statements, Bureau of Economic and Business Affairs, US Department of State; https://www.state.gov/reports/2023-investment-climate-statements/

3. World Bank Enterprise Surveys (2023); https://www.enterprisesurveys.org/en/enterprisesurveys

4. The 2023 Kearney Foreign Direct Investment Confidence Index®: Cautious Optimism; https://www.kearney.com/service/global-business-policy-council/foreign-direct-investment-confidence-index/2023-full-report

5. Global Investment Competitiveness Report 2019-20; World Bank

6. UNCTAD Investment Policy Hub; https://investmentpolicy.unctad.org/country-navigator

7. Asia Regional Integration Center, ADB; https://aric.adb.org/fta-country

8. Country and Product Complexity Rankings, Atlas of Economic Complexity; Harvard Growth Lab https://atlas.cid.harvard.edu/rankings

9. International Trade Portal, Lloyds Bank; https://www.lloydsbanktrade.com/en/market-potential

10. 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.

11. Impact of foreign direct investment on the production complexity of domestic firms; Beata Javorcik, Alessia Lo Turco, Daniela Maggioni, VoxEU.org; June 2017

12. Institutional Reforms in Pakistan: The Missing Piece of the Development Puzzle; FES (2017)

8th Floor, Dawood Center, M.T. Khan Road
Karachi, Pakistan

T - +92 21 3563 0528 - 29
F - +92 21 3563 0530

Ground Floor, Unit No. 7, Block 3001, Rehmat
Plaza, Blue Area, Islamabad, Pakistan

T: 051-8444008
F: 051-8444009

www.pbc.org.pka