CRITERION QUARTERLY

A Renewed Commitment on Foreign Direct Investment

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Abstract

(Development plans and industrial policy have lost their shine but there is a role for long-term strategy to dispel the short-term narrative of imminent collapse. The current hardships are real and IMF conditionality is painful, but the prospect is also substantial. A renewed

commitment on FDI may be born out of adversity but should be sustained for Pakistan to be an upper middle-income country in 2030. – Author)

The multi-billion-dollar Reko Diq mining project is finally back on track after a decade-long dispute and costly detour in international arbitration. Mining has always had a controversial history across the continents. Large projects invite favorable treatment. Windfall discovery invites renegotiation. Identifying the public interest is difficult. The Reko Diq negotiations involved multiple issues and parties. Their settlement within the country, with Supreme Court clearance and protective domestic legislation, suggests renewed national commitment—at federal, provincial and judicial levels—to attract foreign direct investment (FDI).

Pakistan has had uneven success in attracting FDI. Pakistan received more FDI than India in the initial four decades of independence.[1] There have been times when Pakistan was among the top ten recipients in Asia (2006-2008).[2] However, the country's standing slipped in recent years (2015-2021).[3] While India emerged as a major destination for FDI (since the mid-1990s), Pakistan now attracts less FDI than Bangladesh. More importantly, Pakistan attracts well below its economic potential.[4] A renewed commitment to attract FDI can provide a timely boost to the country's economy.

Benefits for Pakistan

FDI is important for three reasons. First, it brings much needed capital, technology and knowhow. Pakistan has had a chronically low rate of capital formation for most of its history, well below the threshold for dynamic economic growth (20% of GDP).[5] The technological content of Pakistan's manufacturing sector is also less than that of lower middle-income developing countries.[6] FDI can help fill those gaps.

Second, FDI can provide access to international markets. This is a more ambitious objective as Pakistan's economy is seen more as a market to sell to, than as a location to sell from. Still, there is need to diversify and expand exports and participate in the more dynamic segments of world trade. Pakistan's *Strategic Trade Policy Framework 2020-25* aims to "transform Pakistan from a factor-driven to an efficiency-driven economy integrated into the regional and global value chains." This will entail active efforts on the part of the government.

Third, FDI does not create debt. More than half of Pakistan's capital inflows (56 % in 2021) involve sovereign bonds denominated in foreign currency that incur high interest debt and are subject to downgrade and the risk of default. The current risks are particularly high.[7] Increased FDI would sustain capital inflows without these risks. Policymakers, understandably, emphasize this benefit given the perennial need to finance trade deficits. However, FDI is more than foreign exchange. It is the real benefits of capital, technology and market access that are all important.

The other caveat is that the benefits are not automatic. Profits can be repatriated *or* reinvested. Factories can depreciate *or* be upgraded with new capital equipment and production process. Workers can be labored *or* trained and equipped for productivity growth. Production can be enclave *or* linked to suppliers in the economy. These decisions are made by the investor but can be influenced by policy.

Investment Climate

FDI, being cross-border, gives rise to several regulatory issues: restrictions on foreign entry, ownership, and repatriation of profits and capital; operating requirements for land leases and worker permits; and protection for fair and equitable treatment, intellectual property and from expropriation. The list of issues is longer. The important takeaway is that Pakistan's FDI laws and regulations appear exemplary

yet lack clarity and implementation.

Clarity: There are more than a dozen laws, acts, regulations, ordinances, and policies, with one dating back to 1913. More recent statutes update earlier decrees in part but not in whole. Key policies and regulations are not established in law. This regulatory patchwork conveys a confusing picture of an otherwise conducive investment climate. Discrepancies create a "noticeable difference in the de jure versus de facto investment regime" (states the State Bank of Pakistan). There is need to codify a unified Investment Act.

The latest Foreign Investment (Promotion and Protection) Act, 2022, is driven by expediency rather than clarity. It unblocks the Reko Diq stalemate—which is welcome—and it provides a much-needed framework for federal and provincial governments to work together. However, it introduces the complication of "qualified investment" which includes a few but not most FDI.[8] Qualified investments must be certified by Schedules to the Act, which presumably requires amendment for the addition of new investments. The Act also confuses protection with promotion. While protection encompasses fundamental investor rights that should apply to all investors, promotion involves inducements (like fiscal incentives) for specific types of investments (like mining) that promote particular social objectives (like employment, training) and are usually timebound and linked to performance. The Schedules for the Reko Diq investment itemize dozens of fiscal exemptions without specifying reciprocal investor responsibilities. The incentive package may well be warranted as the project is expected to generate considerable social benefits for Baluchistan and the country. Nevertheless, while the Foreign Investment Act, 2022, has value in underpinning the Reko Diq settlement, it is more patchwork of the FDI regulatory regime. There remains need to codify a unified Investment Act.

Implementation: A patchwork of regulations is difficult to implement.

There are 34 ministries and dozens of authorities, boards, commissions and provincial bodies. Many are involved in investment decisions. Overlapping jurisdictions can dilute authority, delay action or obscure enforcement. Overall coordination is tasked to the Board of Investment (BOI) but its investment policy was formulated in 2013 and needs updating to reflect changes in 10 years.[9] [https://invest.gov.pk/] Moreover, the BOI is attached to the Prime Minister's Secretariat for visibility but that is a handicap whenever there is a leadership turnover in the country. In South- East Asia, governments change frequently but the implementation of investment policy remains constant. This is achieved by separating the operational from the political spheres of decision-making with clear administrative procedures and consistent application across sectors and levels of government. A similar demarcation is needed in the institutional machinery for investment.

An obvious first step is to streamline procedure. There are 1,391 federal, provincial, and local requirements for registration, licenses, certificates and permits to establish and operate a business. The "Pakistan Regulatory Modernization Initiative" is eliminating non-critical requirements as well as simplifying and automating the essential ones; but it is a slow process: only 300 reforms have been completed since 2016. The initiative needs acceleration.

Another step is to rationalize the BOI's functions. As the apex body for policy coordination, BOI should: provide leadership on regulatory modernization; align federal-provincial procedures; and underpin the convergence of trade, industrial and financial policies of the relevant ministries. The Board should disengage from project approvals and administrative matters. In particular, the BOI's investment promotion and facilitation functions should be assigned to a professional "Invest in Pakistan" agency. The latter should work closely with the provincial promotion agencies and other investment promotion staff at home and abroad. They should: adopt seamless single window operations;

provide on-line portals for registration and applications (i.e., work visa, airport entry pass, construction permits, tax rebates and foreign exchange transactions); and maintain up-to-date information systems on investment opportunities. Successful promotion and facilitation require managers to be client-oriented service providers—a skill latent in the most competent civil service officers.[10]

Investment Potential

Pakistan should be able to attract significantly more FDI than the annual $2 billion at present—at least double, even triple—given its market orientation, permissive policy framework and economic fundamentals (natural resources, large economy, abundant labor, and geographic location). The deterrents are security (i.e., risk of terrorism) and infrastructure (i.e., shortage of energy, skills, suppliers) but these can be overcome.

FDI is mainly concentrated in consumer goods and services (see Table 1). FDI in manufacturing dates back to joint ventures in the 1960s. FDI in services surged with the privatization of banking and telecommunications (2006-2008). Currently, there is notable Chinese FDI in infrastructure (power, roads, railways, ports). In the primary sector, investment in the massive Thar coalfield can meet the country's power requirements for decades. A clear priority is to expand the inflow and benefits of these types of investment (i.e., resource and market seeking FDI).

<u>Mining</u>: The Reko Diq "qualified investment" will bring FDI of $7 billion, employ 7,500 workers during construction and create 4,000 jobs when operational in 2028.[11] [https://www.barrick.com/English/news/news-details/2022/massive-reko-diq-project-gets-all-clear-barrick-starts-updating-plans/default.aspx] Baluchistan will earn royalties, dividends, and other shareholder benefits (25%) with zero financial contribution. An initial $3 million has been disbursed to the province with more to

come. There will be broader economy-wide benefits. The project will extract and process copper and gold concentrate for 40 years (valued at $1 trillion), mainly for export. Development of the Thar coalfield in Sindh for domestic power generation could be another transformational project, attracting investment of $1.3 billion annually for over 20 years.[12] However, the opportunity will fade with the approaching 2030 commitment to reduce carbon emissions. There is need for continued federal-provincial cooperation on regulations and joint development efforts to apply technology for green operations.

SEZs: The centerpiece of the BOI Investment Policy is to create industrial clusters with special economic zones (SEZs) that address infrastructure bottlenecks and security concerns. SEZs are effective in attracting FDI, if implemented well.[13] The SEZ Act, 2012, sanctioned the establishment of zones but implementation has been slow. There were amendments to the Act in 2015 and 2016, and an elaborate approval process was instituted that goes up to the Prime Minister. A whole decade later, only 22 zones have been approved. Meanwhile, in the same time period, Bangladesh approved 97 SEZs, with 26 in operation.[14] [https://www.tbsnews.net/thoughts/mobilising-fdi-special-economic-zones-bangladesh-550706] In any event, the 22 zones now approved will attract $1.73 billion FDI[15]—which is sizable considering the $1.84 billion annual net inflows of recent fiscal years (FY2021 and FY2022). The SEZ process needs to be fast tracked and scaled up. The economy can support 200 zones attracting $15 billion FDI.

CPEC: Chinese FDI accounts for the bulk of the annual inflows since 2015 but the inflow has ebbed with slow implementation of the China-Pakistan Economic Corridor (CPEC). Pakistan attracted a third less Chinese FDI than Bangladesh in FY22.[16] The stalled pace of CPEC implementation needs recharging to capitalize upon the concrete results already achieved—specially in new power generation capacity—

and to be able to ride out the bulge in capital outflows stemming from loan repayments and remittance of profits and dividends on past investments (estimated by the IMF at $4 billion in 2024). There is need to reinvest future outflows as new inflows. The CPEC Long-Term Plan should be revitalized.[17] [https://cpec.gov.pk/long-term-plan-cpec]

Reinvestment: FDI, being a business, earns profits and pays out dividends to shareholders; but FDI is also a business of a long-term character where profits tend to be reinvested rather than repatriated—provided there are opportunities to expand and grow. In FY21, there were FDI inflows of $3 billion and outflows of $1.2 billion resulting in net inflows of $1.8 billion. However, had the outflows been reinvested, then net FDI inflows would have increased by a third to ($1.8 billion + $1.2 billion=) $3 billion.

Reinvestment, then, has a positive macro impact on capital inflows and, more importantly, a positive stimulus at the micro level. Sequential investment might expand the product line, increase employment, train workers, upgrade production technology and share know-how with suppliers, as evidenced in the food and beverage industry (e.g., Nestlé). Or, the reinvestment could be in related industries (e.g., from power generation to power distribution), or in different industries as some legacy FDI have matured into locally-managed conglomerates (e.g., Engro). In these ways, reinvestment can stimulate productivity, backward and forward linkages and economic spillovers within the larger economy— provided there are opportunities for profit and growth. Provincial investment promotion agencies should facilitate reinvestment. There are best practices to emulate (i.e., maintaining constant contact with existing investors, helping them find domestic suppliers, developing stakeholder interaction on shared value and responsible business practice, and encouraging collaboration with other institutions).[18] Reinvestment is a priority as investors are inclined to divest in a stagnant economy (e.g., Telenor, the second

largest mobile digital communications company in Pakistan, is reportedly ceasing operations of $1 billion).

Privatization: In 2006, the privatization of Pakistan Telecommunication Company Ltd (PTCL) attracted FDI from UAE in a $2.6 billion acquisition by Etisalat (U.A.E.) of a 26% stake and management control. The deal, along with licenses to other foreign and domestic operators, modernized landline and telegraph services with digital technology (cellular telephones, data messaging, mobile financial transactions, high speed Broadband Internet, wireless Internet, television streaming, video conferencing and fiber networks). Digital connectivity, in turn, sprouted information-technology enterprises (e.g., call centers, computer programming subcontractors, gaming sites and others). Productivity in the banking sector rose with the infusion of technology and know-how after privatization. Privatization of manufacturing in the 1990s revived the automotive parts industry and enabled localization of motorcycle and car assembly. In contrast, the pending privatization of Pakistan Steel Mills has amassed inefficiencies and impeded the engineering sector.

Privatization needs to be done with care to avoid a fire sale and to conduct open bidding in consultation with stakeholders. Privatization should cut losses and infuse fresh capital and technology. It is important that privatization brings pecuniary and real benefits. However, the opportunity cost of undue caution is high. An inter-ministerial committee has finally unblocked the pending $1.77 billion offer of 2016 by Shanghai Electric Power to acquire majority shares in K-Electric—a private company—after a delay of more than six years of an investment that will improve the distribution of electricity in Karachi. There are some 20 ongoing cases with the Privatization Commission. There are other State-owned enterprises that warrant consideration.[19] [https://devpakblog.com/2022/06/07/the-future-of-state-owned-enterprises-in-pakistan/] The process could be

accelerated with a more accommodating judiciary.

PPPs: The complement of privatization is public-private partnerships (PPPs). Whereas privatization refers to divestment of State assets (through brownfield investment), PPPs provide for private investment in new (greenfield) projects that would normally be in the public domain (e.g., infrastructure). PPPs can leverage private capital, technology and skills in financing and managing public projects (e.g., by build-operate- transfer BOTs). PPPs have attracted some $17 billion FDI (1990-2019). However, PPPs should be transparent in ensuring value for money and apportioning rewards and risk equitably. The early partnerships in the energy sector were overly generous to the independent power producers with off-take guarantees to purchase their output that could not be afforded by the public-sector distributors, compiling the circular debt.

Partnerships cut across levels of government. There is need for coordination between provincial constitutional authorities and federal responsibility for national infrastructure (i.e., power, roads, rail). Most PPPs have been provincial. Federal regulation is recent, with the PPP Policy in 2010 and the Public Private Partnership Authority Act of 2017. However, the federal framework does not encompass projects approved by the provinces.

There is also need for coordination at the federal level: in 2017, the Pakistan Civil Aviation Authority (PCAA) invited partnership proposals for outsourcing the operation, management, and development of the Islamabad, Lahore and Karachi international airports but the Privatization Commission saw the proposal as its jurisdiction. Six years later, the matter has now passed to the Public Private Partnership Authority. There is a backlog of 56 projects at various stages of preparation of which only one has been completed. The process needs speeding up.

Investment for Trade

Pakistan is more attractive to market-seeking FDI than to export-oriented FDI. The latter prefer locations with skilled workers, industrial suppliers, good infrastructure, and efficient trading facilities. In these respects, Pakistan ranks low on international benchmarks—behind Bangladesh, India, Sri Lanka and Viet Nam. Nevertheless, market-seeking FDI can be leveraged for trade.

Some 80% of world trade involves multinational corporations, half of which are linked with global value chains (GVCs).[20] Their operations are increasingly fragmented into high- and low-value segments that are distributed globally and integrated through intra-company trade. In these GVCs, low-value segments are located at the lowest-cost sites. Parent companies focus on design, branding and marketing in their lucrative home market, while their affiliates are low-cost suppliers (to other affiliates) and also sellers in the local market. Pakistan's large domestic market can be leveraged to attract these low-cost affiliates at the entry level of the value chain.

Market-seeking and export-oriented FDI are not separate activities but a continuum. FDI may enter to produce for the large domestic market. In time, after gaining competence in the domestic market, foreign affiliates reposition to expand into the regional market and participate in the parent company's global value chain. The affiliates transpose their standalone operations, upgrading on the productivity of domestic suppliers and, in turn, providing an export channel for domestic suppliers.

Attracting FDI in low-cost, low-value production may be unappealing but the advantages are threefold. First, it is simpler to manufacture components than an entire product. Second, it is easier to market exports through an intra-company network than on the world market. Third, the more dynamic affiliates can move up the value chain, and

even innovate new products under their own brands.

China became the "factory of the world" through low-cost assembly and has moved up the value chain, relocating manufacturing to Viet Nam, Bangladesh and—potentially—to Pakistan. Viet Nam attracted FDI in low-cost assembly and packaging operations to become the world's third biggest exporter of smartphones designed by Samsung in Korea with high-tech components made in Korea, Taiwan, China and the U.S.

Entry into GVCs may also take the non-equity form of FDI, where multinational corporations subcontract domestic enterprises to manufacture for their global brands. The SME industrial cluster of Sialkot manufactures sports equipment for Adidas and Nike. Bangladesh is the world's second biggest exporter of garments made for global retailers with imports of Pakistani cotton fabric and yarn. Pakistan also exports garments to global retailers but the trade share of GVCs (33%) is less than that of other countries (India, 40%; Bangladesh, 49%; Viet Nam, 57%).

There is scope for increased participation in GVCs. The more dynamic firms in the clothing industry have upgraded from providers of fabrics to makers of cut and trimmed components, and a few are at the higher value stages of branding and design. Other possibilities include diversification of the Sialkot surgical instruments cluster by upgrading manufacture to upscale segments of GVCs (i.e., production of disposable items, medical textile items, therapeutics and implantable devices). The value chain in the automotive cluster involves exporting parts, complex components and vehicles. Enterprises in the growing information and communication technology (ICT) sector can increase presence in global offshoring.[21] [https://www.sbp.org.pk/reports/quarterly/fy20/First/Special-Section-1.pdf]

However, moving up the value chain is not easy. Production has to be manufactured to specification and delivered on schedule. Success depends less on low wages and more on skilled workers. Also, external factors—suppliers, infrastructure, trading facilities—can constrain or enhance upgrading. If the total costs of doing business are high, countries may find themselves uncompetitive in the industries in which they should otherwise have comparative advantage. The government can facilitate.

Targeting: The government can promote FDI in industries with potential for learning, scale economies and productivity growth (i.e., light engineering, manufacture of appliances, assembly of vehicles, and services). Malaysia started with FDI in assembly manufacturing with low-tech domestic content, targeting electronics and electrical industries that were fast growing manufactures in world trade in the 1970s. Initially, foreign affiliates imported parts and exported assembled components within the corporate supply chain. But over time, the foreign affiliates upgraded technology and increased local linkages. Today, exports are 65% of Malaysia's GDP, and 52% of those exports are high-technology. Malaysia, like other East Asian economies, pursued active policies to foster industrial capability (i.e., public investment in skills, technology and infrastructure).

SMEs: The categorization of large FDI as "qualified investment" neglects the role of small and medium-size enterprises (SMEs) as the main suppliers in GVCs. SMEs are entrepreneurial but lack business skills, technical knowhow and startup finance. These constraints can be alleviated with relatively little cost and in cooperation with international organizations and donor agencies of trading partners. Promising donor initiatives include the American USAID technology transfer grants to SMEs with potential to attract FDI and increase Pakistan-U.S. bilateral trade and the Japanese JICA technical support program to improve the quality and productivity of domestic suppliers in the automotive value chain. Domestic initiatives include

benchmarking of productivity in the garments, surgical goods and football sector by the Innovation and Technology Center of the Lahore School of Economics, which has devised a subsidy scheme to help Sialkot football manufacturers overcome the high cost of imported cloth-like leather (rexine).

Pakistan's static trade structure—the same exports to the same markets—needs revitalization. A first step is to expand existing exports: market analysis suggests that sales of the top 10 products can be increased by an additional $23 billion.[22] [https://intracen.org/] Some $10 billion can be tapped if regulatory, procedural and other frictions are overcome. A second step is to diversify exports within the existing industrial base (i.e., dried fruit and vegetables; prepared fish and shrimp; apparel with synthetics; parts for consumer goods). Enterprises can diversify by upgrading production but tariffs deter the import of materials.

Another hurdle is non-tariff barriers.[23] [https://intracen.org/resources/publications/invisible-barriers-to-trade-pakistan-business-perspectives] Tariffs are 66% lower for the European Union GSP+ market but documentary requirements are higher. Enterprise surveys cite difficulty in complying and certifying with the technical requirements for export. Agri-food products must meet quality and safety measures. Technical regulations affect textiles, clothing, leather products, surgical instruments and sports goods. Exporters say it is harder to prove compliance with the regulations than to comply with them. Domestic certificates are not recognized internationally. These barriers are insurmountable by SMEs. Support includes business guides such as those funded by the European Union and ILO assistance in compliance with worker conventions. The government should also avail the various technical assistance programs of international organizations for entrepreneurship development, SME training and preparing suppliers to form linkages with foreign affiliates.

The Small and Medium Enterprises Development Authority (SMEDA), established in 1998, needs to be a more operational business facilitation service.

Technology: There is a vast policy and institutional infrastructure that can support export competitiveness. The institutions are of varying capability but their functions are important. The technology ecosystem comprises some 200 institutes and research organizations. There are councils for agriculture research and appropriate technology, and institutes for electronics, silicon technology, cotton textile, fertilizer, and cement. Yet, these industries have low productivity and low-technology exports. A major effort is needed to revitalize the technology sector as a business services provider to enterprises for learning new skills, and absorbing, adapting and mastering technology. The effort requires a "whole of government" approach aligning the trade, industrial and financial policies of the relevant ministries.

Conclusion

To sum up, Pakistan has potential to attract significantly more FDI than at present. Increased FDI would sustain capital inflows without adding to external debt. It would help grow the productive economy, modernize industry and diversify exports. This is possible despite political uncertainties and economic difficulties.

Political uncertainty is a reality for all countries and need not be a deterrent as long as regulations do not change when governments do. To safeguard stability, regulations should be established in law and administered with standardized procedure. Investment opportunity should not be contingent on who runs the country.

Economic difficulty is a catalyst for change. The 1991 reforms that transformed the Indian economy were launched on the brink of default. The imminent threat of a $11 billion penalty expedited the Reko Diq

settlement, for which the previous and current administrations both claim credit. The expediency of federal-provincial interaction should advance other mining projects, and Gwadar and other SEZs. Judicial pragmatism should ease the restraint on the processes for privatization and public- private partnerships. Federal-provincial-judicial cooperation can unblock the pipeline of pending and incomplete projects. Transparency and stakeholder consultation can be managed in ways that do not unduly impede completion.

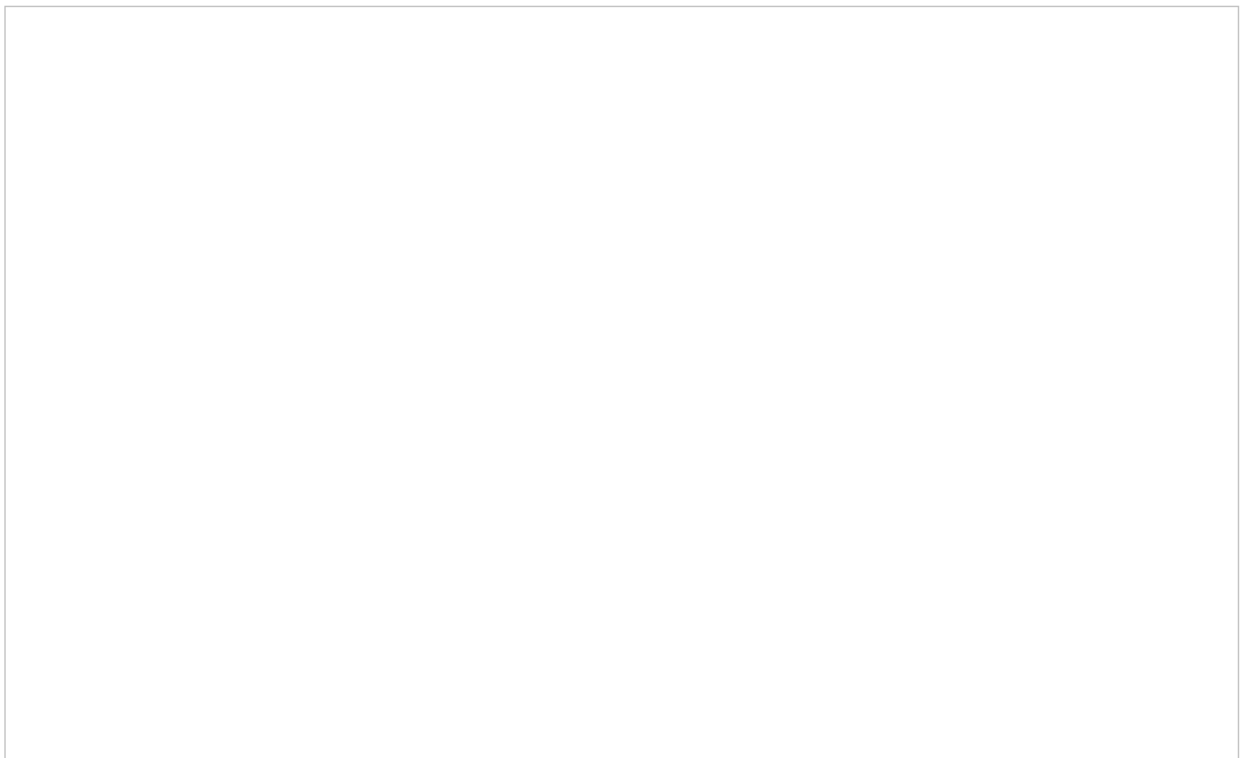
The relationship between government and industry needs a reset. The economy is private-sector led but overregulated. The government should expedite the "Regulatory Modernization Initiative" and make it easier to do business—*Asaan Karobar*. Government agencies should be client-oriented service providers with single window operations for submitting and tracking registration, permits, licenses, claims, payments, refunds, customs clearance and other services. SMEDA should provide greater support to women-led enterprises. All provinces should run entrepreneurship development programs. A vibrant private sector projects an attractive investment climate.

Within the government, there is need for effective policy coordination. The BOI has mandate and machinery to coordinate investment policies with other government departments and agencies at federal and provincial levels. The Board's executive committee includes the private sector, key ministries and all provinces. The BOI is ideally equipped yet it can be more effective. The BOI should focus on core issues: regulatory modernization, federal-provincial coherence, and the convergence of trade, industrial and financial policies. The Board should disengage from project approvals and administrative matters. The BOI's investment promotion and facilitation functions should be assigned to a professional "Invest in Pakistan" agency.

Finally, the government should fast-track Vision 2030. Development plans and industrial policy have lost their shine but there is a role for

long- term strategy to dispel the short-term narrative of imminent collapse. The current hardships are real and IMF conditionality is painful but the prospect is also substantial. A renewed commitment on FDI may be born out of adversity but should be sustained for Pakistan to be an upper middle-income country in 2030.

Table 1. FDI in Pakistan (total stock, 2017)



Source: International Trade Centre (www.investmentmap.org).

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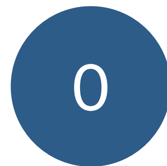

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