



Channelizing FDI Towards Real Economy

F D I

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Policy Advisory Board

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Acronyms

ADR	Alternate Dispute Resolution	KWh	Kilo-Watt Hour
B2B	Business-to-Business	MNC	Multinational Corporations
BOI	Board of Investment	NDFC	National Development Finance Corporation
CIT	Corporate Income Tax	ODA	Official Development Assistance
CPEC	China-Pakistan Economic Corridor	OICCI	Oversees Chamber of Commerce and Industry
EODB	Ease of Doing Business	PICIC	Pakistan Industrial Credit and Investment Corporation
EPZ	Export Processing Zones	PIDC	Pakistan Industrial Development Corporation
EZ	Economic Zones	PIT	Personal Income Tax
FDI	Foreign Direct Investment	PPP	Private-Public Partnership
GDP	Gross Domestic Product	PTCL	Pakistan Telecommunication Company Ltd.
CGE	Global Trade Analysis Project	REIT	Real Estate Investment Trust
GVC	Global Value Chain	SEZ	Special Economic Zones
HH	Household	SME	Small and Medium Sized Enterprises
HTZ	High-Tech Zones	UNCTAD	United Nations Conference on Trade and Development
ILO	International Labor Organization	USD	United States Dollar
IPR	Intellectual Property Rights		
IZ	Industrial Zones		

Executive Summary

Foreign Direct Investment (FDI) accelerates economic integration and regional cooperation among world economies. It is a source of technology transfer and helps develop new corporate entities and human capital formation. Foreign investors in Pakistan have been investing in consumption-oriented sectors with a large domestic market and guaranteeing high rates of return. Export-oriented sectors have attracted the least interest of foreign investors owing to the high cost of doing business, inconsistent government policies, inefficient regulatory framework, law and order situation, and variable return to investment.

An empirical assessment of the impact of technology-driven FDI on existing and priority sectors revealed that technology upgradation in the priority sectors such as food and beverages, light manufacturing exerts the highest positive growth in real GDP followed by heavy manufacturing, textiles, refined petroleum, chemicals and rubbers, and metals. Technological upgradation in each sector is likely to increase its exports from existing levels with a major increase in light manufacturing (67.7%), metals (52.6%), heavy manufacturing (37.7%), textile (33.3%), and chemicals and rubber (15.1%). Similarly, their respective imports from the world will also decline, with a major decrease in light manufacturing (23%), metals (12%), textiles (12%), and heavy manufacturing (8%). All these sectors are reliant on foreign inputs. Thus technological upgradation will result in a reduction in their imports.

Foreign Direct Investment driven through technology upgradation of the existing sectors such as power, financial business, retail trade, and communication enhances real GDP more than the manufacturing sector. However, the average import increase by all other sectors is more profound when the communication sector and retail trade experience technological change. Increasing the technological efficiency in demand-oriented sectors will drive imports more on average as compared to manufacturing and export-oriented sectors (Refined petroleum, Textile, Chemical & Rubber, Leather, Heavy Manufacturing, Light Manufacturing, Metals, Extraction, Food and Beverages). Manufacturing and export-oriented sectors, on average, drive imports up by 1.64%, while power, financial & business, communication & retail trade increase imports by 10.08%. Similarly, CGE simulation also revealed that manufacturing and export-oriented sectors such as Refined Petroleum, Textile, Chemical & Rubber, Leather, Heavy Manufacturing,

Light Manufacturing, Metals, Extraction, Food and Beverages on average decreased trade deficit by 1.32% while retail trade, communication, and financial business increase trade deficit by 5.53%.

The study concludes that manufacturing and export-oriented sectors need to attract foreign investments. Foreign investors' outlook explains that their priorities have market-seeking behavior and are skewed towards a few sectors. To channelize efficiency-seeking FDI towards the real economy government should enhance its focus to provide an enabling environment, reduce the cost of doing business, de-regulate, and create a level playing field for all stakeholders. To increase market competitiveness, efficiency-based and time-bound incentives should be given to foreign investors. Domestic investment stimulates foreign investment. There is a need to redirect the flow of funds from sectors whose productivity levels are derived from speculation activities rather than real production. Some recommended measures are taxing the real estate, reviving PIDC, PICIC and NDFC institutions, and initiating industrial development programs through schemes such as REMIT.

Special Economic Zones (SEZs) should be developed within the stipulated time frame. For investment in new and existing economic zones, preferential tax policies and incentives should be tied with the phases of investment growth and the SEZs' location. SEZs close to seaports and developed cities should be incentivized less than those in underdeveloped areas. Investors operating in SEZs may need to be positive net foreign-exchange earners and are not subject to any minimum value addition norms or export obligations. SEZ investors may retain 100 percent foreign-exchange receipts in Exchange Earners' Foreign Currency Accounts.

Pakistan should initiate a resilient value chain drive, 'Made in Pakistan,' to support backward and forward linkages. The lack of comprehensive sector-specific investment policy and ad-hoc economic decisions has eroded industrial competitiveness significantly. It is recommended that sectors including petrochemicals, light & heavy engineering, minerals & mining, chemicals, and food processing should be prioritized in the investment policy. Investment policies should be coherent with national industrial policy with sector-specific development goals. The policy should include monitoring and evaluation indicators. Lastly, entrepreneurial culture and risk-taking behavior to export and serve beyond the domestic market need to be revived in Pakistan.

1. Foreign Direct Investment: A Brief Overview

Foreign direct investment (FDI) is an important determinant of economic growth and development for host and home countries. FDI accelerates economic integration and regional cooperation among different regions of the world. It is a source of technology transfer and helps develop new corporations and human capital formation. FDI harmonizes and strengthens domestic markets to meet the challenges posed by global business standards. However, the positive impact of FDI is subject to the quality of FDI and the investor's motivation to invest in any host country. John Dunning (2008)¹ broadly highlights four types of foreign investment motives of investors to invest in any host country: market-seeking, natural resource-seeking, strategic asset-seeking, and efficiency-seeking.

Market-seeking motive is derived from market size, growth, purchasing power, and investors' access to regional markets. Natural resource-seeking FDI aims for natural and human resources for any host country. Efficiency-seeking FDI aims to reduce the cost of production of firms that can create competitiveness in the production process. Investors seek markets that can reduce their cost of production in terms of labor and technology, have long term plans to invest, and serve the regional and global market. The quality of FDI matters for the host country. The quality of FDI depends upon its ability to stimulate domestic investment, which creates competition, promotes innovation and transfers technology, and builds supporting industry in the host country.

1.1 Foreign Direct Investment Outlook: Global

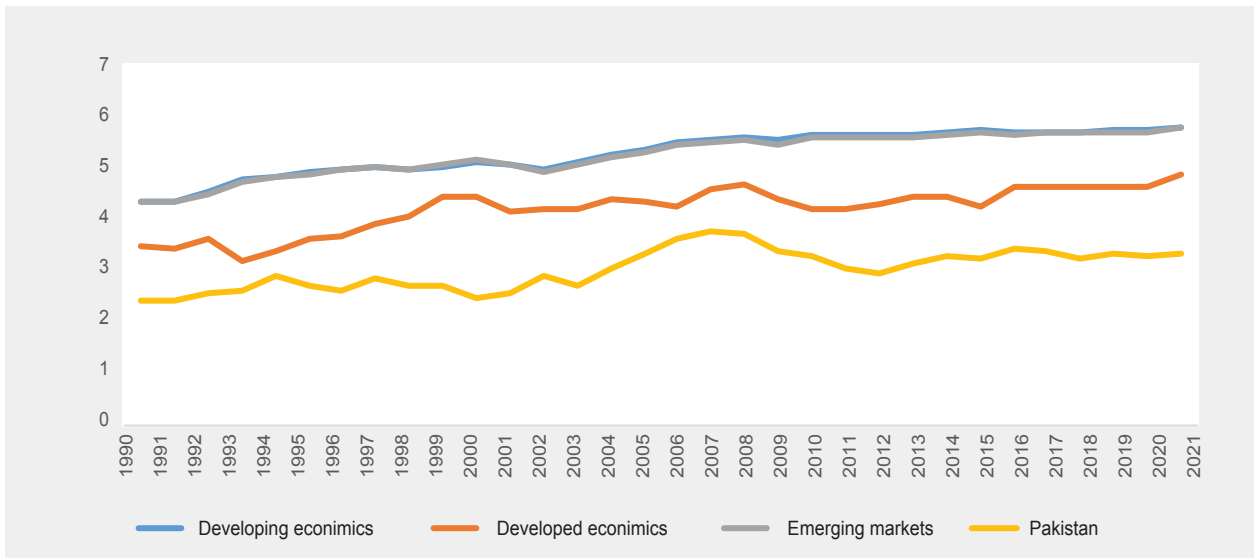
Global FDI flows squeezed amid the pandemic in 2020. The Russian-Ukraine War led to input price hikes and disruption in the global supply chain. The risk-averse behavior of investors in the post-pandemic global recession and the past global financial crisis of 2008 indicates the negative spillover effect of global uncertainty on FDI flows.

Developed countries experienced a fluctuating trend in FDI inflows and were mainly hit by the major financial crisis and recessions. Interestingly, in the post-global financial crisis era, the share of developing and emerging economies in global FDI inflows increased considerably. However, due to quantitative easing in crisis-hit countries, FDI in developed countries rebounded. Low cost of production coupled with developing and emerging economies' specialization in the value chain re-directed investors to these markets.

In developing and emerging economies, FDI inflows have been rising since 1990, with a slight decrease in 2008 and 2020 due to the global economic recession. However, the conducive environment for investors in these economies has led to a convergence in the level of FDI inflows (see figure: 1.1). Pakistan FDI inflows remained far below the developing, developed and emerging markets average (see figure: 1.1).

¹Dunning, J. H., & Lundan, S. M. (2008). *Multinational enterprises and the global economy*. Edward Elgar Publishing.

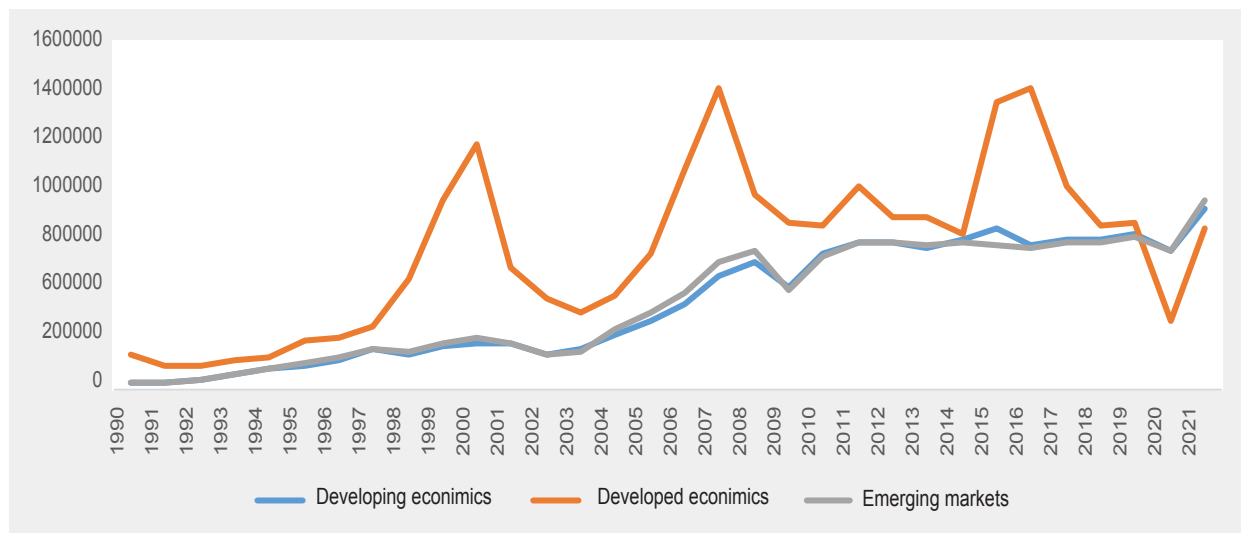
Figure 1.1: FDI Flows Across Different Income Countries



Source: United Nations Conference on Trade and Development, UNCTAD stat. 2022

FDI inflows also vary across world regions. In the post-global financial crisis of 2008, the FDI inflows inclined more toward Asian countries. In 2008, America and Europe attracted 66 percent of global FDI inflows. However, in 2021 Asia received 45 percent of global FDI inflows, with America and Europe making 50 percent. Africa has a share of 5 percent in global FDI inflows. According to UNCTAD, in 2021, North America's growth in FDI was explained by cross-border sales of MNCs through mergers and acquisitions.² While east Asian economies received FDI based on global value chains (GVCs). Globally, the renewable energy sector attracted a renewable capital investment of USD 202 billion, followed by communication (USD 120 billion) and semiconductors (USD 117 billion) (see figure: 1.3)

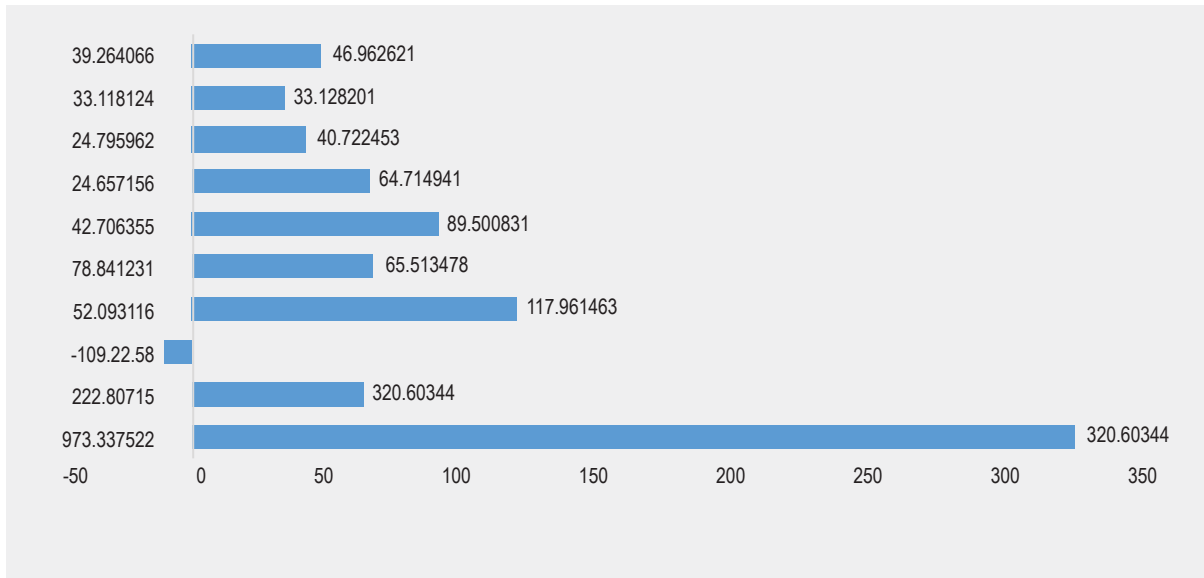
Figure 1.2: FDI Inflows Across Regions (Values in USD Millions)



Source: United Nations Conference on Trade and Development, UNCTADstat. 2022

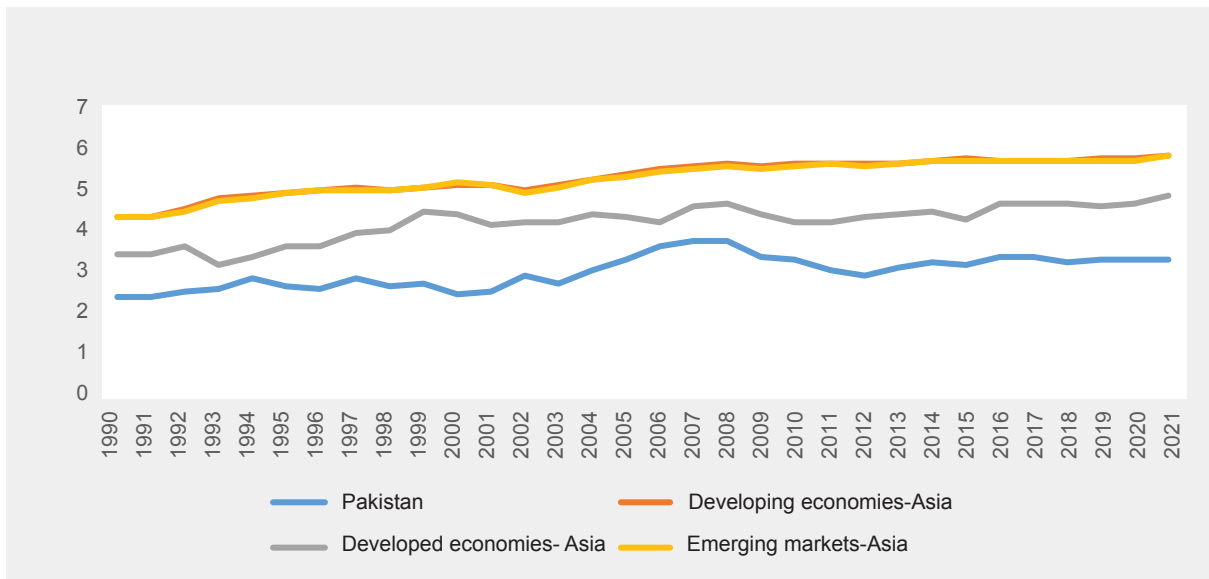
²World Investment Report, 2022, UNCTAD

Figure 1.3: Top 10 Sectors by Capital Investment



Source: FDI Markets (www.fDimarkets.com)

Figure 1.4: FDI inflows Across Asian Economies



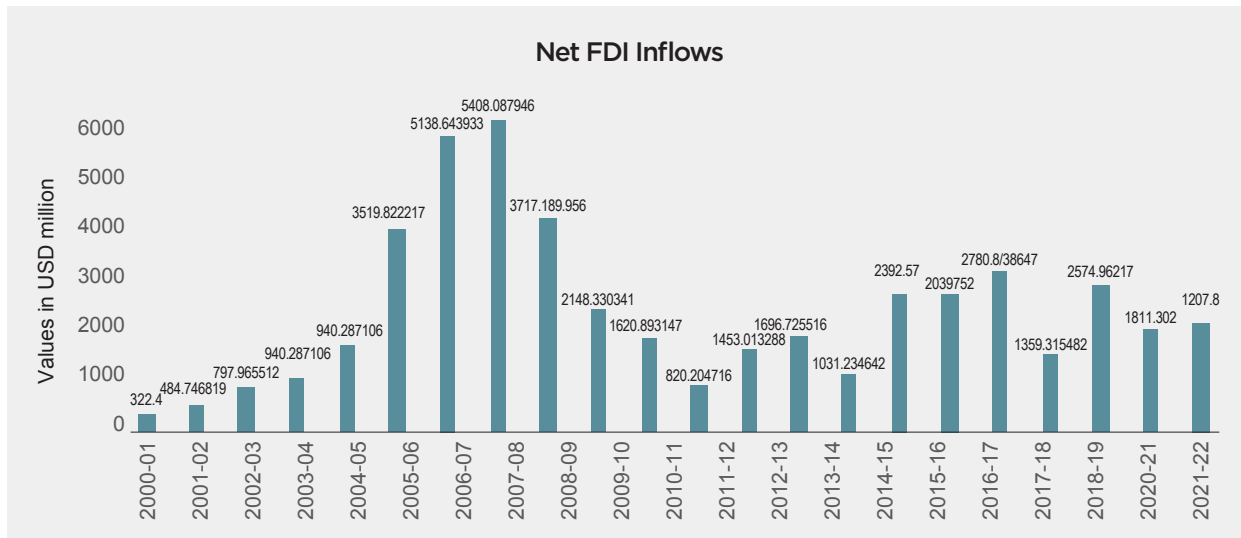
Source: United Nations Conference on Trade and Development, UNCTAD stat. 2022

The developing and emerging markets within Asia are attractive destinations for FDI inflows (see Figure: 1.4). Top six Asian economies having a significant share in global FDI inflows include; China, India, Singapore, Hong Kong, United Arab Emirates, and Indonesia. The primary sectors attracting FDI in China include semiconductors, services, and high-tech industries. In 2021, Singapore and Malaysia attracted investment in chip-making semiconductors, and UAE attracted investors in solar energy projects. India announced 23 renewable energy projects with a Japanese company investing in the construction of steel and cement plants. Pakistan’s FDI inflows remained far below the region’s average (see Figure: 1.4).

1.2 Foreign Direct Investment Outlook: Pakistan

Pakistan initiated market reforms and liberalization policies in the 1990s to integrate into the world market. Pakistan’s net inflows of FDI remained consistently low in the past few decades, with an average FDI of USD 2 billion. The highest-ever FDI received was USD 5.4 billion in 2008 (See figure: 1.5).

Figure 1.5: Inflow of Foreign Direct Investment (Values in USD Millions): Pakistan



Source: State Bank of Pakistan

USA, China, European, and East Asian countries are the major contributors to Pakistan’s total FDI. The percentage share of the countries tends to vary with geopolitics and domestic policies. Pakistan adopted a liberalized investment regime by privatizing and deregulating major sectors. During the military regime in Pakistan and the Afghanistan War over 2003-08, the USA, UAE, and the UK invested the most in value (See table: 1.1). The amount invested by these countries was the highest ever Pakistan received so far. China was the 9th major contributor to Pakistan’s total FDI in the same regime.

In the Pre-CPEC and under the democratic government regime (2009-2014), with the existing investment policies, the amount of FDI from the USA, UK., and UAE slashed to half the numbers that were contributed earlier. China became the 3rd largest contributor to Pakistan’s total FDI.

In the post-CPEC period, China made the highest-ever investment in Pakistan in value and percentage share in the total FDI, followed by the U.K., Hong Kong, Netherlands, and Norway. USA and UAE’s share in Pakistan’s total FDI decreased to 4% and 3%, respectively. The table below also highlights the geopolitical influence in attracting FDI, irrespective of the policies adopted by Pakistan to attract investors.

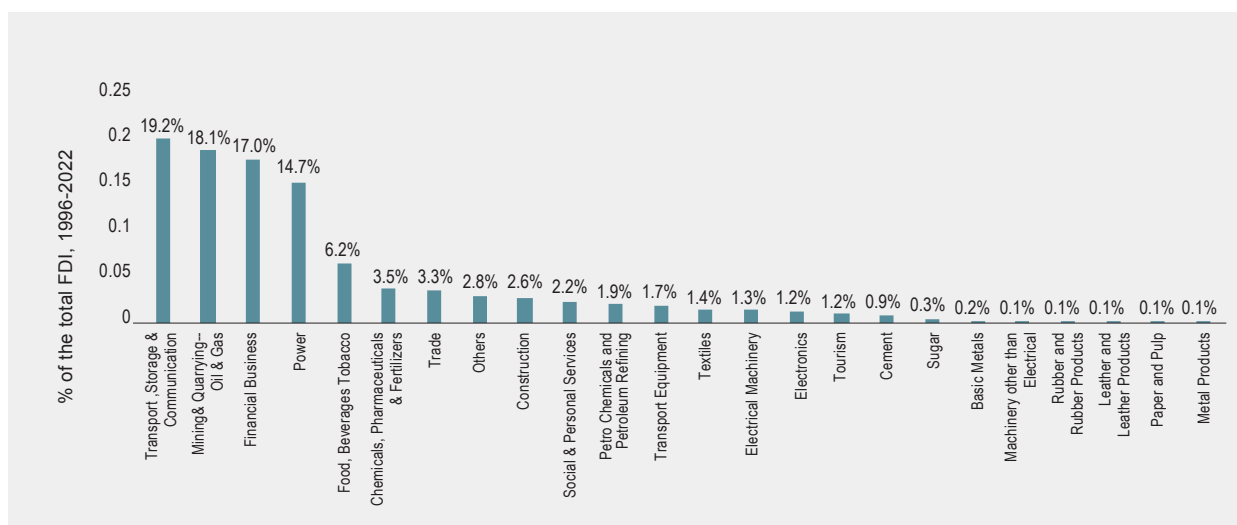
Table 1.1: Country-wise Foreign Direct Investment Inflows (USD Millions & Percentage of The Total)

Rank	Country	2003-2008 USD million	% in total FDI (2009-2014)	Country	2009-2014 USD million	% in total FDI (2009-2014)	Country	2015-2021 USD million	% in total FDI (2015-2021)
Afghan War (2003-2008)			Pre-CPEC (2009-2014)			Post CPEC (2015-2021)			
1	U.S.A.	4,174	23%	U.K.	1,667	21%	China	4,852	37%
2	U.A.E	3,355	19%	U.S.A.	1,597	20%	U.K.	1,117	9%
3	U.K.	2,074	11%	China	1,297	17%	Hong Kong	1,012	8%
4	Netherlands	1,107	6%	Hong Kong	823	11%	Netherlands	887	7%
5	Switzerland	1,085	6%	U.A.E	775	10%	Norway	685	5%
6	Mauritius	935	5%	Switzerland	763	10%	U.S.A.	577	4%
7	Malaysia	886	5%	Italy	613	8%	U.A.E	406	3%
8	Norway	832	5%	Austria	201	3%	Switzerland	386	3%
9	China	641	4%	Australia	200	3%	Italy	369	3%
10	Hong Kong	591	3%	Japan	191	2%	Malaysia	322	2%

Source: State Bank of Pakistan

1.3 Sectoral Analysis of Foreign Direct Investment in Pakistan

The current section examines the FDI received by different sectors of the economy since 1996, when Pakistan moved towards liberalized investment regime. Foreign investors' priorities have been skewed towards a few sectors for almost three decades. The Telecom sector captured the largest share of total FDI received in Pakistan, followed by mining, oil and gas exploration, financial business, power, and food (See figure: 1.6). All other sectors, such as petrochemicals, electronics, electrical machinery, plastics and rubber, metals, leather, textile were unable to attract foreign investors as their share in the total FDI remained stagnant around 2 to 3 percent. Utilizing natural resources and serving the domestic market were the key motives of foreign investors in the past. Return on investment, sectoral policies, domestic investment, and the local business environment also define investors' choice to invest in any host country.

Figure 1.6: Share of Foreign Direct Investment in Various Sectors, 1996-2022

Source: State Bank of Pakistan

Pakistan's liberalization and deregulation policy in the energy, telecom, banking, and insurance sectors paved the way for private sector investment. In early 2000-09, Pakistan attracted sizeable FDI in telecommunications, financial business, mining sector & quarrying, retail trade, and food, beverages tobacco. The total amount of FDI in the era 2000-09 received by the telecom sector was USD 7.5 billion, followed by the financial business, which attracted USD 4.5 billion. Mining and quarrying received an FDI of USD 3.3 billion. Retail trade and food & beverages sectors received FDI of USD 808 million and USD 892 million, respectively.

Post-2008, FDI registered a sharp decline, specifically in financial business and telecom sectors; however, it rebounded in 2013-14 with the China-Pakistan Economic Corridor (CPEC) and favorable power sector policy for investors. In 2014-18, the power sector (30%³), financial business (15%), mining (14%), food, beverages, and tobacco sector (10%) attracted significant investment share.

In the post-CPEC period, Pakistan's average investment remained around USD 2 billion. The following table indicates foreign investors' priority sectors since 2016.

Table 1.2: Percentage Share of Foreign Direct Investment in Pakistan (Sector-Wise)

Consumer Goods						
Sectors	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Food, Beverages & Tobacco	25.61%	4.20%	9.90%	1.51%	2.14%	1%
Capital Goods						
Basic Metals and Metal Products	0.23%	0.14%	0.98%	0.21%	0.02%	0.08%
Machinery	1.12%	0.08%	0.02%	0.01%	0.00%	0.01%
Electrical Machinery	0.28%	0.80%	12.09%	5.96%	6.30%	5%
Electronics	6.06%	1.50%	3.19%	1.10%	1.97%	2%
Chemicals & Fertilizers	-0.19%	2.33%	12.24%	2.28%	1.03%	2%
Transport Equipment	2.00%	0.70%	8.30%	2.09%	0.97%	1%
Manufacturing						
Power	29.77%	42.41%	-23.83%	29.73%	50.33%	39%
Mining & Quarrying	6.24%	13.40%	24.96%	12.14%	12.58%	10%
Petro Chemicals & Petroleum Refining	7.82%	2.15%	0.92%	0.01%	-3.03%	-0.01%
Paper & Pulp	-0.05%	0.00%	0.02%	0.00%	0.05%	-0.08%
Leather & Leather Products	0.01%	0.14%	0.26%	0.10%	-0.01%	-0.04%
Services						
Construction	0.35%	1.45%	5.16%	0.81%	1.71%	1%
Trade	1.36%	5.16%	5.61%	1.68%	6.40%	4%
Tourism	6.80%	2.05%	2.95%	-0.06%	-5.17%	1%
Transport, Storage & Communication	-2.78%	4.65%	-0.74%	27.06%	7.62%	8%
Financial Business	12.36%	14.40%	21.07%	10.67%	13.05%	21%

Source: State Bank of Pakistan

³Percentage share of the sector in total FDI from 2014-18 in the parenthesis

Despite having a liberalized investment policy regime, Pakistan is unable to attract a sizeable share of foreign investments. Existing literature and OICCI's latest survey highlighted several factors responsible for Pakistan's low foreign investment rates, such as; inconsistent government policies, poor infrastructure, the presence of the informal sector, low implementation of intellectual property rights, lack of harmonization of rules between the provincial and federal government, and weak dispute resolution mechanisms.

Subsequent sections analyze the trend in sectors that were successful, lagging and potential sectors for FDI that can build Pakistan's industrial base has been examined.

1.3.1 Net FDI Inflow Attracting Sectors

The major FDI-attracting sectors were power, financial business, food and beverages, and transportation equipment. On average, FDI in the power sector increased from 10 to 20 percent in the past two decades, while its contribution to the overall FDI reached 50 percent in 2020-21(see Figure 1.7). The cumulative total FDI received by the power sector in the past two and half decades stood at USD 7 billion (1996-2022).

Financial business FDI increased from 10 to 16 percent in the past two decades. In 2007-08, its contribution to total FDI reached 34 percent (see Figure 1.7). Interestingly, this was a period when the global financial crisis emerged. The cumulative total FDI received by the financial business is USD 8.1 billion, making it the second-highest sector to receive foreign investment (1996-2022).

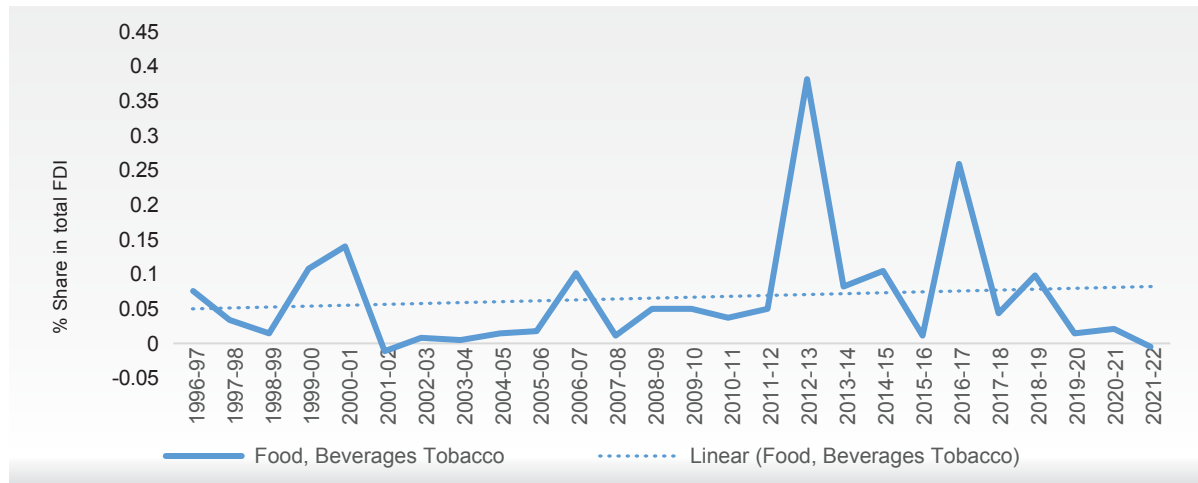
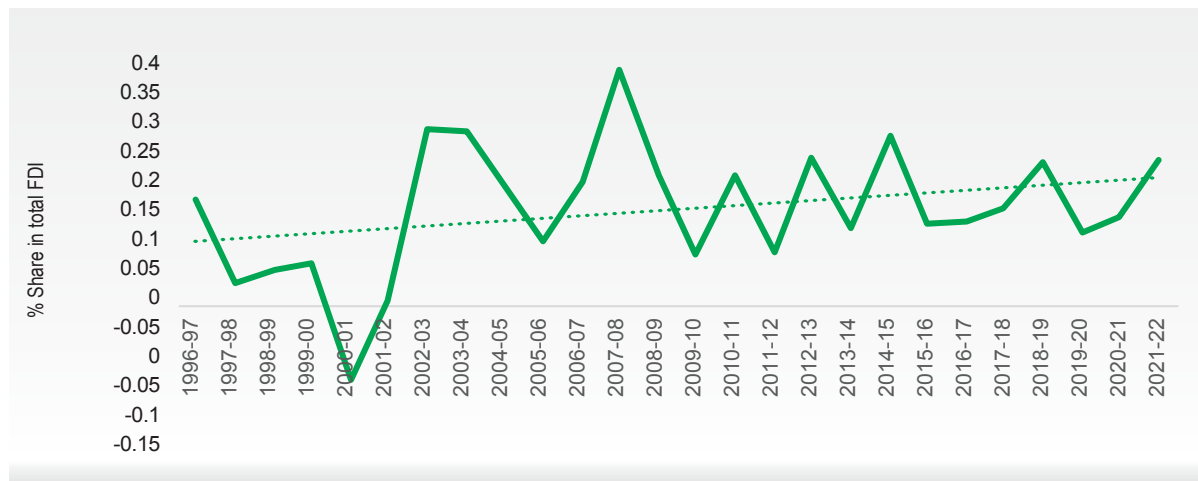
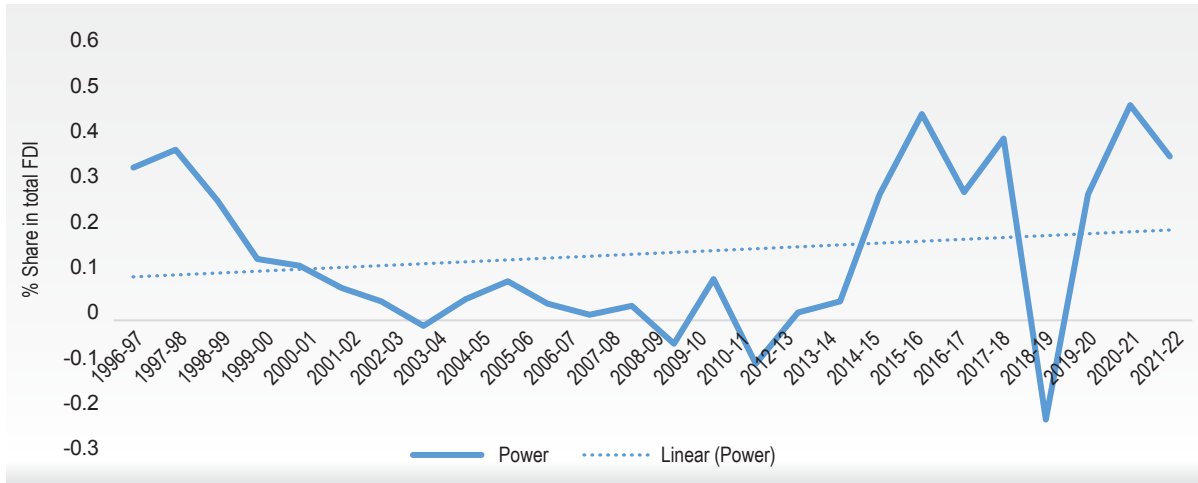
In the past two decades, the food, beverages, and tobacco sector FDI increased its average from 5.0 to 6.8 percent. In 2012-13, its contribution to total FDI reached 38 percent (see Figure 1.7). The cumulative total FDI received by this is USD 2.9 billion (1996-2022).

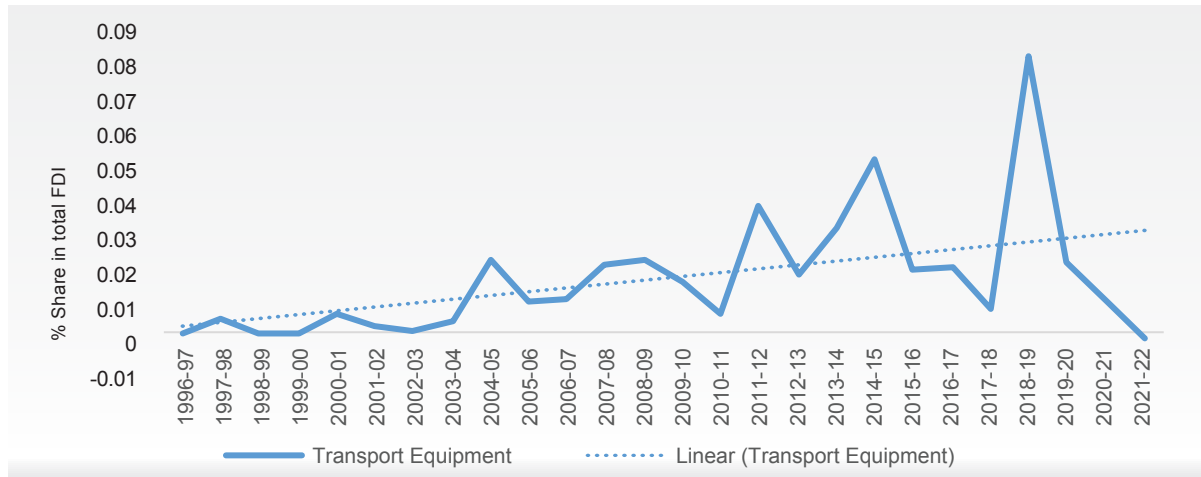
Pakistan has received a cumulative total FDI in the communication sector of USD 9.2 billion. Its contribution to the total FDI reached 55.6 percent in 2006-07. Several policy measures, such as the privatization of state-owned PTCL, competition among many private companies, and Pakistan's first Mobile Cellular Policy in 2004, attracted international investments in the form of Warid (from UAE) and Telenor (from Norway).

Power and financial business in Pakistan have been subject to market-oriented reforms. The Private Power Policy was initiated in 1994 to incentivize and open the market for independent power producers. Some of the major incentives were the high tariff of 6.5 cents/Kilo-Watt-hour based on capacity payments with no restriction on the type of fuel and technology used to generate power.⁴ These lucrative incentives attracted the most FDI in the power sector. State-owned banks were deregulated in the 1990s with an open policy for foreigners in the stock market. The improved competition and efficiency of the banking sector attracted foreign investors in financial business.

⁴For details, see "In power projects: History, Policy and Politics," P.I.D.E by Afia Malik

Figure 1.7: Net FDI Inflow Attracting Sectors 1996-2021





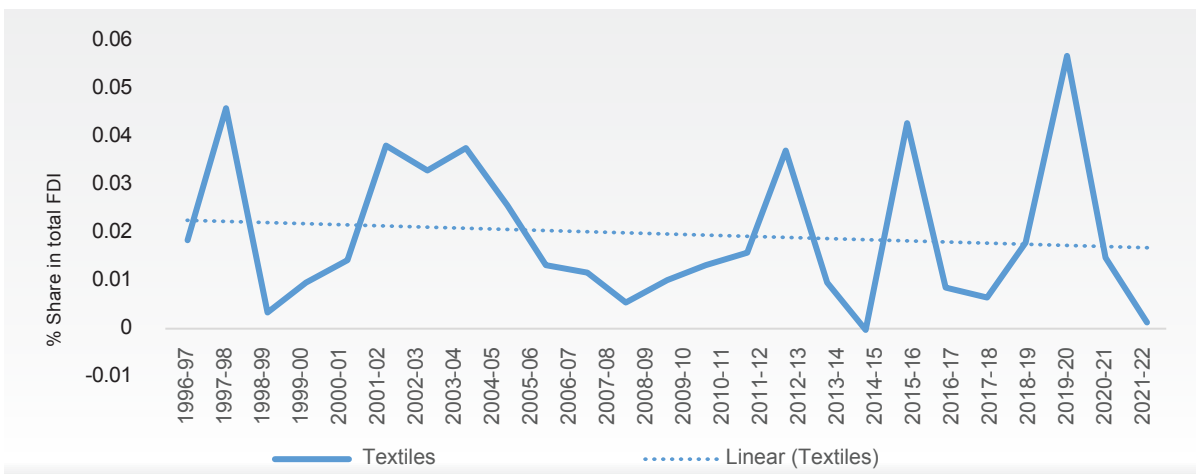
1.3.2 Net FDI Inflow Lagging Sectors

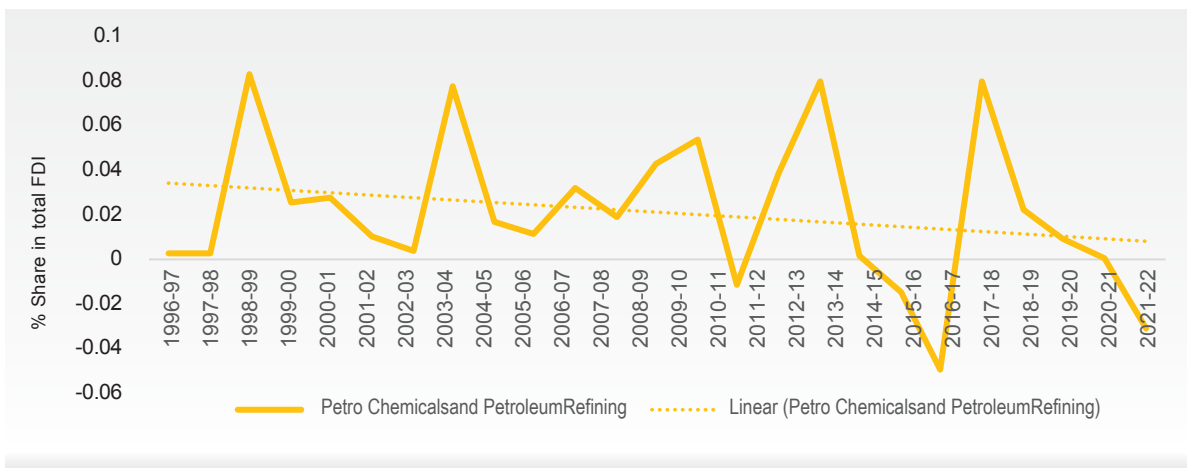
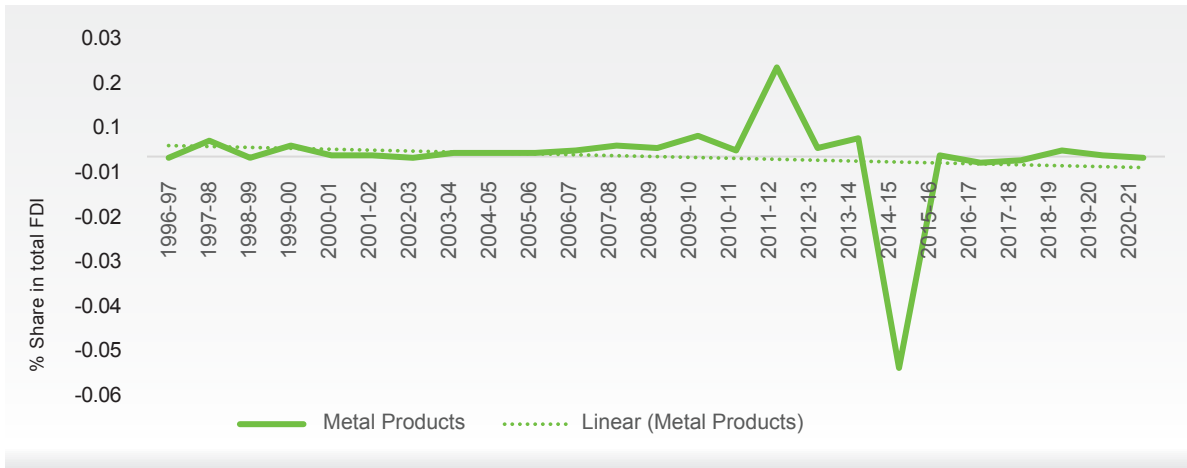
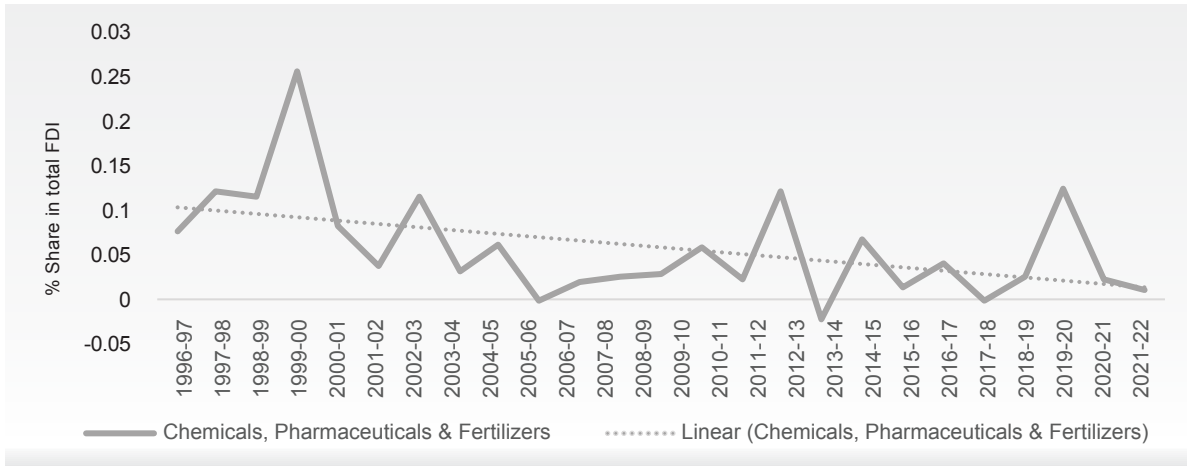
The major FDI-lagging sectors were textiles, chemicals and pharmaceuticals, metals, and petrochemicals. The textile sector’s share in the total FDI has been below 2% of the total FDI, with the highest share of 5.6% in 2018-19. The total cumulative FDI gained by the textile sector in the past two decades stood at USD 689 million. Pakistan can attract foreign investment from China as most textile industries have a sunset with increasing labor costs.

On average, FDI in the chemical, pharmaceutical & fertilizer sector decreased from 10 percent to 3 percent in the past two decades. Its contribution to the overall FDI reached 25.5 percent in 1999-00 (see Figure 1.8). The cumulative total FDI received by the chemical pharmaceutical & fertilizer sector in the past two and half decades stood at USD 1.6 billion (1996-2022).

Metal product FDI share hovers around 0.2 percent of the total FDI. The total cumulative FDI attracted by this sector is USD 73 million. The petrochemical and refinery sector attracted the highest FDI share of 8.2 percent in 1998-99. The average share in total FDI declined from 3.5 percent to less than 2 percent. The cumulative total FDI gained by this sector is USD 931 million.

Figure 1.8: Net FDI Inflow Lagging Sectors 1996-2021





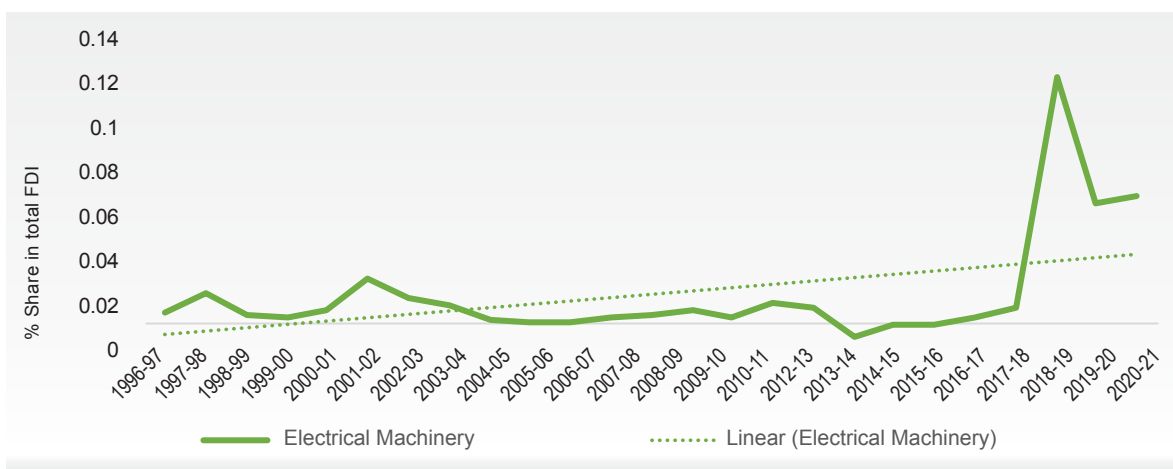
1.3.3 Net FDI Inflow Priority Sectors

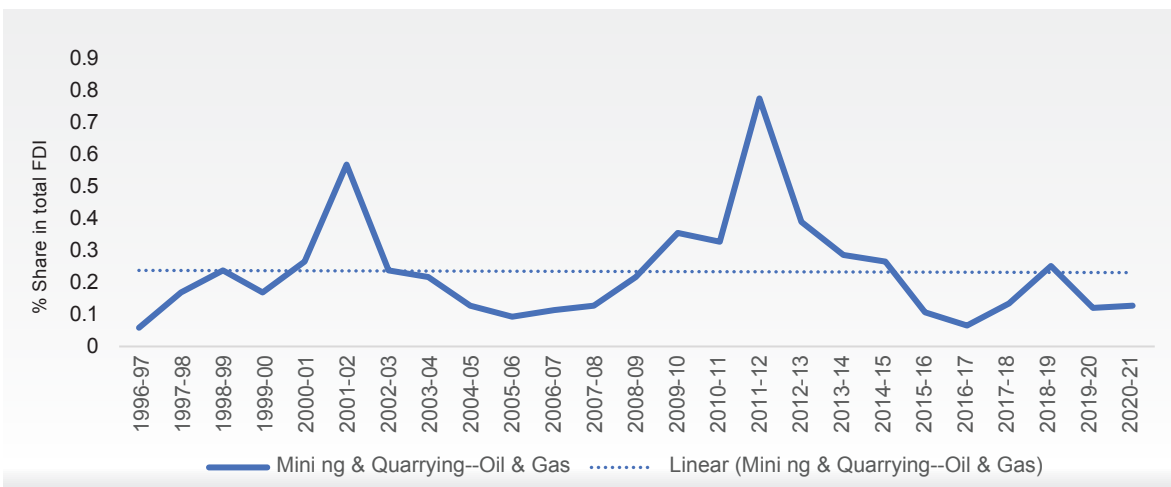
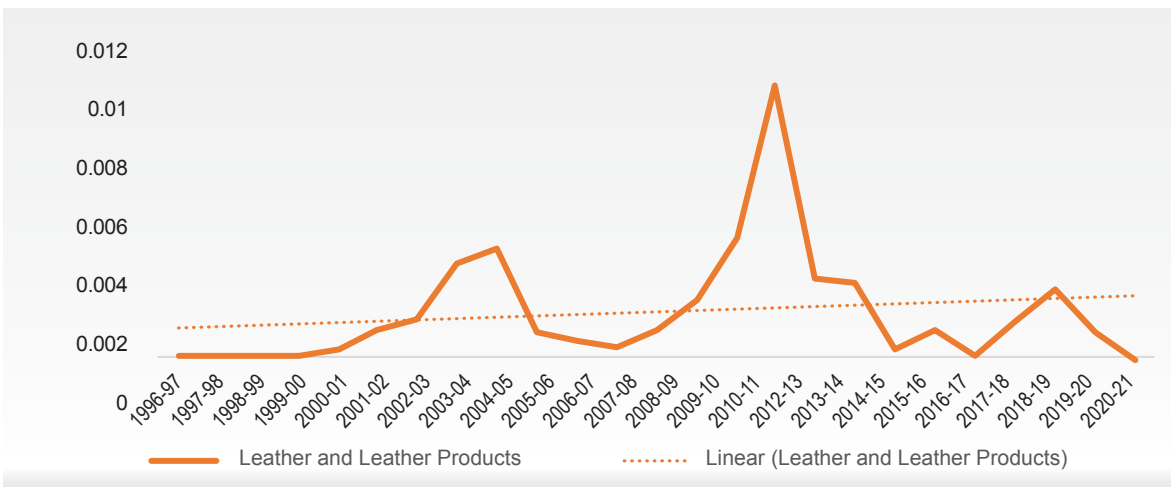
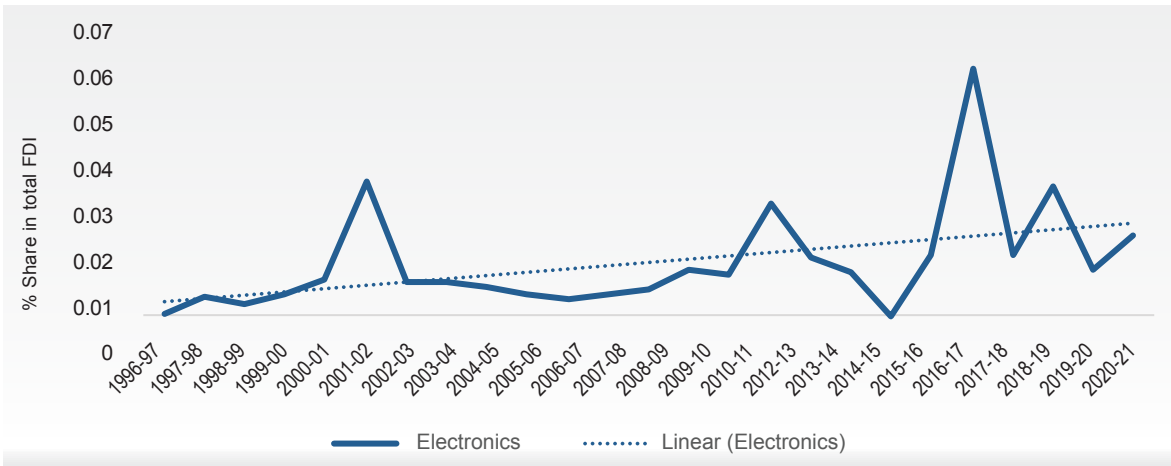
To build our manufacturing base, Pakistan needs to have foreign investment in the sectors that requires support in the form of new technology, working capital, and skill development of the domestic labor force. Industries that can create backward and forward linkages across industries are also considered potential sectors.

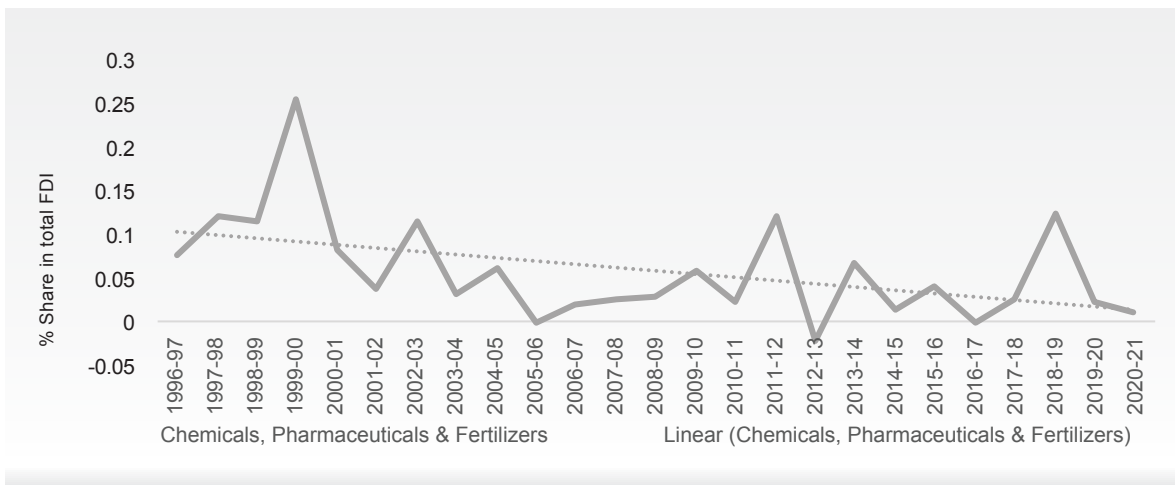
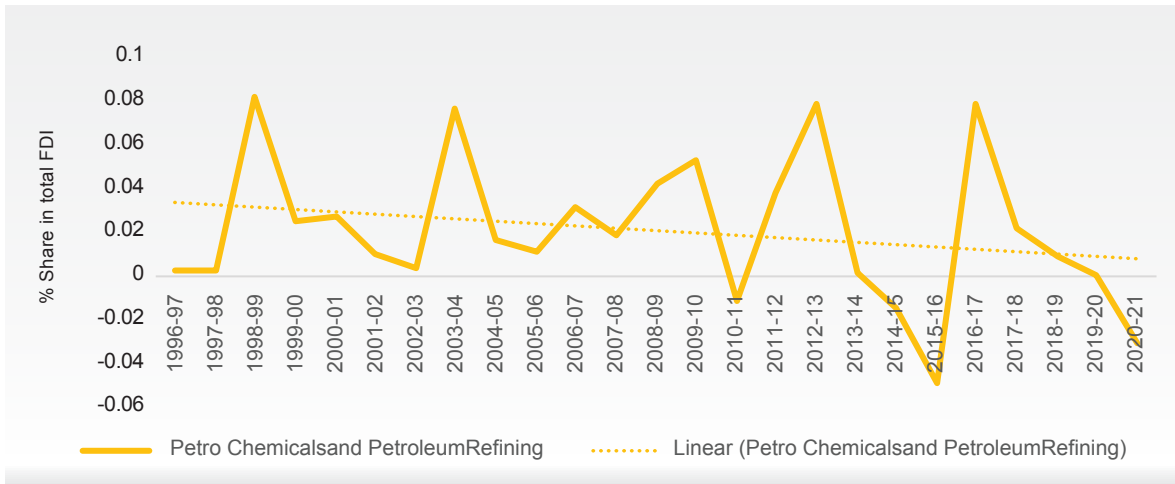
However, the FDI in electrical machinery has increased over the years, but its share in total FDI remained stagnant at around 1 percent. The sector has strong backward and forward linkages with related industries with the potential to become part of the global value chain. The total cumulative FDI gained by the sector in the past two decades stood at USD 615 million. Electronics is another value-added and export-oriented sector struggling to attract foreign investment. Its share in the total FDI has increased from 0.5% to 2%, with a total cumulative FDI of 600 million for the past two and half decades.

Leather is an export-oriented SME sector facing technological and financial constraints to expand and innovate. The cumulative total FDI attracted by the sector is USD 62.5 million. FDI in petrochemical and petroleum refinery is declining for the past two decades. The sector holds a key position and has immense potential with strong forward linkages with other industries. The sector can decrease Pakistan's import bill of refined oil and related petrochemicals to produce plastics, synthetic fiber, rubber, and paints. Mining and quarrying contribution to the total FDI remained 18.1 percent of the total FDI, with a cumulative total FDI of USD 8.7 billion in the past two decades. Pakistan is blessed with rich mineral and resources such as copper, lithium, chromite, coal, and gold that requires the latest technology to mine and refine minerals and convert them to chemicals.

Figure 1.9: Net FDI Inflow Potential Sectors 1996-2021







1.4 Conclusion

Sectoral analysis of FDI received by each sector indicates that foreign investors in Pakistan have been investing in sectors based on consumption, had a large domestic market, and guaranteed high rates of return. Export-oriented sectors remained at the least interest for foreign investors owing to high business costs, inconsistent government policies, regulatory framework law and order situation, and variable return to investment.

2. Domestic Outlook of Sectors

Literature highlights that domestic incentives and industrial performance drive foreign investors' investment decisions in any host country. For a deeper understanding of the industrial structure, incentives, taxes, and performance, we evaluated each sector using input-output tables of Pakistan from 2016 to 2020. The primary objective of the present section is to highlight sectorial performance, the current direction of policy incentives, and the way forward to stimulate industrial structure that could serve two tiers purpose of enhancing domestic manufacturing and attracting FDI that increases our production efficiency.

2.1 Productivity, Value Addition, and Tax to Output ratio

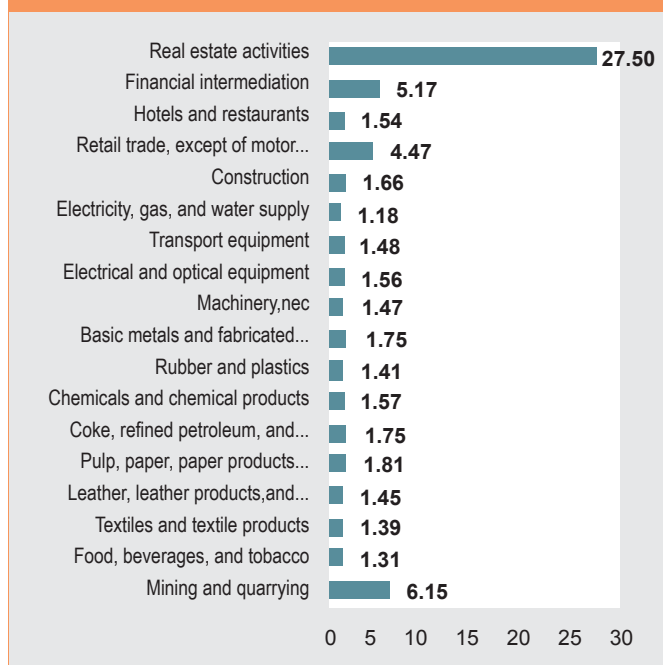
The ratio of output value to intermediate input is used to calculate the sector's productivity. It is the efficiency with which input can be converted to output in various sectors. Both the prices and quantities drive productivity.

The graph shows productivity comparisons across different sectors. Real estate indicates the highest productivity level among other sectors, followed by mining and quarrying, financial intermediation, and retail trade. All other sectors, such as textiles, leather, electrical machinery, electronics, metals, chemicals, plastics, and rubber, have had less than 2 percent productivity levels in the past five years.

The productivity level in each sector also explains the profitable business to invest in Pakistan. Speculation activities and prices drive real estate and financial intermediation. These sectors yield easy and inflation-beating returns. This is more evident if we compare the productivity levels of the real estate and construction sector. The prices of real estate rather than a real economic activity drive it to high productivity levels

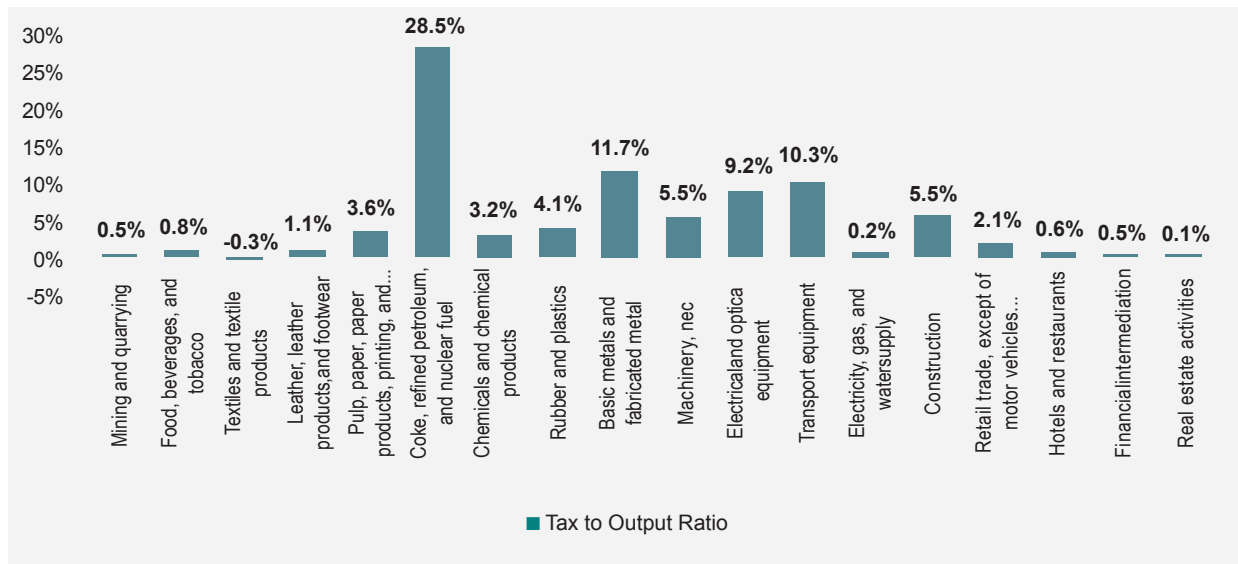
Sectoral tax to output ratio also reveals the direction of resource allocation, incentive structure and profitable businesses in Pakistan. Real estate that yields high returns has the lowest tax-to-output ratio among sectors. Overall, the services sector has low tax to output ratio than the small and large-scale manufacturing in the past five years (See figure: 2.2). Petroleum is the highest tax-paying sector, followed by basic metals, transport equipment, electrical machinery, and construction. The sectors that can take off the manufacturing sectors to a high level are taxed more, given that their productivity levels are already low.

Figure 2.1: Sectoral Productivity Levels, 2016-20



Source: Input-Output Tables (2016-20), Asian Development Bank.

Figure 2.2: Sectoral Tax to Output Ratio, 2016-20

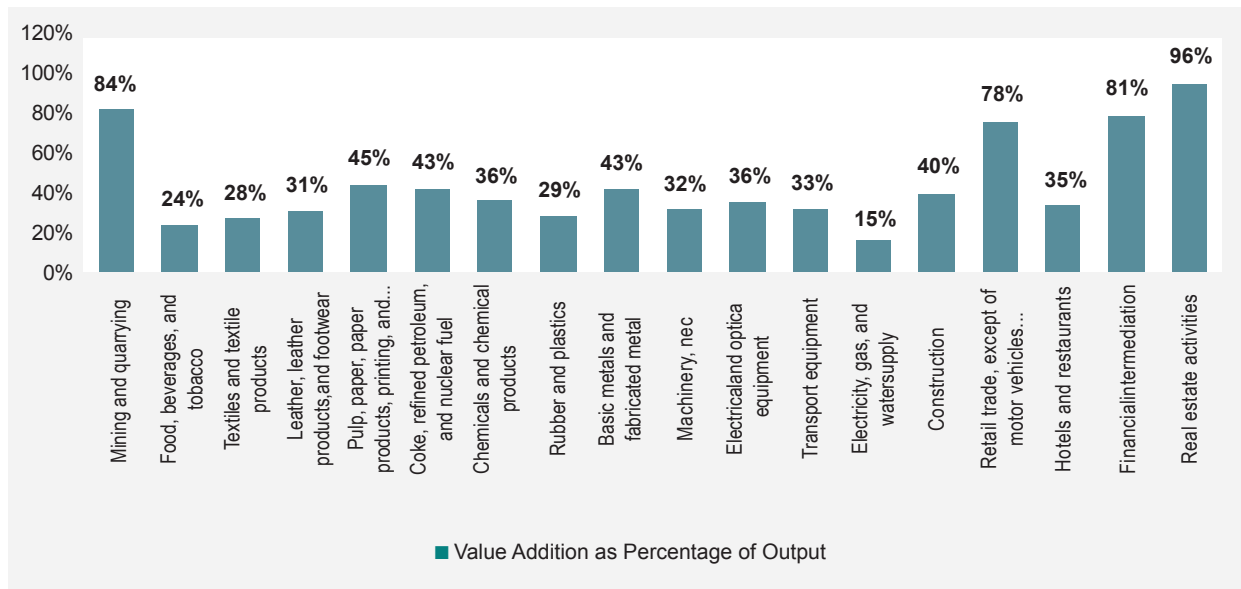


Source: Input-Output Tables (2016-20), Asian Development Bank.

Value addition is the difference in the value of output and input by each sector. It can also be termed as the price consumers pay and the cost incurred by producing it. The services sector, dominated by real estate, financial intermediation, and retail trade, has the highest value-addition contribution as a percentage of their respective output (See figure: 2.3). This also explains the profitability of the service sector as compared to small and large-scale manufacturing.

Pakistan's manufacturing sector has a low share of value addition relative to its output because of the low technological upgradation of its production processes. In addition, the production process depends on foreign input (See figure: 2.5), subject to exchange rate volatility. The output price of the final goods does not fluctuate much relative to the input prices resulting in the vicious circle of low profits, low investment, and low technological upgradation.

Figure 2.3: Sectoral Value Addition as Percentage of Output



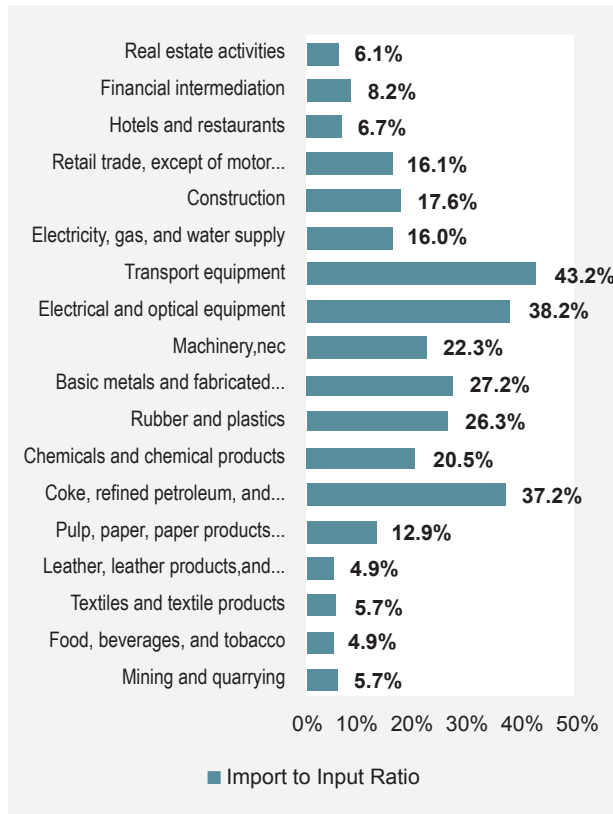
Source: Input-Output Tables (2016-20), Asian Development Bank.

2.2 Trade orientation

Trade orientation is measured by sectoral export and import performance. We have examined the export orientation of sectors by their respective export-to-output percentages. The manufacturing sector is the major contributor to exports compared to the services sector (See Figure: 2.4). However, the behavior of the manufacturing sector shows that producers are inclined more toward domestic sales than the international market over the past five years. The graph also indicates the export mix of Pakistan, dominated by textiles and leather products, having an export share of 39% and 35% in their total output, respectively. Despite having low productivity, low-value addition, and high tax-to-output ratio, the manufacturing sector is an important source of foreign exchange inflow in the country. Import-to-input ratios examine a sector's production dependence on foreign producers (inputs). The major export-producing sectors, such as textile and leather, have low dependence on foreign inputs compared to light and heavy manufacturing sectors.

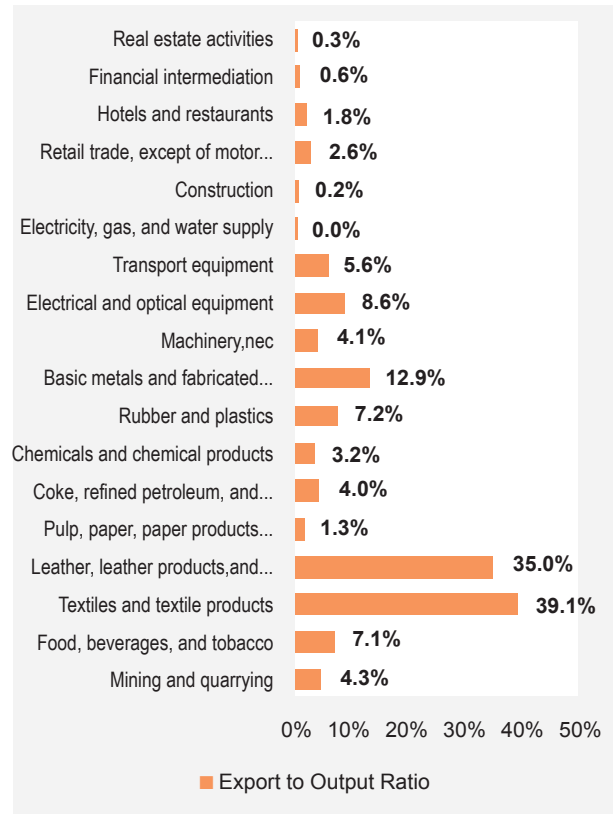
Light and heavy manufacturing relies on foreign input with less than 10 percent of export share in total output and has served the domestic market predominately for the past five years. Transport equipment and electrical machinery have a significant share of foreign inputs among all other sectors of the economy. Even if they depend on foreign input, their underdevelopment can be reflected by their value addition share and export share in total output. A big push investment in technological upgradation and knowledge transfer is required to raise their productivity, value addition, and export-to-output ratio.

Figure 2.4: Sectoral Import Share as Percentage of Output



Source: Input-Output Tables (2016-20),
Asian Development Bank

Figure 2.4: Sectoral Export Share as Percentage of Output



Source: Input-Output Tables (2016-20),
Asian Development Bank

Refined petroleum, chemicals, rubber, basic metals, and transportation equipment have strong forward and backward linkages with light and heavy manufacturing sectors dependent on foreign inputs with less export-to-output ratio. A sector's reliance on foreign input is not a concern until its value addition, export-to-output ratio, or price of its commodity is competitive globally. One missing piece is a lack of competition, the incentive to serve the domestic market, a lack of urge to innovate, and a sizeable investment that can improve the production process. Construction, electricity generation, and retail trade are the key services sector dependent on foreign input.

2.3 Backward and Forward Linkages

Pakistan's industrial structure, inter-sectoral linkages, and spillover effects on related industries are analyzed by calculating the forward (supply side) and backward (demand side) linkages of the sectors under consideration. Leontief models are used to calculate the intra-industry backward and forward linkages.

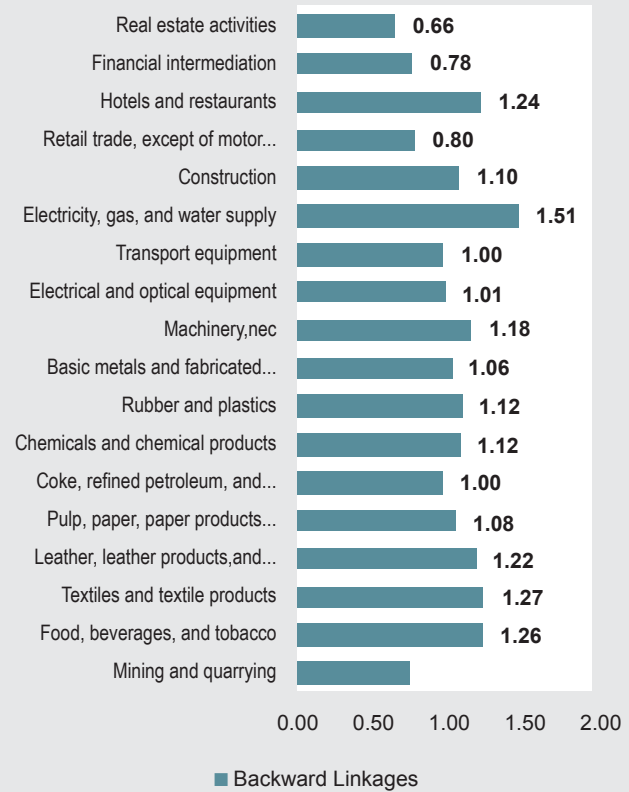
Backward linkages explain a sector's reliance on and interconnectedness with local suppliers. It explains how a change in the output of one sector can change the availability of inputs to other sectors. A sector with high backward linkage has more capacity to further stimulate the economy's overall production as it increases the output of other related industries. The overall industrial mean of backward linkage is averaged to one. Sectors having backward linkage greater than one indicates greater repercussions and dependence on related industries, while industries having backward linkages of less than one show that sectors are relatively independent.

In the case of Pakistan, electricity generation, textiles and leather manufacturing, food and beverages, rubber and plastic, chemicals, basic metals, machinery, and construction have strong backward linkage greater

than 1. For example, in the case of the textiles and leather industry, if the output of these industries increased by one million USD, then the input demand of these sectors relative to other sectors will increase by USD 1.3 million and USD 1.2 million, respectively.

All the manufacturing activities are closely related and thus have high backward linkages compared to services sectors (real estate, financial intermediation, retail trade). Real estate with the highest productivity and value addition has the lowest backward linkage due to speculation activities. The analysis of backward linkages of the manufacturing sector shows that if production in this sector is increased, it can spur industrial growth by creating allied industries, employment generation, and sustainable industrial production.

Figure 2.6: Sectoral Backward Linkages



Source: Input-Output Tables (2016-20), Asian Development Bank

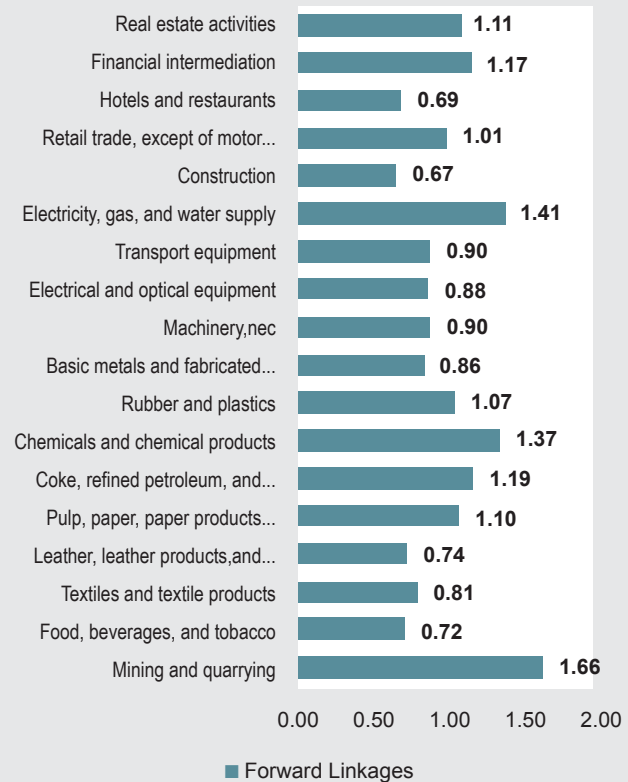
Forward linkages indicate the degree to which input produced in the sectors fuels the output in other sectors. It explains the input structure and its distribution to other sectors of the economy. The overall industrial mean of forward linkage is averaged to one. Sectors having forward linkage greater than one indicate that the output produced in these industries is being used as input by other sectors of the economy.

While industries having forward linkages of less than one shows that sectors are relatively less connected to the output supply chains.

Financial intermediation, real estate activities, retail trade, mining and quarrying, electricity generation, rubber, chemicals, refined petroleum, and paper products are the key sectors having strong forward linkages indicating that the economy relies on these sector outputs. All these sectors in Pakistan are an important part of the supply chain and input structure.

Loans from the banking sector serve as an essential input for manufacturers. Real estate activities provide services to the construction sector, manufacturers, hotels, and restaurants. Manufacturing industries such as chemicals, rubber, paper, and refined petroleum supply their output to various industries for further production. Textiles, leather, electrical machinery, transportation equipment, basic metals, food, and beverages, have weak forward supply linkages as they produce output that is either used as a final commodity or needs more technology to be further used in the production process.

Figure 2.7: Sectoral Forward Linkages



Source: Input-Output Tables (2016-20),
Asian Development Bank

2.4 Conclusion

- Productivity levels, value addition, and tax-to-output ratio indicate the profitable business in Pakistan that clearly show that businesses such as real estate and financial business are the two major sectors thriving. The analysis clearly shows that the financial burden in these two sectors is far less than in other sectors of the economy.
- Manufacturing firms such as textiles, leather, electrical machinery, electronics, metals, chemicals, plastics, and rubber have had less than 2 percent productivity levels in the past five years, which indicates their high cost of production, dependence on foreign inputs, traditional technology, and low-profit returns make them less attractive for domestic as well as foreign investment.
- Trade orientation of sectors explains that textile and leather are the two major sectors within manufacturing responsible for the inflow of dollars to the economy. This also describes Pakistan's low competitiveness in terms of production globally. Pakistan's large and small-scale manufacturers depend on foreign input for their production. Still, their export-to-output ratio is relatively low, indicating that sectors only focus on the domestic economy.
- Large and small-scale manufacturing has higher backward linkages than forward linkages, indicating that the manufacturing sector depends on value chains for its input but cannot supply and be part of the value chain, which is more sophisticated and has more room for value addition.
- An industry may encourage investment in the subsequent stages of production through forward linkage and in earlier stages through backward linkage.

3. Empirical Analysis - A Computable General Equilibrium Model

The primary objective of the present section is to analyze the potential impact of FDI inflows measured by improved capital efficiency on Pakistan's macroeconomic framework. As Pakistan is experiencing a period of underinvestment coupled with de-industrialization over the past few decades, we highlight some potential sectors that require capital in the form of improved technology. In the previous chapter, an important implication derived is that Pakistan's manufacturing sector has low forward linkages owing to the limited usage of sophisticated technologies in the production processes.

The top priority sectors highlighted are; Refined petroleum, textile, chemical & rubber, leather, heavy manufacturing, light manufacturing, extraction, and metals. The existing sectors that have received FDI in Pakistan are power, financial business, food and beverages, transportation and communication, and mining. Using the CGE model, we have assumed that capital efficiency is reflected in the technical change in the capital endowment of Pakistan.

3.1 Research Simulation

To analyze the effect of improved capital efficiency, we have increased the technical change in existing and the new potential sectors by 50 percent. Considering the lack of sophisticated technology in all sectors of the economy, we have assumed improvement in capital efficiency by 50 percent in all the sectors to gauge sectoral differences across sectors in response to a similar increase in capital efficiency led by FDI inflows. Keeping other things constant, it is also assumed that each sector individually receives improved technology.

3.2 Priority sectors

Considering the scenario, the analysis below highlights the potential impact of increasing capital efficiency of priority sectors on sectoral performance measured by real GDP growth, trade orientation, impact on output and prices, and returns to factors of production.

3.2.1 Refined Oil (Oil P)

Assuming that Pakistan's technological efficiency in refineries is improved by 50 percent while keeping other things constant, Pakistan's real GDP will increase by 0.41 percent. Refined oil exports are likely to grow by 7.8 percent. Other related sectors, such as metals, chemicals, rubber, Light manufacturing, heavy manufacturing, electricity generation, and construction will also experience an increase in exports. Import of refined oil will decrease by 3.65 percent, while on average, all sectors of the economy will experience a decrease in imports by 0.2 percent.

With improved technology, the output of refined oil tends to expand by 0.2 percent with a reduction of 1.4 percent in prices. Technological upgradation in this sector will exert a positive spillover effect on metals, chemicals, rubber, electricity generation, other utilities, and construction as they will experience an expansion in their output coupled with the reduction in their respective prices. All these sectors have strong forward linkages with refined oil, which is used as a basic input in these related sectors. Interestingly, all other economic sectors will also experience output expansion. This fact also highlights that refined oil is the key ingredient on which Pakistan's industrial structure depends.

Output expansion will increase the demand for factors of production that, in turn, exacerbates their returns. Natural resources and land returns increase more than skilled labor and capital.

3.2.2 Textile

An increase in the capital efficiency of Pakistan's top exporting sector, i.e., textiles, will increase real GDP by 0.8 percent. Exports of the textile sector will increase by 33.3 percent, while imports will experience a sharp decline of 11.6 percent. However, all sectors of the economy will experience an increase in imports with an average increase of 5.87 percent.

The output of the textile sector will increase by 22.8 percent, with a reduction in prices by 4.86 percent. The price level declines with better quality and competition between efficient producers. Related sectors such as grains and crops, meat and livestock, food & beverages, services such as electricity, utilities & construction, transportation and communication, and other services will experience an increase in output, showing a positive spillover effect of an increase in textile sector output.

Table 3.1 Simulated Impact of an Increase in Capital Efficiency on Refined Oil Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.41 (214,572.06)	7.83	-3.65	0.2	-1.4
Textile		0	0.03	-0.01	0
Metals		0.39	-0.06	0.17	-0.06
leather		0	0.05	0.02	0.01
ChemRub		0.06	0	0.03	-0.01
GrainsCrops		0	0.03	0.01	0.01
MeatLstk		0	0.04	0.02	0.01
Forestry		0	0.07	0.03	0.02
Extraction		0	0.08	0.02	0.01
Food & Beverages		0	0.04	0.02	0.01
LightMnfc		0.02	0.02	0.03	0
HeavyMnfc		0.02	0.04	0.05	0
FinBus		0	0.04	0.03	0.01
Electricity		0.03	0.02	0.04	-0.01
Util_Con		0.03	0.02	0.04	-0.01
TransComm		0	0.05	0.03	0.01
Oth.Services		0	0.03	0.02	0
Average		0.49	-0.19		

Table 3.2 Simulated Impact of an Increase in Capital Efficiency on Textile Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.75 (215,297.7)	0	5.14	0.5	1.38
Textile		33.33	-11.68	22.83	-4.86
Metals		0	6.11	-4.84	2.59
leather		0	11.82	-0.03	3.01
ChemRub		0	7.06	-1.88	2.47
GrainsCrops		0	14.32	0.69	3.13
MeatLstk		0	9.73	0.23	3.24
Forestry		0	3.64	-1.7	2.45
Extraction		0	0.51	-2.29	0.98
Food & Beverages		0	6.37	0.23	2.9
LightMnfc		0	8.45	-1.54	2.78
HeavyMnfc		0	4.84	-1.64	1.9
FinBus		0	4.69	-0.91	3.09
Electricity		0	6.7	0.43	1.97
Util_Con		0	9.4	1.98	2.27
TransComm		0	6.44	0.62	2.92
OthServices		0	6.21	0.09	2.79
Average		1.96	5.87		

Other sectors such as leather, chemical and rubber, and light and heavy manufacturing will experience a reduction in output and increase in prices as resources will flow towards the textile sector more owing to technological upgradation. Secondly, due to an increase in the output of the textile sector, the existing sector will compete on raw and intermediate goods from related sectors.

3.2.3 Chemicals & Rubber

Improving the technical efficiency in the chemical and rubber sector by 50 percent will boost Pakistan's real GDP by 0.23 percent. The sector will experience an increase in exports by 15 percent with a reduction in imports by 4.8 percent. On average, sectors of the economy will experience a slight increase in imports by 0.89 percent. The output will grow by 4 percent, with a price reduction of 2.48 percent. All other sectors of the economy will experience positive growth in output and prices except textiles and metals, indicating the sector's importance to have strong forward linkages with other sectors of the economy.

3.2.4 Leather

Leather is an important export-oriented SME sector in Pakistan. Increasing the sector's technical efficiency while keeping other things constant will increase real GDP by 0.03 percent. Exports will undergo a positive growth of 2.2 percent, with a reduction in imports by 0.93 percent. The output of the leather sector will increase by 0.16 percent with a reduction in price by 0.28 percent. The output of all other sectors will increase slightly while prices in the related sectors tend to remain unchanged. The results also indicate that the leather sector needs more technical efficiency from the current level as the sector is using traditional techniques for production.

Table 3.3 Simulated Impact of an Increase in Capital Efficiency on Chemical & Rubber Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.23 (214,171.13)	0	1.1	0.43	0.25
Textile		0	0.56	-0.95	0.2
Metals		0	1.6	-0.35	0.43
leather		0	1.9	0.15	0.45
ChemRub		15.13	-4.83	3.95	-2.48
GrainsCrops		0	0.25	0.05	0.16
MeatLstk		0	1.47	0.16	0.47
Forestry		0	2.1	0.34	0.62
Extraction		0	0.74	0.03	0.31
Food & Beverages		0	1.4	0.19	0.48
LightMnfc		0	1.55	0.13	0.41
HeavyMnfc		0	1.19	0.06	0.32
FinBus		0	1.05	-0.05	0.6
Electricity		0	1.42	0.42	0.37
Util_Con		0	1.1	0.84	0.31
TransComm		0	1.42	0.35	0.55
OthServices		0	1.17	0.18	0.44
Average			0.89	0.89	

Table 3.4 Simulated Impact of an Increase in Capital Efficiency on Leather Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.03 (213,743.47)	0	0.02	0.03	0
Textile		0	0.03	0	0
Metals		0.01	0.02	0.02	0
leather		2.18	-0.93	0.16	-0.28
ChemRub		0.01	0.02	0.02	0
GrainsCrops		0	0.06	0.02	0.01
MeatLstk		0	0.15	0.09	0.03
Forestry		0	0.03	0.02	0.01
Extraction		0	0.02	0.01	0
Food & Beverages		0	0.03	0.04	0
LightMnfc		0.01	0.02	0.02	0
HeavyMnfc		0	0.02	0.02	0
FinBus		0	0.02	0.02	0
Electricity		0.01	0.02	0.03	0
Util_Con		0.01	0.01	0.01	0
TransComm		0.01	0.03	0.03	0
OthServices		0.01	0.02	0.02	0
Average			0.13	-0.02	

3.2.5 Heavy Manufacturing

Providing better technology in Pakistan's heavy manufacturing sector and keeping other things constant will increase real GDP by 0.86 percent. Being the most capital-intensive sector, technological upgradation will increase sectoral exports by 38 percent and reduce imports by 8.3 percent. On average, the import by all sectors will increase by 3.6 percent. The output of the heavy manufacturing sector will increase by 13.3 percent, with a reduction in prices by 6 percent.

Related sectors such as refineries, mineral extraction, light manufacturing, financial business electricity generation, transportation, communication, and other services will experience an increase in output because of the positive spillover effect and strong backward and forward linkages with heavy manufacturing.

3.2.6 Light Manufacturing

Keeping other things constant, increasing the technical efficiency of the light manufacturing sector by 50 percent will increase real GDP by 1.01 percent. Among the priority sectors considered in the analysis, the sector will experience the highest export increase by 67 percent with the highest reduction in imports, i.e., by 23 percent. On average, all sectors will experience an increase in imports by 4 percent. The sector's output will expand by 15 percent, with a reduction in prices by 11 percent.

Refineries, leather, meat and livestock, food and beverages, heavy manufacturing, financial business, electricity generation, utilities and construction, transportation, and communication will have a positive impact on their output, indicating the upstream and downstream linkages. These results indicate that investment in technical upgradation of light manufacturing will have a more significant positive impact on the sector's performance with positive repercussions on the related sectors.

Table 3.5 Simulated Impact of an Increase in Capital Efficiency on Heavy Manufacturing Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.86 (215,518.09)	9.67	-2.71	1.93	-1.73
Textile		0	3.06	-5.59	1.2
Metals		0	4.59	-0.02	1.11
leather		0	6.25	0.53	1.45
ChemRub		0	2.92	-1.04	1.04
GrainsCrops		0	1.56	-0.41	1.2
MeatLstk		0	4.44	0.51	1.44
Forestry		0	3.45	0.24	1.74
Extraction		0	18.94	1.87	2.76
Food & Beverages		0	3.76	0.58	1.5
LightMnfc		0	5.69	0.33	1.48
HeavyMnfc		37.65	-8.26	13.35	-5.92
FinBus		0	5.54	1.22	1.83
Electricity		1.44	1.17	1.75	-0.26
Util_Con		0	3.88	4.13	0.43
TransComm		0	3.78	0.94	1.32
OthServices		0	3.83	0.69	1.39
Average			2.87	3.64	

Table 3.6 Simulated Impact of an Increase in Capital Efficiency on Light Manufacturing Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	1.01 (215,849.83)	0	3.89	1.61	0.75
Textile		0	3.14	-5.37	1.16
Metals		0	5.22	-1.11	1.5
leather		0	6.83	0.58	1.59
ChemRub		0	2.47	-0.28	0.8
GrainsCrops		0	1.91	-0.36	1.28
MeatLstk		0	5	0.58	1.6
Forestry		0	13.37	7.18	4.68
Extraction		0	3.2	-0.3	1.18
Food & Beverages		0	4.13	0.66	1.63
LightMnfc		67.74	-23.46	15.16	-11.04
HeavyMnfc		0	4.35	0.64	1.18
FinBus		0	4.9	1.11	1.99
Electricity		0	4.79	1.57	1.09
Util_Con		0	4.68	3.81	1
TransComm		0	4.22	1.09	1.48
OthServices		0	3.59	0.92	1.15
Average			3.98	3.07	

3.2.7 Metals

Increasing the basic metal sector's technical efficiency while keeping other things constant will increase real GDP by 0.2 percent. Exports will undergo a positive growth of 52.6 percent, with a reduction in imports by 12 percent. The output of the metal sector will increase by 19 percent with a reduction in price by 7 percent. Expansion in the output of the metal sector will exert positive pressure on related sectors that will tend to increase their output. Sectors include refineries, heavy manufacturing, food & beverages, utilities, construction, transportation, and communication.

3.2.8 Extraction

An increase in the technical efficiency of capital in the extraction sector (coal, oil, gas, and minerals), keeping other things constant, will exacerbate real GDP by 0.2 percent. Extraction sector exports will experience an increase of 23 percent with a reduction in imports by 4.8 percent.

The output will likely expand by 5 percent, with a decline in prices by 2.6 percent. The output growth of the extraction industry will exert a positive spillover effect on related sectors such as refineries, light and heavy manufacturing, metals, forestry, and related services sector.

Table 3.7 Simulated Impact of an Increase in Capital Efficiency on Metals Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.22 (214,150.16)	0	1.86	1.55	0.32
Textile		0	1.19	-2.46	0.52
Metals		52.26	-11.95	19.02	-7.43
leather		0	2.44	0.1	0.6
ChemRub		0	0.91	-0.58	0.43
GrainsCrops		0	0.43	-0.24	0.45
MeatLstk		0	1.62	0.09	0.56
Forestry		0	1.01	-0.21	0.63
Extraction		0	1.39	0	0.55
Food & Beverages		0	1.47	0.12	0.64
LightMnfc		0	2.12	-0.16	0.64
HeavyMnfc		0	1.75	0.16	0.47
FinBus		0	1.42	0.28	0.77
Electricity		0	1.95	1.55	0.35
Util_Con		1.51	0.11	1.55	-0.35
TransComm		0	1.59	0.22	0.66
OthServices		0	1.48	0.11	0.62
Average			3.16	0.63	

Table 3.8 Simulated Impact of an Increase in Capital Efficiency on Extraction Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.2 (214,117.98)	0.03	0.41	0.33	-0.01
Textile		0	0.81	-1.44	0.31
Metals		0	0.71	0.04	0.15
leather		0	1.51	0.15	0.35
ChemRub		0	0.43	-0.15	0.15
GrainsCrops		0	0.42	-0.11	0.32
MeatLstk		0	1.15	0.13	0.38
Forestry		0	1.73	0.71	0.63
Extraction		23.09	-4.83	5.34	-2.6
Food & Beverages		0	0.88	0.16	0.34
LightMnfc		0	1.06	0.01	0.29
HeavyMnfc		0.81	0.15	0.66	-0.13
FinBus		0	0.74	-0.01	0.39
Electricity		0.15	0.36	0.33	-0.03
Util_Con		0	0.58	0.57	0.12
TransComm		0	0.9	0.19	0.32
OthServices		0	1.09	0.31	0.34
Average			1.42	0.48	

3.3.9 Food and Beverages Sector

Keeping other things constant, increasing the technical efficiency of the food & beverages sector by 50 percent will increase real GDP by 5.7 percent. The sector will experience a significant increase in exports, i.e., by 74 percent, with the highest reduction in imports, i.e., by 28 percent in any sector considered in the analysis. On average, all sectors will experience an increase in imports by 0.37 percent. The sector's output will expand by 11 percent, with a reduction in prices by 18.6 percent.

All other sectors of the economy will have a positive impact on their output, indicating the strong upstream and downstream linkages of the food & beverages sector in Pakistan's economy. Meat, livestock, grains, forestry, leather, chemical, and rubber will experience the highest output increase.

3.3 Existing Sectors

The sectors that have attracted the most FDI in Pakistan are examined as existing sectors in this analysis. The power, financial business, retail trade, and communication sector attracted the most FDI in Pakistan and have marginally ungraded their technology compared to other sectors. We have assumed that capital efficiency has improved by 50 percent in a sector keeping other things constant.

3.3.1 Power

The Power sector's increased capital efficiency positively impacts the economy's real GDP by 0.4 percent. The sector expands by positive export growth of 49 percent with a reduction in imports by 22 percent. Overall the economy experiences a reduction in imports by 0.9 percent. Output in the power sector will expand by 1.7 percent, with a decline in power sector prices by 8.8 percent.

The high reduction in prices and output expansion exerts a positive impact on the output of all sectors of the economy, with a

Table 3.9 Simulated impact of an increase in capital efficiency on food and Beverages sector performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	5.7 (225,861.3)	3.22	3.79	5.39	-0.57
Textile		1.95	5.12	3.6	-0.28
Metals		7.75	1.11	4.37	-1.1
leather		69.06	-25.61	8.97	-8.91
ChemRub		9.48	1.49	6.78	-1.55
GrainsCrops		0	10.48	4.15	2.22
MeatLstk		0	12.58	6.73	2.12
Forestry		0.13	5.38	4.77	-0.03
Extraction		0	5.19	1.76	0.8
Food & Beverages		74.57	-28.31	11.32	-18.6
LightMnfc		7.95	0.53	4.75	-1.29
HeavyMnfc		4.54	2.56	3.56	-0.71
FinBus		3.55	3.2	5.11	-0.94
Electricity		5.12	2.9	5.43	-0.91
Util_Con		3.87	-0.96	0.86	-0.89
TransComm		5.26	3.69	6.36	-1.56
OthServices		3.32	3.08	3.77	-0.88
Average		11.75	0.37		

Table 3.10 Simulated Impact of an Increase in Capital Efficiency on Power Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.41 (214,572.06)	0.66	0.32	0.71	-0.12
Textile		0	0.42	-0.1	0.05
Metals		7.63	-1.33	3.1	-1.08
leather		0	0.75	0.32	0.11
ChemRub		1.43	-0.13	0.69	-0.23
GrainsCrops		0	0.51	0.17	0.14
MeatLstk		0	0.71	0.33	0.14
Forestry		0	0.93	0.48	0.23
Extraction		0	1.31	0.31	0.26
Food & Beverages		0	0.54	0.33	0.09
LightMnfc		0.86	0.13	0.61	-0.14
HeavyMnfc		0.7	0.45	0.76	-0.11
FinBus		0	0.61	0.48	0.07
Electricity		49.43	-22.64	1.72	-8.83
Util_Con		0.63	0.12	0.62	-0.15
TransComm		0	0.66	0.46	0.07
OthServices		0.12	0.42	0.41	-0.03
Average		3.62	-0.95		

major increase in heavy manufacturing, refineries, light manufacturing, and chemical and rubber. The results also indicate that a positive spur in the power sector has a greater impact on all the sectors of the economy.

Output expansion in all sectors will increase the demand for factors of production and hence exacerbates their returns.

3.3.2 Financial Business

An increase in the technical efficiency of capital in the financial business will exacerbate real GDP by 3.5 percent. The sector's exports will experience an increase of 55 percent, with a reduction in imports by 14 percent. On average, the imports of the economy will increase by 10.37 percent.

The output of financial business will likely expand by 11 percent, with a decline in prices by 14 percent. The growth of the financial business will exert a positive spillover effect on the output of sectors financially dependent on the banking sector, such as refineries, metals, leather, apparel, light and heavy manufacturing, electricity generation, utilities, transportation, communication, and other services.

3.3.3 Communications, Retail Trade & Transport

Keeping other things constant, increasing the technical efficiency of the transportation and communication sector by 50 percent will increase real GDP by 14.2 percent. The sector includes retail trade, communications, and transportation which are consumer-driven sectors. The sector will experience an increase in exports by 64 percent with a reduction in imports by 13.5 percent, yet all sectors will experience the highest increase in average imports by 20.8 percent.

Table 3.11 Simulated Impact of an Increase in Capital Efficiency on Financial Business Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	0.23 (214,171.13)	0	7.96	4.91	0.75
Textile		0	16.57	-11.66	3.18
Metals		1.35	6.49	6.91	-0.21
leather		0	22.09	2.01	5.1
ChemRub		0	6.35	-1.98	2.29
GrainsCrops		0	8.73	-0.9	4.55
MeatLstk		0	17.81	1.8	5.79
Forestry		0	16.09	1.77	7.11
Extraction		0	15.54	-0.71	3.82
Food & Beverages		0	12.49	2.31	4.79
LightMnfc		0	7.19	5.38	0.39
HeavyMnfc		1.06	5.76	7.43	-0.18
FinBus		55.65	-14.89	11.51	-14.68
Electricity		0	12.29	4.72	2.39
Util_Con		0	11.62	9.56	2.02
TransComm		0	13.49	2.98	4.7
OthServices		0	10.64	3.9	2.93
Average			3.42	10.37	

Table 3.12: Simulated Impact of an Increase in Capital Efficiency on Communications, Retail Trade & Transport Sector Performance

SECTORS	REAL GDP	EXPORTS	IMPORTS	OUTPUT	PRICES
OilP	14.22 (244,070.9)	10.92	14	17.87	-1.99
Textile		0	14.89	-0.8	1.12
Metals		1.77	20.9	19.32	-0.3
leather		0	32.1	12.31	4.92
ChemRub		35.45	0.07	20.04	-5.84
GrainsCrops		0	26.41	5.7	8.09
MeatLstk		0	40.36	11.57	10.31
Forestry		0	41.15	13.29	13.75
Extraction		0	34.08	6.82	6.95
Food & Beverages		0	16.85	13.59	1.2
LightMnfc		0	21.34	18.19	0.49
HeavyMnfc		0	21.54	19.32	0.76
FinBus		0	19.49	12.92	3.28
Electricity		0	19.68	17.63	0.15
Util_Con		0	21.34	24.69	0.28
TransComm		64.26	-13.45	17.38	-19.09
OthServices		0	23.39	15.45	2.42
Average			6.61	20.83	

The sector's output will expand by 17 percent, with a reduction in prices by 19 percent. All other sectors of the economy will have a positive impact on their output, indicating the upstream and downstream linkages. Overall in the economy, returns to all factors of production will undergo a significant increase.

3.4 Conclusion

Technology upgradation in the priority sectors such as food and beverages and light manufacturing will induce the highest positive growth in real GDP, followed by heavy manufacturing, textiles, refined petroleum, chemicals and rubbers, and metals. Trade orientation indicates that each sector is likely to increase its exports from existing levels with a major increase in light manufacturing (67.7%), metals (52.6%), heavy manufacturing (37.7%), textile (33.3%), and chemicals and rubber (15.1%). Similarly, their respective imports from the world will also decline, with a major decrease in light manufacturing (23%), metals (12%), textiles (12%), and heavy manufacturing (8%). All these sectors are reliant on sophisticated foreign inputs. Thus, technological upgradation will possibly result in a reduction of their imports.

Technology upgradation of the existing sectors such as power, financial business, retail trade, transportation and communication drives real GDP more than the manufacturing sector. However, the average import increase by all other sectors is more profound when the communication and retail trade sector experiences technical change. Increasing the technical efficiency in demand-oriented sectors will drive imports more on average than manufacturing (priority sectors), such as Refined petroleum, Textile, Chemical & Rubber, Leather, Heavy Manufacturing, Light Manufacturing, Metals, Extraction, Food and Beverages. Manufacturing and export-oriented sectors, on average, drive imports by 1.64%, while power, financial business, communication & retail trade increase imports by 10.08%. Similarly, CGE simulation also revealed that manufacturing and export-oriented sectors such as Refined Petroleum, Textile, Chemical & Rubber, Leather, Heavy Manufacturing, Light Manufacturing, Metals, Extraction, Food and Beverages on average decreased trade deficit by 1.32% while retail trade, communication, and financial business increase trade deficit by 5.53%. Pakistan needs technical change in existing as well as manufacturing and export-oriented sectors. The amount of FDI received by Pakistan in existing sectors is inclined towards market-seeking rather than efficiency-seeking. Technical change-driven FDI will enhance the efficiency of all sectors.

4. Comparative Analysis of Policies and Stakeholders' Input

4.1 Entry Routes



Generally, two routes prevail in **India**, but different sectors are subject to varying benchmarks beyond which investor requires the government route.

Automatic Route: Sectors with 100% cap such as IT, manufacturing, agriculture, Greenfield pharma, mining (except titanium), courier services, petroleum and gas exploration, brownfield airports, industrial parks

Government Route: Broadcasting, brownfield pharma (beyond 74% equity), print media, satellites, private security agencies, multi-brand retail trading, banking (beyond 49% equity). Extensive scrutiny on investments from countries sharing a land border with India.



Vietnam allows 100% foreign business ownership in most industries - trading, IT, manufacturing & education.

Some industries restrict foreign ownership – advertising, logistics & tourism - in such cases, foreign investors will need a joint venture partner.

There is no minimum capital requirement for most business lines in Vietnam. Many businesses set capital of USD 10,000 – it is possible to open a business service company with USD 3,000. Some business lines with minimum capital requirements include Language centers, Vocational schools, Real estate companies, Banking, Insurance, Finance and Fin-Tech.



In **Pakistan**, all sectors are open to foreign investment at all times other than a few restricted sectors, including ammunition, explosives, radioactive substances, securities, currency, mint and alcohol.

There is no minimum threshold for the amount of foreign equity in any sector. Upper limits to foreign equity ownership do not exist except in the case of airline, banking, agriculture and media.



Stakeholders' input reveals that Pakistan has a liberal policy for entry routes for foreign investors. The real challenge in Pakistan for foreign and domestic investors is the high cost of production and inconsistent government policies.

4.2 Measures for Ease of Doing Business



In 2022, **India's electricity price** was around 0.073 U.S. Dollars per kWh for HH & 0.1 U.S. Dollars for businesses – which includes all components of the electricity bill – such as the cost of power, distribution and taxes.

The average price of electricity in the world for that period is 0.158 U.S. Dollars per kWh for HH & 0.164 U.S. Dollars for businesses.

Corporate income tax for foreign companies in India is 40% (PWC, 2022)

100 percent **value-added tax rebates** upon export of components sourced in India

Income tax exemptions depend upon the business scope and location in India. **Duty-free import** and domestic procurement of goods for the manufacturing and assembly its products within the SEZ.

Labor Productivity as measured by output per worker is around USD 20,422, while the global average productivity is USD 41,017 (ILO, 2022)



In 2022, **Vietnam's price of electricity** stood at 0.079 U.S. Dollars per kWh for HH & 0.075 U.S. Dollars for businesses – which includes all components of the electricity bill – such as the cost of power, distribution and taxes. The price is well below the global average of 0.136 U.S. Dollars per kWh for HH & 0.129 U.S. Dollars for businesses.

Corporate income tax is 20% - high incentives for some key sectors prioritized for investment have contributed to attracting investment & promoting business.

Exemption from import duty is granted to; goods imported for the oil and gas industry, goods imported for carrying out ODA projects, goods imported for implementing export processing contracts with foreign parties, Raw materials and supplies that directly serve the production of software products, agriculture, forestry and fishery. Goods imported to form fixed project assets, including machinery, equipment, means of transportation and construction materials.



Labor Productivity, as measured by output per worker, is around USD 20.129 (ILO, 2022)

In 2022, **Pakistan's electricity price** was around 0.037 U.S. Dollars per kWh for HH & 0.125 U.S. Dollars for businesses – which includes all components of the electricity bill – as the cost of power, distribution and taxes.

Corporate income tax is 29%, both for domestic and foreign investors. A tax credit of 10% of the amount invested in plant and machinery is granted to companies (investment is made between 1 July 2010 and 30 June 2019) for extension, expansion and replacement of the plant and machinery.

Additional tax credits are granted based on; every 50 registered employees (2%), manufacturer registered under Sales Tax who is making over 90% sales to Registered Sales Tax Persons (3%)

At present 20% tax credit on tax payable for enlistment in the stock exchange is available for one year. Thus, the tax credit is being extended to 2 years to encourage listed companies on the stock exchange.

A five-year tax holiday in the form of a tax credit is allowed to a company setting up a new industrial undertaking in Pakistan between 1 July 2011 to 30 June 2019. A tax credit is allowed in the proportion of the equity raised through the issuance of shares against cash to total investment with at least 70% equity

Labor Productivity in Pakistan is USD 17,310 (ILO, 2022) is below the countries considered in the analysis.



Stakeholders' input reveals that Pakistan needs to work more on consistent, transparent, and predictable policy framework and implementation. Easing the complicated regulatory procedures (e.g., Taxation) hindering Ease of Doing Business (EODB). Building labor capacity to bridge the labor demand-supply gap and facilitating IPR law implementation.

Clearly defined incentives, with a single governmental body assigned to oversee implementation. Incentives to be performance-based and for a more extended period (5 years minimum) to bear fruit. Alignment of relevant policies (Investment, Industrial, Taxation, Tariff). Fast-tracked one-window digital service for setting up procedures to improve EODB.

Facilitating and encouraging domestic investors will drive foreign investors to invest in Pakistan.

The government needs to enhance its economic diplomacy efforts, while effectively promoting the improved law and order situation.

4.3 Rules for Profit Repatriation



India allows free repatriation of profits once all the local and central (Tax) liabilities are met.

Dividends can be repatriated without any restrictions (after tax deduction at source or dividend distribution tax)



A foreign shareholder of a Vietnamese company may repatriate its dividends distributed by the Vietnamese company after it has fulfilled all tax obligations of the relevant financial year and obtained a tax clearance by the tax authority.

The current Tax regulation prohibits a company in Vietnam to remit dividends abroad if it still carries accumulated losses



Foreign investors in any sector shall at any time repatriate profits dividend or any other funds in the currency of the country from which the investment was originated.

As per Private Investment Promotion Act and subject to Federal Exchange Manual 2002

4.4 Measures to Develop SEZs



FDI: In India 100 percent FDI is permitted for all SEZ investments, except for activities included in the negative list.

SEZ units should be positive net foreign-exchange earners and are not subject to any minimum value addition norms or export obligations.

SEZ developers also enjoy a 10-year "tax holiday." The size of an SEZ varies with the nature of the SEZ. At least 50 percent of the area of multi-product or sector-specific SEZs must be used for export purposes.

Facilities in the SEZ: Businesses operating in SEZ may retain 100 percent foreign-exchange receipts in Exchange Earners' Foreign Currency Accounts. 100 percent FDI is permitted to those franchisees providing basic telephone services in SEZs.



Facilities in the SEZ: Industries operating in SEZ are exempted from import/procurement duties on goods for SEZs' development, operation and maintenance.

In addition, there is an income tax exemption for ten years or 15 years.

Other facilities include exemption from service tax. Exemption from customs duties on the import of capital goods, raw materials, consumables, spares, etc. Exemption from import license requirements. Exemption from Central Excise duties on procurement of capital goods, raw materials, consumable spares, etc., from the domestic market.

FDI aimed to develop townships within SEZs with residential, educational, health-care and recreational facilities permitted on a case-by-case basis.



Manufacturing zones in Vietnam include industrial zones (IZs), economic zones (EZs), export processing zones (EPZs) and high-tech zones (HTZs). Firms investing in these zones enjoy preferential governmental policies and advantages like modern infrastructure and greater access to utility services.

Investors in EZs enjoy the same preferential CIT incentives that exist within IZs located in areas with "challenging socio-economic conditions."

EZs offer a highly favorable environment for foreign businesses and individuals – in particular, a 50 percent reduction in personal income tax (PIT) applies to foreign and local individuals earning a taxable income within the zone.

Furthermore, foreigners who work, invest and do business in EZs are granted visas per their working time within the EZ.

EPZs provide tax incentives, lower land rentals and reduced regulatory oversight in admin and customs procedures. EPZs are also non-tariff areas, so enterprises are exempt from export taxes when exporting their products, and materials. In addition, they are exempted from import or value-added taxes. EPZ are conveniently connected to seaports and airports.



Incentives for SEZ developers: In Pakistan zone developers are subject to one-time exemption from all taxes and customs duties on plant and machinery imported into Pakistan (except items listed under Chapter 87 of Pakistan Customs) for setting up SEZs.

More over, they are permitted for captive power generation and excess power to be sold to the national grid.



Incentives for enterprises operating within SEZ: One-time exemption from custom duties and taxes on import of plant and machinery into SEZ (except items listed under chapter 87 of Pakistan Customs) for installation in the particular zone enterprise.

Moreover, there is ten-year exemption from all taxes on income for enterprises commencing commercial production in SEZs before 30th June 2020.

Five-year exemption from all taxes on income for those zone enterprises of firms which commence commercial production after 30th June 2020



Stakeholders' input for developing SEZs shows a decentralized management model that allows SEZs to shape laws according to regional requirements

One window facilitation at the special economic zone site should facilitate domestic and foreign investors.

Build industrial clusters within SEZs

5. Recommendations

The study concludes that manufacturing and export-oriented sectors need to attract foreign investments. Foreign investors' outlook explains that their priorities have been skewed toward a few sectors for almost three decades. The following measures are suggested to attract efficiency-seeking FDI in Pakistan.

5.1) Enabling Environment for Foreign Investment

Comparative analysis of the policies across regional peers indicates that Pakistan's investment regime for foreign investors is more liberal. However, the cost of inputs such as electricity and labor productivity augments total cost. Stakeholders' input reveals that Pakistan needs to reduce its cost of doing business. The following measures are suggested to create an enabling environment for foreign investors.

- **A consistent policy** is a crucial factor affecting investment inflows. All policies should be long-term with political consensus across parties. Withdrawal from the policy should be penalized.
- **Investment Facilitation:** Develop a GIS system that should be a complete package for investors with information on land costs and their availability, utilities (electricity, gas, telephone, and internet). Need to initiate a "provincial single window" one-stop digital platform for investment in the province that provides direct access to all relevant laws, rules, and reporting requirements for investors.
- **Dispute resolution processes:** Pakistan needs to set a time-bound limit of 2 years for courts to solve investment disputes. This will increase foreign investors' confidence in Pakistan's contract enforcement laws. The litigation process also needs to be time-bound, transparent, and cost-effective. There is a need for a strong legal alternate dispute resolution (ADR) system for investors based on modern legislation with international best practices.
- **Intellectual Property Rights (IPR) enforcement:** Digitalizing the registration process will ensure transparency and minimum time for registration. This will also create a swift path for technology transfer.
- **Robust Capital Markets:** Pakistan needs to create rules and regulations that align with international standards so that foreign investors know how to operate and trust the system to deliver.

5.2) Investment Policy

The lack of sector-specific investment policy and ad-hoc economic decisions has eroded industrial competitiveness significantly. It is recommended that sectors including petrochemicals, light & heavy engineering, minerals & mining, chemicals, and food processing should be prioritized in the investment policy. Investment policies should be coherent with a national industrial policy with sector-specific development goals. The policy should include monitoring and evaluation indicators.

5.3) Mobilizing Domestic Investment to attract FDI

Domestic investment attracts foreign investment. Pakistan's sectoral tax-to-output ratio also reveals the direction of resource allocation, incentive structure, and profitable businesses. The study highlights that real estate yields high returns and has the lowest tax-to-output ratio among sectors. There is a need to redirect the flow of funds from sectors whose productivity levels are derived from speculation activities rather than real production.

- **Taxing the Real Estate:** Channelizing the flow from real estate to manufacturing sectors by increasing the tax on the real sector and encouraging private-public partnership (PPP) in building railways, roads and highways, warehouses, and ports. In addition, there is a need to limit the maximum amount of investment in real estate. The real estate sector needs to be given the status of an industry that the government should regulate.
- **Infrastructure for Industrial Development:** Revive Pakistan Industrial Development Corporation (PIDC), Pakistan Industrial Credit and Investment Corporation (PICIC) and National Development Finance Corporation (NDFC) institutions for industrial development. Initiate a program as *"Infrastructure for industrial development"* to attract and divert investment from real estate to building industrial infrastructure. Schemes such as Real Estate Investment Trusts (REIT) can be used to direct savings for developing industrial infrastructure.
- **Cost of Borrowing:** The cost of borrowing and the financial burden for manufacturing firms must be lowered to make their profits high and attractive to investors. The SBP should specify and fix the percentage of credit disbursement for large-scale industries, SMEs, and cottage industries for commercial banks. Digitalize the credit disbursement mechanism that ensures minimum time, human interaction, and online submission of documents.
- **Digitalize the National Saving Scheme** and develop mobile applications that provide ease of submitting savings in the national saving centers.

- **Reducing the Corporate Income Tax (CIT):** The sectoral tax-to-output ratio needs to be in accordance with the economy's priority for business development. CIT should be gradually reduced to 25% for manufacturing and high-tech sectors, both for foreign and domestic investors.

5.4) Efficiency and Time-bound Incentives for Foreign Investors

To increase market competitiveness, efficiency-based and time-bound incentives should be given to foreign investors.

- **Performance-Based Incentives:** The industrial incentive structure should be tied with sector-wise production efficiency, up-gradation of technology, and sector export performance. Only further incentivize those firms that can export final products. The incentive can be at the export stage (such as duty drawbacks).
- **Time-bound incentives** should be strictly monitored and should be lifted after the exhaustion period. No further extension should be granted to any sector.

5.5) Transfer of Technology and Attracting Technology-Driven FDI

Results of the study show that a big push investment in technological upgradation and knowledge transfer is required to raise the productivity, value addition and export-to-output ratio in large and small-scale manufacturing in Pakistan. The following measures are suggested for technology-driven FDI.

- **Tax exemptions for foreign investors:** should be given on a preferential basis contingent on contributions to new technology, patents, revamping old technology, and technologies in the priority sectors.
- **Local content requirement:** Local content requirements must be included for foreign investors in terms of technology and knowledge transfer.
- **Pathways to Attract FDI in Technology-Driven Sectors:** It is suggested to incentivize foreign and domestic firms to build their assembling plants with zero duty on raw and intermediate goods imports. Firms investing will realize their full potential of market size with maximum profits.

5.6) Utilizing Special Economic Zones to Attract FDI

- Pakistan needs to handle SEZs under CPEC in a manner that can benefit Pakistan in the long run. Making Pakistan a part of the global value chain, local companies should be encouraged for vertical integration with foreign companies having the stakes of both in the agreement. An awareness campaign should be launched regarding BOI's B2B investment portal.

- For investment in new and existing economic zones, preferential tax policies and incentives should be tied with the phases of growth of investment and the location in which SEZs are located. SEZs close to seaports and developed cities should be incentivized less than those in underdeveloped areas.
- Like India, SEZs in Pakistan should also focus on positive net foreign-exchange earners and may not be subject to any minimum value addition norms or export obligations. Investors should be allowed to retain 100 percent of foreign-exchange receipts in Exchange Earners' Foreign Currency Accounts.

5.7) Capacity Building and Start-Up Culture

- Aggressive reforms in our educational structure to empower youth with skills that can attract high-tech value-added production are inevitable in Pakistan. MNCs should be attracted to produce high-value-added goods at the destination where human capital is skilled in handling sophisticated technologies.
- To export and serve beyond the domestic market, startup culture and risk-taking behavior need to revive in Pakistan. Creating healthy competition, incentives to serve the international market, and innovation can benefit the economy in the long run. Manufacturers should work on a growth strategy to add value to their products.



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