# 7 Factors Constraining Investments in Pakistan: Beyond the Macroeconomics

## 7.1 Introduction

The objective of this chapter is to present a comprehensive diagnostic of the investment landscape of Pakistan and to identify the binding policy, legal and institutional constraints, which undermine the country's ability to mobilize domestic and foreign investments to a level commensurate with its potential. Thus, digging beyond the conventional macroeconomic factors such as low savings, shallow financial markets, and presence of a large informal economy, the chapter first highlights the legal and operational challenges that domestic and foreign investors face, especially when it comes to dispute settlement mechanisms, policy advocacy efforts and investor retention practices. It then elaborates upon the weaknesses in tax collection machinery, particularly the lack of administrative ease and cumbersome documentation procedures, which have for long kept the regulatory environment unfavorable for operating businesses and restrained prospective investments. The focus then shifts to the private sector, where the importance of growth in small and medium sized firms is emphasized, and the difficulties such firms face in scaling up their operations in Pakistan are elaborated upon. Finally, the chapter reflects upon the ongoing policy reforms that are aimed at making the investment landscape of the country more conducive and facilitating, and stresses upon elements that will be crucial going forward to systematically address the problem of chronic under-investment in Pakistan.

Within this context, the chapter argues that discrepancies in the country's investment policies, laws, and bilateral treaties increase the risk of potential contract enforcement disputes arising between the state and enterprises. Similarly, the noticeable difference in the *dejure* versus *defacto* investment regime results in time- and resource-sensitive operational challenges for the business enterprises. Concerning the private sector, stagnancy in the SME segment is found to be a major reason for the dispersed and inadequate nature of investment activities in Pakistan. In this regard, poor management practices of small enterprises is highlighted as a foremost hurdle to their innovation, diversification and growth strategies. Lastly, the poor state of human capital development, dysfunctional institutional and operational infrastructure, and an unsatisfactory focus of the government on investment retention practices leave the ecosystem deficient in terms of facilitation and attractiveness. Resultantly, both the existing and potential investors find it hard to commence, conduct and expand their business activities in Pakistan.

## 7.2 Background

The development strategies in most emerging markets (EMs) have been centered on implementing liberal trade and investment policies.[1] Specifically, the consistently high rate of investment in export-oriented sectors is recognized as the most crucial ingredient of East Asia's so-called development miracle. Similarly, the investment-led growth model has yielded enviable results in China, as this enabled the country to secure top position in global manufacturing and export activity over the span of 20 years. Other EMs such as India, Indonesia, Vietnam, Turkey, Chile and Peru have all been focusing aggressively on capital formation in their catch-up endeavors, and have been able to attract heavy investments from both domestic and foreign sources.

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[1] This is because investment is considered an integral part of the economic development process. A sustained inflow of directed investments enhances the production capacity of the country, increases employment generation, and helps reduce poverty. Moreover, by spurring innovation and adoption of efficient operational techniques and technologies, it also makes the production processes of the businesses leaner and more effective. Finally, public or private investments in physical and digital infrastructure help create an enabling and facilitative ecosystem that results in higher investment retention, while fueling further interest of potential investors in the economy.

The investment rate in Pakistan, however, has remained chronically low both in absolute terms and in comparison to other emerging and developing economies, and worryingly has been declining over the past decades (**Figure 7.1**). Effectively, Pakistan stands out as the only country in the Asian region with a falling growth potential.[2] According to the World Bank's estimate, the persistence of current investment growth rates will make it extremely challenging for the country to reach middle-income status in the coming three decades – the required rate is at least 25 percent, as against the current rate of around 15 percent.[3] The fact that other countries are growing faster than Pakistan makes the task more uphill than it may appear otherwise, especially with regards to attracting foreign investments.

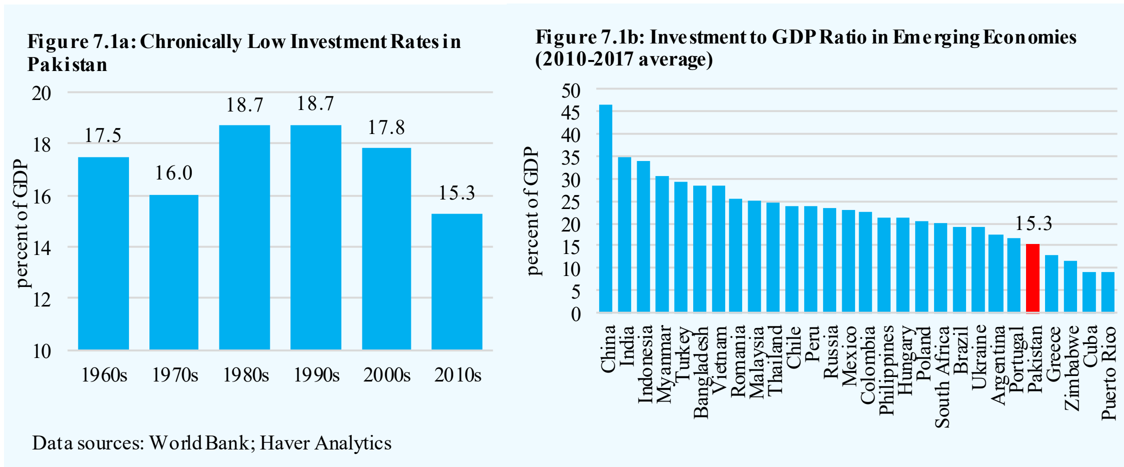



**Figure 7.1a: Chronically Low Investment Rates in Pakistan**

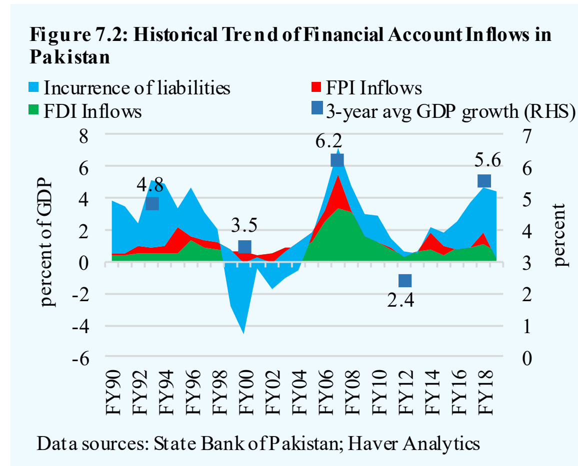
Data sources: World Bank; Haver Analytics

**Figure 7.1b: Investment to GDP Ratio in Emerging Economies (2010-2017 average)**

When we look at sources, the underinvestment appears in both the public and private sectors. In case of public investments, structural weaknesses in revenue mobilization emerge as a binding constraint for the required investment in human capital, transport, energy and digitization in the economy. As for the private sector, while the investment climate has not been too favorable given the unstable macroeconomic environment and infrastructure bottlenecks, investment activity has been further constrained by low domestic savings. Therefore, the country has always relied on foreign savings for achieving high growth and job creation.

The fallout of such a structure of investment finance is that the economy's capacity to sustain growth cycles for a long period has weakened steadily. Specifically, consumption-driven spurts have increased the country's demand at a much higher pace than its supply of goods and services, prompting a need for higher imports. Therefore, it is not surprising to see that nearly all of Pakistan's high-growth periods have coincided with high inflows of foreign savings; whenever such inflows have dried up, economic growth has fizzled out. Even the composition of foreign inflows has remained unfavorable, as the country has struggled to attract significant foreign direct investments, with loans and grants constituting

**Figure 7.2: Historical Trend of Financial Account Inflows in Pakistan**



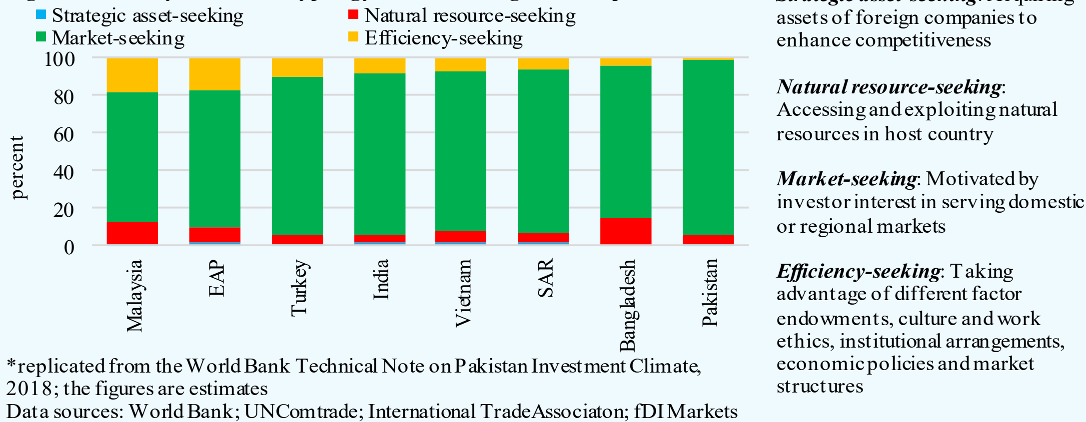

Data sources: State Bank of Pakistan; Haver Analytics

[2] Source: 11th Five Years Plan, Planning Commission, Government of Pakistan, 2013.
[3] Reference: Waheed, Muhammad; Ghumman, Adnan. 2019. Pakistan at 100: Growth and Investment. World Bank, Washington, DC. © World Bank.

the bulk of external inflows (**Figure 7.2**). While this boom-bust nature of Pakistan's growth cycles has been widely discussed, a lesser-known impact of low domestic savings and financial exclusion is the continuously high rate of informal investment activity in the country.[4]

The above discussion raises an important question: what explains persistent underinvestment (both domestic and foreign) in Pakistan, in spite of a liberal trade and investment regime and a large market size? Moreover, it also needs to be explored why – unlike Vietnam, Turkey, Malaysia and India, where a considerable portion of FDI was to seek efficiency – the FDI that has come into Pakistan has predominantly been motivated by market seeking. As may be seen in **Figure 7.3**, Pakistan has the lowest level of efficiency-seeking investment (less than 1 percent) and the highest level of market-seeking investment (94 percent) among comparable countries. It also merits investigation that while existing firms have responded to growing population and income levels in the economy by investing in capacity expansions, the focus on innovation, product diversification and economies of scale has been rather limited. With large enterprises preferring to hold their earnings in cash and, instead of leveraging, using the same to finance their capex needs, the growth in small firms was compromised by limited capital as well as weaknesses in regulatory environment and businesses' structure and management practices. Similarly, even when investible resources were available, these were diverted to less productive sectors of the economy, such as the real estate, due to negligible regulatory oversight and substantial returns. The following sections elaborate on this further.[5]

**Figure 7.3: FDI by Motivation Typology 2005-16 - A Regional Comparison***




*replicated from the World Bank Technical Note on Pakistan Investment Climate, 2018; the figures are estimates
Data sources: World Bank; UNComtrade; International Trade Associaton; fDI Markets

***Strategic asset-seeking***: Acquiring assets of foreign companies to enhance competitiveness

***Natural resource-seeking***: Accessing and exploiting natural resources in host country

***Market-seeking***: Motivated by investor interest in serving domestic or regional markets

***Efficiency-seeking***: Taking advantage of different factor endowments, culture and work ethics, institutional arrangements, economic policies and market structures

## 7.3 Legal challenges

**Discrepancies between the country's investment policy and investment laws**

Pakistan's existing investment policy framework of 2013 is "liberal and fairly open" in terms of facilities that it offers to the prospective investors.[6] Non-discriminatory regulations, openness to FDI in all segments of the economy (except those reserved on account of national security concerns), the possibility of a 100 percent ownership in most of the sectors, and absence of any restrictions on currency convertibility and repatriation of profits attract foreign investors to tap the strong and expanding domestic market of Pakistan. Furthermore, the country's vast network of international

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[4] This vibrancy in the informal sector is represented by a large contribution (71.4 percent) of informal sector in providing jobs, a tax gap of around 10 percent of GDP, and a high cash penetration. Source: Pakistan Labor Force Survey 2017-18.
[5] Here it is important to mention that factors that constrain productive capital formation in Pakistan have been common across both domestic and foreign investors. However, due to limited information available with respect to domestic investments, the Chapter draws heavily from surveys that pertain to foreign investments, e.g., OICCI Perception and Investment Survey, World Bank's Doing Business Indicators and World Economic Forum's Global Competitiveness Report.
[6] Reference: World Bank Group Technical Note, "Pakistan Investment Climate (Prosperity Fund Project – 602167): Findings from the Pre-Implementation Scoping and Diagnostic". World Bank, May 2018.

investment and free trade agreements, at least on paper, ensure smooth and efficient dispute settlements, enactment of minimum treatment standards, and provision of protection against expropriation for potential investments.

However, in addition to the investment policy, two main documents define the overall investment regime in Pakistan: the Foreign Private Investment Act of 1976 and the Protection of Economic Reform Act of 1992. It is pertinent to mention here that the investment policy is more of an attraction document, while the two acts together form the legal foundation that govern the investment related matters of the country. The existence of these three concurrently active documents add to investors' confusion about the permissible scope of investment activities and the overall incentive structure in the economy. Furthermore, there are also discrepancies between the acts and the policy on a number of issues such as the nature of sectors open for investment and rules pertaining to minimum domestic input requirements; mechanisms governing the issues of national and equitable treatment of foreign investments; and expropriation and dispute settlement processes (**Table 7.1**). This makes both the existing and potential investors wary of venturing into any capital formation activity.

**Table 7.1: Comparison of Main Provisions in Investment Laws and the Investment Policy of Pakistan**

| | **Foreign Private Investment Act of 1976** | **Protection of Economic Reform Act of 1992** | **Investment Policy of 2013** |
|---|---|---|---|
| *Scope of application* | Only foreign investors that are already established in the country (post-establishment). | Only foreign investors that are already established in the country (post-establishment). | Both domestic and foreign investors in the pre- and post-establishment phase. |
| *Freedom to invest* | List of specific situations where the Government may authorize investment. | Silent. | All sectors and activities are open for foreign investment unless specifically prohibited or restricted for reasons of national security and public safety. Specified restricted industries include: arms and ammunitions; high explosives; radioactive substances; securities, currency, and mint; and consumable alcohol. |
| *Expropriation* | Only under due process of law and against adequate compensation in the currency of the country of origin. | No expropriation for any reason on ownership, management and control of any banking, commercial, manufacturing or other company. | Silent. |
| *Fair and equitable treatment and national treatment* | Silent. | Silent. | All foreign investors in relation to the establishment, expansion, management, operation, and protection of their investments shall be accorded fair and equitable treatment without discrimination and shall be entitled to treatment "no less favorable" than that granted to national investors in like circumstances. |
| *Local content requirements* | The federal Government may make rules for the employment of Pakistani and foreign nationals in foreign investments. | Silent. | Silent. |
| *Dispute settlement* | Silent. | Silent. | Recourse to international arbitration in case disputes arising from an agreement when provided contracts and only after exhaustion of the local remedies for a period of 6-months. |

Data source: Board of Investment, Pakistan

**Dispute settlement mechanisms are found lacking in terms of contract enforcement and expropriation**

In Pakistan, investors are provided protection against both the indirect and direct form of expropriation, while allowing for full repatriation of profits. A major contribution towards this liberal environment is granted by the 48 bilateral investment treaties (BITs) that Pakistan has with other

countries.[7] However, investors often complain of not getting all the facilitations identified in the respected BITs. Here, it is also worth mentioning that the recent BITs to which Pakistan is a signatory include clauses on which the country's investment laws and policies are either less accommodating or even silent. This has resulted in Pakistan faring poorly both in absolute and relative terms with regards to the perceived risk of expropriation, currency inconvertibility and transfer restrictions, as can be seen in the risk rankings computed and compiled by Credendo, a European credit insurance group (**Table 7.2**).

Existing investors also complain about the long durations of court proceedings for resolving standardized commercial disputes in Pakistan. According to the 2017 perception and investment survey conducted by the Overseas Investors Chamber of Commerce and Industry (OICCI) of Pakistan, over half of the investors stated that the average time for a dispute settlement in the country was over 5 years, while one-fifth of the respondents said that the time taken for such cases was between three to five years (**Table 7.3**).

**Table 7.2: Country Risk Rankings with respect to Direct Investments (Dark Green [1] = Best; Red [7] = Worst)**

| Expropriation Risk | Currency Inconvertibility Risk | Political Violence Risk |
|---|---|---|
| | | |
| | Pakistan | Pakistan |
| Pakistan; Bangladesh | Sri Lanka | Bangladesh |
| Sri Lanka | Bangladesh; Vietnam | India |
| India; Vietnam | India; Malaysia | Sri Lanka; Vietnam |
| Malaysia | | Malaysia |
| | | |

Data source: Credendo (2019); various country profiles

**Table 7.3: Average Time Taken in Pakistan to Resolve a Contract-enforcement Dispute through Courts**

| | 1-6 months | Within 1 year | Within 3 years | Within 5 years | More than 5 years |
|---|---|---|---|---|---|
| | | | *Percent of cases* | | |
| Filing and service | 56 | 22 | 12 | 4 | 6 |
| Trial and judgement | 1 | 16 | 26 | 26 | 31 |
| Enforcement of judgement | 8 | 26 | 24 | 17 | 25 |
| Total time | 0 | 5 | 19 | 19 | 57 |

Data source: OICCI Perception and Investment Survey 2017

Furthermore, a few high-profile dispute settlement cases involving the Pakistani government and established foreign investors have raised concerns regarding the contract enforcement and expropriation protection elements of the investment regime. For instance, Pakistan lost an arbitration case in the London Court of International Arbitration last year in a suit filed by the Independent Power Producers for recovery of dues from the government-owned national grid company, National Transmission and Dispatch Company.[8] Similarly, a Saudi-South Korean joint venture in the steel sector, had also filed a case against Pakistan in an international court of arbitration. The disagreement in this case rose upon the refusal of the government to provide natural gas to the firm's plant at concessional rates, which led to plant's closure since 2014. Furthermore, the International Centre for Settlement of Disputes (ICSID) has heard the cases of a Turkish rental power firm, and Australian coal mining enterprise, against Pakistan. Both the firms had filed the complaint regarding breach of the respective bilateral investment treaties and had first tried the national settlement mechanism (going to the Supreme Court) before proceeding to ICSID.[9]

[7] UNCTAD lists 53 BITs that Pakistan has with other countries. Out of those, 4 have been terminated, while 16 are not in force. URL: https://investmentpolicy.unctad.org/international-investment-agreements/countries/160/pakistan?type=bits.

[8] The IPPs have stated that they may resort to an arbitration filing again amidst the current National Accountability Bureau (NAB) investigation into their operational activities and earnings.

[9] In case of the former, the country was directed to pay about US$ 780 million to the affected firm, with a total liability after including interests amounting to US$ 900 million. Shortly after the announcement, Pakistan registered a petition against the decision, which led to an automatic stay on the enforcement of the award. Concerning the latter, the ICSID awarded US$ 5.8 billion to be paid by Pakistani government for turning down the firm's leasing request for mining purposes.

Alongside resulting in a significant financial burden for the country, such cases have weakened credibility perception of the state of governance in Pakistan. In fact, partially nudged by the greater number of settlement disputes won by investors against the nation-states,[10] governments all over the world have started focusing on modernizing and renegotiating their BITs. This is to ensure that the treaties are not only aligned to the national investment policies of the participatory countries, but that they also include sustainable, development-orientated reforms that safeguard investor rights while encouraging responsible investments and comprehensive settlement procedures. The emphasis is on making the investment related laws and policies as explicitly transparent as possible (**Table 7.4**).

**Table 7.4: Focus on Transparent Regulations and Sustainable Investments in Modern Bilateral Investment Treaties**

| Treaty provisions | Example(s) | Inclusion in Earlier BITs (1959-2010) (percent) | Inclusion in Modern BITs (2010-17) (percent) |
|---|---|---|---|
| Preamble | Health, safety, labor rights, environment-friendliness, sustainable development | 8 | 56 |
| Most Favored Nation treatment | Specifying that such a treatment is not applicable to other IIA's ISDS provisions | 2 | 45 |
| Fair and equitable treatment | Explicitly state minimum standard of treatment under the law | 1 | 29 |
| Indirect expropriation | Clarifying what does and does not constitute as an indirect expropriation | 5 | 42 |
| Free transfer of funds | Include exceptions for Balance of Payments difficulties and/or enforcement of national laws | 18 | 74 |
| Public policy exceptions | Include general exceptions such as for the protection of human, animal or plant life or to limit the exhaustion of natural resources | 7 | 43 |

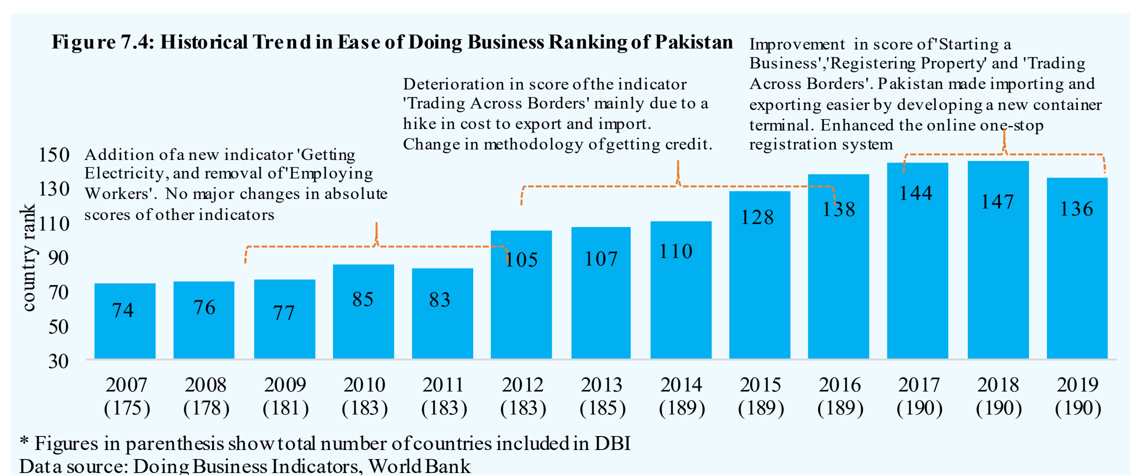
Data source: UNCTAD World Investment Report 2017

## 7.4 Operational challenges

### De jure vs. De facto investment policy

Although Pakistan's investment policy is liberal and draws ample attention, potential and existing investors often state that the actual environment falls short of the promises. This is evident from a very poor ranking of the country in terms of ease of doing business. Over the years, Pakistan has experienced a drop of 62 points in overall ease of doing business (EODB) ranking since 2007 (**Figure 7.4**). Since the ranking is measured relative to other countries, fall in the position does not necessarily indicate an adverse development in doing business environment in the country; rather it may be a sign

**Figure 7.4: Historical Trend in Ease of Doing Business Ranking of Pakistan**



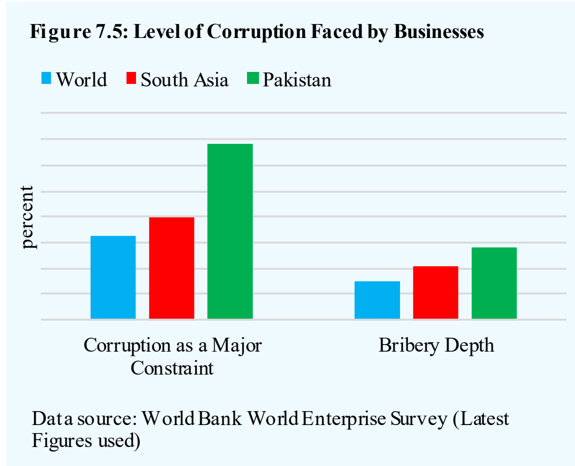

* Figures in parenthesis show total number of countries included in DBI
Data source: Doing Business Indicators, World Bank

[10] From 1987 to 2017, 61 percent of the contract enforcement dispute settlement cases involving investing parties and destination states have been decided in favor of the former. Source: UNCTAD and ICSID.

that other countries have improved their score more relative to Pakistan.[11] However, in case of Pakistan, it appears that the absence of, or delays in, reforms targeting problem areas such as electricity shortages and high costs of trading across borders resulted in the country not posting any meaningful absolute improvement in the rankings during the period under review.

An example of the difference between *de jure* and *de facto* policy is related to operational requirements. The policy states that foreign investors can invest in any of the sectors except those having national security significance, and can start their operational activities prior to receiving the No-Objection Certificate (NOC) from the Interior Ministry. This is a major recent development, as obtaining NOC takes between two to three months. However, the incorporated firms still have to obtain a security clearance certificate that takes at least a couple of months to be processed. Furthermore, there is no standard operating procedure to address complaints of the new businesses systematically. Hence, the investors often have to rely on personal contacts and approach the respective institutions repeatedly to get the issues addressed. Here, incidences of bribery and corruption are also widespread. According to the 2013 World Bank's Enterprise Survey data for Pakistan (the latest available), the percentage of firms identifying corruption as a major constraint and the level of bribery depth (percent of public transactions where a gift or informal payment was requested) is higher than both the regional and world averages (**Figure 7.5**).

**Figure 7.5: Level of Corruption Faced by Businesses**

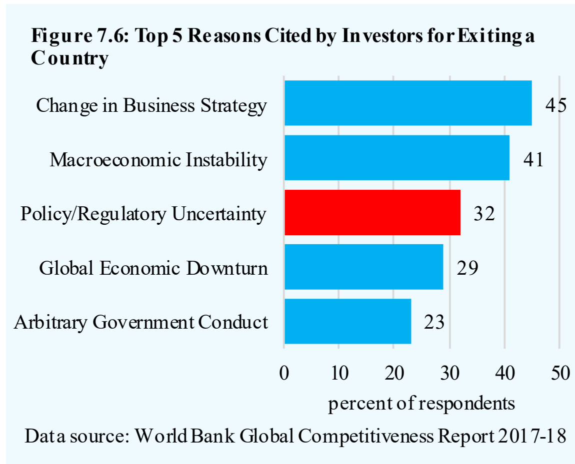



Data source: World Bank World Enterprise Survey (Latest Figures used)

**Investment retention becomes difficult due to regulatory uncertainty and inadequate aftercare facilities**

There is a vast academic literature that reveals that sector-specific policy uncertainty, beyond the overall macroeconomic stability environment, leads to diminution in investor confidence and interest in an economy. In basic terms, incorporating new information as it becomes available is vital for investment and expansion decisions. As policy uncertainty increases, the capability of the investors to integrate the new information (which now becomes unreliable) in their planning and decision-making is adversely affected. The impact of sudden policy reversals or delays in the announcement or implementation of incentives and tax reliefs can also reverberate for months, and it may take substantial time for investments to recover to the initial levels, especially if the investments are irreversible. In fact, apart from a change in the business strategy, multinational

**Figure 7.6: Top 5 Reasons Cited by Investors for Exiting a Country**




Data source: World Bank Global Competitiveness Report 2017-18

[11] The ranking also reflects methodological changes, for instance WB removed Employing Workers in 2011 where country ranked at 146, in next year 'Getting Electricity' was being introduced where Pakistan ranked at 166 position. Due to these methodological changes, Pakistan fell from 83 position to 105 in one year.

enterprises regard policy uncertainty as the second biggest reason for exiting a country, surpassed only by concerns of macroeconomic instability (**Figure 7.6**).

In case of Pakistan, too, policy uncertainty is considered a major barrier to investment growth. Frequent changes in the incentive structures, coupled with the introduction of sector-specific policies that are sometimes not regarded favorably by the investors, make the overall investment climate a challenging one. According to the OICCI's 2017 Perception and Investment Survey, investors regarded policy uncertainty and unpredictability as the fourth major reason for declining investment in Pakistan, after security concerns, image problems and increasing tax compliance on tax compliant sectors. Furthermore, there is no monitoring or review mechanism in place to periodically evaluate the effectiveness of the implemented measures in terms of increasing the existing level of or bringing in more capital formation activities.

It is now widely established that investors value grievance handling, information assistance and policy advocacy efforts of Investment Promotion Agencies (IPAs) on a higher scale compared to promotional activities and first-touch trade and investment exhibitions (**Table 7.5**). There is, hence, a greater focus of IPAs nowadays to move from the *transactional* viewpoint (in which interactions are mostly confined to investment attraction and generation phases) towards a *relationship-enhancing* viewpoint (where existing investors are checked upon and their opinions regarding policy matters are sought on a frequent basis) (**Box 7.1**). In this regard, countries make use of Investor Tracking /Customer Relationship Management (CRM) systems, which the Pakistani Board of Investment (BOI) currently does not have. However, recently BOI has started to actively focus on bringing its aftercare services up to par by introducing country-specific desks, launching a grievance-handling portal and conducting priority sector studies.

**Table 7.5: Percent of Investors Regarding Investment Promotion Agencies' (IPAs) Activities as Important (or Otherwise)**

| | Critically Important | Important | Somewhat Important | Not Important |
|---|---|---|---|---|
| Grievance handling | 28 | 47 | 21 | 4 |
| Information assistance | 26 | 47 | 21 | 5 |
| Improve business environment | 23 | 46 | 25 | 5 |
| Opportunity discussions | 17 | 37 | 35 | 10 |
| Trade and investment exhibitions | 11 | 31 | 42 | 16 |
| IPA advertising | 9 | 30 | 41 | 20 |

Data source: World Bank Global Competitiveness Report 2017-18

**Box 7.1: The Importance of Aftercare Services for Investment Retention**

Aftercare services in terms of investment comprise of "all potential services offered at the company level by Governments and their agencies, designed to facilitate both the successful start-up and the continuing development of a foreign affiliate in a host country or region with a view towards maximizing its contribution to the local economic development" (Young and Hood, 1994). This is one of the four major duties that Investment Promotion Agencies (IPAs) are expected to perform, with the other three being investment generation, image building and making use of policy advocacy. As **Table 7.2.1** shows, aftercare services are of three broad types: *administrative services* (facilitating operations of foreign firms in terms of obtaining licenses and permits); *operational services* (enhancing the efficiency and effectiveness of the operations of foreign investors by locating local suppliers and providing training facilities, etc.); and *strategic services* (influencing the future direction and policy planning of the established firms).

Three major factors are often mentioned to highlight the significance of aftercare services. First, it is a more efficient way of utilizing the budget of an IPA, as it focuses on existing investors. Second, and perhaps more important, the full-scale benefits of inward FDI, such as technology transfers and integration of local producers in the GVCs, cannot be achieved without proper focus on the effectiveness of such investments. Third, satisfied and successful foreign investors can be ideal advertisers of the host destination to other potential investors. Despite the apparent advantages, however, very few IPAs are currently adequately focusing on the aftercare services, utilizing instead their resources on the more traditional activities of attraction and image building. According to the 2018 survey of the World Association of Investment Promotion Agencies (WAIPA), aftercare services account for just 10 percent of the total budget allocations of the IPAs on average. Image building (36 percent) and miscellaneous activities (26 percent) are allocated most of the funds (**Figure 7.1.1**).

**Table 7.2.1: Type of Aftercare Services Provided by Investment Promotion Agencies (IPAs)**

| Type of Service | The Aftercare Service Space | | |
|---|---|---|---|
| | Short Term | Medium Term | Long Term |
| Administrative | Obtain visas, import permits, work permits for spouses, operate in free trade zone | Banking and legal services; obtain food, drugs and administration approvals | Agreement with tax authorities, collaborate with public sector on planning and transport |
| Operational | Find office space, factory, recruit staff, help install ICT equipment, power, etc. | Staff training, new premises, improved connectivity, local supply chains | Local R&D, university collaboration, strong relationships with unions |
| Strategic | Establish firm so that it operates successfully and performs its mandate | Competition legislation, product development, R&D capabilities | Services that support firms in becoming strategic leaders, centres of excellence |

Reference: Young and Hood, 1994

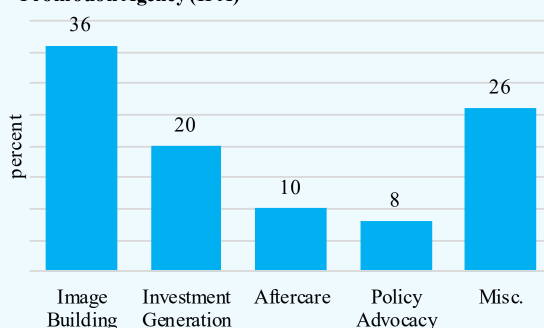
Among the countries having dedicated aftercare initiatives, a few case studies stand out:

(a) *The Investment Aftercare Team in the Republic of Korea*: Active since 1991 under the Korea Trade Investment Promotion Agency (KOTRA), the Investment Aftercare Team of the foreign ombudsman has specialist staff from fields as varied as economics, finance, trade, taxation and law to find solutions to the problems faced by the investors in the country.

(b) *Costa Rican Investment Promotion Agency (CINDE)*: Founded in 1982, the private, non-profit CINDE has been involved in active promotion of foreign investment, local support and post-establishment services. It is considered one of the most successful IPAs in Latin America and across the world, and has been credited in helping attract more than a quarter of the Fortune 500 companies to Costa Rica. The aftercare services provided by the agency include specialized product diversifying and capacity expansion programs, networking and information seminars, and consultation with the investor base about the nature and frequency of issues faced and the way forward.

(c) *United Kingdom Trade and Investment (UKTI)*: The IPA's Investor Development program provides a full-fledge and free-of-cost aftercare support suite. Assistance ranges from workforce skills and recruitment, innovation and technology support, help with exporting overseas and developing forward and backward linkages with the domestic industrial and services base, etc.

**Figure 7.1.1: Average Budget Allocation of an Investment Promotion Agency (IPA)**




Data source: World Association of Investment Promotion Agencies (WAIPA) Annual Survey 2018

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Young, S. and Hood, N. (1994): "*Designing developmental after-care programmes for foreign direct investors in the European Union*", Transnational Corporations, 3(2), pp. 45–72, UNCTAD.

## 7.5 The Unfavorable Tax Environment Merits Special Mentioning

The overall tax regime that encompasses tax structure, rates and payment technology, influences investment climate in the country. To promote investment, the underlying aim of a tax policy regime is to set two distinct goals: first, incentivizing potential investors, and second, increasing revenues to finance essential infrastructure for a business-enabling environment. The pro-investment environment entails a tax system that meets some necessary conditions including fairness, adequacy, simplicity,

transparency, and administrative ease. However, tax authorities in Pakistan have largely struggled to create an environment that is conducive to increase the tax-base, lower the distortions, and promote equitable and efficient tax system in the country. Instead, the complex nature of tax system, perception and incidence of corruption, and cumbersome documentation processes put enough fear and intimidation among a number of existing and emerging businesses to keep them from documenting their setups altogether – certainly, some businesses stay off the radar by their own choice to evade taxes. This has led to a steep surge in the country's informal economy over the years.

In this context, a challenging task for policy makers in the country has been to keep the principal trade-off in providing tax relief to investors while maximizing revenue mobilization. Currently, the tax authorities are struggling to improve the tax-to-GDP ratio, which stagnates around 12 percent in last 5 years, among the lowest in the world. The registered income taxpayers documented in the country were 4.8 million in FY17-18, representing mere 2.2 percent share of current population. In case of sales tax, only 0.2 million business concerns are registered with tax regulatory authorities; 68 percent of overall domestic sales tax revenue comes from nine major sectors including POL, electrical energy, cement, aerated water/beverages, cigarettes, fertilizer, natural gas, sugar, and other food products. The share of other major industries/sectors including auto, textile, chemicals and services sector etc. remained insignificant regardless of the size of their activity in the domestic market.

**Lack of administrative ease: a major hurdle for investments**

The severity of impediments a business faces in dealing with tax-related procedures is reflected in a very low ranking of 173 out of 190 countries in doing business indicator of 'Paying Taxes'.[12] **Table 7.6** compares the different components of Paying Taxes Indicator across major South Asian economies and with the best-scored country i.e., Hong Kong. The absolute score average of paying taxes of Pakistan remained lowest in the South Asian region.

**Table 7.6: Absolute Scores of Paying Taxes Indicator of Doing Business in 2019**

| | Pakistan | India | Bangladesh | Sri Lanka | Hong Kong |
|---|---|---|---|---|---|
| Ease of Taxes RANK (out of total 190 countries) | 173 | 121 | 151 | 141 | 1 |
| Score Average (0=worst; 100=best) | 47.05 | 65.36 | 56.13 | 59.79 | 99.71 |
| Payments (number) | 47 | 12 | 33 | 36 | 3 |
| Time (hours) | 293.5 | 275.4 | 435.0 | 129.0 | 34.5 |
| Total tax and contribution rate (% of profit) | 34.1 | 52.1 | 33.4 | 55.2 | 22.9 |
| Time to comply with VAT refund (hours) | 84.0 | No refunds | 58.0 | No refunds | No VAT |
| Time to obtain VAT refund (weeks) | 79.0 | No refunds | 17.9 | No refunds | No VAT |
| Time to comply with corporate income tax correction (hours) | 69.0 | 3.0 | 37.0 | 3.0 | 2.8 |
| Time to complete a corporate income tax correction (weeks) | 18.6 | 0.0 | 9.3 | 0.0 | 0.0 |
| *Postfiling index (0-100)* | *10.49* | *49.31* | *44.36* | *49.31* | *98.85* |

Data source: Doing Business Indicators, World Bank

For instance, according to the latest report of Ease of Doing Business 2019, a medium-sized manufacturing firm is required to pay 47 payments in a single year to different regulatory authorities in the country. Of these, 17 belong to Federal Board of Revenue (FBR), 12 to Employees Old-Age Benefits Institution (EOBI), and 18 relate to different provincial departments and social security institutions. The indicator scored highest in South Asia and remained well above the regional average of 27.6 in a given year.

The worst performance in the paying taxes was recorded in post-filing index that measures the compliance with and efficiency of completing VAT cash refund and tax audit. More specifically,

[12] Doing Business records the taxes and mandatory contributions that a medium- size company must pay in a given year as well as measures of the administrative burden of paying taxes and contributions and complying with post-filing procedures.

a medium-sized firm requires more than 10 days complying with requisites of VAT refunds and 79 weeks obtaining VAT refunds; this is the worst performance in the region after Afghanistan. For businesses, the inordinate delays in tax refunds create liquidity crunch and increase the risks attached to the viability of upcoming ventures. The latest available statistics suggest that as on June 2018, claims of Rs 372.1 billion were pending with FBR against income tax, sales tax and federal excise duties, FBR had issued Rs 83.1 billion of refunds during July 2018 till March 2019 (**Table 7.7**).

The ranking of the country also remained lowest among the peers for other indicators, such as time to comply with corporate income tax correction and time to complete a corporate income tax correction. In addition, it takes around an average of 45 days to dispose a complaint against revenue division /FBR.[13] The substantially low score of post-filing index reflects the hurdles a business must overcome to continue its operations in the country; it also invokes for massive scale of reforms in tax audit and compliance structure.

**Table 7.7: Claims Pending with FBR**
billion Rupees

| | |
|---|---|
| **Pending Funds (as on Jun 30th 2018)** | |
| Income Tax | 241.6 |
| Sales Tax and FED | 130.5 |
| Total claims | 372.1 |
| **Issuance of refunds during Jul 18 to Mar 19** | |
| Income Tax | 62.0 |
| Sales Tax | 21.2 |
| Total refunds | 83.1 |

Data source: Senate Secretariat

## 7.6 Small Firms Find it Particularly Hard to Scale Up their Operations

Small and medium enterprises are widely considered major contributors to economic growth and employment generation in any economy. In fact, the success of an economy may be gauged by the involvement of such firms in carrying out re-investment activities and graduating into larger enterprises over time. The experience of countries such as the US, UK, Germany and Taiwan signify the importance of the growth-expansion-maturity cycle of small firms via re-investments towards the overall economic prosperity of the nation. However, in case of Pakistan, small firms have struggled to evolve over the decades and have continued to operate at the same size, "failing to benefit from economies of scale or innovation in technology and hence rendered uncompetitive internationally".[14] While uncertain macroeconomic environment and an insipid industrial performance over the years explain limited growth opportunities for small-sized firms, weaknesses in their own management, unfavorable regulatory environment, limited access to finance and skill gaps are found to be major growth barriers for small-sized firms in the country.

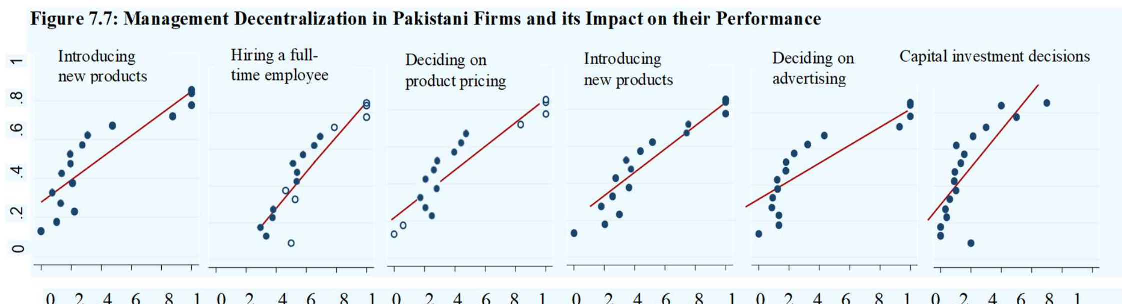
The issue of poor management practices particularly stands out as a major factor for the stagnancy in the performance of small firms. As came out from a systematic face-to-face Management and Organization Surveys in more than 2,000 establishments in Punjab, management practices are less structured in small (and medium sized) firms compared to large firms,[15] especially with respect to decentralization of decision-making, data-driven performance monitoring, target- and incentive-setting, and usage of data for decision-making.[16]

Importantly also, due to a low appetite for risk-taking and poor entrepreneurial expertise amongst the players, expansion is not focused upon as an objective after firms start yielding low but consistent returns. Over time, such enterprises stop investing in upgradation of operational activities,

[13] Federal Tax Ombudsman of Pakistan (FTO)
[14] Afraz, N., Hussain, T., Khan, U., (2013) Barriers to the Growth of Small Firms in Pakistan: A Qualitative Assessment of Selected Light Engineering Industries. IGC Working Paper, pp 5, February 2013.
[15] The study defined large enterprises as employing more than 200 workers, medium and small enterprises as employing 50-199 and 10-49 workers, respectively, and micro establishments as employing less than 10 workers.
[16] Source: Lemos, R., Choudhary, A., Van Reenen, J., Bloom, N., (2016) Management in Pakistan: First Evidence from Punjab, IGC

replacement of outdated machineries, product innovation and skill building of the workforce. Therefore, it is not surprising to observe a strong positive correlation between quality of management practices (and decentralization of decision-making power) and firms' performances in Pakistan in terms of productivity, profitability and growth (**Figure 7.7**).[17]

**Figure 7.7: Management Decentralization in Pakistani Firms and its Impact on their Performance**




The sample includes all MOPS observations from establishments reporting that the headquarters are at a different location, with no missing responses to the autonomy questions and with at least 11 non-missing responses to management questions (857 observations from 462 establishments). The establishment management score is the unweighted average of the score for each of the 16 questions, where each question is first normalized to be on a 0-1 scale, and averaged across establishments in bins of 0.05. The autonomy measures are also normalized to be on a 0 - 1 scale.
Data source: Lemos, R., Choudhary, A., Van Reenen, J., Bloom, N., (2016) Management in Pakistan: First Evidence from Punjab, IGC

To contextualize the above phenomena, the literature uses the terms liability of *senescence* (whereby old firms resist changing their business model and become inert to transformation) and liability of newness (whereby newer firms face a hard time, as they are yet to establish and legitimize their position in the market) to explain major barriers to growth of the small firms. The interplay of these dynamics gradually drive the overall market toward *obsolescence*, as the product focus, operating methods and growth models become incongruent to the trends witnessed in the international market. This results in firms losing their share in the export market as they fail to integrate with the emerging global value chains, and facing stiffer competition in the domestic economy from better quality imported alternatives. **Box 7.2** highlights some of these matters in detail by focusing on a study on small firms operating in the light engineering and sports-goods industries of Pakistan.

**Box 7.2: Barriers to Growth of Small Firms in Pakistan**

International literature investigating the reasons behind small firms finding it hard to scale up their operations points toward more or less the same major hurdles that are referred to when talking about the overall ease of doing business environment in an economy. Issues such as energy shortages, corruption, macroeconomic instability, credit market failures, weak institutions, unskilled labor, and infrastructure constraints are frequently cited. However, the market dynamics of each country tend to vary considerably, and this makes it a useful exercise to complement the international studies with domestic surveys.

In this regard, an important study carried out by the International Growth Center (IGC) in 2014 revealed some critical reasons behind the failure of small firms in Pakistan to expand their operational capacities. The authors covered both the domestic market-oriented firms and the exporting firms, by surveying the fan manufacturing and sports good industries respectively. This was done in order to inspect whether different factors affect these firms differently. The barriers found common across the spectrum are as follows:

(i) *Management and Succession Planning*: Management issues are perhaps the biggest hurdle to small firms' growth and expansion in Pakistan. With markets often predominantly informal, and contract enforcement and copyright laws rarely followed, there exists a constant threat of product counterfeiting and labor defection. Thus, owners/senior executives of the firms are inclined to keep business plans to themselves and confine delegation to a minimum.

(ii) *One third of the surveyed manufacturers stated that finding skilled labor force is difficult*: Although Pakistani firms have the advantage of availability of cheap labor, the prevalence of skills deficit considerably offsets the gains from the

[17] Similarly, firms which were larger, older, export-oriented, and with skilled managers and line managers were found to have higher management scores relative to the other firms.

former. Apart from an overall low level of human capital in the country and inadequate number of available modern technical training facilities, seasonality in the operations also plays a substantial role in increasing search and training costs of the firms. This is because seasonal activity leads to small firms having limited capital off-season to maintain production or keep employees on a payroll.

(iii) *42 percent of the firms had not upgraded their machineries during the last decade:* The authors of the study found that the firms had a really low and stagnant level of productivity, and usage of old machineries turned out to be a major contributing factor in this regard. Interestingly, 92 percent of firms were also outsourcing some of the production due to lack of in-house technical expertise. Over-reliance on own funds (as small firms rarely use bank loans for fixed investments) and cost-competition culture means that scope of collaborative research is negligible. Whatever "R&D" is happening in the sector focuses on reverse engineering of imported alternatives and the products of large players (who are relatively more open to investing in new modes of operations).

(iv) *For every firm working in the formal sector, there were 28 informal units:* There is a high degree of informality in the SME segment, particularly the export-oriented sports sector. Small firms focusing on sporting goods are predominantly based in Sialkot. There are roughly 360 formal and over 10,000 informal such businesses in the city. The high degree of informality gives rise to certain challenges for such small enterprises. For instance, a considerable number of firms in the study were registered for sales tax. However, a general complaint was that the suppliers were reluctant to provide receipts to smaller firms (due to the latter's lower negotiating power), thus making them unable to claim for refunds and concessions.

(v) *Manufacturers are not focusing on products that represent over 95 percent of global trade:* Most of the export-oriented firms were found manufacturing products that were not in-sync with the changing demand landscape. For instance, the sports manufactures in the country are still focusing on direct sports equipment manufacturing (such as balls and bags), while the "lifestyle" goods such as apparel and allied-accessories are providing greater margins and growth potential worldwide.

(vi) *None of the firms reported borrowing from the commercial banks for investment purposes:* Small firms hesitate to take out loans from financial institutions and instead rely either on own-money (retained earnings) or on market credit. Market credit mechanism is circular in nature, whereby the manufactures buy raw material from the suppliers on credit and promise to pay the amount when the orders are sold in the market. The wholesalers then buy inventories from the manufactures on credit contingent upon sales to retailers and/or end consumers, and so on. This makes the whole supply chain particularly vulnerable to any demand or supply side shock, in which case a "bull whip" effect arises and disrupts cash flows of all the agents in a sector

Reference:
Nazish Afraz & Syed Turab Hussain & Usman Khan, 2014. Barriers to the Growth of Small Firms in Pakistan: A Qualitative Assessment of Selected Light Engineering Industries, Lahore Journal of Economics, The Lahore School of Economics, Vol. 19 (Special Edition), pages 135-176, September, 2014.

Another important factor constraining the expansion acitvities of small enterprises in Pakistan is that of lack of access to and demand for formal credit channels. Overreliance of small firms on internal (the retained earnings or life savings of the owners/managers) and expensive informal (borrowings from friends and family, credit from supplier and advances from customers, or from the informal market lenders, etc.) financing channels results in these firms not having adequate access to resources to timely upscale their operations. Inefficient operational activities mean that most of the funds from the aforementioned sources are consumed for the working capital requirements, thereby making investments in fixed capital formation challenging. Here, the preference for status quo exhibited by the founders/executives results in their enterprises getting stuck in the existing mode of operation.

The literature here makes a distinction between firms being credit rationed and credit constrained. Being credit rationed implies that firms are getting adequate access to credit from the informal channels, but would happily switch to cheaper formal financing if their awareness regarding it and the banks' preference towards it increases. Being credit constrained, however, indicates that the firms are not getting as much access to credit as they deem adequate for their growth aspirations. In Pakistan, the small enterprises are usually not only credit rationed but also credit constrained. This is in line with the experience of SMEs in countries with a large informal economy.[18] Another study, focusing on SMEs in Pakistan and using the World Bank Enterprise Survey to construct a panel data,

[18] Reference: Banerjee, Abhijit V., and Esther Duflo. "Do firms want to borrow more? Testing credit constraints using a directed lending program." Review of Economic Studies 81.2 (2014): 572-607.

discovered that access to formal credit channels (commercial banks) was consistently linked with the improvement in growth metrics of the firms, while informal channels were seen to impact SMEs' performance negatively and in a greater magnitude than the positive impact of formal borrowing.[19]

Another issue worth mentioning is that small firms do not have access to equity markets to raise financing, which hinders their growth aspirations. Meanwhile, larger enterprises can avail such funding reltively easily and can also treat their bank loan interest payments as business expenses that are tax deductible. This reduces their tax liability and puts them at an advantaged position over the smaller firms, who cannot treat informal lending (which constitutes the major portion of their financing) in the same manner.

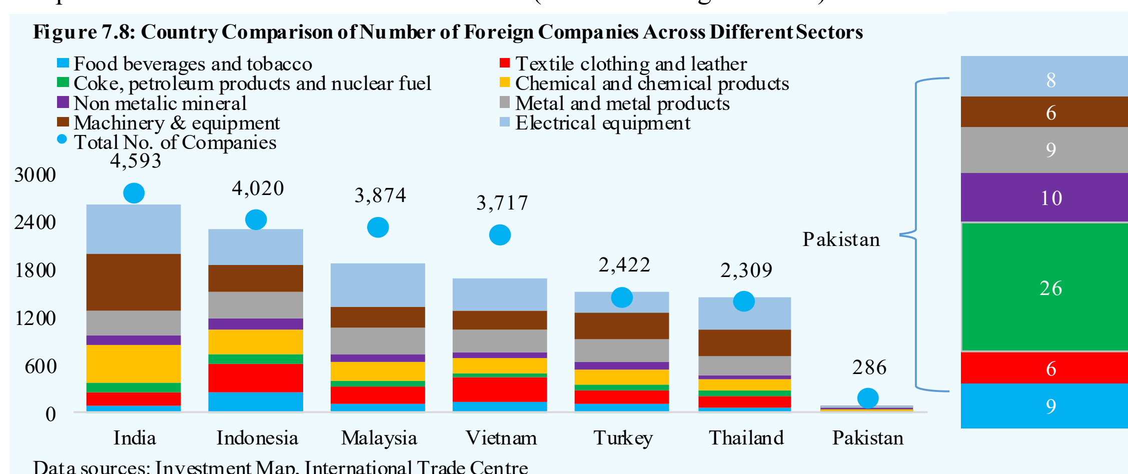
Finally yet importantly, an under-skilled and less productive labor force is a worrying factor hindering the growth and competitivenes of the businesses in the country. However, as both the small and large enterprises are affected by the sub-par level of human capital development, this issue is elaborated upon sepeartely in the next section.

## 7.7 Inadequate Improvement in Human Capital and Competitiveness Indicators Hinders Innovation and Growth Potential

Human capital is an important determinant for attracting investment in a country. This is because the investors desire a labor force with adequate skills and some relevant exposure of the industry and operating methods to go along with it. This is also the reason why governments and investment promotion agencies across the world are working on providing the domestic labor force with vocational training opportunities and relevant experiences in terms of operating modern machineries. The quality and adaptability of labor force are the principal determinants of a facilitative investment environment in a country. Quality is determined by the education, skills training and overall health standards of the population; while adaptability refers to the ability of workers to evolve their skill sets relevant to the changing structures of the Global Value Chains (GVCs).

Being a nation of 210 million people, Pakistan could have attracted significant foreign investment given the abundance of cheap labor, lucrative investment policies and a strategic geographical position. Unfortunately, the country has remained unable to tap the opportunities: currently only 286 companies of foreign origin are operating in Pakistan, vastly outnumbered by the 2,422 firms working in Turkey and 4,593 firms operating in India. As highlighted earlier in the chapter most of these companies have stakes in consumer businesses (market-seeking activities) and few are involved in

**Figure 7.8: Country Comparison of Number of Foreign Companies Across Different Sectors**




Data sources: Investment Map, International Trade Centre

[19] Reference: Khan, Salman. "Impact of sources of finance on the growth of SMEs: evidence from Pakistan." Decision 42.1 (2015): 3-10.

mining and quarrying activities (natural resource-seeking activities). Manufacturing of capital goods, heavy machineries & equipment, steel sector, and tech products have not received significant foreign investment that could otherwise bring positive spillovers such as new technologies, improved overall productivity and skilled job creation (**Figure 7.8**).

As things stand, Pakistan falls behind its regional and comparative economies in terms of human capital standards and development. The country ranks 134th (out of 157 economies) and 150th (out of 189 countries) in the World Bank Human Capital Index and the United Nations Human Development Index, respectively. A host of factors, from low expected years of schooling to high rates of malnutrition amongst the children, account for the unsatisfactory performance in the two indices (**Table 7.8**).

**Table 7.8: Human Capital Index (HCI) 2018 Score and Ranking - Performance of Pakistan**

| Component | Score | Ranking# |
|---|---|---|
| Survival to Age 5 | 0.93 | 142 |
| Expected Years of Schooling | 8.8 | 127 |
| Harmonized Test Scores | 339 | 145 |
| Learning-Adjusted Years of Schooling | 4.8 | 134 |
| Adult Survival Rate* | 0.84 | 93 |
| Not Stunted Rate** | 0.55 | 103 |
| **Overall HCI** | **0.39** | **134** |

# Rank out of 157 countries
*Data available for 156 countries; **Data available for 109 countries
Data source: World Bank

**Table 7.9: The Global Entrepreneurship Index 2018 – Selected Indicators**

| Country | Start-up Skills | Risk Acceptance | Networking | Cultural Support | Human Capital | Product Innovation | Overall Score# | Global Rank* |
|---|---|---|---|---|---|---|---|---|
| China | 0.24 | 0.47 | 0.51 | 0.33 | 0.52 | 1.00 | 0.41 | 43 |
| India | 0.22 | 0.40 | 0.14 | 0.14 | 0.29 | 1.00 | 0.28 | 68 |
| Philippines | 0.43 | 0.34 | 0.19 | 0.29 | 0.44 | 0.82 | 0.24 | 84 |
| Vietnam | 0.28 | 0.07 | 0.25 | 0.24 | 0.46 | 0.44 | 0.23 | 87 |
| Sri Lanka | 0.16 | 0.07 | 0.07 | 0.12 | 0.31 | 0.95 | 0.22 | 90 |
| Pakistan | 0.06 | 0.02 | 0.11 | 0.21 | 0.10 | 0.49 | 0.16 | 120 |
| Bangladesh | 0.04 | 0.05 | 0.10 | 0.21 | 0.13 | 0.04 | 0.12 | 134 |

*Rank out of 137 countries; # 0=worst and 1=best
Data source: The Global Entrepreneurship and Development Institute (2017)

Furthermore, according to the 2018 Global Entrepreneurial Index published by the Global Entrepreneurship and Development Institute situated in London, Pakistan ranks at 120th place out of 137 countries – lower than the regional or peer countries barring Bangladesh (**Table 7.9**). While the country has very low scores in all of the sub-indicators, the poor performance in the risk acceptance, start-up skills, and human capital components of the index is particularly worrying. The former two highlight the firms' lack of ambition towards evolving management methods, product focus and growth models, while the latter signifies the low skill-sets and productivity of the economy's labor force.

**Table 7.10: The Global Competitiveness Index-2019 (Rank/141)**

| | | Human Capital | | Markets | | | | Innovation Ecosystem | |
|---|---|---|---|---|---|---|---|---|---|
| Economy | Overall Ranking | Health | Skills | Product Market | Labor Market | Financial System | Market Size | Business Dynamism | Innovation Capability |
| China | 28 | 40 | 64 | 54 | 72 | 29 | 1 | 36 | 24 |
| Indonesia | 50 | 96 | 65 | 49 | 85 | 58 | 7 | 29 | 74 |
| Turkey | 61 | 42 | 78 | 78 | 109 | 68 | 13 | 75 | 49 |
| India | 68 | 110 | 107 | 101 | 103 | 40 | 3 | 69 | 35 |
| Brazil | 71 | 75 | 96 | 124 | 105 | 55 | 10 | 67 | 40 |
| Sri Lanka | 84 | 43 | 66 | 131 | 118 | 87 | 58 | 70 | 84 |
| Iran | 99 | 72 | 92 | 133 | 140 | 123 | 21 | 132 | 71 |
| Bangladesh | 105 | 93 | 117 | 119 | 121 | 106 | 36 | 121 | 105 |
| **Pakistan** | **110** | **115** | **125** | **126** | **120** | **99** | **29** | **52** | **79** |

Data source: The Global Competitiveness Report 2019- World Economic Forum

The other major reason behind this dismal state of foreign investment in Pakistan is its fragile institutional and operational infrastructure. As may be seen in **Table 7.10**, Pakistan's standing in the World Economic Forum's Global Competitiveness Index 2019 is better in the *innovation ecosystem* dimension relative to the *human capital* and *markets* dimensions. In fact, Pakistan fares better than most of the regional economies and scores closer to what other populous emerging economies (such as China and Indonesia) achieve. This indicates that the private sector has the innovation capability and the potential to improve their operational practices. However, these are constrained by the overall deficiencies witnessed in the product, labor and financial market ecosystem and the regulatory system of the country.

**Table 7.11: Reforms in Different Indicators Mentioned in World Bank Report on Doing Business Indicators**

| Year | Reform | Impact on DBI |
|---|---|---|
| | **Starting a business** | |
| 2018 | Pakistan made starting a business easier by replacing the need to obtain a digital signature for company incorporation with a less costly personal identification number. This change applies to both Karachi and Lahore. | Positive |
| 2019 | Pakistan made starting a business easier by enhancing the online one-stop registration system, replacing several forms for incorporation with a single application and establishing information exchange between the registry and the tax authority. This change applies to both Karachi and Lahore. | Positive |
| | **Registering property** | |
| 2011 | Pakistan made registering property more expensive by doubling the capital value tax to 4%. | Negative |
| 2017 | Pakistan improved the quality of land administration by digitizing ownership and land records. This reform applies to Lahore. | Positive |
| 2018 | Pakistan (Karachi) improved the transparency of the land registration process by making the fee schedule and list of documents to submit for property registration available online. | Positive |
| 2019 | Pakistan (Lahore) made registering property easier by streamlining and automating administrative procedures and by increasing the transparency of its land administration system. Pakistan (Karachi) made registering property easier by increasing the transparency of the land registry. | Positive |
| | **Getting credit** | |
| 2017 | Pakistan improved access to credit information guaranteeing by law borrowers' rights to inspect their own data. The credit bureau also expanded its borrower coverage. This reform applies to both Lahore and Karachi. | Positive |
| | **Trading across borders** | |
| 2011 | Pakistan reduced the time to export by improving electronic communication between the Karachi Port authorities and the private terminals, which have also boosted efficiency by introducing new equipment | Positive |
| 2015 | Pakistan made trading across border made easier by introducing a fully automated, computerized system, (the Web Based One Customer System) for the submission and processing of import and export documents. This reform applies to both Lahore and Karachi | Positive |
| 2017 | Pakistan made exporting and importing easier by enhancing its electronic customs platform. This reform applies to both Lahore and Karachi | Positive |
| 2018 | Pakistan made importing and exporting easier by developing a new container terminal and enhancing its customs platform for electronic document submission. These changes apply to both Karachi and Lahore. | Positive |
| | **Paying taxes** | |
| 2012 | Pakistan increased the profit tax rate for small firms. | Negative |
| | **Protecting minority investors** | |
| 2018 | Pakistan increased minority investor protections by making it easier to sue directors in case of prejudicial transactions with interested parties. This reform applies to both Karachi and Lahore. | Positive |
| | **Resolving insolvency** | |
| 2019 | Pakistan made resolving insolvency easier by introducing the reorganization procedure and improving the continuation of the debtor's business during insolvency proceedings. This change applies to both Karachi and Lahore. | Positive |

Data source: World Bank Ease of Doing Business Reforms Database

The country's limited fiscal space has left little to invest on areas that could increase the competitiveness of the country, for example education, infrastructure, technical trainings, research institutions etc. In addition, the private sector (mostly local participants) also remained inattentive to the ongoing innovations and tech change in the global markets. Low level of technology transfer and lack of skilled labor and has not permitted the private sector to invest in capital-oriented technologies. In addition, ever increasing competition, globalization and technological progress in other countries has made it difficult for local industry to survive.[20]

## 7.8 Recent Improvements are Welcome…

In 2019, Pakistan's Doing Business (DB) ranking witnessed a jump of 11 points. This substantial improvement came on the back of major reforms in three broad segments including 'Starting a Business', 'Registering Property' and 'Resolving Insolvency'. Meanwhile FBR, provincial authorities and other federal agencies such as the BOI and EOBI are working collectively to build on this progress; these reforms are highlighted in **Table 7.11.** Encouragingly, for the DB ranking for 2020, Pakistan has been included in the list of Top-20 *improvers* across the globe. Importantly, out of ten areas, Pakistan exhibited improvement in six areas including starting a business, dealing with construction permits, getting electricity, registering property, paying taxes and trading across borders.

Furthermore, BOI is also working on designing a platform to connect with and track the progress of existing investors in the country. The aim is to help improve the agency's aftercare and policy advocacy facilities. BOI has also started initiatives recently to help increase the aftercare infrastructure in the country. The measures include the development of country-specific and thematic desks, whereby specialized teams have been formulated inside the BOI to help investors pertaining to either certain priority sectors or belonging to countries from where FDI inflows have remained or are expected to be high (such as China). The other reform has been the inception of a digital grievance handling portal, which has already catered to 8,531 complaints, of which 8,312 were forwarded to respective institutions and departments such as the FBR and all the remaining 211 BOI-related complaints were resolved. The IPA has also conducted Ernst & Young-aided thematic studies to help identify the key priority sectors of the country (textiles, IT and ITeS, food processing, automotive and auto parts, and logistics sectors). A SWOT analysis was carried out, and the BOI aims to use the knowledge to help address the concerns faced by the local and foreign business community to make the investment climate more conducive for attracting further FDI inflows.

On the taxation front, FBR has already introduced a number of reforms (see **Table 7.12** for detail). Two developments in particular stand out. First, the number of tax-related payments has been reduced from 47 to 21 by enabling electronic filing and payment of all federally administered taxes (both corporate and VAT taxes).[21] Second, the corporate income tax rate for small firms has been reduced (from 25 percent in 2018 to 24 percent in 2019). Contrary to FBR, however, the provincial authorities could not bring any improvement in their tax administration system during the period under review.

The above-mentioned actions are being complemented by the government's focus on shrinking the size of the informal economy in Pakistan. This is being done via two parallel policy drives. Firstly, measures such as restricting purchases of land by non-filers and increasing the valuation rates of immovable properties may help divert the attention away from the non-productive segments such as real estate (which had for long granted a legal way for tax avoidance and abnormal profitability)

[20] As a result of non-conducive environment, a number of industrial undertakings faced complete closure in last few years, including Pakistan Steel Mills; others confronted serious financial and operational issues, like Pakistan Machine Tool Factory, Heavy Mechanical Complex Taxila etc. In addition, the operations of various private sector industrial units also came to a halt due to stiff competition from the Chinese companies.

[21] With electronic payments, the tax is counted as paid once a year irrespective of frequency of payments in a given year.

towards productive avenues. At the same time, tax authorities are actively working to document the

| **Table 7.12: Reforms in Paying Taxes**[22] |
|---|
| **Electronic Filing of Declarations** |
| Income tax and sales tax returns filed electronically through FBR web portals |
| Introduced preparation of declarations in offline mode for income tax returns, sales tax returns and wealth statements |
| Taxpayers and authorities send and receive correspondence electronically through IRIS |
| Amended income tax laws: Taxpayers can revise income tax return on his own (section 114(6) of Income Tax Ordinance, 2001) |
| Online system reduced the time to comply with income tax correction |
| *Impact: Post filing Index* |
| **E-Payment of taxes through alternate delivery channels** |
| Payment of taxes through internet banking, ATM, mobile banking and contact canters through ADC |
| Reduction in income tax payments |
| Reduction in sales tax payments |
| *Impact: Total number of taxes and contributions paid* |
| **VAT refunds** |
| Zero rated supplies - no carry forward period |
| Online filing of 85 percent of refund claims |
| Enhancement of scope of Expenditure Refund Systems (ERS) |
| No triggering of audit queue based on VAT refund claims |
| Payment of refund through direct bank transfers |
| *Impact: Post filing Index* |
| Data source: FBR |

sales by registered businesses in Pakistan to unregistered enterprises/individuals. Initially, the registered persons were required to issue a serially numbered tax invoice at the time of the sale of goods. The invoices had to include the name, address and registration number of the supplier and recipient of the goods; the date of issue of the invoice; the description and quantity of goods; value of the sales tax applied; and the price inclusive and exclusive of the GST. According to the amendment in the Sales Tax Act 1990, the requirements have been elaborated further and the registered persons have been instructed to record NIC number or NTN of the recipients unregistered with FBR for sales tax in addition to the details being recorded of the registered recipients.[23]

To promote SME sector in Pakistan, the government and SBP have embarked upon collaborated efforts and taken various measures. These include: (i) setting up annual targets for SME financing and advising banks to formulate SME finance strategy; (ii) introducing credit guarantee schemes for small and rural enterprises; (iii) announcement of the refinance facility for modernization of SMEs; (iv) continuation of the Prime Minister's Youth Business Loan Scheme to start new businesses; (v) facilitation from SECP's side to SMEs in raising venture capital and private equity funds; and (vi) setting up of facilitation counters at various ministries and the Chamber of Commerce and Industry, etc.

Lastly, to improve the attractiveness of the domestic labor force along the dimensions of quality and adaptability, the government has initiated various programs under the umbrella of both PSDP and CPEC. For instance, the National Vocational and Technical Training Commission (NAVTTC) of Pakistan is in the process of introducing officially defined skill-set categorizations and an assessment criterion for the technical and vocational education and training (TVET) institutes to help improve the placement and skill matching in the domestic labor market. This is expected to help reduce the matching costs of unemployment in the economy and make the TVETs more accountable. Another welcome development has taken place under the CPEC initiative whereby the relevant government institutions are working with Chinese firms hoping to work in Pakistan for technical skill building of the domestic labor force, to enable them to be prepared for work under various programs. This

[22] These measures have been identified by FBR in a presentation publically available at FBR website. EODB ranking of FY2019 did not incorporate these measures. Due to certain cut-off dates, the impact of some of these reforms will likely be missing in the EODB 2020 ranking.

[23] A relaxation from this clause was granted for sales up to Rs 50,000, if the recipient is an ordinary customer (i.e. a person who is buying goods for his or her own final consumption and not for reselling).

includes emphasis on vocational training (such as the construction of Pak-China Technical and Vocational Institute at Gwadar), scholarships and exchange programs for university and college students as mentioned in the Joint-Statement between the two countries, and collaborative efforts with Pakistani technological platforms (such as the AliBaba eFounders Fellowship program with National Incubation Center, Karachi).

## 7.9 … But More Needs to be Done

While the aforementioned policy measures and reforms currently being implemented are steps in the right direction, there still exist some areas that, if focused upon, would complement the aforementioned efforts in terms of improving the overall investment climate in the country. The following sub-sections elaborate on this further.

**Coherent and consistent policy framework is needed**

From the policy perspective, there is a need to revisit the investment laws, modernize them in light of the recent best practices, and then frame the investment policy document accordingly. Better yet, the three documents may be merged into a single, comprehensive framework; this would substantially help mitigate the confusion and uncertainty that is faced by both the existing and potential investors.

Another needed measure is the renegotiation of older Bilateral Investment Treaties (BITs) that Pakistan has signed with the other economies in order to bring them up to par with modern standards. As stated in the previous sections, elements such as minimum standard of applicable laws; explicit definitions of direct and indirect expropriation; special applicable clauses during phases involving balance of payments difficulties; and health, labor and local requirement conditions, etc. would lead to lower instances of cases involving dispute settlement between the investors and the country.[24]

There is also a need to increase the coordination between the federal and provincial governments, especially with investments now a provincial concern after the 18th Amendment. This would help minimize frictions resulting from the multiplicity of regulatory jurisdictions. Increased coordination would also help address the problems and facilitate negotiations between the investors and the provincial and federal governments. The IPAs, in this regard, can provide a channel for registering complaints about the regulatory hurdles and contract enforcement faced by the investors and then directing those to the relevant authorities for resolution.

**There should be a collaborative implementation of the announced human capital policies**

Strong coordination is needed to improve the state of human capital in the country and by extension, labor productivity. As stressed in previous reports, there needs to be an overarching policy to govern the skill-building process from the public domain to keep the progress aligned with the national objectives. Recently, Sindh, Punjab and Khyber Pakhtunkhwa, all have launched labor policies with the objective of increasing jobs, providing a safe and healthy work environment, ensuring gender parity in employment, and training their respective labor force according to the needs of a transitioning economy. This is an appreciable step, but it is important that these policies are also implemented in letter and spirit to realize the envisioned gains.

Furthermore, active promotion of the training programs would be needed to widen their impact, as currently only 8 percent of workers in Pakistan receive some form of on-the-job training from vocational institutes, and much of that is uncertified in nature.[25] A major impediment is the significantly low number of workers with a secondary or a higher secondary education (the Ministry

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[24] It is important to emphasize here that the various BITs must align with the investment laws of Pakistan.

[25] Reference: "Skills for Growth and Development – A Draft National Technical and Vocational Education and Training (TVET) Policy"– A Consultation Document of The National TVET Policy Task Group (2014). The document is available on the website of Ministry of Federal Education and Training, Pakistan.
http://www.moent.gov.pk/mopttm/userfiles1/file/Final%20Consult%20Paper%20of%20TEVT%20Policy.pdf

of Federal Education and Professional Training puts the figure at 6.5 percent of the total population), which is a prerequisite for entry into most of the certified vocational training programs in the country.

**Clear communication of tax measures is vital for their successful implementation**
While it is encouraging to see that the government is in the process of implementing most of the needed reforms with regards to tax policy, it is equally important to emphasize that the government must also significantly enhance its communication efforts to clarify the motivations behind the measures taken, justify the mechanisms of the proposed. Much of the unrest and opposition against proposed measures arises due to a misunderstanding of the provisions and amendments of the policies on the businesses community's end.

Although the FBR issues clarification circulars and interacts with the businesses on various forums and settings to help clarify the matters and take feedback on the respective issues, it is important that such communication channels be further strengthened and made a permanent part of the dialogue between the two parties. One suggestion is to release non-technical, Urdu briefs of the various acts, SROs and policy documents in action. This would help overcome the language barrier, all the while helping to convey the message in as simple a way as possible directly from the source (the tax authorities). This is vital in terms of ensuring smooth adoption and implementation of policies; cementing transparent policy advocacy channels; and in effect reducing the regulatory and policy distrust and uncertainty in the economy.

**The focus should be on identifying and incentivizing firms with a high-growth potential**
It is important to emphasize that a general focus on SME financing and facilitation can prove to be sub-optimal. As mentioned earlier, most of the SMEs (in Pakistan as well as in other countries) are less productive on average because they are poorly managed and have an operational focus on outdated products. Furthermore, experiences of advanced economies (such as the US and UK) reveal that the major driver for innovation and capital formation activities has not been the SME segment in general but in particular the high-growth enterprises from across the size spectrum: established as well as start-ups; small firms as well as large enterprises.[26] There is also evidence that over-spending and misallocation of funds disproportionally towards small firms can result in the persistently widening total factor productivity gaps in the economies compared to advanced countries.[27]

In other words, while investing in SMEs is widely considered a necessary gamble in terms of achieving economic prosperity, the focus should be on identifying firms having a high-growth potential and then guiding the assistance accordingly. The credit policies and tax incentives, therefore, must be reconsidered in this light to reward firms that demonstrate ambition and incentivize others to increase productivity and meaningful investments to "catch-up" to their more successful counterparts.

**Finally, the role of the state must be enhanced to lead investments in important segments of the economy**
While the facilitative perspective of government intervention – in terms of correcting "market failures" and leaving the innovative drive to the private sector – is widely held, the role of the public sector in terms of capital formation activities merits a reconsideration. The government, especially in a developing economy such as Pakistan, must also first develop fully the "ecosystem" to make possible the innovative activities envisioned to be carried out by the private investors.

[26] Reference: NESTA (National Endowment for Science, Technology and the Arts). 20110 <Vital Growth: The Importance of High Growth Businesses to Recovery". Research Summary, March. Available online at https://media.nesta.org.uk/documents/vital_growth.pdf (accessed 22 August 2019).
[27] Reference: Chang-Tai, H., Klenow, P., (2009) "Misallocation and manufacturing TFP in China and India." The Quarterly Journal of Economics 124.4: 1403-1448.

Furthermore, the government must assume a role greater than facilitating the operations of the private sector. Historically, in countries that have succeeded in enhancing the level of investments and innovation in their economies, the public sector has taken a leading role in investing in meaningful segments of the economy and developing the crucial infrastructure, which was then used to attract further private sector investments. For example, the rise of Japan during the 1970s and 1980s is attributed to its government's focus on implementing strong horizontal policies, as well as developing a tripartite interplay between the enterprises, academia and the government ministries such as its Ministry of International Trade and Industry (MITI). Of equal importance was the government's initiative of sending citizens abroad to learn about the emerging technologies and develop networks, which were then used to integrate Japanese conglomerates in the value chains of established firms of that era such as IBM, General Electric and Xerox. Similarly, the East Asian "miracle" economies were able to break free from the path dependence of slow growth and under-development and achieve convergence with the advanced economies partly because their public sector adopted a functional approach of leading the industrialization drive and providing protection to domestic industries (picking winners) with the potential to carve out competitive advantage in the global markets. Lastly, the example of China using the state capitalism model and rapidly emerging as a global manufacturing powerhouse also underscores the importance of an effective public sector to guide the investment activities of the private enterprises.[28]

In Pakistan, the initiatives of the Punjab government of digitizing the services sector of the economy under the Punjab Information and Technology Board (PITB) is one such example where the government has not only strived to provide an ecosystem for the potential private sector investors, but has also carried out substantial capital formation activities itself. In fact, PITB-led developments such as digitization of land records, automation of government procurement operations and tax filing procedures, and commencement of electronic education and health provision interfaces, etc. have been positively received by the business community and have contributed positively to the improvement in the country's ranking in the World Bank's doing business indicators. It is important that more such measures are taken by the government in other sectors of the economy to foster an enabling and progressive economic environment.

Taken together, the continuation of reforms already announced and the other desired measures mentioned above can help the government reduce regulatory bottlenecks and address the deep-rooted structural impediments prevalent in the economy, thereby improving substantially the doing business and capital formation environment of the country.

[28] Reference: Mazzucato, M. (2015). The Entrepreneurial State: Debunking Public vs. Private Sector Myths. *Anthem Press*.