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TRADE RELATED INVESTMENT POLICY FRAMEWORK 2015-23

Commerce Division has drafted a ***"Trade Related Investment Policy Framework (TRIPF)"*** with a view to attract investment in export-oriented manufacturing. The framework recognizes the critical nexus between trade and investment, identifies the global trends in FDI, analyzes Pakistan's investment performance over the years, evaluates Pakistan's investment policies and strategies, its strengths, weaknesses, opportunities and threats to Pakistan's investment climate and identifies the critical enablers for attracting efficiency seeking investment in Pakistan. The objective of developing the TRIPF is to make the manufacturing sector more competitive in the international market as well as to enable domestic industries integrate into the global and regional value chains. The policy framework will be an integral part of the upcoming Strategic Trade Policy Frame Work (STPF) 2018-23, which incentivizes and facilitates investment in the export oriented and import substituting industries through policy reforms, predictable tariff structure and regulatory transparency.

The draft "***Trade Related Investment Policy Framework 2015-23" has*** been **upload here** for information and feedback of the stakeholders and general public. Comments/feedback may be sent through courier to Ms. Serrein Asad, Deputy Director (Trade Policy), Commerce Division, Block A, Pakistan Secretariat Islamabad or email so.tp.moc@gamil.com by 10th October 2018.

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Trade Related Investment Policy Framework (TRIPF)

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1. Introduction

Investment and trade have a critical nexus. Investment in export-led production is an indispensable component of any export-led growth strategy. Since FY 2013, the GDP growth has increased from 3.65% in 2012-13 to 5.8% in FY2018[1], whereas, the exports posted a negative growth of 19% during 2014-17[2], which reversed in FY2018 with growth of 14%. It means that the economic growth has been mainly domestic-market driven rather than export-led. One of the major causes for the stagnation and decline in Pakistan's exports in the recent past, is the lack of investment in export-oriented manufacturing.

2. Importance of FDI for Exports

Foreign Direct Investment is one of the vital tools that countries employ to develop industrial base, upgrade infrastructure and seek innovation and technology. Globally, the Foreign Direct Investment (FDI) flows have increased dramatically in recent decades. Development in trade logistics, trade liberalization through World Trade Organization and regional trade agreements and emergence of Global Value Chains remained vital factors for this evolution. Resultantly, the policies to attract FDI inflows, trade and investment have become increasingly intertwined.

The Multi National Enterprises (MNEs) are directly involved in 80% of international trade and are, therefore, effective agents of export enhancement of the developing countries[3]. China is a characteristic model of an export processing platform by the MNEs as more than 50% of China's exports are by the MNEs[4].

The vertical FDI – relocation of different stages of production by the MNEs in different countries – is one of the main drivers of global value chains (GVCs). The trade in intermediate goods constitutes more than two thirds of the international trade[5] as the MNEs, instead of producing the goods in a single country, locate the different steps of production process in different countries.

The buyer-driven FDI – investment by the foreign large retailers and brand marketers in production networks of especially the labour-intensive products like textiles, agro-food products and footwear – annually generates huge volume of exports from the host countries.

3. Global Trends in FDI

The trends of investment inflows have seen transition over the last decade, where the share of developing economies, particularly Asia, reached 25% in 2016 from 10.5% in 2000[6]. Number

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[1] Economic Survey of Pakistan, 2017-18
[2] Pakistan Bureau of Statistics
[3] United Nations Conference on Trade and Development (UNCTAD)
[4] Financial Times (https://www.ft.com/content/f4fbea53-6fe4-3e19-8ca1-55ccca4e4596)
[5] International Monetary Fund (http://www.imf.org/external/np/pp/eng/2013/082613.pdf)
[6] UNCTAD (http://unctad.org/Sections/dite_dir/docs/WIR2017/WIR17_tab01.xlsx)

of factors have influenced this transition – low cost of labour, trade liberalization, increase in the number of regional trade agreements, development in technology and high-tech industries, transition in the regulatory regime and development of global value chains. The investment climate of Developing Asia, especially East Asia, made it factory of the world where multinationals across the globe entered under different arrangements to capture benefits of low cost of production, low labour cost, low input cost (mining sector) and transport of goods.

4. Overview of Pakistan's Investment Performance

Pakistan is caught in a low-savings low-investment trap, which seriously hampers its growth potential – the low savings rate reduces the availability of investible funds; low investments make growth unsustainable; the low growth creates low domestic savings.

National savings as per cent of GDP were around 10% during 1960s, which increased to above 15% in 2000s, but declined afterwards. Pakistan's gross domestic saving rate of 7.5%[7] compares unfavorably with the global average rate of 24.5%, Indian 28.9%, Chinese 46.5%, Bangladeshi 25% and Sri Lankan 23.8%[8].

Besides the low rate of domestic saving, the gap in channelizing these savings into investment through financial sector is equally problematic. It is estimated that less than half of the national savings are channeled through the financial sector while the rest go to the real estate and other forms of capital formation by informal ways.

The saving and investment gap is filled through foreign direct investment (FDI). During the last five years, the cumulative FDI inflows into Pakistan were US$ 10 billion, out of which 81% has gone into non-manufacturing sectors like power, oil & gas, construction, financial business, communication IT & telecom, transport and trade[9]. The FDI in manufacturing sector also remains market-seeking rather than efficiency-seeking investment which could provide competitiveness to export-oriented sectors and enhance production capacity of import substituting industries.

The industrial sector remains disproportionately taxed. The manufacturing sector bears 58% burden of taxation compared with its 13.5% share in GDP. It causes diversion of investment into speculative sectors like real estate and stock market rather than industry.

5. Pakistan's Investment Regime

According to World Bank's analysis on the Services Trade Restrictive Index (STRI), Pakistan has one of the most liberal investment policy regimes and public-private partnership frameworks in the entire South Asian region. Pakistan is open to all the sectors for investment, except the

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[7] Economic Survey of Pakistan 2016-17
[8] World Bank (https://data.worldbank.org/indicator/NY.GDS.TOTL.ZS)
[9] Board of Investment (http://www.boi.gov.pk/ForeignInvestmentinPakistan.aspx)

one restricted for national security and public safety reasons (such as arms and ammunitions, radioactive substances, consumable alcohol etc.); 100% foreign ownership is allowed except on airlines, banking, agriculture and media. Foreign companies can own land if they are incorporated in Pakistan. As per the financial regulations, there is no restriction on currency convertibility, repatriation of capital, remittance of profits or royalties, except for franchise. Moreover, the investor is protected against the unlawful expropriation.

Foreign investment in Pakistan has been protected and promoted by the following legal and policy instruments:

i. Foreign Private Investment (Promotion & Protection) Act, 1976
ii. Protection of Economic Reforms Act, 1992
iii. Investment policy 2013
iv. FDI strategy 2013-17

The Investment Policy 2013 provides a comprehensive framework for the attraction of FDI in the country. The guiding principles of the investment policy are: (a) reducing the cost of doing business by facilitating market entry, (b) reducing the process of doing business by moving to one-window operations and reducing unnecessary regulations, (c) ease of doing business with creation of industrial clusters and special economic zones, and (d) linkages of trade, industrial and monetary policies. Similarly, the FDI Strategy 2013-17 provides a framework that promotes for cooperation of public and private sectors, towards mobilizing the Private Investments.

Pakistan is also a signatory to various multilateral and bilateral investment treaties and agreements with investment provisions in Pak-Malaysia FTA, Pak-China FTA, SAFTA and OIC investment agreement besides the obligations under WTO agreements, such as GATS and TRIMS.

6. Pakistan's current investment climate

Blessed with the strategic endowments, Pakistan offers multiple advantages as an investment location.

(i) **Strategic Location:** The country is strategically located at the crossroads of South Asia, East Asia, Central Asia and Middle East, coupled with many inter- and trans-regional trade, customs, tax and investment arrangements. More than 40% of entire global consumer base and an import market of US$ 2.15 trillion, is available on its immediate borders (China, India, Iran and Afghanistan).

(ii) **Natural Endowments**: There are varied and plentiful reserves of natural resources ranging from minerals, coal and gas to metallic and non-metallic species reflecting the country's accessibility to readily available new materials. Besides, the fourseason climate endowment is a privilege to agricultural activities throughout the country and throughout all seasons.

(iii) **Domestic Market & Human Resource Base:** Pakistan's own consumer base of more than 200 million, the world's 6th largest, and a youth bulge offer a potential demographic dividend. It has been the driving force for market-seeking FDI and provides the base for generating economies of scale for generating competitive export surpluses. Pakistan has the 8th largest labour force in the world. According to Labour Force Survey 2014-15, the total labour in the country is approximately 61.04 million out of which 54.42 million were employed.

(iv) **High Growth & Outlook:** Located in a high growth region, Pakistan's economy has grown by 4.1%, 4.5%, 5.3% and 5.8% during the last four financial years. Goldman Sachs has identified Pakistan as one of the Next Eleven countries (along with BRICS), which can become the world's large economies in the 21st century. Bloomberg rated Pakistan as the 14th top potential investment location in 2016.

(v) **Improved Security Situation:** The general security environment has significantly improved, though the sporadic incidents of terror continue to feed into Pakistan's perception abroad as an unsafe destination for investment and trade.

(vi) **China Pakistan Economic Corridor:** The CPEC with its promise to improve infrastructure, improved energy supply and investment by China has generated an interest for investment in Pakistan.

7. Challenges in export-oriented FDI

Pakistan's suboptimal performance in attracting the FDI in general and manufacturing-oriented FDI in particular, has been caused by multiple factors.

(i) Investment Policy's equal preference for all sectors on one hand and the extraordinary incentives for selected sectors such as energy, sugar, fertiliser and attractive returns in Real Estate and Stock Exchange, on the other hand have diverted the capital away from the manufacturing sector. Investment generally, and FDI particularly, has channelized mostly into non-manufacturing sectors. Even in manufacturing, the preference has been to capture local demand rather than exports.

(ii) The enhanced market access, already negotiated under preferential trading arrangements, has not translated into production for exporting to the FTA/PTA partners' market. More FTAs/PTAs need to be negotiated with balanced provisions of market access for exports and protection from non-essential imports.

(iii) At the policy level, there is lack of synergy between the investment, industrial, agriculture, trade and tariff policies.

8. Determinants of Trade-related FDI in Pakistan

The following are the major enablers of trade-related investment.

Competitiveness: The investment is attracted towards the regions and sectors which provide higher return on investment compared with other alternatives. The higher returns directly flow out of competitiveness, which in turn depends on availability and cost of labour, input costs, and taxes.

Market Size and Protection: The size of domestic market and the level of protection provided to the domestic industry attract the market-seeking investment. The protection is to be appropriately calibrated and phased out after a reasonable period to make the industry competitive for export market.

Market Access: Enhanced market access negotiated by Pakistan in the third country through bilateral or multilateral trading arrangements (FTAs / PTAs) is the catalyst for FDI and relocation of industries aiming to benefit from the enhanced market access.

Investment Ecosystem: The ecosystem, besides the competitiveness, is the most important determinant of investment decisions. The investors, especially the MNEs, before taking the investment decisions, take into account the ranking of the countries under global indicators of doing business, corruption perception, governance, competitiveness and enabling trade.

9. Principles of Policy

The Trade Related Investment Policy Framework is based on the following principles:

(i) Structural transformation of Pakistan’s production base;

(ii) Increasing competitiveness to make it attractive for the investors to produce in Pakistan;

(iii) Increasing ease of doing business by removal of bottlenecks, simplifying procedures and improving institutional efficiencies;

(iv) Leveraging market access negotiated with the bilateral and multilateral trading partners;

(v) Leveraging the domestic market through time-bound protection for competitive import substitution and facilitating economies of scale for eventual export-oriented production;

(vi) Integration into global value chains by improving competitiveness and trade facilitation; and

(vii) Leveraging CPEC for regional integration, connecting with the global markets and access to the neighbouring markets, especially China.

10. Policy Framework

10.1 Priority Sectors

In order to structurally transform Pakistan's production base into high value-added sectors integrated with the international market while meeting the demand of the domestic market, it is imperative to (a) enhance quality and range of exports in the existing industrial base (intensive margin), and (b) steer Pakistan into the core of high value global product space where the opportunities for product diversification are higher (extensive margin).

Accordingly, the priority sectors for trade related investment in Pakistan have been identified on the basis of a combination of three major indicators:

(i) **Ease of Diversification,** which is determined by the nearness of the potential new sectors to the incumbent sectors, as the new sectors can benefit from the existing capabilities e.g. knowhow, intermediate inputs, trained labour and confront less potential barriers;

(ii) **Economic Complexity** of the new products, which determines its income-earning potential as the complex products are produced by less number of countries, usually with high GDP, and have higher returns;

(iii) **Size of domestic and global market,** which provides the economies of scale and the high potential for export, as well as import substitution.

Based on the above-mentioned criteria, the following **Priority Sectors** have been identified for export-oriented investment:

a. Relocation, from advancing economies, of labour-intensive sectors - (i) value-added Footwear and Bags, (ii) value-added Apparel and Textiles;

b. Relocation, with local value addition, of resource-intensive sectors of (iii) Copper Cathodes, (iv) Aluminium Sheets and Foils, and (v) high-technology Steel-making;

c. Value addition of resource-intensive sectors of agro-processing especially (vi) Juices and Syrups, (vii) Confectionary, (viii) Fish and (ix) Edible Oil;

d. Import substitution in (x) Oil Refinery and Petrochemicals, (xi) Data Processing / ITC Equipment, (xii) Telecom, (xiii) LED Lights and (xiv) Solar Panels;

e. Integration into global value chains of (xv) Consumer Electronics, (xvi) Integrated Circuits manufacturing, (xvii) Automotive Electronics (xviii) Electricity Equipment; and (xix) Chromium Bromide Batteries.

10.2 Competitiveness Enhancement Measures

Investment into export-oriented manufacturing in the priority sectors primarily hinges on competitiveness of production and market access. The competitiveness enhancement would be targeted through the following interventions.

10.2.1 Tariff Rationalization

Pakistan has amongst the highest average weighted tariffs amongst the 68 countries having more than US$ 20 billion annual exports. The tariffs, especially on raw materials, erode competitiveness and breed inefficiencies. During the last decade, all the 20 fastest export growth economies have reduced import tariffs; the two fastest growing have reduced tariffs by 72% and 51% respectively. In contrast, the import tariffs in Pakistan have increased. A draft National Tariff Policy has been formulated for approval of the Cabinet. It will make Tariff regime predictable and more transparent providing enhanced confidence to the investors generally in the manufacturing sectors.

10.2.2 Input Costs

The major input costs for industries are raw materials, energy, labour and capital, though the ratio of these elements in total cost of production varies between industries. The attraction of efficiency-seeking export-oriented investment in Pakistan, is critically dependent on the proviso that these costs in Pakistan are lower than the competitors. In order to make the production in Pakistan competitive, the following incentives will be available for the Priority Sectors

i) Land will be provided to the investors with the help of the provinces interested in attracting such investment in one of the existing Industrial Estates/Special Economic Zones or Export Processing Zones as preferred by the investor.

ii) Duty free import of machinery and raw materials will be allowed for a period of 10 years.

iii) In order to improve the access to energy and bring the cost of energy comparable with the competitors, the following is proposed:

   a. Electricity Tariff for Industry will be unburdened of cross-subsidies and surcharges, bringing it closer to the cost of generation plus distribution margin, to around Rs. 10-11 per unit;

   b. All industries across the country will be charged the aggregated cost of local gas and LNG rather than different rates and GIDC will be abolished;

   c. New or enhanced industrial electricity and gas connections/loads will be provided within thirty days.

iv) Sufficient tariff protection will be provided for the payback period; thereafter, it will be reduced gradually to make it internationally competitive.

v) The per unit labour cost will be made competitive through (a) increasing labour productivity, skill development and linking wages with productivity, and (b) differentiated wages for regions based on cost of living rather than uniform wages for the entire country, to enable the industry to geographically diversify industrial production in order to benefit from low labour costs.

10.3 Fixing the investment ecosystem

In order to improve the investment ecosystem, the following targets will be set by BOI (Board of Investment) for improving Pakistan's ranking in the crucial indicators by 2023:

i) Global Competitiveness Index from 115th to 70th

ii) Doing Business Index from 147th to 80th

iii) Enabling Trade Index from 122nd to 60th

10.4 Policy Cover

Investment in the **Priority Sectors** shall enjoy the same privileges and tax holidays as are available to Special Economic Zones.

10.5 Sector-wise Policies

Board of investment will formulate and issue sector-wise policies for each of the **Priority Sectors,** within 90 days of the approval of this policy framework, with due consultations and approval.

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