# Chapter 8
# FDI in Pakistan: Prospects for India

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## 8.1 Introduction

Over the past two decades, foreign direct investment (FDI) has been one of the defining characteristics of the world economy. Global FDI has increased substantially since the 1980s and is now among the largest forms of cross-border capital flows. This boom has been especially pronounced in developing countries where FDI has become the primary source of private sector finance (Mold 2004; UNCTAD 2005). Given the potential role FDI can play in terms of injection of capital, technology, and knowledge as well as in accelerating growth and economic transformation, the attitude of developing countries toward FDI has changed with dramatic improvements in their FDI policy regimes (UNCTAD 2005). As a result, developing countries have become an important source and destination for foreign investment. For the first time, in 2012 developing economies absorbed more FDI than developed economies. They accounted for a record 52 % of global FDI inflows, exceeding flows to developed economies for the first time by US$142 billion. The global ranks of the largest recipients of FDI also reflect the increasing importance of developing economies and the changing patterns of investment flows: nine of the 20 largest recipients were developing countries (UNCTAD 2013). Even in terms of FDI outflows, developing economies generated about one-third of global outflows.

Like many other developing countries, South Asian nations have been experiencing increased FDI inflows over the past decade (Table 8.1). Compared to total inflows, intra-regional flows of FDI seem to be increasing, but still accounted for only about 5 % of total cumulative FDI in the past three decades (Athukorala 2013). India accounts for over 90 % of these FDI flows in South Asia.

South Asian economies have great potential to attract FDI. Several policy and regulatory measures have been taken to improve the investment climate and attract

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**Table 8.1** FDI flows for South Asia (US$ billion)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| FDI inflows | 34.5 | 56.6 | 42.4 | 28.7 | 44.2 | 33.5 |
| FDI outflows | 17.7 | 21.6 | 16.5 | 16.4 | 12.9 | 9.2 |

S*ource*: UNCTAD, FDI-TNC-GVC Information System, FDI database (www.unctad.org/fdistatistics)

**Table 8.2** Ranks of South Asian countries (2013)

| | India | Pakistan | Nepal | Sri Lanka | Bangladesh | Afghanistan | Bhutan |
|---|---|---|---|---|---|---|---|
| Ease of doing business index | 132 | 107 | 108 | 81 | 129 | 168 | 148 |
| Starting business | 173 | 98 | 105 | 33 | 95 | 28 | 94 |
| Protecting investors | 49 | 29 | 114 | 169 | 97 | 94 | 71 |
| Political instability index* | 135 | 7 | 19 | 31 | 19 | 7 | 108 |

*Source*: World Bank Indicators; Economist Intelligence Unit
*Political instability index is for the year 2009–2010. A lower rank indicates higher risk

foreign investment in most South Asian countries. However, with the exception of India, all countries attract low amounts of FDI. Many believe that the major investment barriers in South Asia are widespread corruption, poor governance, and weak political and institutional structures (Asian Development Bank 2009; Raihan and De 2013). These factors create a gap between policies and their implementation and, thus, impede investment inflows.

In South Asia, Pakistan has the most liberal investment policy.[1] It ranks 2nd in ease of doing business. The investor-friendly regime followed by Pakistan is the result of policy reforms and liberalization measures taken since the 1980s and a realization by the Pakistan government of the benefits that the Pakistan economy can reap from FDI inflows. For investors looking at Pakistan, economic prospects get dimmed because of political factors (see political instability index in Table 8.2). Thus, Pakistan's attractiveness as an investment destination falls despite its favorable policy regime.

Given the importance of FDI as a source of economic development and growth for developing countries like Pakistan, and against the background of investment trends and the importance of India as a source destination for foreign investment in South Asia, there is great potential for Pakistan to attract FDI from India. In this case, FDI can serve the twin objective of contributing to overall economic development of both countries and strengthening long-term bilateral relations. The normalization of economic relations between the two South Asian giants is also crucial for the economic integration of the South Asian region.

[1] Board of Investment, Pakistan.

This chapter examines the potential for Indian investment in Pakistan. The scope of FDI from India into Pakistan is not limited to the business options arising from India's comparative advantage. As India and Pakistan compete to sell their goods in the global market, there are several areas where the two countries can complement each other's needs and, hence, produce cost-effective quality goods. This can be done through joint ventures to cater to the markets of developed nations. In the process, both nations can learn from each other.

This chapter attempts to understand the investment environment in Pakistan for Indian investors and recommends a three-stage approach to create a mutually beneficial business environment for India and Pakistan. The following research questions are addressed in this chapter:

– What are the prospects for Indian investment in Pakistan?
– What are the potential sectors for Indian investment in Pakistan?
– What is the current policy regime governing FDI flows between India and Pakistan?
– What are the barriers to investment in Pakistan?
– What policy recommendations can be adopted to foster India-Pakistan FDI flows?

The analysis is based on secondary data and primary information collected through a survey of firms based in Delhi and Mumbai. Twenty firms were interviewed during May–June 2013 for this study; the authors also interacted with government officials and researchers from both nations.

## 8.2 Prospects for Indian Investment in Pakistan

Pakistan's geographical location, liberal foreign investment policy, conducive business environment, and a young skilled workforce make it an investor-friendly destination. Strategically located in South Asia, Pakistan is at the crossroads of China, the Central Asian Republics (CAR), and the Gulf States. Pakistan's large market offers huge opportunities to investors from India in terms of the easy access it can provide to markets in Iran, Afghanistan, the Middle East, and CAR.

Pakistan's foreign investment policy has been designed as a comprehensive framework to create a conducive business environment to attract FDI. The investment policy offers foreign investors several incentives with respect to tax and to regulations on repatriation of capital and profit. Pakistan has enacted the Law of Special Economic Zones[2] that allows the creation of industrial clusters and offers liberal incentives, infrastructure, and investor facilitation services to enhance productivity and reduce the cost of doing business. An added advantage is its large trained and skilled English-speaking labor force. The consumer market in Pakistan

[2] The Special Economic Zones Act 2012 was published as Act XX of 2012 vide Gazette Notification No. F. 22(7)/2012.

**Table 8.3** FDI outflows by India (2005–2012) (US$ billion)

| 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|
| 2.9 | 14.3 | 17.2 | 21.1 | 16 | 15.9 | 12.4 | 8.6 |

*Source*: UNCTAD Statistics

is also growing at a rapid pace, and the potential to tap market opportunities provides strong grounds for FDI flows from India into Pakistan.

Indian investment in Pakistan can benefit from several country-specific advantages. The common culture and language between the two countries can immensely facilitate business cooperation. The language spoken is the same in the two Punjabs; in the two main cities of the two countries, Karachi and Mumbai, Sindhi is spoken. There is a certain sense of connection with people across the border. Smooth communication channels help in business interactions by reducing entry and transaction costs.

Given the enormous benefits of FDI, increased investment flows between India and Pakistan could be mutually beneficial for both countries. However, the benefits of FDI seem to be larger for Pakistan than for India, as investment can boost economic growth and help Pakistan overcome the domestic challenges to its economy. Overall, an improvement in the FDI scenario between India and Pakistan will help strengthen bilateral ties.

Against the background of prospects for Indian investment in Pakistan, the following subsections analyze the growing importance of India as an overseas investor and Pakistan as an investment destination.

### *8.2.1 India as a Source Country*

In recent years, emerging market economies like India have become an important source of FDI outflows. The liberalization of government policies and removal of restrictions on outward FDI have led to a rise in overseas Indian investment. Apart from the liberalized policy environment for overseas investment, India has gained ground as an important overseas investor on the back of rapid economic growth, easy access to financial resources, and strong motivation to acquire resources and strategic assets abroad.

Indian companies are acquiring international firms to obtain resources that are not available in India or are cheaper in the foreign country and to obtain greater access to the global market. Such investments increase the competitiveness of the firms and catalyze the growth of exports and transfer of technology.

Between 2005 and 2012, outward FDI from India peaked in 2008 at US$21.1 billion. Since then, annual outflows have been falling gradually. In 2012, Indian FDI outflow stood at US$8.6 billion (Table 8.3).

**Table 8.4** FDI inflows into Pakistan (US$ billion)

| 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|
| 2.2 | 2.3 | 5.6 | 5.4 | 2.3 | 2 | 1.3 | 0.8 |

*Source*: UNCTAD Statistics

### *8.2.2 Pakistan as a Destination Country*

Pakistan's large domestic market and liberal policy environment are attractive for foreign investment. The policy regime in Pakistan is investor friendly, and doing business in Pakistan is easier than in any of its South Asian neighbors (Table 8.2). Further, the World Bank (2013) confirms that Pakistan ranks ahead of Russia, Indonesia, Brazil, and the Philippines.

In the early years after independence, Pakistan received much more FDI than its larger neighboring countries. Due to inconsistent investment policies, the flow of FDI remained insignificant until 1991 but gradually increased after liberalization and showed an upward trend. FDI inflow peaked at US$5.6 billion in 2007. Table 8.4 shows that since 2008, FDI inflows have declined sharply and stood at only US$0.8 billion in 2012.

Since investment decisions are linked with socioeconomic, political, and cultural factors in the host economy, these factors significantly affect the flows of FDI to developing countries. The low rate of GDP, political instability, and energy crises are a few more possible reasons for low FDI in Pakistan (Jaffri et al. 2012; Khalid et al. 2012). However, in terms of attracting FDI, Pakistan has performed well compared with similar economies like Iran and Peru (Hamdani 2011), and there is scope for a reversal of this downfall given the tremendous business opportunities combined with the political will of the new government.

## 8.3 Potential Areas for Indian Investment in Pakistan

As India and Pakistan compete to sell their products in the international market, there are areas in which the two countries can complement each other's needs. There is general interest among businessmen on both sides to invest in the other's country. There is greater interest from the Pakistan side to invest in India in sectors such as cement, hotels, and textiles. There is a general expression of interest by large Indian business houses such as the Tatas and Godrej to invest in Pakistan. Companies such as Dabur already operate via Dubai to cater to the Pakistani market.

In September 2013, the first India-Pakistan joint venture took place. A furniture-making firm in Lahore, IWM Interwood Mobel Private Ltd. and Noble Translinks Private Ltd. of Amritsar jointly set up a firm called IWM Interwood Mobel Private Ltd. (The News International 2013). The stage has been set for investment by these two companies, and this precedent should be followed with more such investments.

During the course of our industry consultations, interaction with policymakers, and review of research reports, we identified sectors for possible collaboration within three broad categories.

### 8.3.1 Primary Sector

India and Pakistan are both principally agrarian economies with agriculture contributing 13.7 % and 21.4 % to GDP, respectively, in the two countries in 2012–2013 (Government of India 2013; Government of Pakistan 2013). Agriculture, with its allied sectors, is unquestionably the largest livelihood provider in both countries. Most industries also depend on this sector for their raw materials. There are considerable opportunities for investment in agriculture and processed foods. Within agriculture, there is tremendous scope for investments/joint ventures in inputs such as seeds, agricultural equipment, and technology (Husain 2013).

Further, the mining sector offers scope for investment. Based on available information, more than 600,000 sq. km of outcrop potentially holds metallic/nonmetallic mineral deposits in Pakistan (Board of Investment, Pakistan n.d.). Except for oil, gas, and nuclear minerals regulated at the federal level, minerals are regulated at the provincial level. The Federal and Provincial governments jointly set out Pakistan's Mineral Policy in 1995 (Board of Investment, Pakistan 1995), providing the appropriate institutional and regulatory framework and an equitable and internationally competitive fiscal framework. The enforcement of the Mineral Policy has paved the way to expand mining sector activities and attract international investment in this sector. Although the opportunity for Indian investment in the mining and mineral sector is good, past experience may deter investors from investing here. In December 2009, the authorities in Balochistan Province passed a motion and threatened to terminate the exploration mining license of the Reko Diq copper and gold mine held by Canadian Barrick Gold Corporation and a Chilean copper mining company. The threat to cancel the license was reportedly on the grounds that the mining lease application was incomplete and not legally compliant with mining laws (Wall Street Journal 2011). However, according to Asia Times (2010), the Balochistan government called the move a step toward getting control over provincial resources. Despite timely intervention by Pakistan's federal government, the dispute sends a negative image of the otherwise lucrative and welcoming attitude of the government toward FDI and may deter Indian investment in this sector.

### 8.3.2 Secondary Sector

Pharmaceuticals, textiles, transport, and energy are a few sectors that offer investment potential to Indian investors in the secondary sector. In the pharmaceuticals sector, there is scope for collaboration in bulk drugs and expansion of formulation

and health products. Indian pharmaceutical products are cheaper than Pakistani pharmaceutical products, and Pakistan's pharmaceutical regime is not strictly regulated for domestic production. There is scope for setting up JVs in Pakistan for sharing technical know-how in this sector. The Indian pharmaceutical industry can provide the necessary support and assistance to Pakistan to expand its industry. Further, this will have a positive impact on Pakistan's industrial growth and help meet the challenge of providing cheaper drugs to Pakistani citizens. The major Indian pharmaceutical player, Biocon, has licensed BIOMAb-EGFR to enter the Pakistan market through a licensing arrangement with Ferozsons Laboratories, Pakistan (Biocon 2007). There is scope for further FDI in the pharmaceutical sector.

With energy demand rising in Pakistan, the greatest benefit could accrue in the sphere of energy cooperation, which could act as the single most effective confidence-building measure. It could result in wider participation from stakeholders and promote market integration in energy-related trade. Several projects involving cross-border trade in coal, hydroelectric power, petroleum products, thermal energy, renewable energy, and bilateral and regional grid interconnection have the potential to be economically viable (Kaul 2013). Cross-border "power trade" could be done via bilateral power trade, pool-based exchange, or a wheeling facility. Overall, there is high potential for energy trade between the two countries, for which talks are ongoing (Lama 2013). India and Pakistan are considering the option of electricity trading. The first meeting of the Joint Group of Experts to examine the feasibility of trade in electricity was held on October 20, 2011 at New Delhi. The Central Electricity Authority and Power Grid Corporation of India Limited/Power System Operation Corporation Ltd. were designated as the nodal technical agencies from the Indian side. They are interacting with the National Transmission and Dispatch Company Ltd. of Pakistan to work out optimal technical solutions for grid connectivity between the two countries. A broad understanding has been reached on possible grid connectivity between Amritsar and Lahore to enable trade of up to 500 MW of power. As of January 2014, the Federal Cabinet in Pakistan approved the signing of a Memorandum of Understanding between the two countries (Business Recorder 2014). Given the importance of electricity for Pakistan's domestic economy, the electricity sector can be seen as one of the most important sectors for investment.

Pakistan has been trying to make the energy sector lucrative for Indian investors by offering incentives such as customs and sales tax exemption in Special Economic Zones, zero import duty on machinery for energy plants, etc. There is a need to pass this information to Indian investors. India is one of the most rapidly growing energy markets in the world and will be able to absorb new sources of supply as they materialize in the region. Pakistan can be a potential transit route for energy from Iran and Central Asia through the construction of pipelines. This will require major capital investment. The Iran-Pakistan-India (IPI) pipeline and the Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline are two such ambitious projects, for which negotiations are underway. A huge transit fee and a share in gas supply on a daily basis is the direct benefit that will accrue to Pakistan in such cases.

Energy cooperation between India and Pakistan would have an overall stabilizing effect on the region, and such ventures can be explored in other areas of energy. For example, India can invest in Pakistan's power sector, on which the backbone of the economy – the textile sector – is also dependent. Pakistan experiences major power cuts that adversely affect its industries. FDI in this sector will have twin benefits. First, it will rectify power problems in the domestic economy. Second, it will contribute to attracting more MNCs to Pakistan. Further, investment in such crucial sectors can ensure better safety of investment and promote economic development in the country. For the long-term strategic benefit of the country, proposals for acquisition of overseas assets in the energy sector through PSUs or a special purpose fund are being discussed.

Textiles is one sector in which Pakistan has a comparative advantage. However, the textiles sector in Pakistan is not technologically advanced. There is a case for India and Pakistan to leverage each other's comparative advantage by complementing each other. Initially, the opening of trade with India can help Pakistan acquire high-tech machinery at lower prices than the ones it currently acquires from Germany. Further, JVs can help combine the strengths of Pakistan's designs and fabric with Indian marketing skills. This sector offers scope for technology sharing. Pakistan and India are competing for the same international markets. The two countries can jointly cater to international markets, such as Europe, by producing high-quality and cost-effective textile products. In other words, instead of acting as competitors, both countries can collaborate by focusing on value addition and joint marketing for European and ASEAN countries.

Pakistan's performance on most logistics indicators, including quality of trade and transport infrastructure, is lower than for most Asian countries, particularly India (World Bank 2012). The transport sector in Pakistan suffers from low quality, long travel times, and poor reliability that hinder the economic growth of the country. In this regard, India can offer logistics support to meet increased transportation requirements in Pakistan. India can invest in infrastructure projects similar to its successful home projects like the Delhi Metro. Investments in trade corridors should also be encouraged.

### *8.3.3 Tertiary Sector*

India has established itself as a major player in the information technology (IT) segment. Although the software industry in Pakistan is still in its nascent stages, it has the potential to emerge as a major software export and training center. India and Pakistan could enter into joint ventures to tap the global market for software. While Pakistan can provide professionals at lower wages, Indian companies could help procure international contracts (Husain 2011). India has a comparative advantage in IT in terms of low-cost, qualified, English-speaking personnel. This can be replicated in Pakistan. Another area where the two countries could gain is if India sets up training institutes in Pakistan or if professionals from Pakistan are allowed to go to India to get professional training.

Healthcare services is another area in which there are opportunities for both countries. India has emerged as an important destination for provision of medical

services due to affordable treatment costs and advances in medicine. Despite a relatively tight visa regime, the number of patients going from Pakistan to India has been on the rise. Several Pakistani patients have been visiting India for medical treatment, such as liver and kidney transplants and open heart surgery (Ahmad 2012), and the Mumbai Obstetric and Gynaecological Society provides fertility treatment to Pakistani couples (Mid-Day 2012). In February 2012, a group of Indian and Pakistani doctors jointly performed a complicated liver transplant procedure in a Lahore hospital, opening new avenues for cooperation in healthcare services (Times of India 2011).

The common culture and language in India and Pakistan provides immense opportunities for trade and cooperation in the film, television, and music sector. India is the second largest producer of movies in the world, whereas Pakistan produces very few movies. Pakistan had imposed a ban on the screening of Indian films in 1965 following the Indo-Pak War (Chi n.d.). The ban was intended to protect the domestic film industry, but despite the ban the Pakistani films industry has not done well (The Express Tribune 2012). The ban was lifted in 2008, but there has been no consistency in policy implementation since bans on Indian films are often imposed on a case-by-case basis. Through the years, the ban has been practically ineffective since the demand for Indian movies is met through pirated DVDs and satellite cable broadcasts of Indian films. There is interest in both India and Pakistan in each other's music – both audio and visual. There is also an interest in Indian television serials and in Pakistani plays in India. However, Pakistani entertainment channels are not broadcast in India, whereas several Indian channels are broadcast in Pakistan. Exchanging broadcast rights to telecast each other's programs on television is yet another trade opportunity for the two countries.

For the potential investments to fructify, the two countries have to take measures in several areas. It is important to examine the regulatory regime governing investment flows between India and Pakistan, the existing barriers to investment in Pakistan, and the need for banking channels to facilitate investment flows between the two countries.

## 8.4 FDI Policy Regime

Policy regime is a key factor that drives foreign investment flows to a country. Apart from the underlying macroeconomic fundamentals, the ability of a nation to attract foreign investment depends on its policy regime. This section examines the policy regime that governs investment flows between India and Pakistan.

As a part of its economic reform agenda, Pakistan began to liberalize its foreign investment policy toward the end of the 1980s. Several policy and regulatory measures were taken to improve the business environment and attract FDI. A Board of Investment, attached to the Prime Minister's Secretariat, was set up to generate investment opportunities and facilitate investment. A "one-window" facility was established to overcome difficulties in setting up new industries (Zakaria et al. 2014).

**Table 8.5** Pakistan's attractive investment packages

| Policy parameters | Manufacturing | Agriculture | Infrastructure and social | Services including IT and telecom |
|---|---|---|---|---|
| Government permission | Not required except for specified industries | Not required except for specific licenses from concerned agencies | | |
| Remittance of capital, profits, dividends, etc. | Allowed | | | |
| Upper limit of foreign equity allowed | 100 % | | | |
| Minimum investment amount (US$ million) | No | 0.3 | 0.3 | 0.15 |
| Customs duty on import of PME | 5 % | 0 % | 5 % | 0–5 % |
| Tax relief (IDA, % of PME cost) | 50 % | | | |
| Royalty and technical fees | No restrictions on payment | Allowed as per guidelines. Initial lump sum up to $100,000; max. rate 5 % of net sales; initial period 5 years | | |

*Source*: Board of Investment, Pakistan, Government of Pakistan

As a result of liberalization of the investment regime, Pakistan today offers one of the most investor-friendly and liberal investment regimes in the South Asian region.[3] The government of Pakistan has put in place a policy framework on foreign direct investment that is transparent, predictable, and easily comprehensible. Foreign investment in Pakistan is at present regulated by the "Investment Policy 2013." The policy consolidates existing policies by related line ministries and has further liberalized the policy, besides drawing up futuristic strategic programs to implement the policy. The policy has been designed to provide a comprehensive framework to create a business environment that is conducive to FDI (Table 8.5). The Special Economic Zones (SEZ) Act 2012 (Board of Investment, Pakistan 2012), which is the centerpiece of Investment Policy 2013, is expected to encourage industrial clusters and bring Pakistan on the international economic radar by offering a liberal investment regime and adequate physical infrastructure (Board of Investment, Pakistan 2013).

The key features of the liberal investment policy of Pakistan are given below:

- Equal treatment of local and foreign investors
- All sectors of economy open to foreign investment
- Foreign equity up to 100 % allowed
- No government permission required

[3] Pakistan's rank in ease of doing business indicators is the second lowest in South Asia; refer to Table 8.2.

- Remittance of capital, royalty, profits, technical, and franchisee fees allowed
- Network of export processing zones
- Foreign investment protected by Foreign Private Investment (Promotion and Protection) Act, 1976, and Protection of Economic Reforms Act, 1992

Although Pakistan has always followed a liberal and nondiscriminatory policy toward all countries, including India, until 2012 India had restrictions on outward investments to and inward investments from Pakistan (Box 8.1). In a major confidence-building measure, India overturned the ban in August 2012. Both inward and outward investments must be routed through the "approval" route, which requires prior approval from the Reserve Bank of India. Requests under the approval route are considered by taking into account, inter alia, the prima facie viability of the Joint Venture (JV)/Wholly Owned Subsidiary (WOS) outside India; the likely contribution to external trade and other benefits that may accrue to India through the investment, financial position, and business track record of the Indian party and the foreign entity; the experience and expertise of the Indian party in the same or a related line of activity outside India; etc.[4] While the routing of investment via the approval route should not be a deterrent to enhancing FDI flows between the two countries, approvals must be accepted/rejected in a transparent and time-efficient manner.

**Box 8.1: Case of India-Bangladesh FDI**

Until recently, India had Sri Lanka, Bangladesh, and Pakistan on the negative list for investment; however, in 2006 and 2007, India permitted FDI from Sri Lanka and Bangladesh, respectively, making Pakistan the only country from where India did not permit any FDI inflows. As of date, apart from Pakistan, investments from and to Bangladesh are also routed through the "approval" route, which is applicable to all sectors. The India-Pakistan FDI relation can draw lessons from the success of the India-Bangladesh FDI scenario. Until 2007, Bangladesh was also on the banned list of Indian FDI regime. With the removal of restrictions, investments from India into Bangladesh have increased at a tremendous pace (Table 8.6).

According to UNCTAD (2013) and the Bangladesh Board of Investment, India has emerged as the largest South Asian investor in Bangladesh.

**Table 8.6** FDI inflow by India in Bangladesh (2007–2010) (US$ million)

| 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|
| 6.09 | 1.67 | 11.29 | 7.99 | 43.19 |

*Source*: Board of Investment, Bangladesh. http://www.boi.gov.bd/

[4] For more details, visit rbi.org.in.

## 8.5 Existing Barriers in Pakistan

Despite the investor-friendly nature of the FDI policy offered by Pakistan government, investment from India has not yet entered the Pakistan market. There are tangible and intangible barriers to investing in Pakistan that are not due to the policies, but to the underlying nature of the Pakistan economy. The major barriers in the way of foreign investment are described below.

### *8.5.1 Law and Order*

In recent years, the law and order situation has deteriorated all over the country. It is far from satisfactory even in the growth capital of the country, that is, Karachi.

### *8.5.2 Lack of Political Stability*

Political risks largely depend on political stability and governance by the government (Husain 2009). Political stability is extremely important for the normal macroeconomic and business environment of a country. It enhances the probability of attracting FDI inflows into countries, as it builds confidence among investors. Several studies show that the degree of political stability is an important factor that investors consider when entering business, and it significantly affects FDI flows (Lambsdorff 1999). If the country's political stability is low, foreign investors hesitate to bring in projects until they are assured that the business environment is conducive and favorable (Brada et al. 2005; UNCTAD 2010; World Bank 2011). Pakistan has been suffering from instability in its political system, and this can be identified as the most important barrier that has prevented Pakistan from receiving large inflows of FDI from countries including India. Even the World Bank (2011) categorically states that private sector investment is low in the country because of political instability and corruption.

Since 2008, political instability in the country has increased. One measure of political instability is the *political instability index* that shows the level of threat posed to governments by social protest. Table 8.7 shows the political instability index score for Pakistan compared to India. Pakistan's score has deteriorated since 2007 and signifies high risk. In fact, Pakistan's rank is 7 in terms of political instability out of 165 countries, which indicates very high risk. On the other hand, India has shown considerable stability and stands at a rank of 135.

The issue of investment protection and safety is a major concern for every investor, the lack of which adds a component of risk to investment. In general, risk can be of two types: risk on profit and risk on capital. Political instability in Pakistan exposes investors to both types of risk. In the short run, investors may be willing to bear losses if there are chances of profits in the long run. However, with regard to

**Table 8.7** Political instability index: India and Pakistan

| | India | Pakistan |
|---|---|---|
| Political stability index | | |
| **2007** | 4.5 | 5.8 |
| **2009/2010** | 4.5 | 7.8 |

*Source*: Economic Intelligence Unit
*Note*: The index is on a scale of 0 (no vulnerability) to 10 (high vulnerability)
The index scores are derived by combining measures of economic distress and underlying vulnerability to unrest. The index covers the period 2009/2010, and scores were compared with the results for 2007. EIU data, retrieved June 10, 2013, from http://viewswire.eiu.com/site_info.asp?info_name=social_unrest_table&page=noads

Pakistan, investors fear 100 % risk with regard to the security of their capital too. The investment scenario is further dampened by an idiosyncratic risk related to the political relations between India and Pakistan (Desbordes 2010; Desbordes and Vicard 2009).

### 8.5.3 Pakistan's Economic Performance

Macroeconomic indicators are important determinants of FDI. However, over the past few years, Pakistan seems to be losing its macroeconomic strength. Pakistan's economy grew at an annual average rate of only 2.9 % during the past 5 years. Deterioration in the power sector is a major constraint to growth, and power outages have shaved annual GDP growth to 2 %. GDP growth has been stuck at a level that is less than half of Pakistan's long-term trend potential of 6.5 % per annum.

### 8.5.4 Transparency of the Regulatory System

A transparent regulatory system is vital for foreign investors, because nontransparency imposes additional costs on businesses. These additional costs arise because firms have to tackle the lack of information that should have been provided by the appropriate government department in the implementation of its policies and as part of the activities of government institutions. Transparent policies also facilitate cross-border mergers and acquisitions. When firms decide to acquire abroad, they are often required to have their acquisitions approved by a commission or government body in the foreign country (Drabek and Payne 1999). Nontransparent applications of government regulations have also been responsible for the low levels of FDI in Pakistan (Khan 1997). The privatization program and incentive packages have also not been without controversy, that is, surrounding the transparency of the deals, job losses, and/or profit repatriations (Hamdani 2011).

**Table 8.8** Control of Corruption Index in Pakistan

| Year | Control of Corruption Index |
|---|---|
| 2005 | 13.7 |
| 2006 | 23.4 |
| 2007 | 24.3 |
| 2008 | 21.8 |
| 2009 | 12.4 |
| 2010 | 12 |
| 2011 | 15.6 |

*Source*: Worldwide Governance Indicators (2012)
*Note*: Higher values indicate better governance

### 8.5.5 Corruption

If corruption keeps increasing in a country, the reputation of the country suffers in the eyes of the foreign investor. Aburime (2010) probed into the influence of corruption in FDI and effectiveness in the case of Pakistan. The study observed that the Pakistan economy is "haunted by hovering clouds of corruption causing adverse effects." Several other studies also point out that corruption is a major problem in the development of the Pakistan economy (Shahbaz et al. 2008; Shahbaz and Rahman 2010).

The World Bank's Control of Corruption Index reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. Table 8.8, which shows the control of corruption index for Pakistan, indicates that Pakistan's control of corruption is not good represented by low values on the corruption control index.

### 8.5.6 Cost of Doing Business

In Pakistan, the cost of doing business is higher than the global norm. Pakistan's rank is 107 out of 183 countries. Although this is lower than in most South Asian countries, it is high compared with other developing countries of the world.

### 8.5.7 Infrastructure

The availability, reliability, and cost of infrastructure facilities (power, telecommunications, water supply, etc.) are important determinants of a conducive business environment. Unfortunately, infrastructure facilities in Pakistan are inadequate and, thus, act as a barrier to attracting investment flows (Khan 1997). Poor infrastructure leads to an increase in transaction costs, limits access to both local and global markets, and discourages FDI.

### 8.5.8 Tax Structure

Payment of taxes and contributions is a complex and cumbersome process in Pakistan (Jacobs and Coolidge 2006). In addition to corporate income taxes, a large number of direct and indirect taxes are levied at the federal, provincial, and local levels. Foreign investors in Pakistan sometimes complain of the confusing array of federal and provincial taxes and controls. Administrative discretion plays a large role in assessing tax, resulting in discrimination among taxpayers. The number of approvals, permits, and licenses required from various government entities prior to launching a business project in Pakistan poses a significant hurdle to investment in Pakistan, but many of these licenses and permits have been removed over the past few years. It is no longer mandatory to register with the Board of Investment, but investors must still register with the Securities and Exchange Commission of Pakistan (SECP) and the State Bank of Pakistan (SBP).

### 8.5.9 Banking and Financial Services

Banking channels play a catalytic role in promoting and facilitating investment flows, because they guarantee payments that are essential for building new and lasting business partnerships. The extent to which investment potential can be realized depends on the availability of banking and financial services between India and Pakistan. However, currently there are no Indian banks in Pakistan and no Pakistan banks in India. So, even though the FDI policy allows for repatriation of dividends freely, this is not possible directly and easily for Indian and Pakistani investors unless there are banks that operate in each other's country. In the absence of such a mechanism, profits are routed via third-party banking arrangements or correspondent banks.[5] This results in delays in payments and increases cost; it raises issues of double taxation and overseas transaction tax.

If India and Pakistan open bank branches in each other's country, then transactions can get processed within a day or so. Intra-bank processing happens through electronic clearance unlike interbank processing in which usually routing is done via a third-country bank.

In 2005, the Reserve Bank of India and the State Bank of Pakistan signed an agreement to open branches of two Indian banks in Pakistan and two Pakistan banks in India. This agreement has still not been implemented, as procedural difficulties have been allowed to overwhelm the substance of the agreement (Husain 2013). Without banking services, investment flows cannot flourish.

[5] Banks usually undertake transactions in countries in which they do not have a presence through correspondent banking. This involves opening vostro/nostro accounts. A vostro account is another bank's account with the reporting bank, while a nostro account is the reporting bank's account with another bank (IMF 2011).

### *8.5.10 Restrictive Visa Regime*

International investment requires personal contact with business partners. Visa restrictions render such personal meetings difficult. The current visa regime between India and Pakistan is complicated and restrictive. Some of these restrictions are delays in granting visas, only city-specific visas are granted, visitors have to report to the police on arrival and before departure, and visitors have to depart from the port of entry. Pakistan should strive to remove these bottlenecks in a bid to enhance its competitiveness in attracting FDI flows.

## 8.6 Conclusion and Policy Recommendations

India and Pakistan should increase their cooperation, especially on the economic front, to enhance trade and investment flows, as these are the two economic partners most suited to bring about a huge change in the entire South Asia region. As the FDI regime between India and Pakistan is liberalized, much remains to be done on both sides to facilitate and enhance investment flows.

First, regulatory and administrative barriers to investment need to be addressed. The mobility of capital and labor are two important issues in international investment. An efficient banking channel can provide the backbone for smooth flow of capital and investment between countries. Opening branches of Indian and Pakistani banks will facilitate the movement of capital and lower transaction costs. Political willingness to remove such barriers is necessary to build international relations. Similarly, free movement of labor is important to facilitate FDI flows. The current visa regime is restrictive, complicated, and a major deterrent in the flow of labor across the border; hence, it needs to be liberalized.

For business deals to be finalized, it is important to have good channels of communication. A primary requirement of business communities on both sides is better telecommunications. The rules with regard to international roaming facility should be relaxed. (Joint Statement 2012).

Although policy changes have been instituted, the complementary policies and actions required to introduce liberal foreign investment are still missing. This study proposes stagewise recommendations for better and sustained formulation of investment relations between India and Pakistan (Fig. 8.1).

### *8.6.1 Stage 1*

Governments on both sides need to engage with each other to send the right signals about their willingness to take the trade normalization process forward. Businesses on both sides need to engage with each other proactively to continue the momentum

**Fig. 8.1** Three-stage recommendation

of the process of trade normalization. There is lack of awareness and apprehension among businesses about business opportunities in the other country. Awareness needs to be spread and the information gap needs to be filled. This needs to be pursued at multiple levels through collaborative efforts across governments, business chambers, and academic institutions in both India and Pakistan.

#### 8.6.1.1 Informal Events

Informal events like road shows for sustained interest in bilateral business and regular exchange and interaction among business delegations need to be promoted. Chambers of commerce in India need to assist Pakistani businessmen in conducting road shows that focus on key sectors in Pakistan that could benefit from Indian investment. This can be done in association with state-level investment boards in India. The events have to be organized every month so that the business potential remains in public memory. Recently, a cross-border business plan competition, *Start-up Dosti*, was organized by Dosti Partnership to connect Indian and Pakistani entrepreneurs and facilitate investment and collaboration (Atlantic Council 2013). Dosti Partnership is the product of a cross-border partnership between the Atlantic Council (US), the Indian Angel Network (India), and SEED Ventures (London, Karachi). It seeks to build on the improved economic relations between India and Pakistan by promoting greater trust and collaboration in the business community, providing opportunities for cross-border investment, and supporting young entrepreneurs. Such innovative events to attract youth potential should be encouraged through think tanks and educational institutions.

#### 8.6.1.2 Trade Fairs

Annual trade fairs in the two countries can help create awareness of existing business opportunities and pave the way for technology exchange across the border. The unprecedented number of fairs and exhibitions held in India and Pakistan (see Box 8.2), displaying each other's products, has received an overwhelming response from consumers, which provides support for such efforts to continue (Taneja et al. 2013).

**Box 8.2: Recent Pakistan Trade Fairs and Exhibitions in India**

| | |
|---|---|
| Made in Pakistan Exhibition, Chandigarh | April 2013 |
| Indo-Pak Expo, Ludhiana | February 2013 |
| Indo-Pak Expo, Jalandhar | March 2013 |
| Made in Pakistan Expo, Mumbai | August 2012 |
| Pakistan Mega Lifestyle Exhibition, New Delhi | April 2012 |

*Source*: Rawalpindi Chamber of Commerce & Industry rcci.org.pk.
http://www.ficci.com/PressRelease/985/ficci-press-aug30-pak.pdf

#### 8.6.1.3 Formalization of Indirect Investment

Given the attractive business opportunities in Pakistan, several Indian business entities operate in Pakistan via Dubai. This is partly due to the congenial and hassle-free business environment offered by Dubai and partly to its proximity to Pakistan. The exchequers of both countries lose significant potential revenue because of such indirect investment. For instance, Dabur operates in Dubai to access the huge market in Pakistan for its products such as Hajmola Chulbuli Imli. The aim should be to identify such investors, understand the reasons for their reluctance to invest directly in the other country, and remove the causes that drive them to operate through third countries. This would help drive mechanisms and regulations that would promote direct business.

#### 8.6.1.4 Progress Region-Wise

There is a need to take small steps. The first attempt can be to tap the synergies across the two Punjabs, which share a lot in terms of culture, language, and business ethics. The success of business in these regions can pave the way for moving to other provinces and states in the two countries. During a recent meeting between the chief ministers of the two Punjabs in December 2013, the need to integrate the economies of these states was reiterated. The joint statement, the first of its kind between any two provinces of India and Pakistan, released after the meeting

has proposed free movement of academics, students, and interns and the promotion of community contacts and understanding through the exchange of delegations consisting of professionals and practitioners from different sectors, including agriculture, trade, industry, and commerce (Naqvi 2013). The chief ministers focused on promoting cooperation and sharing learning in the livestock sector, including dairy development, vaccinations, animal husbandry, veterinary sciences, and water management. Such high-profile meetings and the resolution to promote peace and harmony across the Punjab region must be replicated at the national level too.

#### 8.6.1.5 Removing Bias

There is need to remove the prevailing bias against Indian goods in Pakistani markets and against Pakistani goods in India. A recent study found that Pakistani businesses find it difficult to sell their goods in India, as there is an "image issue." For instance, Pakistani bed linen is sold in India under European and Indian labels (Trade Development Authority of Pakistan 2012). A similar fear persists in the minds of Indian businesses, as their business partners in Pakistan advise them not to use the "Made in India" label.[6] However, new products, for example, sweets and snacks by a large Indian manufacturer, have made a successful entry into the Pakistani market under the Indian label.[7]

Efforts are needed to make these goods more acceptable in order to increase demand. This can be done by celebrity endorsement of goods and building the brand image of "Made in India" goods in Pakistan and vice versa in India.

#### 8.6.1.6 Government Participation

The Indian government can set a precedent by taking the initiative to invest in Pakistan. This will send encouraging signals to private investors. When a region is not conducive for business, public investment can have a demonstration effect that leads to additional projects by foreign country investors. A good example of this is the investment by the Indian public enterprise ONGC Videsh Ltd. for exploration of oil and natural gas in Afghanistan. The success story of ONGC has generated confidence among investors and has paved the way for future private foreign investment in Afghanistan.

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[6] Interviews with manufacturers who are trying to enter the Pakistani market after their products were included in the positive list.

[7] Interview with an exporter of packaged sweets and snacks to Pakistan under the Indian label.

### *8.6.2 Stage 2*

Innovative solutions are required to mitigate the risk, perceived or real, of investing in Pakistan and to pave the way for investor confidence.

#### 8.6.2.1 Encourage Investors of Pakistani Origin

Investments from Indian investors who are originally from Pakistan should be encouraged. There is a strong business community that migrated from Pakistan to India in the 1980s and 1990s and has recent memories of Pakistan. These businessmen have expressed an interest in investing in Pakistan, provided that the business proposal and investment climate is sound. However, they are apprehensive of losing the trust of the Indian government by investing in Pakistan. The Indian government needs to address such fears and encourage investment in Pakistan. Investment by Pakistan-origin businessmen settled in India can then percolate to the entire Indian business community.

#### 8.6.2.2 Common SEZs

Pakistan and India can learn from Jordan and Israel that face continuous tension along their common border. The areas on the border between Jordan and Israel have been designated as Qualifying Industrial Zones[8] (State of Israel, Ministry of Economy). Initially, only a few Jordanian companies took advantage of this because they faced hostility in doing business with Israel; gradually, more Jordanian businesses began to set up establishments when business considerations began to overshadow political hostilities. India and Pakistan can learn from the success story of business development between two border nations (Jordan and Israel) with a background of political hostility. Pakistan could also consider setting up an SEZ near Lahore with special incentives. By using Pakistan land, manpower, and other resources, such SEZs would generate employment in Pakistan and foster economic development in both countries. Economic cooperation will also generate a sense of peace and prosperity in the region.

By this stage, several Indian business organizations would have got first-hand experience of operations in Pakistan. Their experience needs to reach out to other business organizations by word of mouth. This can be done by sharing experiences through social media and joint meetings with potential investors.

[8] Qualifying Industrial Zones are a special type of free trade zone.

### *8.6.3 Stage 3*

Eliminating risks from investment to levels that are palatable to investors can be partially achieved by smoothing the investment landscape using guarantees and innovative insurance products.

#### 8.6.3.1 Support from International Organizations

Political risk is a major investor concern in developing countries. The World Bank (2009) rated Pakistan as among the five most risky investment destinations. In 2002, the Asian Development Bank created an insurance cover, namely, the Political Risk Guarantee (PRG), against specific political or sovereign risks. PRGs are designed primarily for cases where commercial lenders are prepared to take on the commercial risks of a project, but require assistance from multilateral institutions or private insurers to mitigate political risks. This facility is counter-guaranteed and indemnified by the Pakistani government. There is flexibility to increase this coverage (up to US$175 million) through commercial reinsurance arrangements. Although there have been no terrorist incidents targeting FDI in Pakistan so far, the investor's security concerns can be addressed through support from the Multilateral Investment Guarantee Agency (MIGA), which is an international financial institution that offers political risk insurance and guarantees. MIGA is popular in countries in Africa that have managed to attract a lot of FDI despite disturbed domestic conditions. In Pakistan, too, MIGA has provided several guarantees to Habib Bank AG Zurich, Switzerland, to support the expansion and growth of its branch operations in Pakistan.

#### 8.6.3.2 Bilateral Investment Treaty (BIT)

As the FDI regime between India and Pakistan has been liberalized, the next obvious step for both governments should be to set up an institutional mechanism that would guarantee each other's investments. The countries should work toward signing a bilateral investment treaty that protects and promotes investments on a reciprocal basis and includes provisions on fair and equitable treatment, protection from expropriation, and national treatment (Taneja and Bimal 2012). Signing a BIT is also required to instill confidence and a sense of security among investors on both sides. In case of an unforeseen event, this can act as a sovereign guarantee too.

#### 8.6.3.3 Dispute Settlement Mechanism

An innovative and well-defined dispute settlement mechanism to address the issues faced by investors can go a long way in building a conducive and strong business environment between India and Pakistan.

To conclude, given the lucrative Pakistan market, the geographical proximity of the two countries, and the access to the Central Asian Republics that Pakistan could make available to India, there is a strong case to encourage Indian investment in Pakistan. To realize the untapped investment potential, there is a need for coherence in investment policy with other areas of investment facilitation and business practices in order to enhance the investment climate. Although India and Pakistan have made considerable progress in liberalizing their FDI regime, implementation problems continue to affect investment flows. The governments on both sides need to address the regulatory and administrative challenges that Pakistan faces in attracting investment from India. Innovative solutions are needed to increase investment flows. It is important for businesses on both sides to create multiple channels of communication and engagement to bridge the information gap. This will enhance economic relations between India and Pakistan, which could play a critical role in improving overall bilateral relations between the two countries.

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