Partnering to Bolster Growth and Enhance Pakistan's Competitiveness

Policy Recommendations to Sustain and Attract Foreign Investment

U.S.-PAKISTAN BUSINESS COUNCIL

U.S. CHAMBER OF COMMERCE
International Affairs

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Executive Summary

Members of the U.S.-Pakistan Business Council (USPBC), based at the U.S. Chamber of Commerce, are confident that Pakistan has the potential and the resources to become a vibrant and dynamic emerging market economy. Pakistan has a population of 186 million people, consumer spending amounting to over $100 billion, relatively low wages, high rates of return on investments, and a large and growing middle class. The U.S. private sector believes that with the right policies, the achievements of the past three years can help accelerate Pakistan's economic resurgence and improve the country's position in attracting investment.

The government of Prime Minister Nawaz Sharif has taken some important steps in improving Pakistan's economic conditions. Since implementing initial reforms in 2013, Pakistan has made macroeconomic progress in a number of areas—growth is now above 4% and is projected to rise close to 5% in 2016—but more must be done to further strengthen these economic gains. Energy shortages persist, public finances are still fragile, and the country's fiscal situation faces challenges.

The main engine of sustained economic growth will be foreign direct investment (FDI). If the Government of Pakistan wants to create an environment that is conducive to foreign investment, it should implement a variety of economic and institutional reforms to address the constraints that many foreign companies face in their daily operations and potential expansion.

A critical factor inhibiting foreign investors is the security situation, which while having improved, will require a sustained and long-term effort to improve. The security challenges, however, remain outside the scope of this study, and the report focuses on the economic and business environment in Pakistan as it relates to FDI.

The U.S. Chamber of Commerce strongly supports the efforts of the USPBC to strengthen the bilateral commercial relationship between the United States and Pakistan. The USPBC is testimony to the increasing interest in Pakistan as an investment venue for U.S. companies. The USPBC is eager to work with the Government of Pakistan to bolster growth and enhance Pakistan's competitiveness, and to set the country on a path to sustain and attract critically needed FDI.

As friends and partners in Pakistan's progress, the USPBC recommends the following steps:

- **Pursuing macroeconomic stability.** This is essential with or without an International Monetary Fund (IMF) program and will involve policies to improve public finances, increase exports by diversifying products and foreign markets, and generating private and official external financing.

- **Implementing reforms to sustain and attract foreign investment.** Addressing the security situation and energy shortages are obvious, but steps should be taken to make the business climate more conducive. From a small survey conducted by the USPBC, current investors identified three main areas for such reforms: (1) taxation regime and policies (2) protection of intellectual property rights, and (3) introducing a modern bankruptcy law along with a transparent dispute settlement procedure. Enhancing the business climate, implementing the government's reform agenda, and the recommendations of USPBC members on these three key areas can significantly increase the attractiveness of Pakistan to foreign investors. Our recommendations can be found on page 16-23.

- **Supporting energy and infrastructure development.** Pakistan needs to continue to improve its energy systems and invest in its infrastructure, with power and transportation at the top of the list. In order to attract American investment and improve overall outcomes in these areas, government officials should consider integrated policymaking and infrastructure development plans to spur investment and lending in the sectors. U.S. companies welcome public-private partnerships to help improve investment in, access to, and delivery of infrastructure. The Government of Pakistan should also continue to pursue all avenues and fuel sources to meet its energy demand and consider short- and medium-term solutions.

- **Launching U.S.-Pakistan Business Dialogue.** We hope that the Government of Pakistan would establish a regular U.S.-Pakistan Business Dialogue between senior Pakistani government officials and established American investors in Pakistan, to focus on concrete steps that can be taken to expand investments and attract investors. Through these high-level discussions, foreign investors would have more certainty about proposed policies, and government officials in turn would have a clearer understanding of the needs and concerns of investors.

The U.S. private sector is committed to jointly work with Government of Pakistan officials to help achieve the country's economic development objectives and sustain and attract critically needed foreign investment. A regularized engagement between the government and

private sectors can deliver viable solutions and provide a forum to develop benchmarks against which to measure progress on economic reforms and business policies, as well as the growth of the U.S.-Pakistan commercial relationship.

Introduction

A question that is often raised in economic and business circles is why Pakistan is not a more favored destination for FDI. It has a population of 186 million, of which 125 million are less than 30 years of age; consumer spending of more than $100 billion, or 40% of gross domestic product (GDP); relatively low wages; high rates of return on investments; and a large middle class of 38 million and an emerging middle class of 141 million. The World Bank forecasts that the middle class in Pakistan will reach 84 million by 2025.[1]

Pakistan's unique security situation creates a challenge for some investors; however, there are other important economic and business factors that impede foreign investment as well. These include frequently changing economic policies, severe energy shortages, inadequate infrastructure, institutional weaknesses, a slow-moving bureaucracy with limited accountability, somewhat cumbersome business-related regulations, and corruption.

This study focuses exclusively on the economic and business situation in Pakistan as it relates to FDI, viewing the security situation as outside the scope of this report. It examines the main reasons that inhibit new FDI and constrain established foreign investors in Pakistan from expanding their operations despite the country's large and growing opportunities. The analysis uses published overall economic and business data, as well as the responses to a specifically designed survey of U.S. foreign investors in Pakistan.

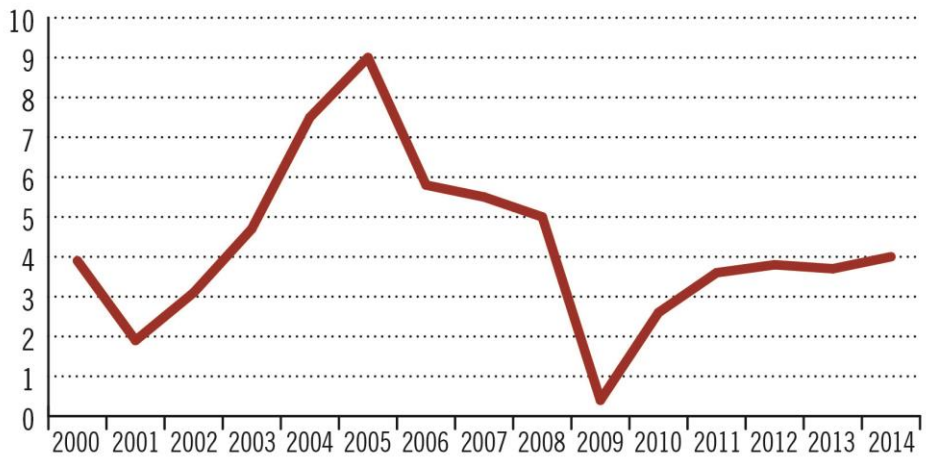
This report argues that Pakistan has the potential and the resources to become a vibrant and dynamic emerging market economy. FDI can be instrumental in achieving this objective, but this would require putting in place some more sound economic policies and undertaking a variety of institutional and structural reforms. If successful, Pakistan could easily double or even triple the amount of FDI inflows. This is by no means an impossible task. Many countries, particularly in East Asia and Latin America, were at some point in a similar economic situation to that of Pakistan now. These countries were able to transform their economies and thus attract large inflows of FDI. So can Pakistan, provided that there is political will to undertake the required reforms. In short, the Pakistani government has the opportunity to put the economy on a higher growth trajectory through greater investment. It should seize this opportunity.

[1] The World Bank, IMF, Oxus Research Database

Economic Overview

During the first decade of the century, the Pakistani economy performed reasonably well. The growth of real GDP had been rising steadily from 2001 onward, hitting a peak of 9% in 2005, after which it began to fall and reached a low point of only 0.4% in 2009. For the decade as a whole, the economy grew at an annual average rate of 4.5%, which was certainly respectable (Chart 1).

Chart 1. Pakistan: Real GDP Growth Rate, 2000-2014 (%)



Source: IMF

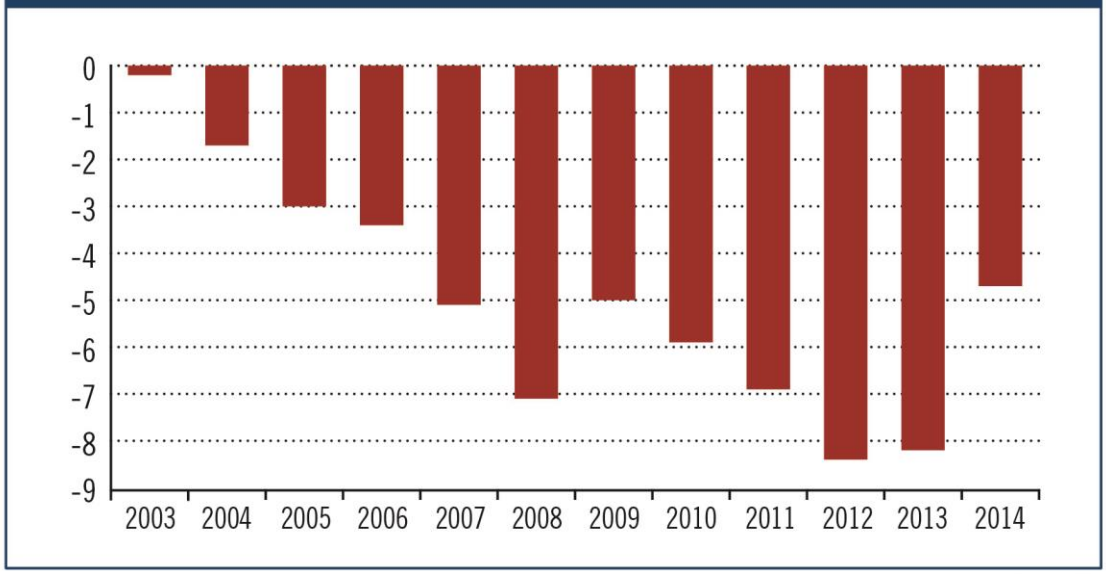
The growth over 2000—-2008 was driven largely by consumer spending as total investment remained relatively stable at about 16% of GDP. FDI rose from only $300 million in 2001 to $5.4 billion in 2008, which clearly had a strong positive effect on the growth of the overall economy. As total investment declined between 2008 and 2013, FDI also declined to only $1.5 billion.[2]

Inflation was kept largely in check at an average rate of 7.5% per year, although it went into double digits in 2008. While it can be argued that high inflation in 2008 and 2009 was the result of the sharp increase in international oil prices in the first half of 2008, as well as higher food prices, the fact that inflation stayed well above 10% in the subsequent three years was due to lax monetary and fiscal policies. In the case of the latter, the fiscal deficit averaged 4% of GDP for the decade, but it had been growing steadily from 2003 on and reached 8.4% in 2012 (Chart 2).

[2] The bulk of FDI went into the information technology (IT) and telecom sectors, as well as into the energy (upstream oil and gas) sector.

The balance of payments and level of international reserves have been a perennial concern of Pakistani policymakers. The external current account balance was in continuous deficit starting in 2005 and reached 8.1% of GDP in 2008 as a consequence of the rise in world oil prices. The deficit thereafter began to come down steadily and, in fact, there was a small surplus in 2011. The main reason for the improvement in the current account was workers' remittances, which increased from $1 billion in 2000 to $13.2 billion in 2012. International reserves reached nearly $15 billion in 2011, their highest level historically. However, the sharp turnaround in the external current account, which moved from a surplus of 0.1% of GDP to a deficit of 2.1% in 2012, as well as the halving of FDI from $1.6 billion to $0.8 billion between 2011 and 2012, led to international reserves falling by $4 billion to $10.8 billion in 2012 and then further to $6 billion in 2013 (Chart 3).

Chart 2. Pakistan: Fiscal Balance, 2003-2014 (% of GDP)



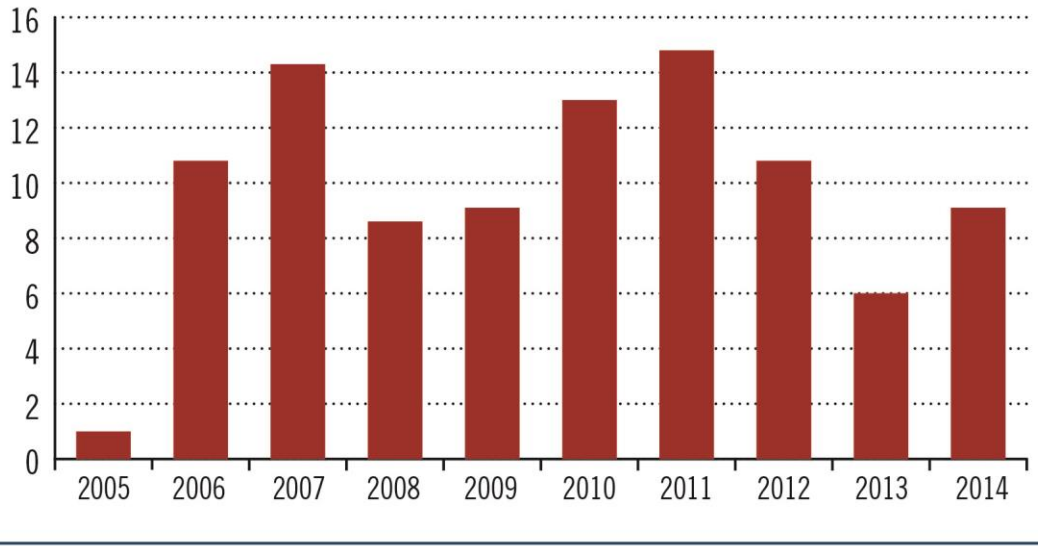
Source: IMF

Economic Reforms Progress

The government of Prime Minister Nawaz Sharif that assumed office in June 2013 inherited an economy in very poor shape. The new government launched an economic program in September 2013, with the financial and technical support of the IMF to reverse the deteriorating macroeconomic picture, characterized by low growth, high inflation, a large fiscal deficit, and rapidly declining international reserves. The three main pillars of the economic reform program were reducing energy shortages, stabilizing public finances, and improving the external balances. If successful, over the following five years starting in 2014,

this program was envisaged to raise the growth rate from 3% to 5% a year,[3] bring inflation down from double digits to 5%, reduce the fiscal deficit by 5 percentage points to 3% of GDP, and increase international reserves to more than $20 billion from the level of $6 billion in July 2013—the lowest level they had been in the previous 10 years.

Chart. 3. Pakistan: International Reserves, 2005-2014 ($ U.S. billion)



Source: IMF

Realizing Potential Energy Capacity

The government has made it clear that increasing the energy supply is one of its highest priorities. Pakistan continues to be in the midst of a serious energy crisis that is seen in country-wide electricity shortages and daily cuts in power for 6-12 hours. This creates considerable hardship for households,[4] but it also has a severe impact on industry. Many production units, particularly heavy industry, have been forced to operate at only 50%-60% capacity. Increasing energy supply would lead to an immediate jump in the growth rate without any need for additional capital investment, as industry could utilize the existing idle capacity.

On average, power plants are supplying 17,000 MW of energy and operating well below their installed physical capacity of 22,000 MW. The gap between capacity and output is striking,

[3] See, for example, Ali Khizar, "Beyond Stabilization: Moving towards a Growth Economy," Jinnah Institute Policy Brief, Islamabad, June 19, 2015.
[4] Indeed, the English term "load shedding" has entered Urdu and other local languages.

especially as peak demand exceeds 25,000 MW. Clearly the government must find ways to close this large gap and to increase physical capacity. However, this is a long-term proposition as it takes time to construct new power plants and develop alternative energy sources. For example, the construction of the Diamer-Basha dam, which would add 4,500 MW of electricity to the national grid, will take some 12 years to complete.[5] The proposed Iran-Pakistan gas pipeline has also been under prolonged negotiations. With the lifting of sanctions on Iran, work on the pipeline can presumably proceed, but it will take several years to complete.

Under these circumstances, the government has had to focus on the rehabilitation of existing plants to enable them to increase their supply. Yet these efforts have led to a relatively small increase in the power supply. Further, the government must address governance issues in the energy sector, including setting appropriate tariff rates, eliminating arrears to power companies—namely the "circular debt"—reducing line losses, and collecting payments.

Despite the fact that the government views the reduction of energy shortages as a high priority, the power sector remains a major bottleneck for growth and a drain on public finances.[6] The system is still operating below cost recovery levels, which results in underutilization of capacity and a buildup of arrears. Moreover, even with the large fall in international oil prices, budgetary subsidies remain significant. With the plans to increase physical capacity and the output from the existing capacity, the government hopes to achieve supply-demand balance by 2017-2018. Whether this optimistic scenario can be realized is an open question, but it is clear that absent a significant increase in energy supply, Pakistan will continue to be stuck in a low-growth equilibrium and unable to create sufficient jobs for the growing young labor force.

Public Finances and Reversing the External Account Deficit

As part of the agreement with the IMF, the government moved quickly to address the public finances. It managed to reduce the budget deficit sharply from 8% to under 5% of GDP in the first year of the program, thereby keeping the government debt ratio at 63% of GDP. On the revenue side, the government committed to increase the tax ratio by 1% of GDP for the next five years from its 2013 level of 10.4%, one of the lowest ratios in the South Asia region. This required the introduction of some new taxes, but it mainly involved enhancing the collection of income and sales taxes by expanding the tax base and eliminating tax exemptions and concessions granted through the statutory regulatory order (SRO) system.

[5] The feasibility study for the Dasu dam, expected to produce another 4,320 MW of electricity, was completed in 2015. There have also been delays in the 1 MW Neelum-Jhelum hydropower project, which was expected to come online in 2015.

[6] IMF, *Pakistan: Seventh Review under the Extended Arrangement and Modification of Performance Criteria*, Staff Report, Washington, June 2015.

On the expenditures side, the government undertook to reduce subsidies, particularly energy subsidies, which were running close to 2% of GDP. It also announced a program to reform state-owned enterprises, whose losses amounted to 1.5% of GDP in 2013. This reform program included the privatization of some 65 state-owned enterprises and the restructuring of the largest ones, including Pakistan International Airlines, Pakistan Steel Mills, and Pakistan Railways.

While the government was able to bring the fiscal deficit down to 4.7% of GDP in 2014, this was achieved largely by one-off revenue measures, foreign grants, and cuts in development spending. There is considerable controversy among Pakistani economists on what the "true" fiscal deficit was in 2014 and 2015.[7] The tax ratio has increased by only 0.5% of GDP in the two years since the beginning of the program, and government spending has remained relatively constant as a share of GDP. The overall fiscal deficit target has been met by treating privatization receipts and foreign grants as ordinary revenues, putting the energy arrears—which are running more than $5.7 billion in 2015[8]—outside the budget, delaying tax refunds, and requiring prepayment of certain taxes. It is estimated that without these adjustments, the fiscal deficit would have been closer to 8.5% of GDP.[9] There has also been little progress in eliminating SROs, which the government had committed to doing as part of the IMF agreement; reducing energy subsidies; and restructuring and/or privatizing state-owned enterprises.

Correcting the external imbalances and generating external financing were other major issues that the government had to tackle. To reverse the bleeding of international reserves that would eventually lead to a balance of payments crisis, the government had to stabilize and then reverse the current account deficit. Exports stagnated while imports continued to grow. Nevertheless, the government was successful in reducing the current account deficit largely because of the continued strong growth of remittances, which rose to $15.8 billion in 2014 and are expected to be close to $18 billion in 2015.

More important, the government made a major effort to secure external financing from donors, international financial institutions, and the international capital markets. The three-year $6.6 billion IMF arrangement initiated in September 2013 was an important breakthrough, as it was followed up by additional financing from the World Bank and the Asian Development Bank. The Gulf Arab countries continued with their long-standing support of Pakistan, with Saudi Arabia providing a grant of $1.5 billion in March 2014.[10] In addition, despite its low credit rating, the Government of Pakistan was able to successfully

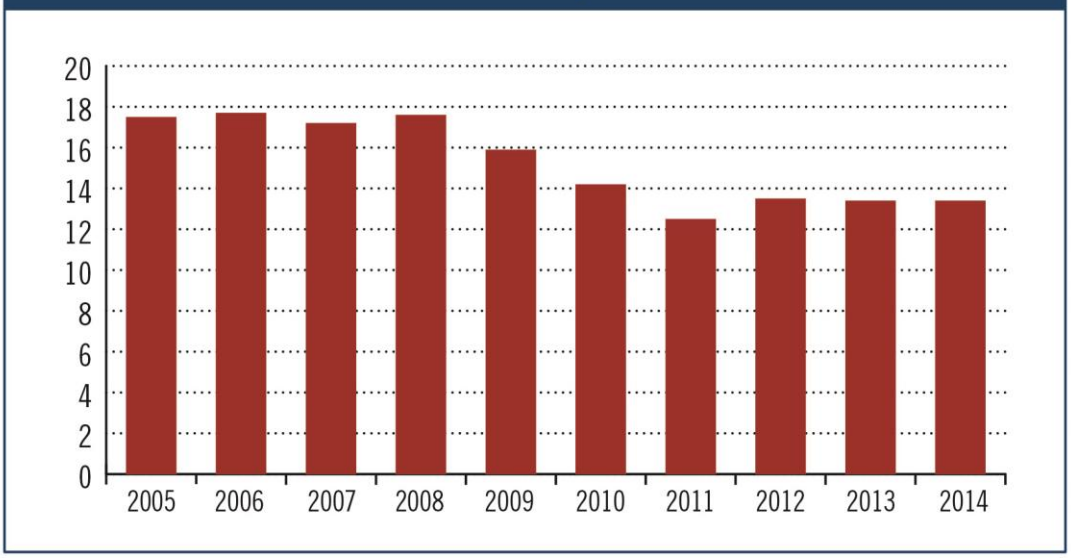
[7] See Ashfaque H. Khan, *Budget Deficit 2014-15 Revisited*, Business Recorder, September 23, 2015; and Ehtisham Ahmed, *Sustainable Development in Pakistan: Geopolitical, Economic Security and Environmental Constraints*, paper prepared for the Routledge South Asia Review, 2016.
[8] At the beginning of the Sharif government, about $3 billion of existing arrears (circular debt) was cleared.
[9] See Victor Mallet and Farhan Bokhari, *Disdain over IMF's Rosy View of Pakistan*, Financial Times, August 23, 2015.
[10] The details of the Saudi Arabia financing are not publicly known, so it is not clear if this is a grant or a loan.

tap the international capital markets. In 2014, it sold $2 billion worth of Eurobonds with 5- and 10-year maturities.[11] In November 2014, it followed up with the 5-year $1 billion Sukuk (Islamic bond) at 6.75%. And in September 2015, it floated a 10-year $500 million Eurobond in a fairly volatile market. The stabilizing of the current account deficit and the capital inflows enabled the country to build up its stock of international reserves, from $6 billion in 2013 to more than $15 billion by mid-2015.

Sustaining Growth and Attracting Foreign Direct Investment

From the standpoint of the main macroeconomic indicators, the economy is showing signs of improvement, but we believe that Pakistan still needs a heightened plan to foster growth and improve the country's competitiveness. Growth is above 4% and is projected to rise close to 5% in 2016. This rate of growth is not making a significant dent in the unemployment rate, which is still well over 6%. Youth unemployment (ages 15-24 years) is running at about twice that rate. Labor participation rates, particularly among youth, have also been declining as young workers move abroad or into the informal economy. Inflation is down significantly, partly due to the fall in energy and food prices, but also because of stable monetary policies followed by the State Bank of Pakistan (SBP).[12] The buildup of international reserves has clearly reduced the risk of a foreign exchange crisis, which was a real possibility when this government took over.

Chart 4. Pakistan: Gross Fixed Capital, 2005-2014 (% of GDP)



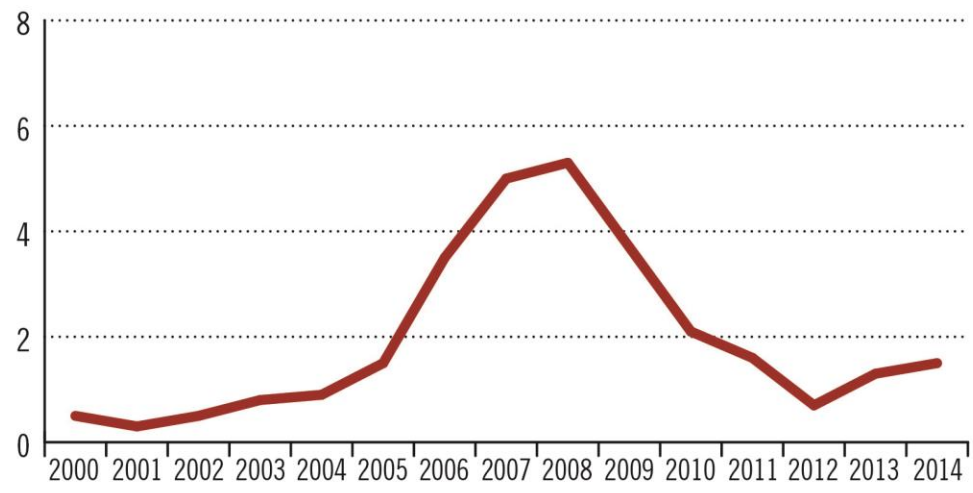
Source: IMF

[11] The interest rate was 7.25% on the 5-year bond and 8.25% on the 10-year bond.
[12] The SBP is now no longer permitted to engage in deficit financing of the government.

These positive macroeconomic developments, much praised by the IMF and other international financial institutions, mask significant weaknesses in the Pakistani economy. Energy shortages persist and are likely to continue for the next several years, public finances are still fragile and the observed reduction in the fiscal deficit somewhat suspect, and most of the increase in international reserves reflects borrowing and workers' remittances rather than an improvement in the underlying foreign trade flows, particularly exports.

The main engine of sustained high growth will be investment. Unfortunately, domestic investment has been steadily falling from a high of 17.6% of GDP in 2008 to 13.4% in 2014 (Chart 4). Government capital expenditures reached a high of 4.7% of GDP in 2007 and have continued to fluctuate between 3% and 3.5% of GDP since then. FDI is probably the best economic indicator of how well the country is doing and how it is perceived in international circles. FDI brings in financing and technology transfers, as well as conveys confidence in the economic prospects of the country. FDI peaked in 2008 at $5.3 billion and has steadily declined since then to amount to only $1.5 billion in 2014 (Chart 5).

Chart 5. Pakistan: Foreign Direct Investment, 2000-2014 ($ U.S. billion)



Source: IMF

Alongside these reforms, the Pakistani government must find a way to include more of its population in the formal economy. The Pakistani civilian labor force comprises about 60 million workers, with the majority working in agriculture (45%), services (34%), and manufacturing (14%).[13] The average official unemployment rate was 6.8% during the past decade, coming down slightly to 6.3% between 2011 and 2012. With labor supply increasing

[13] The total labor force of 60 million does not include workers in the informal economy.

by 3% per year, Pakistan must grow by 6%-7% a year on a sustained basis to absorb the new entrants into the labor market.[14] Absent job opportunities in the formal economy, many job seekers moved into the informal economy, estimated now to be about $100 billion—nearly half the size of total GDP.

The Business Climate

Despite the fact the current government is widely regarded as pro-business, Pakistan's business environment is challenging. Currently, Pakistan does not rank very highly on standard international indicators of competitiveness and the business climate (Table 1).

In the World Bank's 2016 *Doing Business Report*—an annual study that provides objective measures of regulations that both enhance and constrict businesses operating across the globe—Pakistan ranked 138th out of 189 countries in terms of ease of doing business. In addition, its ranking has fallen from 136 in the previous year. In the South Asia region, Pakistan ranked 6th out of 8 countries, with only Bangladesh and Afghanistan below it. Sri Lanka had a ranking of 107, and India's ranking had improved from 134 in 2014 to 130 in 2015. Pakistan ranks particularly low in the categories of paying taxes (171), trading across borders (169), getting electricity (157), enforcing contracts (151), registering property (137), and getting credit (133).

The Heritage Foundation's 2015 *Index of Economic Freedom*, which takes a wider perspective than the World Bank and evaluates a country on more categories—principally the rule of law, limited government, regulatory efficiency, and open markets—ranks Pakistan 121st out of 178 countries in the sample. In the South Asia region, Sri Lanka (101) scored better, but India (128) and Bangladesh (131) were below Pakistan. Also, Pakistan improved its score slightly as a result of improvements in investment freedom and monetary freedom, but that was counterbalanced by deteriorations in labor and business freedoms. The Heritage Foundation argues that problems of property rights, corruption, and inefficient regulatory agencies inhibit business expansion and growth. Corruption and lack of accountability and transparency that is evident at all levels of government, including in the broader justice system, despite the improvements in the democratic process of the higher judiciary.[15] Oversight mechanisms are generally weak, and property rights are not protected effectively.

According to the World Economic Forum (WEF) 2015-2016 *Global Competitiveness Index*—an assessment of the competitiveness landscape and drivers of productivity and prosperity across economies—Pakistan's ranking rose to 126th out of 140 countries from 129 the previous year. The highest scores were achieved in market size (28), business sophistication

[14] Technically, this implies that the elasticity of employment is about 0.5. That is, a 1% increase in the growth rate will lead to a half percent increase in employment.
[15] In the 2014 *Corruption Perception Index* of Transparency International, Pakistan was ranked 126th out of 175 countries included in the index. India and Sri Lanka were both ranked 85th.

(89), innovation (89), and financial market development (99). The difficulties in doing business in Pakistan according to the WEF were, in order: corruption, taxation, inflation, access to financing, government bureaucracy, government and policy instability, infrastructure, and workforce education.

Table 1: *Pakistan's Business Indicators Rankings*

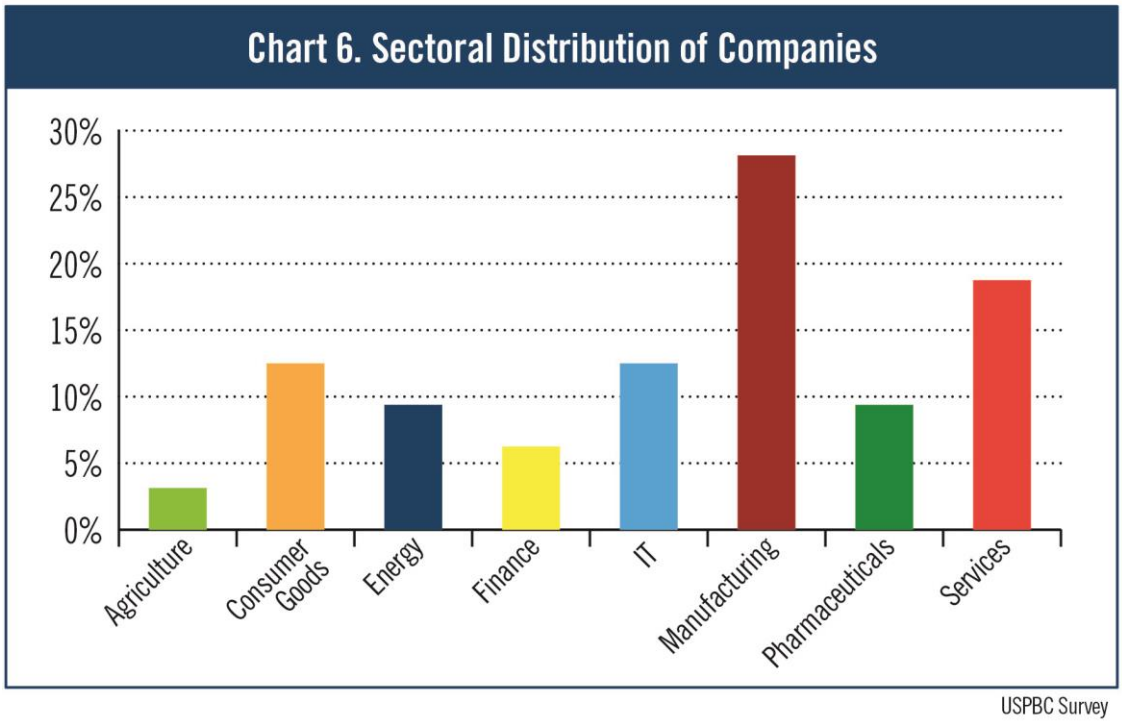
Survey	Rank	Total Economies
World Bank's 2016 *Doing Business Report*	138	189
WEF's 2015-2016 *Global Competitiveness Report*	126	140
Heritage Foundation's 2015 *Index of Economic Freedom*	121	178

All in all, the three sets of indicators looked at by businesses and foreign investors show an economy that has potential but has many problems that must be overcome if it is to realize this potential.

Foreign Investors' Views and Recommendations

To ascertain the views of investors on the business environment in Pakistan, the U.S.-Pakistan Business Council, in collaboration with the American Business Council (ABC) in Karachi and the American Business Forum in Lahore, undertook a small survey of member companies currently operating in Pakistan, held a roundtable session to listen to its members, and conducted in-depth interviews with other companies. The USPBC comprises leading American companies investing and doing business in Pakistan, and the basic purpose of this outreach was to identify the main constraints these companies face and the key reforms that businesses on the ground feel should receive priority by the government. The specific question posed was the following: W*hat are the most important economic policies and reforms the Government of Pakistan should implement in order to improve the business climate and thereby encourage additional investments in the country?*

A total of 30 companies responded to the questionnaire. The various sectors in which these companies operate are shown in Chart 6. The main sectors are manufacturing, services, IT, and consumer goods. There were also three companies operating in energy and pharmaceuticals as well as two in the financial sector. Only one company in the agriculture sector responded.



Most of these established companies have an overall positive view of the business opportunities in Pakistan.[16] **More than three-quarters of respondents have increased their investments in Pakistan in the past five years and plan to do so in the next three years.** The reasons for this cited by the respondents were the size and growth of Pakistan's market, continuing urbanization, high returns on investments, the country's geo-strategic location, a young population, and relatively low costs of doing business.

However, virtually all the companies listed a number of constraints they face in their operations and potential expansion. In order to create an environment that is conducive to foreign investment, Pakistan not only should implement a variety of economic and institutional reforms to address these constraints, but do so in consultation with business stakeholders.

Three major issues raised by many of the investors relate to security, energy shortages, and corruption. The Government of Pakistan recognizes the problems these factors create for current and future investors. But the planned solutions to these are currently long term in nature.

[16] At the same time, it is worth noting that some U.S. companies have recently exited or sold out to their local partners.

Businesses responding to the USPBC questionnaire identified some key priorities that could be addressed in the short term. The three main areas where reforms are critical as identified by survey participants, were taxation, protection of intellectual property rights (IPRs), and bankruptcy and dispute resolution procedures. Enhancing the business climate and implementing the government's reform agenda in these three key areas can significantly increase the attractiveness of Pakistan to foreign investors.

Taxation

A major issue for multinational companies operating in Pakistan is transparency and predictability of the tax system. Some 23 of the 30 companies in the survey noted that various aspects of the structure and administration of the tax system must be reformed to encourage the expansion of established companies and attract new investors. This view is consistent with the results of international indicators of doing business in Pakistan. In the WEF *Global Competitiveness Index* report, tax rates were the second most problematic factor in doing business in Pakistan, after corruption. In the World Bank's *Doing Business Report*, Pakistan placed 171st out of 189 countries in paying taxes.[17]

The current government has often said that the tax base is small and must be expanded. The ratio of tax revenues to GDP has remained virtually constant at about 10% for the past few years, including in the two years that this government has been in power.[18] It remains unclear whether the government would be able to achieve its target of an increase of 1% of GDP per year over five years, as was stated in the program with the IMF in September 2013. So far the government has not met its target and, accordingly, revised it to a projected increase of about 0.5%-0.6% of GDP per year.

The fact that expanding the tax base has proved to be extremely difficult has led the government to rely on a whole host of ad hoc measures to raise revenues. In the most recent fiscal year, ending June 2015, the Federal Board of Revenue (FBR) collected a total of 9.5% of GDP, made up of direct taxes (4%), federal excise duty (0.6%), sales taxes (3.9%), and customs duties (0.9%). The other main source of government revenue was a petroleum surcharge of 0.4% of GDP.[19]

The corporate income tax accounts for more than two-thirds of total direct taxes, while the bulk of the rest is paid by unincorporated businesses.[20] Multinationals shoulder the largest burden of taxes. A uniform corporate income tax of 35% of taxable profits was set in 2007 for both private and public companies. The corporate tax rate has since been reduced to

[17] While India was ranked higher than Pakistan at 157th, the total tax rate was 60.6% of profits in India, compared with 32.6% in Pakistan.
[18] For a summary discussion of the tax system in Pakistan, see Anwar Rashid, Farooq Tirmazi, Jawad Abbasi, *Taxing Pakistan: A Brief Overview*, Federal Board of Revenue, Islamabad, December 2012.
[19] The government had also planned to impose a gas development surcharge, but it is facing legal challenges.
[20] Salaried persons account for less than 5% of income tax collections.

33% (with the exception of banks) and currently yields about one-third of all FBR revenues. With low direct tax receipts, successive governments have depended on indirect taxes to raise revenues. The principal indirect taxes are the generalized sales tax (GST), the federal excise tax, and customs duties. The GST revenues are now almost the same as income tax revenues, while customs duties have been flat. The federal excise tax applies to only five categories of goods: cigarettes, natural gas, cement, services, and beverages. The excise tax rate is 10.5% and is in addition to the sales tax, amounting effectively to discriminatory double taxation for a subset of companies.

The tax system in Pakistan contains numerous loopholes. Aside from lack of enforcement and non-compliance, governments have historically given the FBR the power to issue SROs to lower the tax liability of businesses by exemptions or zero-rating from sales taxes and customs duties. Not only do SROs lower tax revenues by narrowing the tax base, complicating tax administration, and weakening tax compliance, but they also bypass the parliament, which by the constitution is the only entity that can impose or withdraw taxes. Recognizing this fact, the government has said that it plans to eliminate the SROs over time. In the first instance, in fiscal year 2014-2015 the FBR granted no new tax concessions through SROs, and the government has proposed legislation that would permanently prohibit the issuance of SROs by the FBR.[21]

Unable to raise sufficient revenues from the existing tax system, successive governments have relied on ad hoc taxes and surcharges to meet their expenditure requirements. To meet the fiscal year 2015-2016 budget deficit target of 4.3% of GDP agreed to with the IMF, the government intends to enhance tax revenues by 1% of GDP. The tax measures in the current budget include imposing a higher excise on tobacco products; raising tax rates on higher-income and non-filing taxpayers; and raising the GST for a range of goods, including food, mobile phones, Internet usage, petroleum products, pharmaceuticals, steel, and financial transactions.[22]

The main concern of foreign investors are the uncertainty created by ad hoc increases in taxes and the absence of a level playing field as not all manufacturers pay their fair share of taxes. Tax assessment procedures also lack transparency, resulting in discrimination among taxpayers, inefficiency, and corruption. This obviously has negative implications for long-term investments. Foreign investors must have some certainty about the future tax regime so that they can incorporate their potential liabilities into their business plans. In some cases, companies felt they were overtaxed, but the government continued to come back to the existing taxpayers rather than expanding the tax base.[23]

[21] The government intends to retain the authority to grant temporary exemptions in exceptional circumstances.
[22] The tax on cell phone usage was doubled, while the tax on Internet usage and bank transactions applies only to non-filers.
[23] For example, it is estimated that only 20% of the taxable population actually files tax returns.

In particular, multinational corporations have been disproportionally harmed by the inconsistent application of tax laws. This is compounded in some sectors, by the proliferation of illicit trade and the absence of a level playing field within these sectors. This has an adverse effect on investors by reducing their market share and also causes revenue losses for the Government of Pakistan.

Another concern is tax discrimination among different companies that are expected to pass on to consumers both the sales tax and the excise tax through price increases (or a combination of reduction in profits and price increases). Finally, Pakistan continues in large part to maintain a tax system that is based on direct contact with taxpayers. Aside from the very real dangers of corruption this creates, it also gives tax collectors power to harass companies. Pakistan must have a modern tax administration, like that of many other countries, designed to minimize contact between tax officials and taxpayers.

The government of Pakistan should continue its efforts on ongoing tax reform, with the goal of implementing a fair and balanced system of taxation in which tax rates are kept as low as possible and the tax base is increased through the effective implementation of broad-based and non-discriminatory taxes with limited exemptions.

We strongly believe that American companies can help Pakistan achieve its objectives and could work with government officials to review business reforms and investment policies. The American Business Council of Pakistan, a USPBC affiliate, could serve as a member of the recently formed committees to improve Pakistan's rating on the ease of doing business index and on broadening of tax base.

Specifically, the Government of Pakistan should consider the following recommendations:

- Broaden the tax base to prevent a disproportionate tax burden from falling on compliant multinational corporations. Efforts should be made to ensure a level playing field, whereby all manufacturers pay their fair share of taxes. The Government of Pakistan should develop a tax structure that creates the right incentives for federal and provincial governments to strengthen their tax efforts—rather than using the current system.

- Increase the number of companies and individuals that file tax returns, using penalties for non-compliance through a withholding tax for non-filers. By raising the cost of being outside of the tax net, these measures would serve the dual purpose of raising revenue through a broadened tax base and helping reduce the informal economy.

- Reduce or eliminate all discriminatory excise taxes that do not meet the strict criteria for such taxes laid out by the IMF —notably that such taxes must be applied only to

goods whose consumption is typically not impacted by price increases, whose sale is closely supervised by the government, or whose consumption directly causes negative externalities. In many cases, the elimination of excise taxes may stimulate sales growth so that overall government revenues actually increase from the collection of other existing taxes, such as sales tax, directly from the sector and from its value chain.

- Improve the transparency and predictability of the tax system by eliminating ad hoc taxes, surcharges, and "minibudgets" as well as ensuring that international best practice standards are applied for accounting and assessment of taxes, as opposed to the discriminatory, opaque, and discretionary "best judgment of the commissioner" standard currently enshrined in the tax code. Ensure consultation with all affected stakeholders around new tax proposals.

- Establish procedures to ensure that when disputes arise they can be resolved with due process. This includes improving the capacity of courts and judges that handle them.

Intellectual Property Rights

The lack of adequate protection of IPRs represents an important obstacle to investment in Pakistan. According to the *U.S. Trade Representative's Special 301 report on the adequacy and effectiveness of U.S. trade partners' protection and enforcement of IPR*, Pakistan remains on the Priority Watch List.[24] The report highlights Pakistan's slow pace of implementation of IPR laws, lack of effective IPR enforcement, and need to reform copyright (joining and updating digital rights in terms of the World Intellectual Property Organization Treaties) and trademark legislation to address piracy challenges. Pakistan also ranks low on IPR protection in the main cross-country international indices. For example, in the WEF *Global Competitiveness Index*, Pakistan ranked 112th out of 140 countries. The picture is even worse in the *International Property Rights Index 2014*, where Pakistan ranked 95th out of 97 countries and 15th out of 16 countries in Asia.[25]

The U.S. private sector appreciates Pakistan's attempts to address the shortcomings of its IPR landscape by passing the Intellectual Property Organization (IPO) of Pakistan Act of 2012. The establishment of the IPO and its designation as the central IPR body in Pakistan reflects the Government of Pakistan's commitment to updating the existing IPR laws per the requirements of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), especially in the area of data protection and improvement in the administration and enforcement of IPR in Pakistan.[26] However, in order to implement the IPO Act, Pakistan

[24] Office of the U.S. *Trade Representative, 2015 Special 301 Report*, Washington, April 2015.
[25] India, on the other hand, ranked 50th on the WEF index and 46th in the International *Property Rights Index*.
[26] The TRIPS is an international agreement administered by the World Trade Organization that sets out the minimum standard for many forms of IPRs for the signatories, including Pakistan.

must continue establishing specialized IPR tribunals and a functioning IPO Policy Board as required by act.[27] American companies recognize that Pakistan has taken some steps to improve IPR enforcement through new border enforcement rules and the establishment of an online intellectual property (IP) records system administered by Pakistan's FBR. Also, there have been increased rates of seizures, arrests of offenders, and prosecutions. Unfortunately, these efforts have not had a material impact on improving IPR protection.

Businesses holding IPRs, in particular IT and pharmaceutical companies, argue that pirated software, medicines, and printed materials seriously hamper their ability to operate in the market and have adversely affected their growth and profits. The lack of adequate IPR protection, specifically patent, copyright, and trademark protection, has led to extensive patent infringement and counterfeiting. This is prevalent in many sectors. In the case of the pharmaceutical industry, the Drug Regulatory Authority of Pakistan does not view registering generic drugs as patent infringement and makes all clinical tests accessible, thereby allowing companies to manufacture and sell generic drugs during the patent period. The lack of regulatory data protection, coupled with the inability to effectively enforce patents in the courts, has severely undermined the value of pharmaceutical patents in Pakistan. Many innovative pharmaceutical companies have left Pakistan or reduced the scope of their operations in the country.

The problem of counterfeiting is also pervasive in the consumer goods industries, and there have been several instances of trademark infringement. Counterfeiting is widespread across retail channels and impacts multiple sectors markets, an indictment of the presence of a systemic supply chain and distribution network. Counterfeiting imposes a serious cost on society, with substandard products and a substantial loss of tax revenues for the government. The main recourse of affected companies has been the courts, which have proved to be both expensive and cumbersome. Due to the lack of enforcement, companies have been forced to work with private counterfeit agencies to conduct raids in markets and remove fake products by involving local law enforcement agencies. Besides the added cost of counterfeit raids, these private sector efforts are not a practical solution without government action and proper law enforcement. Pakistan should move expeditiously to fully implement the IPO Act and establish transparent mechanisms to protect IPRs.

American companies rely on the rules-based international trade framework and its supporters to sustain economic growth, employment, and prosperity. Foreign investors value strong IPRs as a driver of innovation and creativity for both domestic and foreign rights holders. Lack of protection of trademarks, patents, and copyright poses a major deterrent to foreign investment. Therefore, the Government of Pakistan should engage with all relevant stakeholders as it considers changes to its IPR laws and enforcement procedures. Broad stakeholder input will ensure that the resulting changes reflect the needs of the IPR user community and the public. It is also essential for Pakistan to raise awareness of IPRs

[27] The IPO Policy Board has had two meetings since it was formed on January 20, 2015.

through public campaigns and by including IP modules in grade school and college curriculums. Creating a transparent and predictable IPR environment will encourage innovation, inward investment, and economic growth.

To encourage foreign investors, the Government of Pakistan should consider the following recommendations:

- Establish IPR tribunals and appoint judges with IPR experience.
- Enable ex officio/cognizability by enforcement officials (e.g. Federal Investigation Agency [FIA] and FBR customs) of IPR infringement without the requirement of a complaint being brought forward by the rights holder.
- Assess and increase penalties with mandatory minimum sentences to deter both civil and criminal IPR infringement.
- Enforce and reform (consistent with IPO treaties) copyright laws to address the problem of digital piracy.
- Ensure that all government offices procure, use, and regulate the use of licensed software products.
- Make sure that patents, including registration of computer-implemented inventions, are protected for the prescribed period.
- Provide regulatory data protection for pharmaceutical and agrochemical products to preclude third parties from relying on the innovator's proprietary safety and efficacy data to obtain marketing authorizations or follow-on generic approvals.
- Penalize retail outlets for stocking and selling counterfeit and pirated products.
- Ensure that all granted trademarks be made available online and accessible to any company registering for a trademark, to avoid duplication and trademark infringement.
- Regularize IPR enforcement training for officers of the FBR, FIA, and police, as well as promote cooperation with stakeholders.

The USPBC stands ready to work with the Government of Pakistan on legislative reform and IPR awareness-building activities. Increasing capacity in the law enforcement community is also critical. Working in collaboration with the FBR and FIA and its

specialized enforcement units, the U.S. private sector can help raise awareness, conduct product identification sessions, and promote the use of the new customs records system. We are committed to working with government officials, the private sector, and stakeholders to contribute to strengthening the implementation of IPR laws and help foster an innovative society in Pakistan.

Bankruptcy and Dispute Resolution Procedures

The Pakistani government recognizes that the absence of a fully functioning and effective bankruptcy code seriously hampers investments, but it has not yet prepared or enacted a modern bankruptcy law. This should be a high priority for the government. Currently, the closing down of companies takes place under the Companies Ordinance of 1984, administered by the Securities and Exchange Commission of Pakistan, and the exit of banks and financial institutions is covered by the Banking Companies Ordinance of 1962, handled by the State Bank of Pakistan. The auction of the property and assets of the bankrupt company is organized by court-appointed liquidators. According to the World Bank's 2015 *Doing Business Report*, Pakistan ranks 94th out of 189 countries in resolving insolvency.[28] More specifically, it takes an average of 2.7 years to complete a bankruptcy procedure, and the recovery rate is less than 40%.

Furthermore, the dispute resolution mechanism is slow and ineffective, despite Pakistan being a member of the International Center for the Settlement of Investment Disputes. Foreign investors experience serious difficulties related to the timely settlement of investment disputes and have considerable concerns about how arbitration cases are resolved in Pakistan. For example, such investment disputes in the mining and energy sectors are ongoing in Pakistani courts, with no clear timetable of when they may be resolved. The WEF *Global Competitiveness Index* ranks Pakistan 108th out of 140 countries in the efficiency of the legal system in settling disputes. The judicial system functions very slowly and cases can be in the system for several years, even decades, without resolution. The courts are lacking in case management resources and basic facilities such as transcription, record keeping, and trial procedures.

U.S. investors include the right to international arbitration in their contracts, and Pakistani high and superior courts have generally endorsed international arbitration clauses in commercial contracts.[29] Nevertheless, any disputes can take considerable time to resolve, especially if dealt with by the district courts.[30]

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[28] This is more relevant for joint ventures between U.S. and Pakistani companies. U.S. companies have not really faced serious issues with regard to bankruptcies.

[29] The Arbitration Act of 1940, enacted before India and Pakistan were partitioned, is still relied on for arbitration commercial disputes.

[30] For example, in one case, despite a favorable ruling by the International Chamber of Commerce arbitration panel in 2000, and subsequent rulings by the relevant Pakistani courts supporting the U.S. multinational, the local

In this connection, it would be helpful if negotiations between Pakistan and the United States on a Bilateral Investment Treaty (BIT), which began in 2004 and are now stalled, were reestablished. Given Pakistan's strong desire to increase investment, it is especially important that negotiators find treaty language that will effectively encourage investors to take advantage of the opportunities in Pakistan, while reassuring them that their investments will be safe.

Forty-eight countries with relatively less investment in Pakistan enjoy bilateral investment treaties,[31] several of which obviate the need to go through Pakistani courts to finalize the settlement.[32] Countries in South Asia and beyond are competing to attract investment; a BIT could help Pakistan improve its position in attracting American investment.

As the Government of Pakistan seeks to promote private sector growth and enhance the country's investment environment, USPBC members urge government officials to consider the following recommendations:

- Develop a transparent and rules-based dispute settlement mechanism to reassure U.S. investors that the cases will not simply languish in the courts for years without resolution.

- Reestablish negotiations on a U.S.-Pakistan BIT. This treaty would undoubtedly give greater confidence to investors who may be interested in Pakistan's market, but who are seeking additional safeguards to secure their investment.

Future Steps

The Pakistani government has repeatedly signaled that reviving the economy is a central priority. It has taken some important steps toward achieving this objective. Going forward, the government should maintain the momentum and put the country on track to make Pakistan a thriving private-sector-led economy that provides jobs and shared prosperity to all its citizens. Foreign investment could be key to this, and the government must ensure that the established foreign companies expand their investments and that new foreign investors come into the market. Over the rest of its term, the government should focus on the following:

Pakistani partner was able to drag the case on in the Pakistani courts until finally withdrawing its appeal in 2009. This case is mentioned in the U.S. Department of State, *Pakistan Investment Climate Statement 2015*, Washington, June 2015.

[31] Board of Investment of Pakistan Investment Guide (http://boi.gov.pk/investmentguide/BITs.aspx).

[32] Instances include: Australia, United Kingdom, Italy, Kuwait, and Mauritius.

- **Pursuing macroeconomic stability.** This is essential with or without an IMF program and will involve policies to improve public finances, increase exports by diversifying products and foreign markets, and generate private and official external financing. There is an opportunity for the private sector to play a more constructive role in public policy to promote Pakistan's economic development. American companies operating in Pakistan are uniquely positioned to work in cooperation with the stakeholders in the Pakistani and U.S. public and private sectors to create the conditions that can lead to faster economic growth, job creation, and shared prosperity.

- **Implementing reforms to sustain and attract foreign investment.** Pakistan must make itself more attractive to foreign investors and develop the policies and implement reforms that are consistent with international best practice suited for the 21st century global economy. Pakistan offers many advantages as an investment destination, and the government should make the necessary reforms to unleash the country's potential as an investment destination.

  This will involve streamlining business and investment regulations. Such reforms should be comprehensive and across all sectors and policies, and instill principles of liberalization (easing entry and exit of investments and allowing capital inflows and outflows—including repatriation of funds—utilizing "automatic routes" without requiring State Bank of Pakistan review or approval).

  From a small survey conducted by the U.S.-Pakistan Business Council, current investors identified the three main areas for such reforms, which are covered in this study: taxation regime and policies, protection of intellectual property rights, and introducing a modern bankruptcy law along with a transparent dispute settlement procedure. Enhancing the business climate and implementing the government's reform agenda in these three key areas can significantly increase the attractiveness of Pakistan to foreign investors.

- **Supporting energy and infrastructure development.** Pakistan must continue to improve the country's energy systems and invest in the country's infrastructure, with power and transportation at the top of the list. The planned Diamer-Basha dam and the Islamabad-Karachi motorway are two examples of projects designed to improve power and transportation in the country. The most significant recent development, the China-Pakistan Economic Corridor (CPEC) project, is expected to bring in $46 billion to be invested in transport infrastructure and energy-related projects, including roads, railways, pipelines, and power plants over the next 15 years. Thus, CPEC has the potential to reduce infrastructure bottlenecks and stimulate domestic and foreign investment over the longer run.

In order to attract American investment and improve overall outcomes in these areas, government officials should consider integrated policymaking and infrastructure development plans to spur investment and lending in the sectors. Pakistan must also consider public-private partnerships similar to other countries that can reduce the burden on public funds and help improve investment in, access to, and delivery of infrastructure.

Regular updates on policy and reforms to U.S.-based organizations such as Overseas Private Investment Corporation, The U.S. Agency for International Development, ExIm Bank and other financing institutions would encourage their greater participation. To improve the legitimacy of public procurement processes, government officials should build on the Public Procurement Regulatory Authority rules and strengthen enforcement of the legislation; provide training to procuring authorities to improve compliance; and recommend participation of reputable third parties to help ensure fair valuation of technical evaluations, especially for advanced technologies. Regulatory approvals should be expedited to include a more transparent and structured approach with market-based and competitive feed-in tariff regimes. As Pakistan advances short- and medium-term solutions, it should consider acceleration of liquefied natural gas (LNG) import facilities and associated infrastructure to ensure there is sufficient pipeline capacity to actually get regasified LNG to market.

- **Launching U.S.-Pakistan Business Dialogue.** The USPBC has strongly supported annual U.S.-Pakistan business opportunity conferences, which are valuable forums to advance trade and investment ties between the two countries. In tandem with the policy reforms outlined in this report, the USPBC urges the creation of U.S.-Pakistan Business Dialogue between the government and established U.S. investors to focus on concrete steps that can be taken to expand investments and attract investors.

  The U.S.-Pakistan Business Dialogue would include senior Pakistani officials and foreign business leaders. Through these high-level discussions, foreign investors would have more certainty about proposed government policies, and government officials in turn would have a clearer understanding of the needs and concerns of foreign investors.

Conclusion

The U.S. Chamber's U.S.-Pakistan Business Council has been a consistent advocate for advancement of stronger commercial ties between our two countries. We are strong supporters of the talks under the U.S.-Pakistan Trade and Investment Framework Agreement and efforts of both governments to strengthen cooperation on economic issues. USPBC members will continue to look for opportunities to support the U.S.-Pakistan Strategic Dialogue, especially in the areas to promote private sector investment and economic growth.

USPBC members applaud the efforts of the government of Prime Minister Nawaz Sharif to restore macroeconomic stability and improve growth prospects, which can significantly increase the attractiveness of Pakistan to foreign investors. American companies are increasingly bullish about business prospects in Pakistan. There is an opportunity to take substantial action and demonstrate tangible progress. The USPBC remains committed to jointly work with government officials, in consultation with business stakeholders, to help expand bilateral trade and investment flows between the United States and Pakistan. More important, the success of U.S. companies currently operating in Pakistan can help bridge the gap between U.S. investor interest and actual investments on the ground.

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