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Attracting Foreign Direct Investment in Pakistan

The Role of Governance, National Security
and Global Investment Trends

Sakina Lavingia

An Undergraduate Thesis Presented to the Faculty
Department of Politics
Oberlin College

Faculty Advisor: Professor Eve Sandberg

April 11, 2016

Abstract

Private sector investment has become one of the most essential sources of international capital flows to developing countries. Foreign Direct Investment (FDI) as one type of private sector investment has the potential to drive economic growth and development. Understanding the factors that motivate or deter foreign investors from investing in a developing country therefore is crucial. This thesis examines the particular case of Pakistan and analyzes internal and external factors that have affected the inclines and declines in inflows of FDI to the country between 2000 and 2014. By performing a comparative sectoral analysis, this thesis examines the effects of government efficacy, national security, and global levels of FDI inflows on FDI inflows on three distinct sectors in Pakistan: Energy, Telecommunications, and Financial Services. The thesis argues that a rapidly deteriorating domestic situation post-2008 due to weakened governance and limited security provision within the country has increased the perceived levels of risk and uncertainty associated with investing in Pakistan. This has resulted in a sharp decline in FDI inflows to the country.

Acknowledgements

I would like to thank Professor Eve Sandberg, for her guidance and support throughout this process, and for all that she has taught me during my time at Oberlin as a researcher and writer.

I am truly grateful to Professor Kristina Mani and Professor Bijetri Bose for agreeing to serve as my second and third readers, and to Professor Chris Howell for leading our Honors Seminar. Their advice and directive has been incredibly valuable throughout this year.

I am so lucky to have had an amazing group of peers in the Honors seminar this year. Without them, this process would most definitely not have been as fulfilling.

I would like to express my gratitude to Joel Whitaker, Majid Munir, Taimour Noorani, Shaista Khilji, Fawzia Naqvi, Chris Canavan and Pratima Singh for taking out the time to share their thoughts and suggestions with regards to my thesis. Their opinions have added a unique perspective that I would have been unable to access elsewhere.

I would like to thank Oberlin for the four years I have spent here, learning, questioning, and growing. I am so grateful to have found a home away from home, filled with people that I love and respect.

Last, I would like to thank my parents, without whom I would not be where I am today. I am so blessed to have their love, support and prayers guide me through my everyday.

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List of Abbreviations

BOI	Board of Investment
CPEC	China-Pakistan Economic Corridor
FATA	Federally Administered Tribal Areas
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GoP	Government of Pakistan
IMF	International Monetary Fund
IPP	Independent Power Producers
KESC	Karachi Electric Supply Culture
KP	Khyber Pakhtunkhwa
MDG	Millennium Development Goals
NEPRA	National Electric Power Regulatory Authority
PAEC	Pakistan Atomic Agency Commission
PML-N	Pakistan Muslim League (Nawaz)
PML-Q	Pakistan Muslim League (Quaid-e-Azam Group)
PPIB	Private Power and Infrastructure Board
PPP	Pakistan Peoples Party
PTA	Pakistan Telecommunication Authority
PTC	Pakistan Telecommunication Corporation
SAP	Structural Adjustment Program
SBP	State Bank of Pakistan
TPP	Tehrik-e-Taliban Pakistan
UNCTAD	United Nations Conference on Trade and Development
WAPDA	Water and Power Development Authority

Chapter One

Introduction

The field of international development has evolved significantly since World War II, when it first emerged as a formal area of study. Priorities within the international development agenda have shifted from stimulating economic growth to identifying ways of enhancing standards of living. The United Nations' Post-2015 Development Agenda is a culmination of the shifts that have occurred over the last seven decades, and relies upon the ability of a diverse range of actors and stakeholders to participate in what has been termed, a “global partnership.”¹ As it becomes critical to look beyond aid and integrate all forms of international initiatives capable of affecting development results, the role of the private sector is particularly important.² James Michel, Senior Advisor at the Center for Strategic International Studies argues that, “to the extent that private investment creates jobs and helps lift people out of poverty and into the formal economy, there can be a virtuous cycle of growing markets, increased investment, and expanded wellbeing.”³

Over the last decade private sector investment has become one of the most important sources of international capital flows to developing countries.⁴ A critical component of private sector financing, the growth of Foreign Direct Investment (FDI)

¹ Michel, James. 2016. *Beyond Aid: The Integration of Sustainable Development in a Coherent International Agenda*. Center for Strategic and International Studies. P. iv, 1. Accessed February 2016. http://csis.org/files/publication/160111_Michel_BeyondAid_Web.pdf

² Ibid, p. iv

³ Ibid, p. vii

⁴ Ibid, p. 31

inflows to developing countries provides evidence of the private sector's increased capacity to contribute to the development agenda. The Organization for Economic Co-operation and Development defines Foreign Direct Investment as:

“a category of cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy.”⁵

Ownership of 10% or more of the voting power in an enterprise in one economy by an investor in another economy is evidence of such a relationship.

Unlike international aid, higher levels of FDI suggest greater investor confidence in the economic strength of a country, as well as in the capacity of investments to accrue competitive rates of return while accounting for risk and uncertainty. Governments of developing countries have come to rely on FDI as a critical source of external finance due to its ability to assist in human capital formation and create a pool of resources that allows for socio-economic advancement. Combined with sound macroeconomic policies, and greater openness to trade, FDI can provide developing countries with increased access to capital, technology transfers, and market competition, thereby contributing to and driving levels of economic growth.

Given that foreign direct investment has the potential to promote a country's economic growth, it is critical for us to understand the factors that motivate or deter foreign investors from investing in a given developing country. This thesis explores the particular case of Pakistan, and analyzes internal and external factors affecting FDI inflows to the country between 2000 and 2014. The time period chosen in this study encapsulates the sharpest incline and decline of FDI inflows within Pakistan.

⁵ OECD Data: Foreign Direct Investment. Accessed January 2015. <https://data.oecd.org/fdi/fdi-flows.htm>

Like its regional and economic counterparts, Pakistan experienced a substantial increase in FDI inflows between 2000 and 2007. This trend suddenly ceased and then reversed following the global financial crash of 2008, when most regional developing countries experienced sharp declines in inflows of FDI. However, while nearly all of Pakistan's regional and economic counterparts were able to recover—or at least stabilize—rates of growth in FDI by 2009, FDI inflows to Pakistan dropped consistently until 2013, the first year that a modest rate of growth was recorded since 2007.

This dynamic presents an interesting puzzle, making Pakistan an exceptional and important case to study. Pakistani economists such as Muhammad Arshad Khan and Nayyira Zeb have attributed lower levels of FDI inflows to Pakistan on limited political stability, inadequate infrastructure, corruption, and poor levels of security.⁶ Investment banks such as Santander's and KMPG have echoed these concerns alongside issues that include arbitrary administration of laws and regulations and non-respect of intellectual property rights.⁷ Each of the factors is reflective of the Pakistani government's limited capacity to offer an attractive investment climate to foreign investors.

To understand and explain the Pakistani experience, this study analyzes the effects of internal and external shifts that have influenced Pakistan's capacity to attract inflows of FDI. In particular, this paper examines the effects of government efficacy, national security, and global investment trends, on domestic FDI inflows to Pakistan between 2000 and 2014. Government effectiveness, as measured by the World

⁶ Arshad Khan, Muhammad and Ali Khan, Shujaat. *Foreign Direct Investment and Economic Growth in Pakistan: A Sectoral Analysis*. Pakistan Institute of Development Economics. 2011. Accessed October 2015. <http://pide.org.pk/pdr/index.php/wp/article/viewFile/2968/2917>

Foreign Direct Investment and Economic Growth in Pakistan: A Sectoral Analysis; Zeb, Nayyira et al. *Role of Foreign Direct Investment in Economic Growth of Pakistan*. International Journal of Economics and Finance 6, no. 1 (2014): 32 – 38.

⁷ Santander Trade Portal. *Pakistan: Foreign Investment*. Accessed September 2015. <https://en.santandertrade.com/establish-overseas/pakistan/investing>

Governance Indicators, captures the quality of civil service institutions, policy formulation and policy implementation.⁸ National security, as measured by the Global Terrorism Index, encapsulates the frequency of intentional acts of violence or threats of violence by non-state actors.⁹ Global investment trends, as calculated by the United Nation's Conference on Trade and Development (UNCTAD) World Investment Report, represents the total amount of global FDI inflows in any given year. Each of these factors reflects the extent to which Pakistan has been able to provide an investment climate that is attractive foreign investors.

This paper argues that the instatement of a fragile democratic government and rapidly deteriorating domestic security situation increased the perceived levels of risk and uncertainty associated with the investment climate in Pakistan. The implications of worsening internal conditions in Pakistan on investment returns were more thoroughly considered by foreign investors at this time due to the weakened international financial climate that had reduced total global investment levels. The simultaneous deterioration in internal and external conditions rendered Pakistan as a riskier investment destination, resulting in a decline in FDI inflows that was sharper and protracted.

Recognizing that the effects of a decline in FDI was not felt equally across the Pakistani economy, this paper undertakes a comparative sectoral analysis of FDI inflows within Pakistan, analyzing the ways in which government effectiveness, security, and global investment levels have affected Pakistan's FDI inflows nationally and across sectors. The sectors analyzed in this study are Energy, Telecommunications, and

⁸ World Governance Indicators 2015. Accessed December 2016. <http://info.worldbank.org/governance/wgi/index.aspx#doc>

⁹ Global Terrorism Index. 2015. Accessed January 2016. <http://economicsandpeace.org/wp-content/uploads/2015/11/Global-Terrorism-Index-2015.pdf>

Financial Services. By examining the effects of the three selected explanatory variables on each of the three sectors, this paper discusses the conditions limiting the provision of an environment that promotes the inflow of FDI to Pakistan. Analyzing differences in the relationships between each of the aforementioned independent variables and inflows of FDI across sectors, this paper concludes by discussing ways the Pakistani government can then intervene on a national and sectoral level to create an environment that is conducive to foreign investment.

1.1 Changing Trends in Foreign Direct Investment: Emerging Markets and Pakistan

FDI inflows to developing economies have been growing significantly since the early 2000s. Faltering briefly in 2009, FDI inflows to developing economies increased to US\$ 681.4 billion in 2014, representing a share of 54% of global FDI inflows.¹⁰ This growth emerges at a time when FDI inflows to the developed world have been declining, highlighting a recognition of growth opportunities existent within the developing world.

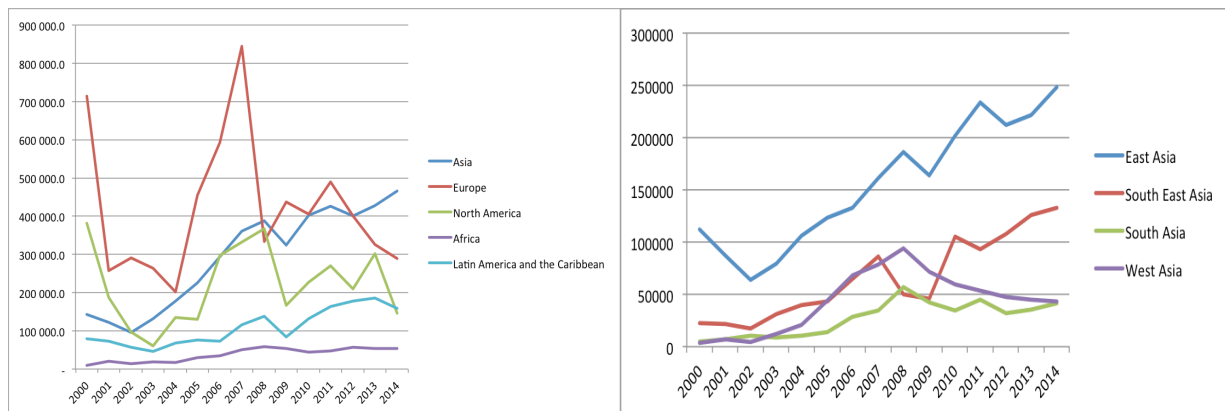


Figure 1a: FDI Inflows Across Continents, 2000 – 2014
Source: UNCTAD World Investment Report 2015, Data Compiled by Author

Figure 1b: FDI Inflows across Asia, 2000 – 2014
Source: UNCTAD World Investment Report 2015, Data Compiled by Author

¹⁰ United Nations Conference on Trade and Development. *World Investment Report 2015*. Accessed January 2016. http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf

As observed in Figure 1a, Asia has received increasing attention as a lucrative destination for FDI inflows within the developing world. Since the early 1990's, several Asian emerging market economies have worked towards reforming and liberalizing their trade regimes, opening their markets to foreign investment. However, the impact of trade liberalization on FDI inflows within Asian economies has varied across countries. Figure 1b indicates that FDI inflows to East Asia have remained the highest between 2000 and 2014, followed by South East Asia. Inflows of FDI to West Asia have been in decline since 2008. FDI inflows to South Asia increased steadily until 2008, after which they have been unable to record significant rates of growth. However, the slight upward trend in FDI inflows to South Asia observed in 2013 hints at the possibility of growing foreign investor interest in the region.

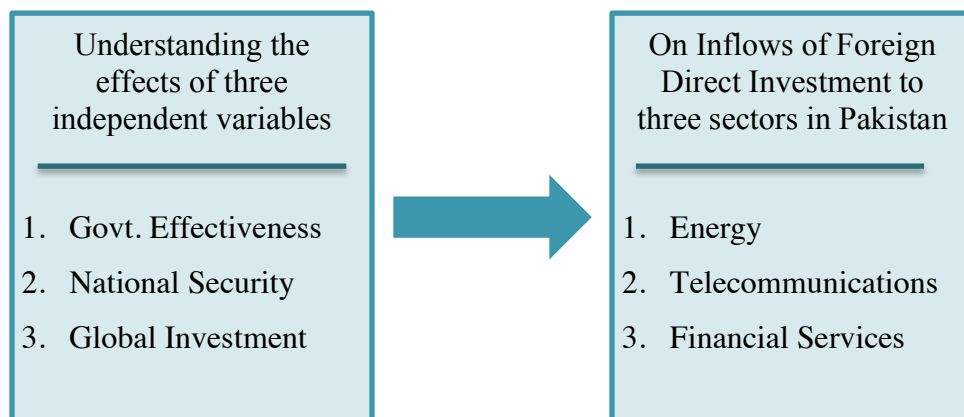
Asian economies listed on the MSCI Emerging Market Index in 2002 maintained fairly similar rates of growth in FDI inflows until the global financial crash of 2008.¹¹ Following the crash, emerging markets listed on the MSCI Emerging Market Index experienced a sharp decline in FDI inflows. All but Pakistan, however, were able to recover growth in FDI inflows within the next three years. The inability of Pakistan's economy to perform at a rate similar to other Asian emerging markets within the international economy resulted in its demotion from Emerging Market status to Frontier Market status in 2012. Pakistan was the only Emerging Asian Market to be demoted in the 2012 rankings. Given that all emerging Asian economies barring Pakistan were able to recover from the external shock of the financial crash in 2008 suggests that external

¹¹ The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets. Emerging markets refer to developing countries that are experiencing rapid growth and industrialization. Frontier markets refer to nations that are at an earlier stage of economic development as compared to emerging markets. Asian Emerging Markets in 2002 were China, India, Indonesia, Malaysia, Pakistan, Philippines, Sri Lanka, Thailand and Taiwan. Sri Lanka was demoted to a frontier market in the index's 2007 ranking.

limitations were not the sole reason for Pakistan’s inability to regain growth in FDI inflows. Rather, internal changes specific to Pakistan were preventing a full recovery in growth rates of FDI inflows to the country. Examining trends in FDI inflows across three sectors—energy, telecommunications and financial services—this paper argues that security and governance deficits have rendered Pakistan a risky investment destination, and dampened the nation’s capacity to attract and maintain foreign direct investment at levels comparable to other emerging Asian economies.

1.2 Methodology: A Sector Analysis Approach

While FDI has played a critical role in the development of the Pakistani economy over the last fifteen years, its effects have been varied across sectors. By applying a comparative sector analysis approach, this paper analyzes disaggregated units of the Pakistani economy, and examines the relationship between sectoral FDI inflows and three explanatory variables: government efficacy, security and global investment levels.



The sectors analyzed in this study are energy, telecommunications, and financial services. The motivation behind choosing these sectors was threefold: First, the three sectors have on average been the largest recipients of FDI since 2000. Second, the three sectors represent important components of infrastructure development, and the services industry. By installing infrastructure for communications and energy, the Telecommunications and Energy sectors are developing resources that can promote investment in other areas of the economy such as manufacturing. The provision of such infrastructure is crucial to long-term capital gain and economic development within Pakistan. Financial Services plays an important role as a conduit of foreign direct investment. A well-developed financial services sector encourages higher levels of foreign investor confidence in the country. Third, public ownership of companies within each of the three sectors is drastically different: telecommunications is almost entirely privately owned, while energy is mostly owned or managed by the government. Financial services falls in the middle of the spectrum in terms of public ownership and government involvement. Performing a comparative sectoral analysis of three sectors that vary in terms of industry type and extent of government involvement, this study provides a unique perspective on the ways in which the effects of security, government efficacy and global FDI inflows vary across sectors within Pakistan.

This study utilizes a variety of quantitative and qualitative data sources to analyze the effects of each of the independent variables on FDI inflows within Pakistan. For each of the three sectors, this paper measures the effects of government effectiveness, security, and global inflows of FDI on national and sectoral inflows of FDI between 2000 and

2014. However, the paper is unable to analyze the effects of the independent variables on FDI between 2000 and 2002 due to unavailability of data.

Data sources used in this study are: 1) Global Terrorism Index¹² to measure security, 2) World Governance Indicators¹³ to measure government effectiveness and political stability, 3) UNCTAD’s World Investment Reports¹⁴ for data on global and national inflows of FDI between 2000 and 2014, and 4) Pakistan’s Board of Investment¹⁵ for data on inflows of FDI by sector between 2000 and 2014.

Name of Ranking	Variable Measured	Methodology of Measurement	Measurement Scale
Global Terrorism Index	Security	There are four factors counted in each country’s yearly score: 1. Total number of terrorist incidents 2. Total number of fatalities caused by terrorism 3. Total number of injuries caused by terrorism 4. Approximate level of total property damage from terrorist attacks	0 to 10, with higher values corresponding to lower security provision
World Governance Indicators	Government Effectiveness	Captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.	–2.5 to 2.5, with higher values corresponding to better governance
World Investment Reports	Global Investment Levels	Total inflows of FDI to all countries.	Higher numbers correspond with higher levels of global FDI inflows

¹² Produced by the Institute for Economics and Peace, the GTI is based on data from the Global Terrorism Database (GTD), which is collected and collated by the National Consortium for the Study of Terrorism and Responses to Terrorism. Source: <http://economicsandpeace.org/wp-content/uploads/2015/11/Global-Terrorism-Index-2015.pdf>

¹³ The World Governance Indicators report aggregate and individual governance indicators for 215 economies across six dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. These indicators combine the views of a large number of enterprise, citizen and expert survey respondents, and are based on over 30 individual data sources produced by a variety of survey institutes, think tanks, non-governmental organizations, international organizations, and private sector firms.

Source: <http://info.worldbank.org/governance/wgi/index.aspx#home>

¹⁴ United Nations Conference on Trade and Development. *World Investment Report 2015*

¹⁵ Pakistan Board of Investment. <http://boi.gov.pk/foreigninvestmentinpakistan.aspx>; Asian Development Bank, *Private Sector Assessment: Pakistan*. Page 9. Accessed January 2016. <http://www.adb.org/sites/default/files/institutional-document/32216/private-sector-assessment.pdf>

Country reports, market analyses, and investment risk reports published by international organizations, multi-national corporations, and Pakistani corporations were also utilized in this study. These include reports by the Economist Intelligence Unit, Standard and Poor's, International Finance Corporation, Arif Habib Bank, KPMG, and the World Bank. Qualitative information specific to each sector was primarily accessed from annual reports published by national regulatory authorities: National Electric Power Regulatory Authority (NEPRA), Pakistan Telecommunication Authority (PTA) for Telecommunications, and State Bank of Pakistan (SBP) for Financial Services. Interviews with researchers and practitioners working within the field of development economics, or each of the individual sectors, were also conducted. These interviews provided first-hand opinions of investors and development economists who are assessing the risks and benefits deterring or encouraging the decision to invest in Pakistan.

1.3 Structure of the Paper:

The chapters of this paper are as follows: Chapter Two discusses the role of the private sector in promoting economic growth within developing countries. The Chapter provides a brief overview of the evolution of development models from the 1950's till present day, and discusses the growing importance of the private sector and foreign direct investment within the global development agenda. Chapter Three argues the importance of Pakistan as an important case in the study of FDI inflows to developing countries. The chapter begins by presenting an historical analysis of FDI inflows to Pakistan since the 1970s, when the country began to move away from a policy of nationalization towards liberalizing the economy, opening it up to international markets. Next, it discusses

present day opportunities available to investors within the country, followed by an overview of governance and security conditions within the country that have influenced domestic conditions and increased the level of risk associated with investing in Pakistan since 2000 until 2014. The chapter concludes with a comparative discussion of FDI inflows across Energy, Telecommunications, and Financial Services. Chapter Four, Five, and Six analyze the effects of government effectiveness, national security, and global trends in FDI in Energy, Telecommunications, and Financial Services respectively. The chapters offer a comparative sectoral analysis of the internal and external factors affecting FDI within Pakistan, and the ways in which the factors differently affect each of the sectors before and after the financial crash of 2008. Chapter Seven discusses steps the Pakistani government can take in order to provide a more stable investment climate within the country, and offers a conclusion for the thesis.

Chapter Two

Advancing the Global Partnership

Importance of Private Sector Involvement in Economic Development

Since the introduction of the Millennium Development Goals (MDGs) in 2000, there has been a steady push towards the diversification of development financing. James Michel argues that the role of aid as the primary source of funding is quickly changing in many developing countries as alternative sources and strategies for financing become more prominent and popular.¹⁶ In 2015, the Investment to End Poverty Report by Development Initiatives presented a breakdown of financial flows to developing countries. Approximately USD 163 billion was disbursed in Official Development Aid (ODA), while international investment flows stood at USD 1.88 trillion in 2013.¹⁷ Private domestic and international investment flows in low and middle income countries have more than tripled over the last decade, accounting for over half of the financial resources available in 2015.¹⁸ As the influence of traditional development assistance gives way to an increasing diversity of actors, financiers, and implementation approaches, it is becoming crucial to create a “global partnership” that integrates and streamlines international cooperation in a way that can positively affect development results.¹⁹

¹⁶ Michel, James. P. 26.

¹⁷ In the same year, commercial domestic spending was USD 2.2 trillion. Michel, James. P. viii.

¹⁸ European Commission. *A Stronger Role of the Private Sector in Achieving Inclusive and Sustainable Growth in Developing Countries*. Brussels, 2014. Page 11.

¹⁹ Michel, James. P. 26

This chapter studies the role and influence of one actor—the private sector—within the emerging global partnership. Given the private sector’s growing involvement in the developing world, and its capacity to finance infrastructure development by expanding capital stock, it is important to understand the role it has played historically and continues to play currently within the international development agenda. This chapter begins by presenting a brief history of the evolution of the field of development, followed by an examination of the present-day, post-2015 development agenda. It discusses the role of the private sector within the present day agenda, and concludes by discussing the influence of foreign direct investment as a driver of economic growth.

2.1 A Brief Overview of Development Models: Post WW2 – Present

Initial models of development emerging at the end of World War II focused almost entirely on economic growth and advocated for massive injections of capital as the means of achieving rapid increases in gross domestic product (GDP). According to Syed Nawab Haider Naqvi, a noted Pakistani economist, the 1950’s – 1980’s marked the stage of Traditionalist Development.²⁰ This model emphasized the importance of, “achieving high rates of economic and human development in the post-colonial periods, with a view to reducing poverty and achieving convergence with the developed countries.”²¹ Agriculture was regarded as the leading sector in the process of growth creation. It was argued that gains within the agricultural sector would result in a “structural transformation” of labor allocation away from agriculture and towards

²⁰ Naqvi, Syed Nawab Haider. 2010. *The Evolution of Development Policy: A Reinterpretation*. Karachi; New York: Oxford University Press. Page 6.

²¹ Ibid, p. 43

manufacturing and services.²² Mechanisms instituted for achieving this process included increasing the share of manufacturing activities within the economy along with implementing extensive land reforms.²³

By the end of the 1970's and early 1980's the Traditionalist model gave away to the emerging Liberalist paradigm. Liberalists argued that high growth rates observed in the post-colonial and post-WW2 era were artificially stimulated through extensive and unsustainable government intervention.²⁴ Liberalist theorists—otherwise also called New Growth theorists—such as Paul Romer and Robert Lucas shifted the focus of the development agenda away from labor and capital restructuring. Instead, free market policies, that aggressively attempted to minimize the role of the government within the development process were prioritized. These policies were contained in the Washington Consensus: a set of ten strategies that the United States government and international financial institutions believed were necessary elements of “first stage policy reform,” that developing countries needed to adopt in order to increase economic growth.²⁵ Liberalists rapidly introduced and implemented initiatives such as Structural Adjustment Programs (SAPs) of the International Monetary Fund (IMF) and World Bank. SAPs radically altered the government-led development framework that had been established within the Traditionalist model by restructuring developing economies to become more market oriented. The Programs included policies requiring internal changes such as privatization and deregulation, and external changes such as the reduction of trade barriers. In many ways, the emergence of the Liberalist paradigm represented the beginning of the formal

²² Dang, Giang, Low Sui Pheng, and Ohio Library and Information Network. 2014; 2015. *Infrastructure Investments in Developing Economies: The Case of Vietnam*. Singapore; 4: Springer. Page 16.

²³ Naqvi, Syed Nawab Haider. *The Evolution of Development Policy: A Reinterpretation* P. 6

²⁴ Ibid, P. 7

²⁵ Glossary. World Health Organization. Accessed April 2016. <http://www.who.int/trade/glossary/story094/en/>

involvement of the private sector as an independent and influential actor within the field of international development.

The Liberalist paradigm received extensive criticism from development economists that argued against the framework's inattention to the importance of good governance and institutional structures, and questioned the model's reliance on international aid transfers as the primary source of funding.²⁶ Critics claimed that free market approaches would encourage the dependency of developing countries on developed markets, multilateral institutions, and exploitative corporations. Maia Green argues that the pursuit of liberalist policies would result in the emergence of a "Development State."²⁷ The development state, she writes, are states that are, "materially and ideologically sustained through development relations. Such states are largely dependent on aid transfers to meet recurrent budgets."²⁸ The development state is fiscally dependent on international development financing and on the institutions that disburse this financing. By extension, the development state is required to follow the strategies employed by international finance agencies, resulting in their inability to develop independently and strengthen domestic institutions or the economy.

A growing acceptance of the limitations of Liberalist development ideology reintroduced the need to prioritize more than just the expansion of the free-market, resulting in the emergence of the Human Development Model in the mid-1990s. The model directed attention away from prioritizing market friendly approaches towards identifying ways to improve standards of living in developing countries. While the

²⁶ Dang and Pheng, P. 19

²⁷ Green, Maia. 2014. *The development state: aid, culture & civil society in Tanzania*. Woodbridge, Suffolk. Page 15.

Maia Green is a Professor of Social Anthropology at the University of Manchester

²⁸ Ibid.

market—and by extension the private sector—was still important, the Human Development Model did not consider it to be the sole or primary route through which development could be pursued. David Booth presents the argument that weak or dysfunctional political systems present barriers to the construction of more developmental leadership.²⁹ A stable government allows for the integration of multifaceted aspects of development in a way that allows for sustainable transformation, implementable policy, and concrete results. The Human Development Model reintroduced the value of good governance as a necessary ingredient for sustainable development, alongside the development of the private sector. The model in many ways, serves as an initial introduction to what has since been termed the global partnership.

The Human Development Model forms the basis of the present day development agenda. The next section of this chapter discusses the design of the Millennium Development Goals introduced in the early 2000's, and the subsequent construction of the Post-2015 Development Agenda. The Millennium Development Goals and the Post-2015 Development Agenda encapsulate and expand ideas presented in the Human Development Model, identifying ways to integrate a variety of actors and stakeholders into the development process.

2.2: Development Today: Advancing the Role of the Private Sector

From 2000 until 2015, the United Nations' Millennium Development Goals (MDGs) served as the primary development model. The MDGs focus on core issue areas such as poverty alleviation, gender equality, education, health, sustainability, and female

²⁹ Booth, David. 2011. *Can aid become more relevant to 'getting things done'?* World Bank. Accessed February 2016. <http://blogs.worldbank.org/governance/can-aid-become-more-relevant-to-getting-things-done>

equality. While Traditionalist and Liberalist theorists differed on the basis of whether government or markets should be the primary actor guiding the development process, the MDGs advocated for synthesizing of the two positions, focusing instead on the creation of a global partnership. This partnership would incorporate a diverse range of actors and stakeholders including governments, multilateral organizations, and private institutions in the development process. Such a strategy emerged from a recognition of the challenges associated with achieving any of the listed MDGs. The consensus was that a partnership was necessary in order to successfully meet the targets set out in the MDGs. In particular, the MDGs focused on the importance of developing a strong relationship between the private sector and domestic governments. The role of the private sector as a provider of financing and capital in developing countries where governments had limited resources was particularly important. Given that investment decisions made by the private sector are motivated by considerations of benefits and risks, the existence of a partnership between foreign companies and domestic governments allows for a clearer understanding of the opportunity set existent within a specific country. Further, such a partnership understands the necessity of including and supporting domestic governments within the development agenda, a consideration that was not forgotten within the MDGs.

In 2014 the European Commission released a report advocating for a stronger role of the private sector in achieving inclusive and sustainable growth in developing countries.³⁰ The Commission argued that by increasing investment and playing a more active role in the development process the private sector could send a “powerful signal about the important role it can play in contributing to inclusive and sustainable growth in

³⁰ European Commission, p. 16.

developing countries.”³¹ Given the diversity of the private sector in terms of capacity, opportunity and approach, it is able to operate at different levels and regions of the economy and in very different country contexts.

The current Post-2015 development agenda continues with the goal-oriented vision established by the MDGs through global partnership. The agenda relies on two foundational pillars: (1) a commitment to human wellbeing, security and dignity as was laid out in the Human Development Model of development, and (2) a commitment to sustainable development.³² James Michel has argued that the, “successful implementation of the new agenda will require that international cooperation proceed in new ways that transcend the traditional aid-centered paradigm.”³³ He identifies the growing need to “do development differently,” and focus attention on national priorities, interests and systems.³⁴ The new agenda demands that we look beyond aid as the primary source of development financing. As Michel argues, it is necessary to, “include all available sources and types of financing, [and] expand domestic resource mobilization...while conserving resources and increasing efficiency and effectiveness.” By recognizing the role and actively taking advantage of the foreign private sector within the global partnership, the Post-2015 Development Agenda is creating access to an economic pool of resources that can drive investment and economic growth within developing countries.

³¹ Ibid.

³² Michel, James. P. vi

³³ Ibid, P. 70.

³⁴ Ibid.

2.4 Foreign Direct Investment as a Driver of Economic Growth

FDI has become one of the most important sources of international capital flows to developing countries and is directly influencing domestic private entrepreneurship. FDI is considered to be the largest source of capital formation in the world and is often presented as a key element for international economic integration and development.³⁵

The development of an emerging or frontier market is correlated with its ability to expand stock of knowledge, accumulate capital, and make profitable investments. Muhammad Arshad Khan, a researcher at Pakistan Institute for Development Economics, argues that most developing countries rely primarily on FDI as a source of external finance because FDI is able to stimulate greater economic growth relative to other sources of capital inflows.³⁶ Modernization theories suggest that FDI can promote economic growth under the principle that growth requires high levels of investment.³⁷ Through capital accumulation, FDI is able to introduce new forms of technology into the production function of the domestic economy.³⁸ Growth theories emphasize the effect of such technological transfers on encouraging employment growth and education, allowing for skill acquisition and the development of human capital. FDI is important for filling the gap between domestic savings and the desired level of investment in developing countries, allowing for capital formation and sustained economic growth.

During the last decade, several developing countries have recognized that restricting FDI inflows is an ineffective and sometimes counterproductive policy. In an

³⁵ Zeb, Nayyira et al. *Role of Foreign Direct Investment in Economic Growth of Pakistan*.

³⁶ Arshad Khan, Muhammad and Ali Khan, Shujaat, *Foreign Direct Investment in Pakistan: The Role of International Political Relations*.

³⁷ Zeb, Nayyira et al. *Role of Foreign Direct Investment in Economic Growth of Pakistan*.

³⁸ Toulaboe, Dosse et al. *Foreign Direct Investment and Economic Growth in Developing Countries*. *Southwestern Economic Review* 36, no. 1(2013): 155 – 170. Page 158.

attempt to encourage FDI inflows many low-income countries have worked towards removing trade restrictions, adopting liberal, market-oriented reforms that favor the interests of foreign investors.³⁹ According to the United Nations Conference on Trade and Development (UNCTAD), FDI inflows to developing countries as a percentage of global FDI inflows grew from approximately 33% in 2006 to 54% in 2013.⁴⁰ However, while reforms have increased FDI inflows to the developing world, concerns regarding negative domestic and international externalities have not been lost. Dependency theories for instance suggest that reliance on foreign investment by low-income economies may result in a negative impact on growth and income distribution. Dependence on foreign capital and means of employment may result in the underutilization of domestic resources, effectively crowding out domestic investment.⁴¹ In order to prevent such a dynamic it is crucial for domestic policies instituted by the host country to establish an interaction between foreign investors and domestic stakeholders within the economy.

Ultimately however, the effects of FDI on investment and economic growth are specific to a country. Distinct domestic political and economic circumstances mean that empirical studies are unable to provide conclusive cross-country results regarding the true effect of FDI in a given developing country. Effects of FDI on sustainable economic growth are invariably tied to the capacity of the foreign private sector to collaborate with and be supported by domestic governments. It is important to remember that private sector involvement is only one aspect of the Post-2015 development agenda. The goal of this paper is not to determine whether the inclusion of the private sector within the

³⁹ Ibid, P. 157.

⁴⁰ World Investment Report, 2015.

⁴¹ Arshad Khan, Muhammad and Ali Khan, Shujaat. *Foreign Direct Investment in Pakistan: The Role of International Political Relations*. P. 2

development agenda is inherently beneficial or not. Rather, given international trends regarding the growth of FDI in developing countries, this paper recognizes the importance of studying the role of the private sector as a driver of economic growth and a provider of development financing.

The next chapter discusses historical trends of FDI inflows within Pakistan. It examines policies that have been implemented since the 1970's to attract FDI, and discusses the present day opportunity set for foreign investors interested in investing in Pakistan. The final section of the chapter provides an overview of events that have occurred within Pakistan since 2000 that have affected its investment climate.

Chapter Three

Foreign Direct Investment in Developing Countries

Pakistan as an Important Case Study

Pakistan's foreign investment regime is one of the most liberal and attractive in South Asia. The government of Pakistan offers foreign investors 100% project ownership in a vast number of sectors and allows the remittance of capital, profits and dividends without any regulatory approvals.⁴² Yet FDI inflows to Pakistan lag behind the nation's regional or economic counterparts. The goal of this chapter is to discuss the evolution of Pakistan's policies for attracting FDI, and to examine events occurring between 2000 and 2014 that affected government effectiveness and national security levels in Pakistan, and altered global investment trends internationally. The first section of this chapter provides an historical overview of FDI inflows to Pakistan from the 1970's until today. The next section explores present day opportunities available to foreign investors interested in investing in Pakistan. Section three provides an account of major shifts occurring domestically and within the international economy, and discusses the ways in which changes in government efficacy, security, and global investment trends affected national FDI inflows. The chapter concludes with a comparison of FDI inflows between the three sectors analyzed in this paper namely energy, telecommunications, and financial services.

⁴² Asian Development Bank, *Private Sector Assessment: Pakistan*. Page iii.

3.1: Foreign Direct Investment in Pakistan: A Historical Analysis (1970's – Present)

Prior to the late 1970's, Pakistan's trade and investment policies vacillated between import substitutions and export promotion. Nationalization under the Zulfikar Ali Bhutto regime in the early 1970's made the government the largest player in the economy. While foreign investments were not nationalized, an increased focus on the public sector and excessive regulation of trade discouraged foreign investors.⁴³

Recognizing the consequences of nationalization on foreign investment, the government began to draft policies intended to be friendlier towards foreign investors by the mid-1970's. The Foreign Private Investment Act of 1976 marked the beginning of the establishment of a regulatory framework that facilitated and protected the transactions of foreign investors. The Act of 1976 guaranteed the remittance of profit and capital, and introduced policies that avoided double taxation, lowering initial costs of investment for foreign parties.⁴⁴

In 1984 an industrial policy statement that gave equal weight to the public and private sectors was announced. The policy encouraged foreign investment in the form of joint equity participation with local areas, thereby establishing a business climate that was more favorable for foreign investors. As Figure 2 indicates, the mid-1980's mark the beginning of a fairly sustained increase in FDI inflows to Pakistan until 2008. FDI inflows grew from 0.3% of GDP in 1986 to 0.6% in 1990.

⁴³ Arshad Khan, Muhammad. *Foreign Direct Investment in Pakistan: The Role of International Political Relations*. Working Paper Series, University of Oxford Department of International Development. Page 9

⁴⁴ *Ibid*, p. 10

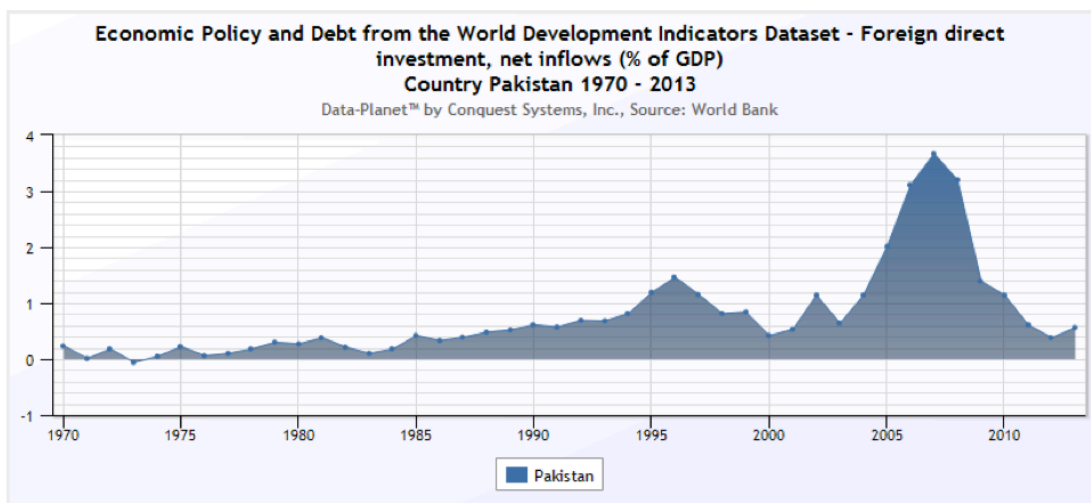


Figure 2: Net Inflows of Foreign Direct Investment as a % of GDP, 1970 – 2013
 Source: World Bank

During the 1980's and 1990's, the Government of Pakistan initiated several market-based reforms liberalizing the trade and investment regime by introducing various trade and fiscal incentives to foreign investors. These provisions included increased tax concessions, credit facilities, tariff reduction, and the easing of foreign exchange controls.⁴⁵ Remnants of restrictions on capital inflows and outflows that had been placed during the period of nationalization continued to be lifted. Foreign investors were allowed to hold 100% of the equity of their industrial project and remittance of dividends and disinvestment proceeds were permissible without any prior permission of the State Bank of Pakistan.⁴⁶ The establishment of the Pakistan Board of Investment in 1990 helped generate opportunities for FDI within Pakistan and provide investment services to interested foreign investors. These initiatives placed Pakistan on the International Finance Corporation's list of emerging South Asian stock markets in 1992, along with India, Indonesia, Malaysia, and Thailand. The country was also ranked an emerging market by

⁴⁵ Arshad Khan, Muhammad. *Foreign Direct Investment and Economic Growth: The Role of Domestic Financial Sector*. Pakistan Institute of Development Economics Working Paper Series, 2007.

⁴⁶ Ibid, p. 16

MSCI in 1997, a placement that reflected upon development within the economy, deepening of domestic financial markets, and increased accessibility of capital markets to international investors.⁴⁷

By 1997 the Government had announced the New Investment Policy that aimed to increase foreign investment in areas such as industrial base expansion, infrastructure, software development, electronics, construction industries, and value-added textile items. The push towards developing the manufacturing sector and advancing overall levels of infrastructure within the country was central to this new policy, and allowed foreign investors to capitalize on opportunities within sectors that had initially been closed to them. The policy provided various tariff and tax incentives and continued to protect the foreign investors' rights to remit royalties, technical fees, capital, profit and dividends. However, a weakened international economic climate caused by the 1997 Asian Economic Crisis and a fragile democratic government meant that the introduction of the policy was unable to produce much growth in FDI inflows towards the end of the decade.

FDI Inflows began to stabilize and grow again in Pakistan by 2000. During the Musharraf era (1999—2008), policy makers worked to create an environment where foreign direct investment was able to thrive. In his memoir, *In the Line of Fire*, Pervez Musharraf states the four-pronged strategy his administration pursued: 1) achieving macroeconomic stability, 2) making structural reforms to remove microeconomic distortion, 3) improving the quality of governance, and 4) alleviating poverty.⁴⁸ Deregulation, fiscal incentives, and liberal remittance of profits and capital were core

⁴⁷ Bambaci, Juliana et al. *Built to Last: Two Decades of Wisdom on Emerging Markets Allocations*. MSCI Applied Research, 2012. Accessed February 2016. https://www.msci.com/resources/pdfs/built_to_last.pdf, p8.

⁴⁸ Musharraf, Pervez. 2006. *In the Line of Fire: A Memoir*. New York: Free Press.

tenets of the nation’s investment policy.⁴⁹ The privatization of enterprises was fully protected which meant that the government legally could not nationalize or expropriate any foreign enterprises. Additionally, the Pakistani government introduced measures to reduce red tape, rationalized utility charges, and improved infrastructure. Expenditure on health and education grew, creating a progressive economic environment that was attractive to foreign investors. These policies diminished distortions within the market, increased the efficiency of exchange, and reduced levels of perceived risk and uncertainty regarding the sudden alteration of economic policies. FDI net inflows increased sharply within the earlier half of the decade, increasing from US\$ 534 million in 2003 to peaking at US\$ 5.6 billion in 2008 (Figure 3).

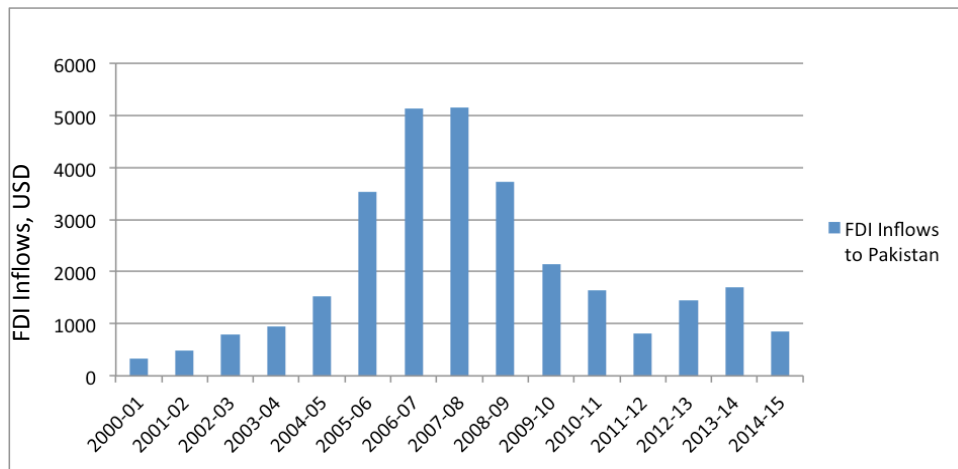


Figure 3: Inflows of Foreign Direct Investment Inflows to Pakistan, 2001 – 2013
Source: Pakistan Board of Investment

While the level of growth experienced within Pakistan during this time was impressive, it is important to note that the nation’s FDI levels lagged behind the rest of the developing world. In 2007 capital inflows to Pakistan were 4% of GDP while average

⁴⁹ Atique, Zeshan, Mohsin Hasnain Ahmad, Usman Azhar, and Aliya H. Khan. 2004. “The Impact of FDI on Economic Growth Under Foreign Trade Regimes: A Case Study of Pakistan [with Comments]”. *The Pakistan Development Review* 43 (4). Pakistan Institute of Development Economics, Islamabad: 707–18. <http://www.jstor.org/stable/41261022>.

capital inflows to other developing countries were 7.5% of GDP.⁵⁰ It has been argued that the reasons for this difference stem from an unstable political environment, inadequate infrastructure, and high levels of security risk, concerns that were not as present in other developing and emerging markets. Even though the Pakistani economy was growing rapidly, the country was still in its early stages of development, and thus more vulnerable to domestic and external shocks as compared to its regional counterparts. Hence, the deterioration of government effectiveness, national security, and global investment levels post-2008 triggered an immediate and severe reduction in FDI inflows to Pakistan.

Following calls for Musharraf's impeachment and his subsequent departure in 2008, the Pakistani economy moved from rapid rates of growth to a state of crisis. Real GDP growth slowed sharply and foreign exchange reserves plunged. Heightened security concerns consumed the newly elected fractious and fragile democratic government's attention, causing economic crises to be deprioritized as a time when they demanded more attention. Low investment in human capital, shortage of energy, and rising security concerns challenged the nation's capacity to attract foreign investors. The global financial crash of 2008 induced further stress on the domestic economy as Pakistani exporters struggled to sell their goods to the nation's largest export market, the United States. Deteriorating diplomatic relations and failure by the Pakistani government to service the nation's debt increased uncertainty over future returns, discouraging foreign firms to invest in Pakistan.⁵¹ As a result, Pakistan failed to rank on MSCI's list of emerging markets in 2012, or Standard and Poor's list of emerging stock markets.⁵²

⁵⁰ Zeb, Nayyara et. al. P. 33

⁵¹ Atique, Zeshan et al., p.20

⁵² Standard and Poor's Emerging Markets Core Index serves as an alternative for investors seeking more balanced country and sector weightings and less exposure to developed market economies.

Today, the Pakistani government is acutely aware of the need to boost Pakistan's image as a competitive investment location relative to other emerging economies.⁵³ In 2013 the Board of Investment (BOI) published a report discussing their strategy for attracting FDI between 2013 and 2017. The report acknowledges that Pakistan is a high-risk investment proposition. The report states that, "boosting Pakistan's international competitiveness on a global scale will be crucial in reaching Pakistan's growth targets in general and its FDI targets in particular."⁵⁴ To that end the Investment Policy of 2013, which is outlined within the 2013-2017 BOI Strategy Report, focuses specifically on enhancing Pakistan's international image as an investment location.

In October 2014 the Board of Investment hosted a two-day conference for foreign companies registered with the department to discuss this policy. The Board introduced several additional incentives for foreign investors including 100% tax credit for five years on new industries established by June 30th 2016, as well as credit for investment in infrastructure updates, extensions and replacements.⁵⁵ Additionally, the development of the China-Pakistan Economic Corridor (CPEC), a mega bilateral project that aims to connect Pakistan's southwestern Port of Gwadar to the northwestern region of Xinjiang, China, has allowed foreign investment within Pakistan to increase again, especially in the telecommunication, energy and transportation sectors. These shifts have stimulated moderate growth in FDI inflows to the country since 2013. Positive economic growth trends have refocused attention on opportunities existent within Pakistan, allowing for FDI inflows to advance development efforts within the country. The next section of this

⁵³ Board of Investment. *Foreign Direct Investment Strategy 2013 – 17*. Accessed March 2016. <http://boi.gov.pk/UploadedDocs/Downloads/InvestmentStrategy.pdf>

⁵⁴ *Ibid*, p.9

⁵⁵ KPMG. 2015. *Pakistan – Gearing Up to Attract Foreign Investment*. <https://home.kpmg.com/xx/en/home/insights/2015/02/pakistan-gearing-up-attract-foreign.html>

chapter discusses the importance of FDI within Pakistan, and presents reasons for why the country has latent potential to serve as an attractive host country for FDI.

3.2 Investing in Pakistan: Opportunities and Risks

FDI has served as one of the main sources of foreign capital inflows to Pakistan since the 1960's along with international aid, and is considered an important vehicle for economic growth within the country.⁵⁶ The Pakistani government's desire to attract high levels of FDI inflows has resulted in the creation of the most liberal foreign investment frameworks in South Asia, allowing foreign investors to own up to 100% of their equity, repatriate a 100% of profits, and receive numerous tax holidays such as a 100% tax credit for five years on new industries or new equity investment.⁵⁷

Pakistan has one of the highest consumption-to-GDP ratios in the region, driven by a rapidly urbanizing population. With more than 180 million citizens, and the age demographic skewed towards the youth, there is great capacity for growth within sectors such as Telecommunications, Financial Services, Energy, Textiles and Information Technology.⁵⁸ Foreign investors can benefit from the trend of youth entrepreneurship in Pakistan which can potentially induce a paradigm shift in the economy.⁵⁹ Pakistan's location as a shipping hub, neighboring two BRIC economies—China and India, as well as Iran, a fast growing economy, provides foreign investors with opportunities for

⁵⁶ Arshad Khan, Muhammad. *Foreign Direct Investment and Economic Growth: The Role of Domestic Financial Sector*. P. 3; 21

⁵⁷ KPMG. *Investment in Pakistan*. 2013. Accessed October 2015. P.9

<https://www.kpmg.com/PK/en/IssuesAndInsights/ArticlesPublications/Documents/Investment-in-Pakistan2013.pdf>

⁵⁸ Ibid

⁵⁹ Ibid

regional trade. Pakistan's strengthening relationship with China is encouraging the most significant incline in FDI inflows to the Pakistan since the early 2000's.

However, several factors deter foreign investors from investing in Pakistan. These include internal concerns such as government inefficacy and security concerns, and external considerations such as changes in global economic trends, each of which are variables this paper employs to analyze FDI trends across sectors within Pakistan.

One of the key hindrances to Pakistan's growth story is its low investment-to-GDP ratio. The ratio stood at 13.5% in 2014, one of the lowest in the world.⁶⁰ As a result the government has been unable to develop infrastructure, resulting in limited provision of facilities such as energy, water, or consistently paved roads. Additionally following the decision to participate in the War on Terror, Pakistan has been perceived as a nation with poor national security. These limitations along with poor government efficacy and political instability have resulted in FDI moving away from Pakistan and towards those developing markets that are less risky to foreign investors.

Today, Pakistan continues to be perceived as a high-risk high-return investment proposition. The next section of this chapter provides an overview of events occurring during the last fifteen years that drastically changed domestic conditions. Understanding the events that contributed to deteriorating political and economic conditions within Pakistan allows for an accurate understanding of why the nation has found it difficult to attract and maintain sustainable levels of FDI particularly post-2008.

⁶⁰ Government of Pakistan, Ministry of Finance. *Pakistan Economic Survey*. 2013-14. Accessed December 2015. http://finance.gov.pk/survey_1314.html

3.3 The Last Fifteen Years: Internal and External Shocks to the Pakistani Economy

Since 2000 Pakistan has witnessed drastic changes in the amount of inflows it has received. This section provides an account of major internal and external events occurring during the last fifteen years that have affected FDI inflows within the country.

2000 – 2004:

During the first half of the decade, Pakistan moved away from a stable military regime presided by Pervez Musharraf, to one that was rapidly weakening due to growing demands for democracy. Pakistan nominally returned to civilian rule in late November 2002 with the creation of Musharraf’s “democratic” party, the Pakistan Muslim League - Quaid-e-Azam (PML-Q), although Musharraf still retained massive powers including the ability to dismiss the elected parliament. In 2002 PML-Q formed a coalition government with a majority of one vote, attempting to combine democracy with military rule, and faced the strongest opposition in Pakistan’s recent history.⁶¹

At the same time, however, economic performance remained strong. The country recorded an estimated 4.7% current account surplus in 2002.⁶² According to the Federal Bureau of Reserves exports grew by more than 16% between July and December of 2002, reaching a value of USD 4.71 billion.⁶³ By 2004 the IMF commended Pakistan, stating that a host of structural reforms had been implemented and the debt situation had improved.⁶⁴ Further, they suggested that while external support had been beneficial the

⁶¹ Economist Intelligence Unit, Pakistan Country Reports. November 2002

⁶² Ibid, June 2003

⁶³ Ibid

⁶⁴ Ibid, August 2004

improvement primarily reflected a government-led change of policy implementation and enforcement.⁶⁵ Government effectiveness as measured by the World Governance Indicators improved marginally during this time. The IMF asserted their concerns about public expenditure management and the slow pace of reform in sectors such as power generation. These issues aggravated conditions in Pakistan post-2008 when the country witnessed a rapid decline in political stability, coinciding with deep economic shocks and growing security concerns that resulted in a decline in FDI inflows to the country.⁶⁶

2005 – 2009:

Efforts made by policy makers to restructure laws and regulatory bodies in Pakistan created an environment conducive to the foreign private sector's involvement and participation. The Pakistani government increased expenditure on healthcare and education initiatives to promote Pakistan's long-run economic growth potential. Both, foreign and domestic private investment grew within this time period. Government effectiveness increased marginally between 2005 and 2006, as measured by the World Governance Indicators. The economy continued to expand until 2007, and Pakistan experienced a peak in FDI inflows, resulting in the investment growth rate to reach nearly 20%.⁶⁷ The government continued to focus on private sector expansion as a tool for economic growth and development. Measures incentivizing FDI included reforms in the banking and utility sectors, and efforts to reduce red tape.⁶⁸

⁶⁵ Ibid, December 2004

⁶⁶ Ibid, December 2004

⁶⁷ Ibid

⁶⁸ Ibid, September 2007

However, Pakistan's sustainability and competitiveness as an international player was limited due to vested national political interests, and weakening military rule that was giving way to an even weaker democratic setup. In 2007, rising international oil prices and domestic inflation started to threaten macroeconomic stability. Rapid economic growth and development within Pakistan stopped abruptly by the end of 2007 and early 2008, when the country was faced with simultaneous internal and external shocks. The global financial crash of 2008 resulted in a significant loss of FDI, as global investment levels declined. The political system was in shambles as Pervez Musharraf refused to relinquish power, and imposed a state of emergency. Musharraf's suspension of Supreme Court judges in November 2007 furthered his unpopularity, fueled calls for his dismissal, and resulted in declining government effectiveness. The assassination of Benazir Bhutto, returned past Prime Minister and leader of the opposition, deepened the political crisis, and raised concerns regarding national security provision in Pakistan.

The escalation of security risks and the destabilization of the Pakistani government, combined with a weakened international investment climate between the end of 2007 and early 2008 had a strong, negative effect on FDI inflows. While most South Asian countries were able to attract FDI between two to three years of the global economic crash, inflows within Pakistan continued to decline. Predictions of investment growth, which had been the main driver of economic growth, fell from 20% a year to 6.9% a year by the beginning of 2008. The sharp increases in political and operational risk in recent months no longer allowed the liberalized economy to present itself as an opportunity that was independent of the political situation within the country.⁶⁹

⁶⁹ Ibid, January 2008 and July 2008

By November 2008 Asif Ali Zardari, husband of Benazir Bhutto and the new leader of the Pakistan People's Party (PPP), was elected President of the country. During his presidency economic policy focused on short-term crisis management. Despite reluctance to rely on the IMF, the government turned to the organization for assistance in November 2008. By accepting IMF financing, the Pakistani government lost an extensive degree of autonomy in designing economy policy, and was required to eliminate subsidies in sectors like Energy. Investment growth continued to contract, curtailing public expenditure.

By July 2009 the Pakistani army had launched a large-scale offensive against the Tehrik-e-Taliban Pakistan (TTP) in the North West Frontier Province (since renamed Khyber Pakhtunkhwa [KP]), with intentions to expand to the Federally Administered Tribal Areas (FATA).⁷⁰ The War on Terror required Pakistan to increase its military budget, and raised concerns regarding security provision in the country.⁷¹ The simultaneous security and economic crisis added to the concerns of a divided and weak democratic government, and fueled growing anti-government sentiment among the general population. Given the poor international economic climate, foreign investors were not prepared to invest in Pakistan at a time when political stability was weak, government effectiveness was low, and security provision was in decline. Thus, Pakistan continued to experience a decline in FDI inflows through the end of the decade.

⁷⁰ Ibid, July 2009

⁷¹ Ibid, November 2009 and December 2009

2010 – 2014:

By 2010, the Economist Intelligence Unit predicted a meager 1.5% annual rate of investment growth in Pakistan. Remittances were now the main driver of economic growth within the country. The economy continued to be constrained by a lack of improvement in security and limited infrastructure capacities.⁷² The floods of 2010, which resulted in the death of more than 2,000 people only exacerbated the situation. Millions more were displaced, redirecting the government's attention to immediate rescue, rehabilitation and crisis management efforts. Pakistan continued to remain heavily dependent on multilateral institutions and bilateral donors for concessional loans and emergency aid during this time.⁷³

Relations between Pakistan's main political parties remained volatile. Government effectiveness as ranked by the Economist Intelligence Unit and the World Bank's World Governance Indicators stayed low, and growing pressures on Zardari's government meant that political stability remained a dim possibility. The capture of Osama Bin Laden in 2011 by U.S. Special Forces refocused negative attention on Pakistan. Questions regarding the capacity and will of the Pakistani government to combat terrorism raised security concerns and contributed to a further withdrawal of FDI.

Economic expansion continued to fall short of potential due to poor policy-making, shortages of energy and water, ongoing security concerns, and low investment in human capital.⁷⁴ Tighter domestic credit markets and a continued lack of foreign financing further weakened the position of the country.

⁷² Ibid, November 2010

⁷³ Ibid, August 2010

⁷⁴ Ibid, April 2012

Following the national elections of 2013, many speculated the possibility of an upswing in domestic circumstances. Nawaz Sharif (PML-N) was elected Prime Minister in June 2013.⁷⁵ His priorities to curb the domestic energy crisis and control terrorism fared well for the possibility of political stability. In 2014 FDI inflows recorded modest growth. However, due to constant power outages, poor basic infrastructure, and weak security conditions, Pakistan has been unable to take full advantage of international economic stability and opportunity. It is likely that the USD 46 billion CPEC trade deal will allow for development in power and infrastructure. China's involvement in Pakistan will help promote economic links between Pakistan's Gwadar port and China's Xinjiang province.⁷⁶ Such a partnership is likely to help boost the economy and promote foreign investment within the country.

3.4: A Sectoral Comparison of FDI inflows to Energy, Telecommunications and Financial Services from 2000 – 2015

FDI inflows to Pakistan grew rapidly between 2000 and 2007 (Figure 4). Attracting USD 308 million in 2000, FDI inflows peaked at USD 5.29 billion in 2007.⁷⁷ Soon thereafter inflows began to decline, dropping to USD 5.4 billion in 2008 and to US \$859 million by 2012. While open, market-oriented policies contributed to a positive investment environment in the mid-2000s, the simultaneous occurrence of numerous external and internal shocks such as declining government effectiveness, weakening

⁷⁵ This was Nawaz Sharif's third time in office. He had previously been Prime Minister for two incomplete terms in the 1990's.

⁷⁶ Ibid, June 2015

⁷⁷ World Development Indicators. *Foreign Direct Investment, net inflows (BOP, current US\$)*. World Bank. Accessed October 2015. <http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD>

national security. and diminishing levels of global investment caused a significant reduction in foreign investor confidence in Pakistan,

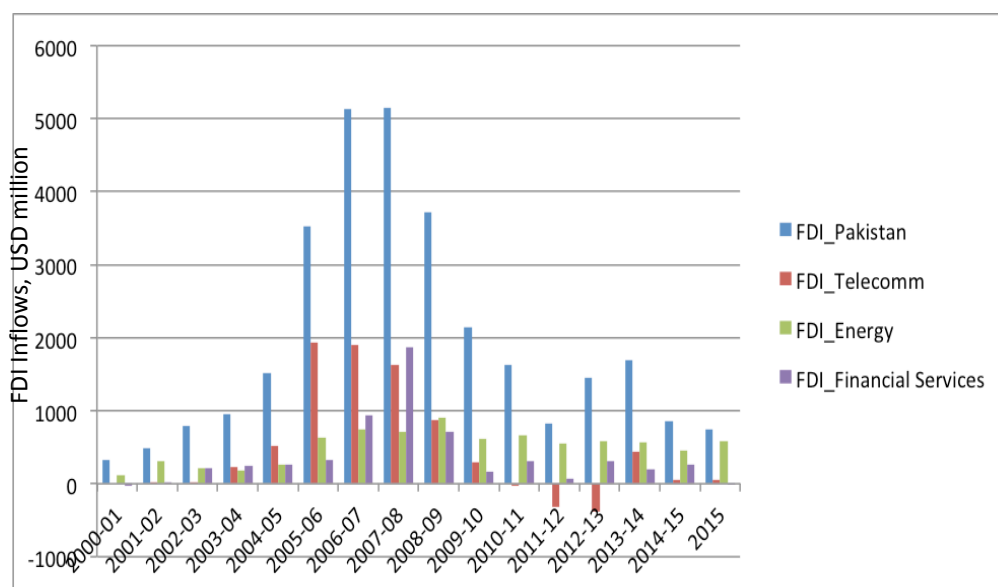


Figure 4: Differences in Inflows of FDI to Pakistan Across Sectors ,2000 - 2015
Source: Board of Investment, Author's Calculations

Between 2000 and 2014, FDI inflows to the Energy, Telecommunications and Financial Services Sector accounted for an average of 68% of total FDI inflows to the country.⁷⁸ Trends in FDI inflows within these three sectors as compared with national FDI trends during this time period, however, have varied. Inflows to the Energy Sector have remained almost entirely consistent between 2005 and 2015, only increasing slightly between 2006 and 2008 (Figure 4). FDI inflows to the Telecommunications Sector weakly match national FDI inflow trends between 2004 and 2009. However, the sector has been unable to increase growth in FDI inflows since then. FDI inflows to Financial Services are normally distributed around 2007-08, and closely match trends in national FDI inflows. Differences in inclines and declines in FDI inflows across Energy,

⁷⁸ Authors calculations of numbers from BOI data

Telecommunications, and Financial Services suggest that changes in political stability, government effectiveness, security, and global investment levels have had different effects across sectors and the economy as a whole. The next three chapters offer a comparative sectoral analysis of FDI inflows to each of these three sectors between 2000 and 2014, and examine the ways in which government effectiveness, national security, and global investment levels have influenced FDI inflows within each sector.

Chapter Four

Power and Energy

Power cuts and energy shortages have created an inescapable bottleneck to advancing long-term economic growth and development within Pakistan. Dr. Musadik Maik, special assistant to Prime Minister Nawaz Sharif, maintains that the energy crisis is a result of three major issues: the wide gap between supply and demand, the high cost of power, and “inefficiencies” within the system, a code word for electricity theft across the country.⁷⁹ The National Electric Power Regulatory Authority (NEPRA) has estimated that repeated breakdowns and shortfalls of power have resulted in a 2-3% reduction in the GDP of the country.⁸⁰ Given high capital costs, it is unlikely that the Pakistani government will be able to restructure the sector independently. Therefore, there is a need to integrate the private energy sector as part of a broader sectoral reform framework.⁸¹ Writers such as Michael Kugelman⁸², Javed Akbar⁸³, and Afia Malik⁸⁴ have stressed the

⁷⁹ Malik, Musadik. *Pakistan's Energy Crisis: Challenges, Principles, and Strategies*. Published in Kugelman, Michael, ed. 2015. *Pakistan's Interminable Energy Crisis: Is There Any Way Out?* P. 25 Accessed December 2015. https://www.wilsoncenter.org/sites/default/files/ASIA_150521_Pakistan's%20Interminable%20Energy%20Crisis%20rpt_0629.pdf

⁸⁰ Government of Pakistan Ministry of Finance, *Pakistan Economic Survey 2014-15*. Islamabad, Pakistan, 2015. P. 243. Accessed January 2016. http://www.finance.gov.pk/survey_1415.html

⁸¹ Fraser M., Julia. 2005. *Lessons from the Independent Private Power Experience in Pakistan*: The World Bank, The Energy and Mining Sector Board. P. 12. Accessed February 2016. <http://info.worldbank.org/etools/docs/library/240338/Lessons%20from%20the%20Independent%20Private%20Power%20Experience%20in%20Pakistan.pdf>

⁸² Michael Kugelman is a Senior Associate for South Asia at the Woodrow Wilson Center for International Scholars

⁸³ Javed Akbar is the Chief Executive of Javed Akbar Associates (Private) Limited, a consulting company that specializes in energy analysis and forecasting

⁸⁴ Afia Malik is a Senior Research Economist at the Pakistan Institute of Development Economics

importance of private sector involvement, particularly foreign private sector involvement, in the restructuring and advancement of Pakistan's energy sector. However, poor policy implementation, an inability by the government to fulfill commitments made to private investors, and a precarious security situation has discouraged foreign investors from investing in Pakistan's energy sector. According to the United States Institute of Peace, almost all foreign companies that financed generation projects in the 1990's had sold off a portion their shareholdings by 2015.⁸⁵

This chapter analyzes the effects of government effectiveness, security, and global FDI inflows on inflows of FDI to the Energy Sector in Pakistan. It argues that the foreign private sector has been deterred from investing in Pakistan's energy sector due to weak government efficacy and growing security risks. The first section of this chapter provides an overview of energy production and distribution systems within Pakistan, and discusses the role of the foreign private sector within the industry. The following sections discuss the effect of each of the three independent variables on FDI inflows to the energy sector. The chapter concludes with a comparative analysis of the implications each of the variables might have on future policies and government strategy.

4.1 An Overview of the Energy Sector in Pakistan:

At the time of independence, Pakistan's power generation capacity rested at a meager 60 mega-watts (MW). By the mid-1960's the nation's generation capacity had increased to approximately 2,500 MW.⁸⁶ Rapid domestic industrialization and a growing

⁸⁵ Aziz, Rashid and Munawar Baseer Ahmad. 2015. *Pakistan's Power Crisis: The Way Forward*. Washington, DC: United States Institute of Peace. P. 5

⁸⁶ *An Overview of Electricity Sector in Pakistan*. Islamabad: Islamabad Chamber of Commerce and Industry. Chp. 1.1

population demanded growth within the sector. During the 1980's the government began introducing reforms to attract foreign investment inflows to the energy sector.⁸⁷ These reforms were unable to attract a significant response and demand continued to increase well into the early 1990's, causing frequent and massive blackouts throughout the decade. As a response to the growing gap in supply versus demand for energy, the government created the 1994 Power Policy, which introduced a series of incentives and returns on investment for private foreign investors interested in Pakistan's energy sector. The most important of these incentives was that the Pakistani government guaranteed itself as a buyer of the power supplied by the private sector. By signing exclusive Power Purchase Agreements with private investors—domestic or foreign—the Pakistani government and the private investor agreed on a rate at which units of energy would be sold to the government. The Agreements also guaranteed investors a return on equity for the power plant. Additionally, the price at which energy was bought was dollar-indexed which meant that the private investor was protected against fluctuations in the Pakistani rupee.⁸⁸ By offering these provisions, and effectively pledging a guaranteed return on private investment in Pakistan's energy sector, the Pakistani government aimed reduced the risk and uncertainty associated with investing in the energy sector for foreign investors.

A Private Power and Infrastructure Board (PPIB) was set up in 1994 to oversee the implementation of this policy. In 1997, NEPRA was formed to oversee transparency and regulation in the Energy sector. NEPRA's main responsibilities were to, “issue licenses for generation, transmission, and distribution of electric power; establish and enforce standards to ensure quality and safety of operation and supply of electric power

⁸⁷ *Annual Report, 2004-05*, National Electric Power Regulatory Authority (NEPRA)

⁸⁸ Majid Munir in discussion with the author, February 2016.

to consumers; approve investment and power acquisition programs of the utility companies; and determine tariffs for generation, transmission and distribution of electric power.”⁸⁹

Between 2001 and 2005, annual growth in electricity consumption was approximately 7.5%.⁹⁰ Demand for electricity grew by 3-4% annually until 2004.⁹¹ In order to keep up with demand, high investments in the energy sector were required, placing pressing the Pakistani government to deliver results quickly. During this time, Pakistan’s power sector comprised of four main power producers: 1) Water and Power Development Authority (WAPDA), 2) Pakistan Atomic Energy Commission (PAEC), 3) Karachi Electric Supply Corporation (KESC), and 4) Independent Power Producers (IPPs).⁹² Of the four producers, WAPDA and PAEC were publically owned companies.

Policy changes and attempts at regulation played a pivotal role in enabling the establishment of several private plants during the growth years in Pakistan.⁹³ To meet demand, the government increased its reliance on private energy producers. By 2005 there were twenty-one IPPs operating in Pakistan, a marked increase since 1994, when there were fifteen.⁹⁴ Additionally KESC, a publicly owned company, was privatized in November 2005 when multiple Pakistani and foreign businesses purchased a 71% stake in the company.⁹⁵

⁸⁹ Asian Development Bank, *Private Sector Assessment: Pakistan*. December 2008. P. 31.

⁹⁰ *Annual Report, 2004-05*, National Electric Power Regulatory Authority (NEPRA). Calculations by author.

⁹¹ Malik, Afia. 2012. *Power Crisis in Pakistan: A Crisis in Governance?* PIDE Monograph Series. Islamabad: Pakistan Institute of Development Economics

⁹² IPPs (International Power Producers) are private entities that own facilities to generate electric power that is sold to the Pakistani government.

⁹³ The years between 2000 and 2005 are understood as being the growth years of the Pakistani economy.

⁹⁴ *Annual Report 2004-05*, NEPRA; *An Overview of Electricity Sector in Pakistan*.

⁹⁵ A full list of investors is available on K-Electric’s website: http://www.ke.com.pk/investor/company_profile/index.html

Since privatization, the Pakistani government has retained a minimum 27% in KESC—since renamed K-Electric—to serve as, “a measure of comfort to the prospective buyer of the utility.” K-Electric is a vertically integrated private company responsible for the generation, transmission, and distribution of electric power in its area, which includes the

Since privatization, K-Electric's financial and operational performance has improved. In the first five years post-privatization, the company increased generation capacity and fuel efficiency by 39%, and reduced transmission and distribution losses from 36% to 28%.⁹⁶ K-Electric's net losses decreased from PKR 15.5 billion in 2009, to PKR 14.6 billion in 2010.⁹⁷ By 2012, the company reported a profit of 2.6 billion rupees. Saad Hasan, a writer at the *Express Tribune*, a Pakistani English daily, wrote: "The power utility has come a long way since it was privatized in 2005. From a company beset by rampant theft, [a] network of rickety power lines and corruption [when it was publically owned], it has emerged as a benchmark for other electricity suppliers in Pakistan."⁹⁸ The company has been able to incorporate additional private investment within its structure by contracting engineering companies such as Siemens (German) and Descon (Pakistani). These opportunities have influenced the increase in FDI inflows to the Energy sector since the end of 2005 (Figure 4), and provide the basis for Pakistani economists and researchers to conclude that Pakistani investment needs in the energy sector cannot be met by the public sector alone.⁹⁹

Since 2005-06, growth in FDI inflows to Pakistan's energy sector has remained nearly consistent, increasing marginally between 2006 and 2009, but declining again in 2010 (Figure 4). Increases in FDI inflows to the energy sector between 2000 and 2014 did not directly correspond with the introduction of policy incentives offered by the

city of Karachi, and certain areas in the province of Balochistan. K-Electric serviced approximately 80 billion Pakistani rupees of debt with the Pakistani government in exchange for equity in the company, and arranged for public entities to pay their outstanding dues. (*Annual Report 2005-06*, NEPRA. P. 5; *Annual Report, 2014-15*, NEPRA. P. 22, 139)

⁹⁶ Akbar, Javed. *Addressing the Present Energy Crisis by Avoiding Mistakes of the Past*. Published in Kugelman, Michael, ed. 2015. P. 12

⁹⁷ Asian Development Bank, *Private Sector Assessment: Pakistan*

⁹⁸ Hasan, Saad. *Turnaround: The Story Behind K-Electric's Rs12b in Profits*. *The Express Tribune*, September 26, 2014. Accessed March 2016. <http://tribune.com.pk/story/767390/turnaround-the-story-behind-k-electrics-rs12b-in-profits/>

⁹⁹ Malik, Afia. 2012. *Power Crisis in Pakistan: A Crisis in Governance?* P. 24

government, which suggests that policy incentives were not the primary factors motivating or deterring foreign investors from investing in Pakistan's energy sector. Dr. Ashfaq Khan argues that increased incentives were ineffective due to poor long-term planning by the Pakistani government, weak oversight, and high sunk costs of capital, which increased the risk of investing in the sector.¹⁰⁰ The government's inability to perform on promises made in the 1994 Power Policy by providing adequate liquidity to foreign investors created a number of fiscal, financial and transparency related issues for foreign investors interested in investing in Pakistan's energy sector.

Issues of weak government oversight and rising security risks have presented themselves in different capacities throughout the last fifteen years. The next three sections of this chapter discuss the ways in which governance, security, and global investment trends have affected FDI inflows to the energy sector between 2000 and 2014.

Government Effectiveness and Inflows of FDI to Energy:

The Pakistani government is the sole buyer of power sold by private producers within the country. As part of the 1994 Power Plan, the government and private producers sign Power Purchase Agreements at the time when the private investor invests in the energy sector. The Agreement outlines the rate at which the government will buy energy from the private producer. Given the wide gap between demand and supply of energy in Pakistan, and the government's inability to reduce this gap, the Energy sector is very much a seller's market. The government therefore buys electricity at the value

¹⁰⁰ Dr. Khan is a Professor of Economics at the National University of Sciences and Technology (NUST) in Islamabad, Pakistan
Khan H., Ashfaq and Yun-Hwan Kim. 1999. Foreign Direct Investment in Pakistan: Policy Issues and Operational Implications.: Asian Development Bank, Economics and Development Resource Center. P. 28-29. Accessed January 2016. <http://www.adb.org/sites/default/files/publication/28178/er066.pdf>

provided by the power producer, which makes the per-unit cost of private energy more expensive as compared to energy produced by publically owned companies. Additionally, the government subsidizes electricity for its consumers—the Pakistani public, and is therefore unable to recover costs. Consequently, the Pakistani government is unable to provide timely compensation to power companies, which results in the creation of “circular debt,” a problem that is substantially limiting the country’s ability to attract long-term foreign investment in the energy sector..¹⁰¹

In their 2014 Investment Strategy, Arif Habib Limited stated: “Energy availability in Pakistan has been declining over the last few years, as a result of low investment in the sector. ... Despite several measures taken by the government, prolonged and frequent power cuts have affected production activities and kept economic growth under [a] stiff grip from reaching its full potential.”¹⁰² Afia Malik has argued that the problem of circular debt could have been curbed right from the onset if cost effective electricity tariffs for consumers had been introduced early. She maintains that such a policy measure by the government would have suppressed the exponentially rising and thus unmanageable growth in domestic demand, and would have also been able to attract and maintain investment levels in the future.¹⁰³ The Pakistani government’s lack of professional and long-term management has increased levels of market and performance risks associated with investing in the energy in Pakistan for foreign investors, and has hence deterred foreign investors away from the country.¹⁰⁴

¹⁰¹ The government’s inability to provide remuneration in time causes private producers to face a liquidity crunch, which disables them from being able to forward payments to oil and diesel refineries. In return, oil and diesel refineries are unable to make payments to distributors, resulting in the creation of a vicious cycle of debt creation.

¹⁰² Arif Habib Limited. 2014. *Pakistan Strategy 2014: 2014 Unfolds another Chapter of a Growth Story!* P. 18. Accessed November 2015. <http://investorguide360.com/wp-content/uploads/2014/01/AHL-Research1.pdf>

¹⁰³ Malik, Afia. 2012. Power Crisis in Pakistan: A Crisis in Governance? P. 4

¹⁰⁴ *An Overview of Electricity Sector in Pakistan*. Islamabad: Islamabad Chamber of Commerce and Industry, Chp. 2.2.

However, when studying the correlation between government effectiveness and inflows of FDI in the Energy Sector between 2000 and 2014, a negative relationship is observed (Figure 5). FDI inflows seem to increase when government efficacy declines.

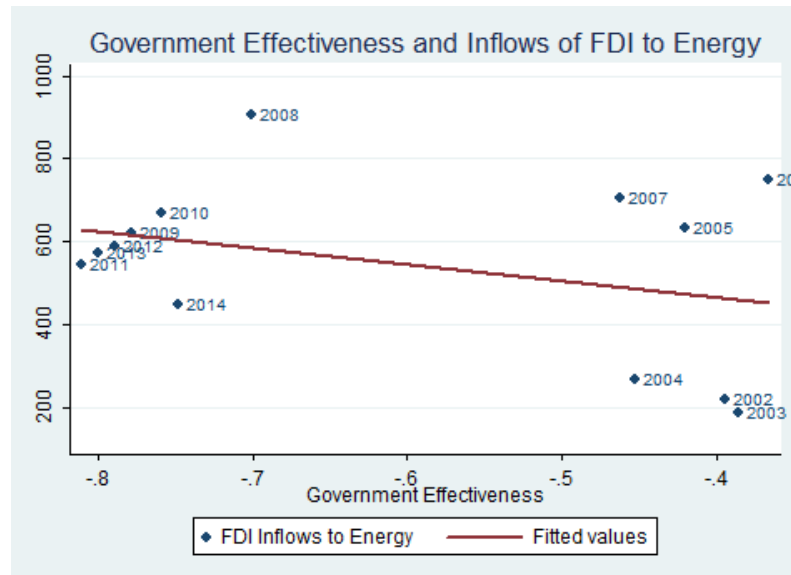


Figure 5: Correlation between Government Efficacy and FDI Inflows to Pakistan's Energy Sector; Author's calculations

One would expect that higher levels of government efficacy would correlate with higher levels of FDI inflows to the sector. However, several reasons might contribute to the opposite conclusion. Taimour Noorani argues that foreign investors have a greater incentive to invest in Pakistan's energy sector when government effectiveness is low.¹⁰⁵ He argues that limited government efficacy creates opportunities for foreign investors to monetize from regulatory loopholes within a system that is corrupt and lacks cohesive checks and balances.¹⁰⁶ Private producers inflate expenses incurred in setting up a power plant in order to state a higher per unit cost of energy in their Power Purchase

¹⁰⁵ Interview with Taimour Noorani (Senior Analyst for Principal Investments in Bank Al-Falah's Merchant Banking Group) in discussion with the author, March 2016

¹⁰⁶ Ibid

Agreements. Due to limited resources, and sometimes vested interests, the government is often unable or unwilling to measure the true cost of energy provided by private power producers, allowing foreign investors to advantage from inefficiencies within the system.

4.3 Security and Inflows of FDI to Energy

Two types of security threats, distinct in terms of location, primarily affect Pakistan. The first threat includes attacks in the mountainous and mostly rural areas of the country such as KP, North Waziristan, and the largely ungoverned territories of FATA. The second threat to security comes from attacks occurring in populated city centers. In either case, power production has historically remained unaffected since power production plants and distribution centers generally do not tend to be located in or near either of these sites. They are usually constructed in the outskirts of towns and cities.

The security threat therefore, did not directly affect production or distribution patterns in the energy sector prior to 2008. As observed in Figure 6, FDI inflows to the energy sector continued to grow until 2008, even as the security situation in Pakistan worsened. Thus, on average, the relationship between security and FDI inflows is positive, which suggests that lower levels of security provision correlate with higher levels of FDI inflows to the energy sector.

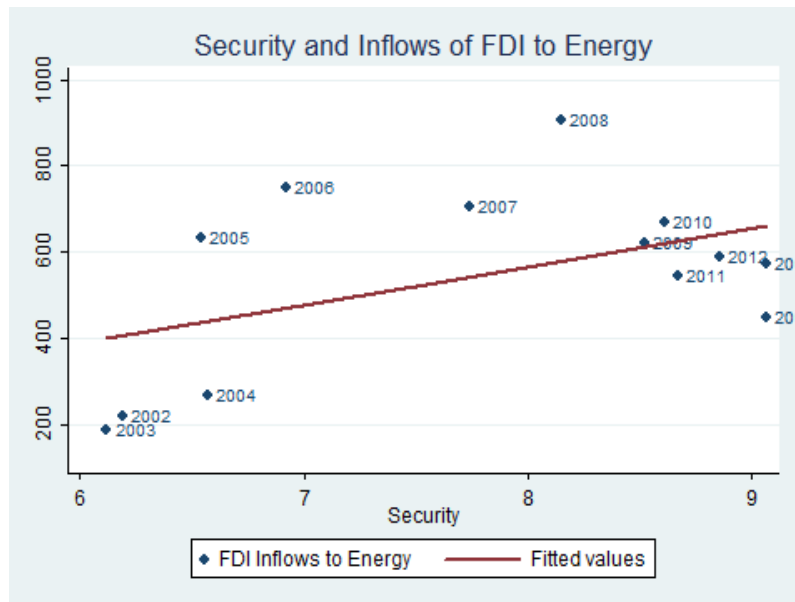


Figure 6: Correlation between Security and FDI Inflows to Pakistan's Energy Sector; Author's calculations

However, since 2009, the relationship has changed. The graph indicates that FDI inflows to the energy sector have begun to decline as security conditions worsen in Pakistan. It is likely that such a trend has started to emerge in recent years due to two reasons: One, it is possible that foreign investors have wanted to exit the market since before 2009 due to deteriorating security conditions, but were unable to do so due to the time needed to close or sell power plant investments. Two, security limitations have started to affect the energy sector more directly in recent years, as militants are beginning to attack power plants within the country in an attempt to disrupt the provision of power to the Pakistani population. In 2013, at least seven people were killed in an attack by dozens of militants on an electricity plant located on the outskirts of Peshawar.¹⁰⁷ In January 2015, another attack by terrorists on power transmission lines in Balochistan

¹⁰⁷ Pakistan Attack: Deadly Raid on Peshawar Power Plant. BBC News, April 2, 2013. Accessed March 2016. <http://www.bbc.com/news/world-asia-21999352>

resulted in nearly 80% of the country facing a power blackout.¹⁰⁸ Deteriorating security conditions in Pakistan have now started to affect power production and distribution directly, adding to the foreign investor's risk considerations. As a result, foreign investors are likely to be deterred from investing Pakistan's energy sector due to growing security concerns in the coming years.

4.4 Global Investment Trends and Inflows of FDI to Energy

In their 2013 Investment Report, KPMG, a Dutch financial services firm with an office in Pakistan wrote: “[The GoP] is providing an investment friendly environment for the oil and gas sector to attract local and foreign investment. As a result...this sector has emerged as one of the most attractive for investment in the country.”¹⁰⁹

Figure 7 presents a positive relationship between global inflows of FDI and inflows of FDI to the energy sector. As global inflows of FDI increase, there is a corresponding increase in FDI inflows to the energy sector in Pakistan. Such a trend likely has to do with Pakistan's investment regime being a high-risk-high-return investment proposition.¹¹⁰ Foreign investors are more willing to absorb risk when the international economic climate is positive. Inflows of FDI to Pakistan's energy sector were highest between 2006 and 2008, when global inflows of FDI were high as well. In 2006, the government signed agreements worth USD 42 million with international companies to carry out exploration activities in the oil and gas sectors. Pipeline projects

¹⁰⁸ Baloch, Shehzad. *Attack on power lines in Balochistan causes national blackout*. The Express Tribune, January 25, 2015. Accessed March 2016. <http://tribune.com.pk/story/827139/parts-of-punjab-sindh-balochistan-left-without-power-after-guddu-transmission-line-trips/>

¹⁰⁹ KPMG. 2013. *Investment in Pakistan*. P. 28. Accessed October 2015. <http://www.kpmg.com/PK/en/IssuesAndInsights/ArticlesPublications/Documents/Investment-in-Pakistan2013.pdf>

¹¹⁰ Majid Munir in discussion with the author, February 2016

were discussed and negotiated with several countries including Qatar, Turkmenistan, and Iran.¹¹¹ These projects were long-term contracts that has allowed for the maintenance of stability in energy sector inflows even after national FDI inflows crashed.

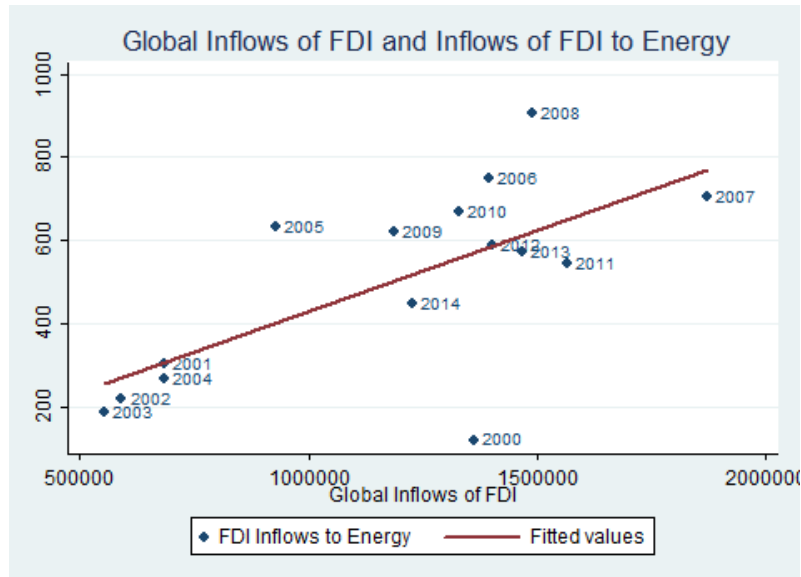


Figure 7: Correlation between Global Investment trends and FDI Inflows to Pakistan’s Energy Sector; Author’s calculations

In 2015, domestic and foreign private producers controlled approximately 41.5% of total generation capacity, an increase from 30% in 2011.¹¹² The USD 47 billion CPEC trade deal has put energy provision at the center of the government's agenda. The energy sector is arguably at a point where it has both, the need and the opportunity to transform. Creating a sustainable partnership with the private sector will allow the government to meet the growing energy demands of the country.

¹¹¹ Annual Report 2005-06, NEPRA. P. 5

¹¹² Rizvi, Jawwad. *Demystifying Pakistan’s Energy Crisis*. 2015. Accessed March 2016. <http://www.technologyreview.pk/demystifying-pakistans-energy-crisis/>; *An Overview of Electricity Sector in Pakistan*. Islamabad: Islamabad Chamber of Commerce and Industry

4.5 Assessing the Impact of Government Effectiveness, Security, and Global Investment Trends on FDI Inflows to the Energy Sector

"Pakistan's problems are rooted in "shortages of governance than of pure supply [of power]," Michael Kugelman argues.¹¹³ Multiple factors have contributed to the current energy crisis in Pakistan. According to the United States Institute for Peace, there are three primary shortages affecting Pakistan's energy sector: 1) Physical shortage: supply has not managed to keep pace with demand; 2) Financial Shortage: below cost tariffs and expensive subsidies have not been able to cover the cost of supply, resulting in repeated annual deficits; 3) Governance: government owned utilities and institutions have been unable to ensure commercial or regulatory discipline, resulting in sub-par energy provision and service.¹¹⁴ Ineffective governance has created budgetary problems such as circular debt, limiting the power sector's capacity to expand especially. The issue was exacerbated after 2008, when foreign investors were faced with limited liquidity options, were unable and unwilling to take on significant investment risks.

Since 2008, growing security concerns have increased the risk associated with investing in Pakistan's energy sector. Limited government effectiveness and weak security provision has increased the risk associated with investing in Pakistan, and deterred significant growth in FDI inflows since 2008. As a result, Pakistan's energy sector has been unable to attract long-term private sector investment.

Pakistan's energy sector requires large capital outlays, and is thus more affected by a slowdown in investments.¹¹⁵ United States Institute for Peace concludes that the shortfall in generation stems from a failure to achieve required investment that is

¹¹³ Kugelman, Michael. *Powerless in Pakistan*. Foreign Policy, June 2015. P. 2. Accessed January 2016. <http://foreignpolicy.com/2015/06/30/powerless-in-pakistan/>

¹¹⁴ Aziz, Rashid and Munawar Baseer Ahmad. 2015. *Pakistan's Power Crisis: The Way Forward*. P. 2

¹¹⁵ Aziz, Rashid and Munawar Baseer Ahmad. 2015. *Pakistan's Power Crisis: The Way Forward*. P. 5

necessary to expand and maintain power generation, preventing the energy sector from developing new, cheaper, and more efficient production patterns.¹¹⁶ Afia Malik argues that in addition to building capital stock for power generation, investments must also focus on increasing capacity for electricity transmission and distribution to overcome the losses the sector has suffered.¹¹⁷ Unfortunately, controlling or restructuring companies that provide energy is challenging.

At its core, FDI inflows to Pakistan's energy sector are diluted due to inefficient governance, expensive tariff structures, a deteriorating security situation.¹¹⁸ Pakistan has the capacity to produce electricity on its own, but without streamlining the existing system, and accounting for commitments made to private investors, the government will be unable to maintain its strategy of promoting foreign investment as a means to finance growth within the energy sector.

¹¹⁶ Aziz, Rashid and Munawar Baseer Ahmad. 2015. *Pakistan's Power Crisis: The Way Forward*. P. 2

¹¹⁷ Malik, Afia. 2012. *Power Crisis in Pakistan: A Crisis in Governance?* PIDE Monograph Series. Islamabad: Pakistan Institute of Development Economics. P. 23

¹¹⁸ Arif Habib Limited. 2014. *Pakistan Strategy 2014: 2014 Unfolds another Chapter of a Growth Story!* P. 18

Chapter Five

Telecommunications

The telecommunications sector plays an important role in the overall development of the Pakistani economy by providing core communication services that reduce transaction costs of doing business.¹¹⁹ The availability of telecommunications infrastructure and services such as cellular towers, help centers and data centers is an integral tool that economies require to develop.¹²⁰

Since 2000, the telecommunications sector has been one of the fastest growing sectors in the Pakistani economy. Between 2001 and 2015, the sector has attracted USD 7.2 billion in foreign direct investment. With a consumer base of over 121.13 million cell phone subscribers, 2.2 million broadband subscribers, and 30 million Internet users, the sector is ripe with opportunity for foreign investors.¹²¹ In their Investment Strategy Report, KMPG wrote of Pakistan as becoming the “destination of choice” for several international information and technology companies looking to relocate their operations offshore.¹²²

¹¹⁹ Ahmad, Fahad et al. *Telecommunication Sector: Its Role, Contribution to FBR Revenue, Problems and Issues*. Abstract. Directorate General of Training and Research, (IR) Lahore. Accessed January 2016.

http://www.dgtrdt.gov.pk/Research/37th_synndicate_%20rports/6.pdf

¹²⁰ Mahmood Pannu, Qaisar. 2010. *Factors Influencing FDI in the Pakistan Telecom Sector*. Masters of Business Administration, School of Management Blekinge Institute of Technology. P. 45. Accessed February 2016.

<http://www.diva-portal.se/smash/get/diva2:830980/FULLTEXT01.pdf>

¹²¹ *IT & Telecom Sector Overview*. Prime Minister's Office Board of Investment, accessed December, 2015, <http://boi.gov.pk/Sector/SectorDetail.aspx?sid=5>.

¹²² KMPG. 2013. *Investment in Pakistan*. P. 23

However, FDI inflows to Pakistan's telecommunications sector have declined significantly since 2008. This chapter studies the variations in inflows of FDI between 2000 and 2014, analyzing the role of government efficiency, national security, and global investment levels on FDI inflows to the telecommunications sector in Pakistan. This chapter argues that the decline in government effectiveness and in security conditions since 2008 has diminished the attractiveness of Pakistan's telecommunications sector as a viable investment destination for foreign investors. Section One of this chapter provides an overview of Pakistan's telecommunications sector, and discusses how ownership of companies has shifted from the government to the sector. Sections two, three and four discuss the influence of government efficacy, national security, and global investment trends on inflows of FDI to the telecommunications sector. The final section of this chapter analyses the impact that each of these variables is likely to have on the ability of Pakistan's telecommunications sector to attract FDI inflows in the future.

5.1 An Overview of the Telecommunications Sector in Pakistan

In 1947, the Post and Telegraph Department was all that existed of the Telecommunications sector. In 1962, the Department was separated into two distinct units: Pakistan Post Office Department and the Pakistan Telephone and Telegraph Department. The separation was motivated by the availability of new and cheaper communications technology, which incentivized the creation of an entity exclusively dedicated to expanding the telecommunications sector. In 1991, the Pakistan Telephone and Telegraph Department was renamed the Pakistan Telecommunication Corporation (PTC). The PTC took over the functions and operations of its predecessor. The same

year, the Pakistan Telecommunications Corporation Act was signed. This Act illustrated the government's focus towards encouraging private sector participation in the telecommunications sector. It served as the platform through which the Pakistani government announced its intention to privatize the PTC.¹²³ By 1996 the PTC was restructured as a public limited company named Pakistan Telecommunication Company Limited (PTCL) listed on the Karachi Stock Exchange. The restructuring was part of the Pakistan Telecommunication Re-Organization Act of 1996 which mandated the formation of the Pakistan Telecommunication Authority (PTA). Although still a government agency, the PTA was structured as an independent regulator of the telecommunications sector, and was responsible for creating "a fair regulatory regime to promote investment, encourage competition, protect consumer interest and ensure high quality Information and Communication Technology (ICT) services."¹²⁴ The PTA provided policy recommendations to the Pakistani government regarding improvements and changes required within the telecommunication sector, and implemented any policies pertaining to the telecommunications sector.

In July 2003, the PTA announced the Deregulation Policy, which further open the telecommunications sector for local and foreign investors to provide better services at competitive prices.¹²⁵ In 2004 the PTA introduced the Mobile Cellular Policy, liberalizing the cellular services sector in order to attract foreign investors as well.¹²⁶ By March 2006, the Pakistani government had sold 26% of PTCL's shares and transferred management

¹²³ Ahmad, Fahad et al. *Telecommunication Sector: Its Role, Contribution to FBR Revenue, Problems and Issues*. P. 8

¹²⁴ Mahmood Pannu, Qaisar. 2010. *Factors Influencing FDI in the Pakistan Telecom Sector*. P. 46

¹²⁵ Ibid. P. 63

¹²⁶ Ibid. P. 72-73

control to Etisalat—a U.A.E. based company. The privatization of PTCL effectively ended the Pakistani government’s monopoly over the telecommunications sector.

By 2005-06, FDI inflows to the telecommunications sector had increased to USD 1.94 billion, the highest annual inflow of FDI the sector has ever received (Figure 4). The exponential growth in FDI inflows to the telecommunications sector shortly after the introduction of the 2003 Deregulation Policy suggests that foreign investors were at least partially incentivized by the investment regime established within the sector.

Besides a liberalized investment climate, the telecommunications sector also presented extensive growth opportunities for foreign investors. Teledensity, defined as the number of telephone connections for every hundred individuals living within an area, grew from 6.25 in 2003 to 44.06 in 2006 (Figure 8).¹²⁷ Nearly seven million new connections were added on average in every quarter during the fiscal year 2006-07.

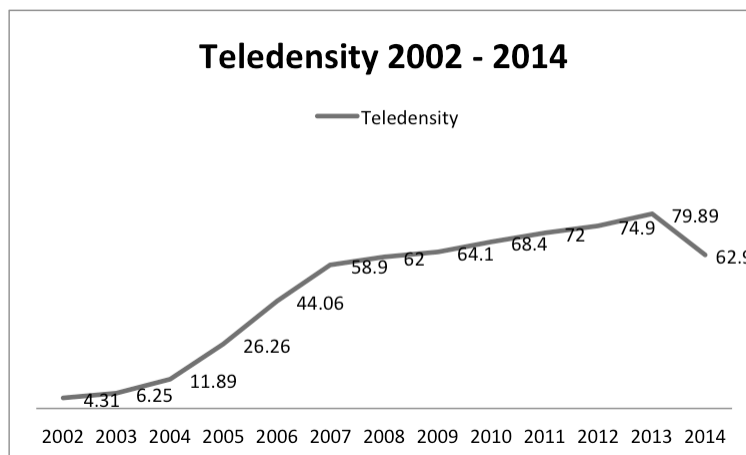


Figure 8: Teledensity in Pakistan 2002 – 2014
Source: PTA, Author’s Calculations

Given the favorable investment climate that emerged in 2003 due to a liberalized foreign investment regime and high market growth potential, the telecommunications sector attracted several foreign investments. Between 2006 and 2007, three deals were

¹²⁷ PTA figures

signed: First, Orascom Telecom, an Egyptian company with 88% stake in Mobilink, the largest cellular operator of Pakistan, acquired the remaining 11% stake in Mobilink from a local investor for USD 290 million.¹²⁸ Second, Warid Telecomm, a U.A.E. based company, finalized a deal with Singtel, which acquired a 30% stake in Warid Telecom for USD 758 million.¹²⁹ Third, CM-PAK of China Mobile injected USD 700 million in Pakistan's telecommunications sector, focusing primarily on expanding its network in rural areas. This deal was part of a larger USD 2 billion investment plan for the next three years, with all financing coming from China.¹³⁰

However, by 2008-09 FDI inflows to the telecommunications sector fell sharply, and have not been able to recover since (Figure 4). The decline in inflows of FDI to the telecommunications sector mirrors the decline in FDI inflows to the Pakistani economy. According to the Ministry of Finance in Pakistan, the Pakistani economy faced a series of unexpected and severe shocks during 2008-09. Negative shock came from severe macroeconomic crises that cause several policy-induced imbalances, reducing the amount of foreign capital available to finance and invest in the economy.¹³¹

The sudden reversal in growth of FDI inflows to the telecommunications sector is still surprising, especially given that teledensity grew consistently until 2013, indicating the continued presence of strong growth opportunities (Figure 8). The fact that telecommunications was unable to recover FDI inflows after the global crash of 2008, suggests that growth was not exclusively limited by a decline in international investment

¹²⁸ Inam, Asif. 2007. *Foreign Direct Investment in Pakistan's Telecommunications Sector*: Pakistan Telecommunication Authority. P. 23. Accessed January 2016. https://www.itu.int/ITU-D/finance/work-cost-tariffs/events/tariff-seminars/Korea-07/presentations/FDI_Aasif_Inam.pdf

¹²⁹ Ibid. P. 23

¹³⁰ Ibid. P. 24

¹³¹ Hameed, Sadika. 2014. *Opportunities in the Development of Pakistan's Private Sector*: Center for Strategic and International Studies. P. 79. Accessed October 2015. http://csis.org/files/publication/140917_Hameed_PakistanPrivateSector_Web.pdf

levels. The following sections of this chapter examine the effects of government efficacy, national security, and global investment on inflows of FDI to the telecommunications sector between 2000 and 2014.

5.2 Government Effectiveness and Inflows of FDI to Telecommunications

The Pakistani telecommunications sector presents itself as a unique sectoral case study: the sector is almost entirely privatized and de-regulated, but is still monitored by the PTA. Following the 2003 Deregulation Policy, the PTA has been responsible for implementing and enforcing policies created by the Pakistani government. Private investors are allowed to own a 100% of equity, offered an initial depreciation allowance of 50% of plant, machinery and equipment cost, and charged only 0-5% percent customs duty on imports of plant, machinery, and equipment related to the telecommunications sector.¹³² Additionally, the PTA allows telecommunication companies to independently determine pricing structures. This allows investors to price products in a way that allows them to cover costs and compete with other companies in the sector. Unlike the complex tariff structure existent in the Pakistani Energy sector, independent pricing generates low political pressures and has well mapped risk and risk mitigation strategies, creating a friendly investment climate for private foreign investors.

Effective governance and policy implementation incentivizes foreign investors to invest in the telecommunications sector in Pakistan. Figure 9 presents a positive relationship between government effectiveness and FDI inflows to telecommunications.

¹³² Harianawala, Shabbir and Owais Aziz. *Pakistan Telecom Sector Overview*. Haidermota BNR. Accessed February 2016. <http://www.hmcobnr.com/includes/Telecom%20Sector%20Overview.pdf>

Higher levels of government efficacy correlate with higher levels of FDI inflows. The graph also presents the cluster of years between 2009 and 2014 in the bottom left hand corner, which indicates that the lowest levels of FDI inflows to the telecommunications sector were experienced when government effectiveness was also at its lowest.

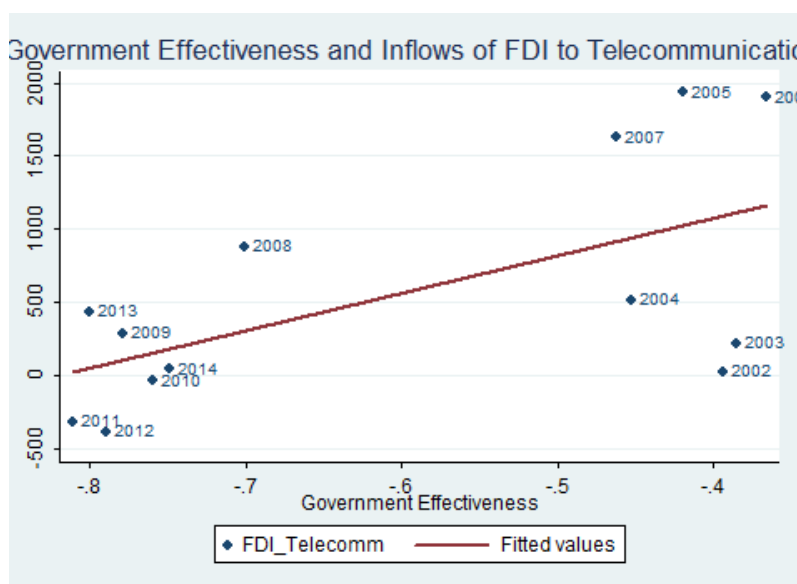


Figure 9: Correlation between Governance and FDI Inflows to Pakistan's Telecommunication Sector; Author's calculations

The transition to a weak democratic regime in 2007-08 resulted in the instatement of a government that has paid little attention to encouraging foreign investors to invest in the telecommunications sector. National elections in 2013 postponed the rollout of 3G cellular data service options. Such delays have weakened the quality of policy implementation and government efficacy in the telecommunications sector, and thus increased the perceived level of risk and uncertainty associated with investing in the telecommunications sector.¹³³

¹³³ 3G is the third generation of mobile telecommunications technology. This is based on a set of standards used for mobile devices and mobile telecommunications use services and networks that comply with the International Mobile Telecommunications-2000 specifications by the International Telecommunication Union

Additionally, even though the telecommunications sector offers one of the most liberalized investment policies, tax rates within the sector are some of the highest in the world. The telecommunications sector in Pakistan is charged a corporate tax rate of 34%.¹³⁴ The Pakistani government has also increased tax rates for consumers. In 2014, cellular subscribers were paying 19.5% GST, 15% withholding tax, and up to 8% of service charges on telecommunication services.¹³⁵ Such a tax structure disproportionately affects low-income communities that are no longer able to afford services that cellular services provide. The inability of the telecommunications sector to provide low-income groups—a sizeable market in Pakistan—with access to communication services reduces growth opportunities available to the sector in Pakistan. Thus as the risks associated with government effectiveness have increased, the incentives offered to foreign investors have declined, thereby reducing the attractiveness of Pakistan’s telecommunications sector as a lucrative investment decision.

5.3 Security and Inflows of FDI to Telecommunications

The first time that the provision of security and the provision of telecommunication services were in conflict with each other was in 2004, when a bomb disposal squad found mobile phone technology used to detonate a bomb in Karachi.¹³⁶ Since then mobile phone controlled devices have often been used to detonate bombs

¹³⁴ Pomerleau, Kyle. 2014. *Corporate Income Tax Rates Around the World, 2014*: Tax Foundation. Accessed March 2016. http://taxfoundation.org/sites/default/files/docs/FF436_0.pdf

¹³⁵ GST: Goods and services tax; Baloch, Farooq. *Budget 2014-15: Giving Relief to the Telecom Sector*. The Express Tribune, June 3, 2014. Accessed March 2016. <http://tribune.com.pk/story/716958/budget-2013-14-giving-relief-to-the-telecom-sector/>

¹³⁶ Khan, Faraz. *Ban on cellular service: Police fear terrorists may use other means besides cellphones*. The Express Tribune, November 22, 2012. Accessed March 2016. <http://tribune.com.pk/story/469406/ban-on-cellular-service-police-fear-terrorists-may-use-other-means-besides-cellphones/>; accessed april 1 2016

during processions and political rallies. Cellular phones were used again in 2010 to detonate bombs during processions held on the 8th, 9th and 10th of Muharram.¹³⁷ While cases of shutting down cellular services were heard of as early as 2005 when cellular service in certain areas of Balochistan was restricted due to ongoing military operations, the government has started applying this strategy in most parts of the country, and at a wide range of events including religious or national holidays, protests, and marches.¹³⁸ A report published by the Institute for Human Rights and Business in 2015 writes:

“Telecommunication operators often bear the responsibility of executing government orders to shutdown communications, whether mobile networks in particular cities or regions, Internet access, or access to particular websites or messaging applications. The request process may be unclear, execution is technically complex, and there is in most cases virtually no transparency. In addition, it is still a difficult topic for companies to discuss publicly, due to the national security element.”¹³⁹

The increased frequency in cellular service shut downs has made it challenging for telecommunication operators to provide quality service to their customers and simultaneously cooperate with security agencies.¹⁴⁰ Deteriorating security conditions are affecting the work environment, and are influencing the decline in FDI inflows to the telecommunications sector in Pakistan. As observed in Figure 10, inflows of FDI to the telecommunications sector have dropped with a decline in security in the country.

¹³⁷ Ibid.

Muharram is the first month of the Muslim Calendar. It is mostly observed by Shia'a Muslims who mourn the martyrdom of Imam Hussain, grandson of the Prophet Muhammad in the Battle of Karbala. Imam Hussain was martyred on the 10th of Muharram.

¹³⁸ Purdon, Lucy (ed.). *Security v. Access: The Impact of Mobile Network Shutdowns*. Institute for Human Rights and Business. P. 17. Accessed April 1, 2016. <https://content.bytesforall.pk/sites/default/files/2015-09-Telenor-Pakistan-Case-Study.pdf>

¹³⁹ Ibid. P. 5.

¹⁴⁰ Ibid.

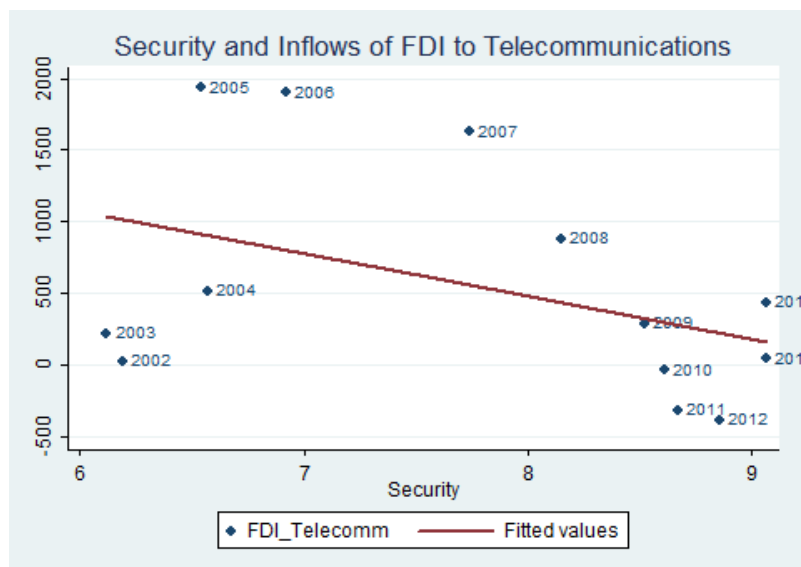


Figure 10: Correlation between Security and FDI Inflows to Pakistan’s Telecommunication Sector; Author’s calculations

In 2014, the National Action Plan introduced by the government to increase security provision affected the telecommunications. The National Action Plan required the PTA to plan, implement, and monitor the biometric re-verification of cellular SIM cards.¹⁴¹ While this drive has created a reliable and necessary database, it has caused a drop in teledensity for the first time since 2000. Teledensity dropped to 61.8% at the end of fiscal year 2015, from 79.6% in 2014. Further, the rollout of 3G and 4G cellular data services received less attention due to total priority being placed on the re-verification drive. Thus far, the provision of national security has been incompatible with the interests

¹⁴¹ In 2014, the Pakistani government launched a campaign requiring all cellular SIM cards—microchips that store the cellular phone’s number—to be re-registered under the owner’s name. The owner’s biometrics (fingerprints) were also taken, re-verified, and then matched to the cellular number. This information was then tallied and synced against the individual’s National Identity Card. While all new cellular numbers are verified through this process, older phones still needed to be checked. Numbers that could not be matched or identified against the owner’s information were disconnected. The motivation behind this strategy was to control deteriorating security conditions, limit the ease with which terrorists could access a cellular phone and number, and allow the government, army and intelligence units to trace numbers to suspects of terrorist activities.

According to the 2014 Investment Report by Arif Habib Bank, a total of 215.4 million cellular SIM cards were re-verified under this drive, out of which 114.9 million cellular SIM cards were identified as belonging to their rightful owners, while 98.3 million cellular SIM cards—including 26.7 million active cellular SIM cards—were blocked because ownership was inaccurately listed, or could not be verified. (Arif Habib Limited. 2014. *Pakistan Strategy 2014: 2014 Unfolds another Chapter of a Growth Story!* P. 9)

of the telecommunications sector in Pakistan, and has increased the uncertainty associated with investing in the sector. The consequences of providing higher levels of security have resulted in the deterrence of FDI inflows to the telecommunications sector in Pakistan.

5.4 Global Investment Trends and Inflows of FDI to Telecommunications

Liberalization of the telecommunications sector in the early 2000's contributed to an increase in levels of FDI to the sector. Immediate increases in inflows of FDI were observed following the implementation of the 2003 Deregulation Policy. The policy was created at a time that global inflows of FDI were rising. Until 2007, the relationship between global investment levels and inflows of FDI to the telecommunications sector remained positive, illustrating that higher levels of global investment correlated with higher levels of FDI inflows to the telecommunications sector (Figure 11).

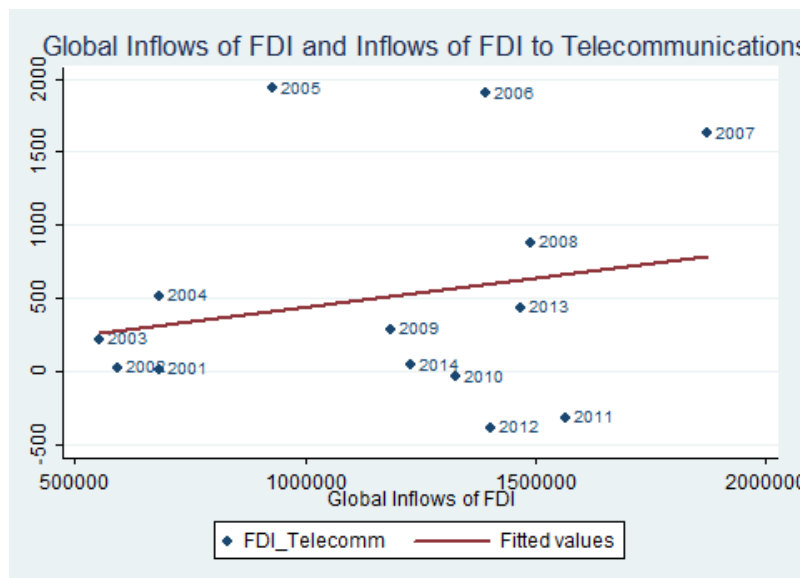


Figure 11: Correlation between Security and FDI Inflows to Pakistan's Telecommunication Sector; Author's calculations

It is possible that the telecommunications sector received higher levels of FDI inflows between 2000 and 2007 due to rising global investment. However, in the years between 2009 and 2014, global investment has remained high, while inflows of FDI to telecommunications have declined. Since 2010, the telecommunications sector has been receiving close to zero or negative inflows of FDI. Inflows of FDI to the telecommunications sector are moving away from the country at a time when there is a favorable international climate for attracting FDI inflows. Such a trend suggests that the decline in government effectiveness and the growing cost of security measures has increased the risk associated with investing in Pakistan's telecommunications sector.

In 2013, Prime Minister Nawaz Sharif promised a more "business friendly" agenda.¹⁴² He has sought to refocus attention on Pakistan's market potential through closer cooperation with foreign businesses and countries. Such an effort might allow for the telecommunications sector to re-attract more inflows of FDI in the upcoming years, making the sector a competitive and attractive investment opportunity once again.

5.5 Assessing the Impact of Government Effectiveness, Security, and Global Investment Trends on FDI Inflows to the Energy Sector

At the end of fiscal year 2014-2015, there were five major market players operating within Pakistan's telecommunications sector, each of which was entirely or partially owned by a foreign investor.¹⁴³ As a result growth in FDI inflows directly affects growth in Pakistan's telecommunications sector.

¹⁴² Purdon, Lucy (ed.). *Security v. Access: The Impact of Mobile Network Shutdowns*. P. 17

¹⁴³ Moblink (29.2% market share), Telenor (27.5% market share), CMPak (19.3% market share), Ufone (15.5% market share) and Warid (8.6%). (PTA Report 2014 – 15)

Between 2000 and 2014, the Pakistani telecommunications sector has experienced drastic changes in the levels of inflows of FDI. This inconsistency has partially been caused due to weakening government efficacy, which has led to a decline in policy enforcement, and the creation a highly exploitative tax regime. Increased government interference in the telecommunications sector through policies such as the National Action Plan have disrupted the capacity of companies operating within the telecommunications sector to provide consistent service. Weakened government effectiveness, and a decline in national security have contributed to outflows of FDI from Pakistan's telecommunications sector.

Today, while most urban areas are almost entirely connected to a grid, there are several rural areas that remain untouched. In order to access capital and technology necessary to develop a strong telecommunications market in rural areas, it is important for the government to develop partnerships with foreign companies in order to boost FDI inflows to the telecom sector. In doing so, the government also opens up the possibilities of developing rural areas through telecommunications; for instance, through the expansion of branchless mobile banking services such as *Easy Paisa* which allow for families in rural areas to access capital far more easily within their own communities.

The telecommunications sector has been able to benefit significantly from foreign direct investment, be that through access to capital, development of human capital, and overall economic growth and development. It is a sector that holds tremendous opportunity, and continuing to develop that opportunity will not only be instrumental for the growth of the sector, but also for the growth of the Pakistani economy at large.

Chapter Six

Financial Services

In an essay published in 2005 Dr. Ishrat Husain, former governor of the SBP wrote: “No economy can grow and improve the living standards of its population in the absence of a well functioning and efficient financial sector.”¹⁴⁴ He argued that economic development Pakistan is inter-related with the development of its financial services sector. It is argued that a well-developed financial services sector is a pre-condition for attracting FDI.¹⁴⁵ A strong financial system provides a more conducive investment climate in two ways: First it mobilizes savings, which increases the amount of resources available to finance investments. Second it monitors and facilitates investment projects, lowering acquisition costs and increasing the efficiency of on-going projects.¹⁴⁶ The strength of a country’s financial services sector is positively correlated with investor confidence regarding the capacity of investments to generate competitive rates of return.

The advancement of the financial services sector is crucial to the overall development of the Pakistani economy and its capacity to attract long-term and sustainable sources of FDI. Stability within the financial sector reduces the risk involved

¹⁴⁴ Husain, Ishrat. *Banking Sector Reforms in Pakistan*. Blue Chip – The Business People’s Magazine. January 2005. Accessed April 1, 2016. <http://www.bis.org/review/r050203e.pdf>

¹⁴⁵ Arshad Khan, Muhammad. *Foreign Direct Investment and Economic Growth: The Role of the Domestic Financial Sector*. PIDE Working Papers. Islamabad: Pakistan Institute of Development Economics. P. 24. Accessed November 2016. http://130.56.61.71/sites/default/files/documents/PIDE_Khan_2007_05.pdf

¹⁴⁶ Ibid. P. 14

in financial transactions, lowers the cost of financial intermediation, and optimizes the allocation of resources available in the economy.¹⁴⁷ Additionally the development of Pakistan's financial system determines the ease with which firms are able to borrow and access capital from financial institutions.¹⁴⁸

Since the privatization of major domestic banks in Pakistan during the 1990's, the financial services sector has expanded in size and become more competitive.¹⁴⁹ Relatively improved management as compared to the 1970's has increased profitability and reduced the number of non-performing loans.¹⁵⁰ Yet opportunities within the field remain largely unexploited. In 2014 only 13% of Pakistan's adult population had individual or shared accounts at formal financial institutions.¹⁵¹ The Pakistani population's limited access to financial services is an indicator of the lack of development in financial services and the availability of growth opportunities for foreign investors.

This chapter argues that weak government effectiveness and poor security conditions have contributed to limited development of the financial services sector in Pakistan. The first section provides an overview of the financial services sector in Pakistan. The next three sections discuss the effects of government efficacy, security and global inflows of FDI on inflows of financial services in Pakistan respectively. The final section of this chapter discusses the role that the Pakistani government can play in the future in order to improve and encourage FDI inflows to the financial services sector in Pakistan.

¹⁴⁷ State Bank of Pakistan. 2005. *Pakistan Financial Sector Assessment: Chapter 8 (Financial Sector Development)*. P. 145. Accessed February 2016. <http://www.sbp.org.pk/publications/FSA/2005/>

¹⁴⁸ Arshad Khan, Muhammad. *Foreign Direct Investment and Economic Growth: The Role of the Domestic Financial Sector*. P. 30

¹⁴⁹ Banks had been nationalized in the 1970's

¹⁵⁰ State Bank of Pakistan. 2009. *Pakistan 10 Year Strategy Paper for Banking Sector Reforms*. P. 3. Accessed March 2016. <http://www.sbp.org.pk/bsd/10YearStrategyPaper.pdf>

¹⁵¹ World Bank. *Financial Inclusion Data/Global Findex*. Accessed April 2016. <http://datatopics.worldbank.org/financialinclusion/country/pakistan>

6.1 An Overview of the Financial Services Sector in Pakistan

Prior to the early 1970's the financial sector in Pakistan comprised of a mixture of public and private banks. In the early 1970's Zulfikar Ali Bhutto, then Prime Minister of Pakistan, pursued an aggressive nationalization policy. Private domestic banks were nationalized and the role of public sector development finance institutions was expanded.¹⁵² Government-owned financial institutions dominated the financial services sector in Pakistan.¹⁵³ However, by the end of the 1980's it became apparent that the socio-economic development objectives had not been achieved by nationalization policies. Assessing the financial sector that existed towards the end of the 1980s, the State Bank of Pakistan concluded:

“The pre-dominance of [the] public sector in banking and non-bank financial institutions, coupled with the instruments of direct monetary control, were becoming increasingly responsible for financial inefficiency, crowding out of the private sector, deteriorating the quality of assets and rising vulnerability of financial institutions.”¹⁵⁴

By the early 1990's a number of amendments were made to the State Bank of Pakistan Act of 1956 and the Banks (Nationalization) Act of 1974.¹⁵⁵ The objective was to encourage privatization of Non-Commercial Banks, enhance competition in financial services by allowing the private sector to establish new banks, increase autonomy of the SBP in formulating and implementing monetary policy, and consolidate the role of the SBP as a regulator of banks and non-bank financial institutions.¹⁵⁶ In 1991 the private

¹⁵² State Bank of Pakistan. 2000. *Financial Sector Assessment 1990-2000: Executive Summary*. P. 1. Accessed March 2016. <http://www.sbp.org.pk/publications/fsa/>

¹⁵³ Ahmad, Usman, Shujaat Farooq, and Hafiz Hanzla Jalil. 2009. *Efficiency Dynamics and Financial Reforms: Case Study of Pakistani Banks*. International Research Journal of Finance and Economics (25): 173-181. P. 173.

¹⁵⁴ State Bank of Pakistan. 2000. *Financial Sector Assessment 1990-2000: Executive Summary*

¹⁵⁵ State Bank of Pakistan. 2000. *Financial Sector Assessment 1990-2000: Chapter 2 (Financial Sector Reforms During 1990s)*. P. 3.

¹⁵⁶ Ibid.

ownership of banks was permitted. The government liberalized investment policies in order to attract foreign and domestic private sector investors towards Pakistan's financial services sector. Ten new private banks were authorized to operate in 1991. Market share of private domestic and foreign banks increased from 7% in 1990 to 44% in 2000.¹⁵⁷

By 2000, Pakistan's investment policy provided complete freedom of investment to foreign investors investing in the financial services sector. The State Bank of Pakistan (SBP) only required foreign investors to register all FDI inflows with the bank. Otherwise, foreign investors were free to repatriate profits and dividends, and dis-invest from the country at any point without prior approval from the SBP.¹⁵⁸

In 2014 the financial services sector in Pakistan consisted of thirty-eight Commercial Banks, ten Microfinance Banks, and eight Development Finance Institutions. Domestic private banks held approximately 78% of total assets of the banking system, while public sector and foreign banks held a 20% and 2% share in total assets respectively.¹⁵⁹ FDI inflows to the financial services sector have closely matched national FDI inflow trends. Inflows remain minimal until 2005-06, after which they rise sharply for the next two years (Figure 4). Inflows of FDI to the financial services sector surpass those going to the telecommunications sector in 2007-08. However, the financial services sector was unable to revitalize inflows of FDI after 2008. The next three sections of this chapter assess the ways in which government effectiveness, security, and global investment levels have affected FDI inflows to the financial services sector. In doing so,

¹⁵⁷ Burki, Abid A. and Niazi, G.S.K. Impact of Financial Reforms on Efficiency of State-Owned, Private and Foreign Banks in Pakistan. Center for Management and Economic Research Working Paper Series. Lahore: Lahore University of Management Sciences. P. 3. Accessed February 2016.

http://130.56.61.71/sites/default/files/documents/LUMS_Burki_2006.pdf

¹⁵⁸ Financial Services Sector Overview. Prime Minister's Office Board of Investment. Accessed December, 2015, <http://boi.gov.pk/Sector/SectorDetail.aspx?sid=9> BOI financial services sector

¹⁵⁹ Ibid

this section studies the causes behind weak inflows to the financial services sector pre-2006 and post-2008.

6.2 Government Effectiveness and Inflows of FDI to Financial Services

Until the end of the 1980's, public sector financial institutions held the bulk of assets, deposits, and investments of Pakistan's financial sector.¹⁶⁰ High government borrowing, bank-by-bank credit ceilings, interest rate controls, and subsidized credit characterized Pakistan's financial system.¹⁶¹ The system required excessive government monitoring, management and supervision, making it very ineffective. The financial structure was not conducive for meeting the growing financial needs of the economy.

Thus, the government implemented broad-based reforms in order to liberalize the financial services sector in the 1990's. Private banks were allowed to operate and compete with publicly owned commercial banks. These reforms were focused towards attracting FDI into the economy.¹⁶² By the end of 1991, the International Finance Corporation ranked Pakistan as one of the leading emerging markets in the world.¹⁶³

The Musharraf government continued to liberalize Pakistan's financial services sector. The Administration chose to not keep banks under government ownership and control, and decided to privatize and consolidate them instead. The government injected 30.7 billion rupees into the financial services sector to offset the losses incurred by

¹⁶⁰ State Bank of Pakistan. 2000. Financial Sector Assessment 1990-2000: Chapter 1 (Pre-Reform Structure in 1990)

¹⁶¹ Ibid.

¹⁶² Ejaz Ali Khan, Rana and Qazi Muhammad Adnan Hye. 2014. Foreign Direct Investment and Liberalization Policies in Pakistan: An Empirical Analysis. *Cogent Economics and Finance* (2): 1-12. Accessed February 2016. <http://www.tandfonline.com/doi/pdf/10.1080/23322039.2014.944667>

Foreign direct investment and liberalization policies in Pakistan: An empirical analysis. 9

¹⁶³ State Bank of Pakistan. 2000. Financial Sector Assessment 1990-2000: Chapter 1 (Pre-Reform Structure in 1990). P. 7-8

nationalized commercial banks and to recapitalize them.¹⁶⁴ Such an initiative helped to increase trust in government effectiveness and boost investor confidence in the financial services sector. Additionally, during the Musharraf government, professional bankers were appointed as Chief Executives, while experienced and reputable businessmen were invited to join the Board of Directors. Shaukat Aziz, Minister of Finance from October 1999 till November 2007, was appointed as Prime Minister as well in 2004. According to Majid Munir, Mr. Aziz was “the right man doing the right job.”¹⁶⁵ A professional economist and financier, Mr. Aziz understood the nuances of the Pakistani economy. His efforts to maintain cordial and friendly relationships with major trading and investor countries allowed for Pakistan to be seen in a positive light within the international investment community. By establishing a balance between freedom and oversight in the financial services sector, the government created a positive investment climate attractive to foreign investors.

The system quickly unraveled after 2008, when Asif Zardari was elected president of Pakistan. At this time the weakened global economic climate demanded an effective government in Pakistan. The fragile democratic government’s inability to provide effective governance and direction at a time of economic despair resulted in the departure of several foreign banks from Pakistan. HSBC, ABN-AMRO, and the Royal Bank of Scotland all closed up operations between 2008 and 2013.¹⁶⁶ Foreign banks that stayed reduced operations: The American owned Citibank downsized from fifteen branches in

¹⁶⁴ Husain, Ishrat. *Banking Sector Reforms in Pakistan*

¹⁶⁵ Majid Munir in discussion with the author, February 2016

¹⁶⁶ *HSBC sells Pakistan arm*. The Telegraph. September 10, 2012. Accessed April 2016. <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9533856/HSBC-sells-Pakistan-arm.html>; *RBS to sell off its Pakistan bank*. BBC News. Accessed April 2016. <http://www.bbc.com/news/10133868>

Pakistan, to three branches only, between 2008 and 2010.¹⁶⁷ Credit Suisse, a Swiss bank closed operations in Pakistan after 2008, even though they still had an active operating license.¹⁶⁸

Ineffective governance under the Zardari presidency also contributed to the expansion of Pakistan’s informal economy. The difficulty of accurately accounting for jobs and income generated through the informal economy resulted in a lot of economic activity being hidden from the analysis regarding Pakistan’s market potential. The inability of the Pakistani government to transfer operations of the informal economy into the formal economy resulted in an under-representation of domestic economic performance. Weak government effectiveness thus led to the underweighting of economic opportunity and the overweighting of investment risks by foreign investors. This perception deterred FDI inflows to the financial services sector in Pakistan.¹⁶⁹

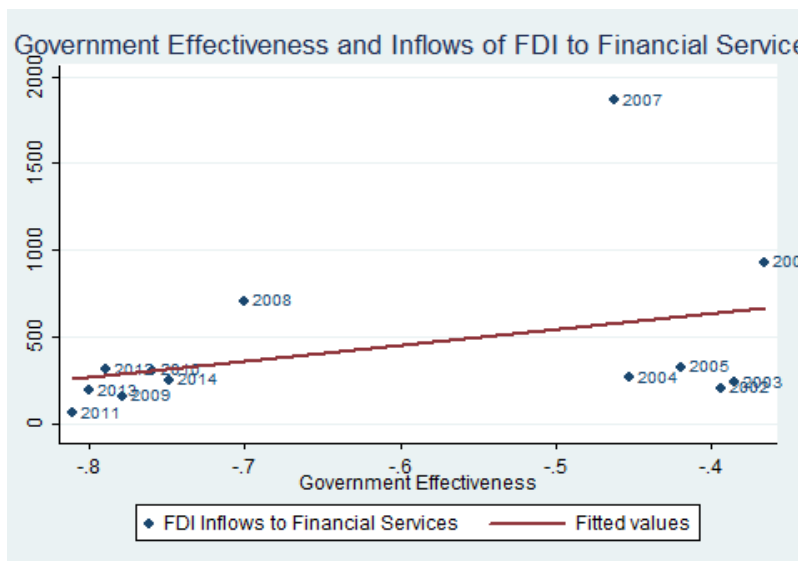


Figure 12: Correlation between Government Effectiveness of FDI and FDI Inflows to Pakistan’s Financial Services Sector; Author’s calculations

¹⁶⁷ Majid Munir in discussion with the author, February 2016

¹⁶⁸ Ibid.

¹⁶⁹ The informal economy is the diversified set of economic activities, enterprises, jobs, and workers that are not regulated or protected by the state. The concept originally applied to self-employment in small, unregistered enterprises. It has been expanded to include wage employment in unprotected jobs.

Between 2000 and 2014, financial services in Pakistan has benefitted from higher levels of government effectiveness. A more effective government is likely to attract higher inflows of FDI to the financial services sector. This intuition aligns with the relationship observed in Figure 12: higher levels of FDI to the financial services sector in Pakistan correlate with better government effectiveness.

There are two main clusters of years in the bottom half of Figure 10. The one on the right includes years from 2002 till 2005, while the cluster on the left includes years from 2008-2014. Both clusters have similar levels of inflows of FDI to the financial services sector. However, governance is far more effective between 2000 and 2005, as compared to 2008 till 2014. This discrepancy suggests that while government efficacy is important to attracting FDI to the financial services sector in Pakistan, it is not exclusively contributing to inclines and declines of FDI inflows to the sector either.

6.3 Security and Inflows of FDI to Financial Services

Karachi is the financial and commercial hub of Pakistan. It is also a city that has been experiencing high levels of security crises such as terrorist attacks and grave political instability. The assassination of Benazir Bhutto in December 2007 was carried out on Shahre-Faisal, the financial vein of the city. The concentration of financial services in a highly insecure city has deterred foreign investors from investing in Pakistan.¹⁷⁰ According to the Economic Survey of Pakistan, the economic loss due to incidents of terrorism is USD 106.98 billion. Annual economic losses started to increase steadily in 2007, and peaked in 2011.

¹⁷⁰ Pratima Singh (Senior Analyst at Frontier Strategy Group) in discussion with the author, January 2016

Limited security provision has most directly started to affect small and medium size enterprises (SMEs) in Pakistan. The poor security situation has resulted in the repeated closure of small businesses due to “unexpected holidays” that are announced by the government due to bomb blasts, strikes organized by political parties, and riots. The inability of small businesses to generate adequate revenue directly affects their capacity to service debt.¹⁷¹ Given that SMEs constitute nearly 90% of all enterprises in Pakistan, their inability to perform due to security concerns significantly affects economic growth prospects in Pakistan.¹⁷² These concerns are factored into the analysis of foreign financial institutions that would much rather invest in a lower risk investment opportunity.

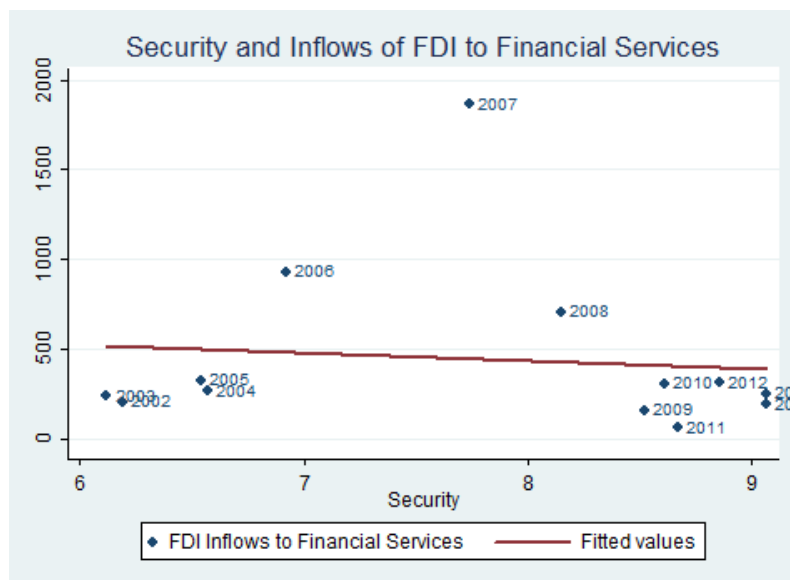


Figure 13: Correlation between Security and FDI Inflows to Pakistan’s Financial Services Sector; Author’s calculations

However, the data on the relationship between security and FDI inflows to the financials sector is fairly ambiguous (Figure 13). A weak positive relationship between

¹⁷¹ Alam, Kazim. *PMN Survey: Poor security dampens microfinance industry*. January 11, 2015. Accessed April 2016. <http://tribune.com.pk/story/820207/pmn-survey-poor-security-dampens-microfinance-industry/>

¹⁷² Small and Medium Enterprises Development Authority. *State of SMEs in Pakistan*. Accessed April 2016. http://www.smeda.org/index.php?option=com_content&view=article&id=7:state-of-smes-in-pakistan&catid=15

security and inflows of FDI to the financial services sector exists, which indicates that FDI to the financial services sector in Pakistan has been low when security provision has been weak within the country. However, the correlation has become more significant since 2009. The cluster of years in the bottom right of Figure 13 indicates that lower levels of security provision have strongly correlated with low levels of FDI in the financial services sector between 2009 and 2014. The trend suggests that security risks have likely become more of a concern for foreign investors since 2008, and have deterred FDI inflows to the financial services sector.

6.4 Global Investment Trends and Inflows of FDI to Financial Services

Foreign investors are mainly attracted by strong economic fundamentals in host economies.¹⁷³ These include market size, level of real income and possibilities for the expansion of business activities. However, structural weaknesses in Pakistan's economy, such as power shortages that lead to an underutilization of industrial capacity, rising costs of production, circular debt, and trends in the decline in FDI, reinforce the perception that Pakistan is not a viable place for FDI.¹⁷⁴

In many ways, the financial services sector serves as a mediator and facilitator of FDI inflows being injected into the rest of the economy. Trends in the national economy serve as a magnified mirror for trends observed in the financial services sector. Higher levels of FDI inflows to Pakistan indicate correspondingly high levels of FDI inflows to the financial services sector. As a result, factors limiting inflows of FDI to the national

¹⁷³ Ejaz Ali Khan, Rana and Qazi Muhammad Adnan Hye. 2014. Foreign Direct Investment and Liberalization Policies in Pakistan: An Empirical Analysis. P. 4.

¹⁷⁴ Taimour Noorani in discussion with author, March 2016

economy, such as poor government efficacy and weak security provision will invariably affect and constrain the performance of the financial services sector.

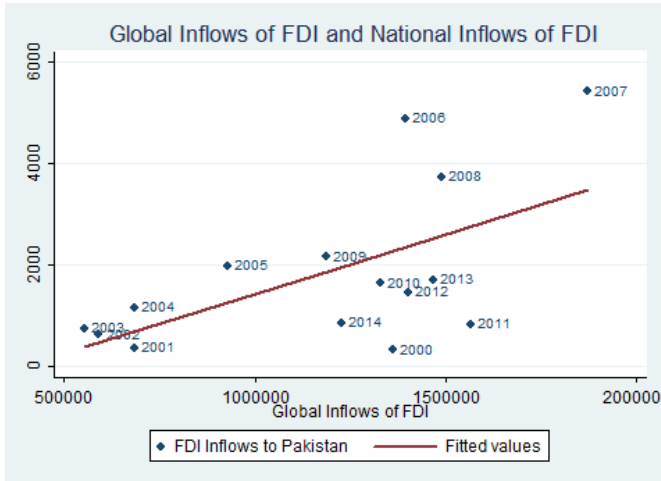


Figure 14a: Correlation between Global Inflows of FDI and FDI Inflows to Pakistan; Author's calculations

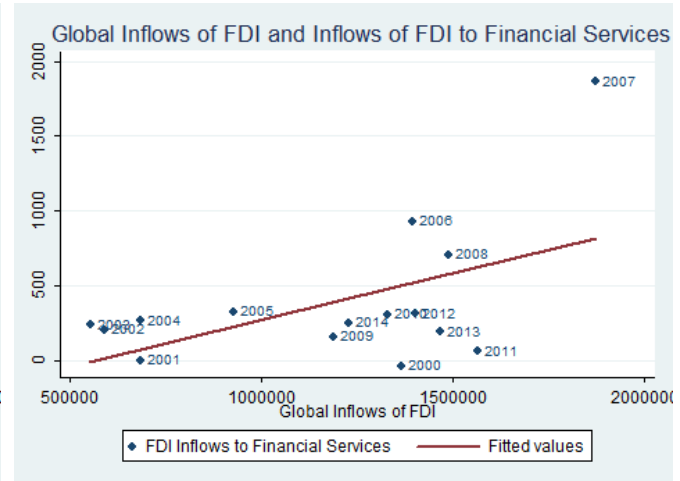


Figure 14b: Correlation between Global Inflows of FDI and FDI Inflows to Pakistan's Financial Services Sector; Author's calculations

The relationship is observed in Figure 14a and 14b. The relationship between global inflows of FDI to Pakistan, and global inflows of FDI to Pakistan's financial services sector is almost entirely the same. Thus, in order to understand the factors limiting inflows of FDI to the financial services sector in periods of economic growth, it is necessary to understand the factors restricting inflows of FDI to the Pakistani economy at large. This thesis has argued that weakening government efficacy and declining security provision has increased the risk associated with investing in Pakistan. Poor governance and security is therefore going to deter foreign investors away from Pakistan's financial services sector as well.

6.5 Assessing the Impact of Government Effectiveness, Security, and Global Investment Trends on FDI Inflows to the Energy Sector

Financial markets affect both the financing of investment and day-to-day business activities.¹⁷⁵ Well-developed financial markets encourage entrepreneurial activities and output, encouraging a positive feedback effect on FDI inflows to the financial services sector, and then to other sectors in the country.

Since 2008, perceived levels uncertainty associated with investing in Pakistan have increased. The simultaneous weakening of governance in Pakistan, decline in domestic security, and crash of the international financial system contributed to the sharp decline in inflows of FDI to Pakistan, and thus, to Pakistan's financial services sector. Continued government inefficacy and security deterioration has resulted in Pakistan's inability to gain fully from growth in global investment since 2009.

If the Pakistani government is to boost national FDI inflows, it must work towards strengthening the nation's financial services sector in order to boost Pakistan's image as a viable destination for foreign investors. There is a need for effective leadership in the State Bank of Pakistan that can increase the ease with which foreign investors can invest in Pakistan. The government must also focus on expanding the role of the formal economy, and increase security provisions, particularly in Karachi. If they are to increase FDI inflows to Pakistan, the Pakistani government must reduce risk and uncertainty perceptions regarding the investment climate in Pakistan. Working towards this goal by strengthening the country's financial services sector allows for the country to sustainability achieve this goal.

¹⁷⁵ Arshad Khan, Muhammad. Foreign Direct Investment and Economic Growth: The Role of the Domestic Financial Sector.

Chapter Seven

Conclusion

Foreign Direct Investment has become an integral part of the effort to create an open international economic system, and is considered a key provider of capital and advanced technology in developing countries. Maintaining a consistent partnership with the foreign private sector, allows developing economies to stimulate economic growth and development independent of solely relying on foreign assistance.

Since the 1990's, several developing countries have liberalized their economies in order to incentivize foreign investors, and have succeeded in attracting substantial amounts of FDI.¹⁷⁶ The Pakistani experience, however, has been different. In spite of offering one of the most liberal foreign investment regimes in Asia, Pakistan has been unable to attract or maintain substantial inflows of FDI since 2008. Motivated by this puzzle, this thesis examined and assessed the internal and external factors affecting the inclines and declines in FDI inflows to Pakistan between 2000 and 2014. Undertaking a comparative sectoral analysis, this study compared the effects of government effectiveness, national security, and global investment trends on FDI inflows to three sectors in Pakistan: Energy, Telecommunications and Financial Services. This study has argued that declining government effectiveness and poor national security provision has contributed to an increase in perceived levels of risk and uncertainty associated with

¹⁷⁶ Khan H., Ashfaque and Yun-Hwan Kim. 1999. Foreign Direct Investment in Pakistan: Policy Issues and Operational Implications, p. 33

investing in Pakistan. This thesis has demonstrated that Pakistan's capacity to attract desirable levels of FDI inflows was diminished after 2008. Foreign investors were more unwilling to pursue high-risk, high-return investment opportunities such as those offered in Pakistan during a global financial crisis.

This study began by providing a brief overview of international development models that have existed since the 1950's. By examining the evolving role of government and the private sector in international development efforts, this thesis discussed the growing importance of finding a sustainable partnership between these two actors in the post-2015 development agenda. Having established the need for cooperation between the public and private sector, this thesis discussed the particular role of FDI as a provider of development finance and a driver of economic growth and development. The study then introduced Pakistan as an important case study, and offered an overview of the country's relationship with FDI since the 1970's. The historical analysis reviewed the Pakistani government's stance regarding private sector involvement in the domestic economy, and discussed the ways in which economic policies have evolved from widespread nationalization towards liberalization and privatization. This study argued that the active effort by the Pakistani government to encourage FDI inflows in the 1990's was indicative of the nation's realization of FDI's role as a driver of economic growth and development. Having established the reasons behind the Pakistani government's pursuit of economic liberalization, the study examined the factors affecting limited inflows of FDI to the country since 2008. By analyzing the trends in FDI inflows to the Energy, Telecommunications, and Financial Services sectors between 2000 and 2014, this study discussed the ways in which government efficacy, national security, and global inflows of

FDI promoted or limited the provision of an environment conducive to foreign investors in Pakistan. Each of the sectors had different relationships with the three independent variables, which indicated that the extent to which FDI inflows were affected by government efficacy, security, and global investment was unique to each sector.

This research has established that the liberalization of Pakistan's FDI regime has not served as an adequate or sufficient strategy for attracting higher inflows of FDI in the country. Between 2000 and 2014, FDI inflows to Pakistan were extremely variable, resulting in unbalanced economic growth and development.¹⁷⁷ If the Pakistani government is to pursue economic development through foreign private sector involvement, it will need to offer more consistent policies to foreign investors, and focus on the long-term implications of policy creation and implementation.¹⁷⁸ In addition to offering attractive policies, the Pakistani government must also focus on altering perceptions that foreign investors hold regarding the risk associated with investing in Pakistan. The government should identify methods of improving Pakistan's image as a viable and opportune host country by providing more effective policy enforcement mechanisms, offering infrastructure facilities and ensuring higher levels of national security.¹⁷⁹

The Pakistani government must also work towards revising, introducing and implementing policies particular to each sector. In the case of the Energy sector in Pakistan, the government must revisit the tariff and subsidy framework, and restructure current pricing strategies in order to reduce the costs associated with private power

¹⁷⁷ Interview with Shaista Khilji (Professor of Human and Organizational Learning at the George Washington University's Graduate School of Education and Human Development) in discussion with the author, March 2016

¹⁷⁸ Ibid; Majid Munir in discussion with the author, February 2016

¹⁷⁹ Khan H., Ashfaque and Yun-Hwan Kim. 1999. Foreign Direct Investment in Pakistan: Policy Issues and Operational Implications

production in the country. There is also a need to improve power generation and distribution facilities in the country. Within the telecommunications sector, the government must identify ways to partner with private companies regarding issues pertaining to national security provision, and reexamine the tax structure currently imposed on consumers of telecommunication services. Within Financial Services, the government should pursue strategies that improve Pakistan's image as a viable investment destination, thus incentivizing foreign banks to continue operations within the country. Within each of the sectors, the Pakistani government must consistently work towards developing long-term partnerships with foreign investors that align with the vision of the Post-2015 Development agenda, and further economic growth and development opportunities within the country.

It can be argued that the Pakistani government has started to move in this direction. The Board of Investment's Foreign Direct Investment Strategy 2013-2017 recognizes the limitations and risks associated with investing in Pakistan. The Report primarily focuses on marketing strategies that will improve Pakistan's image as a destination country for FDI. Additionally, the signing of the USD 46 billion CPEC trade deal between China and Pakistan will increase infrastructure facilities available in the country, particularly in energy, telecommunications and transportation. The trade deal is representative of the establishment of a long-term partnership that will further technological capacity, reduce the gap between investment and savings, and contribute to long-term economic advancement in Pakistan.

This research serves as an important first step in understanding the factors that have affected FDI inflows to Pakistan, and across sectors within the country. This paper

has demonstrated that ineffective governance and declining national security contribute to a reduction in inflows of FDI to Pakistan. In coming years, the Pakistani government's capacity in encouraging and maintain FDI growth will be crucial to the development of the domestic economy. The government will need to closely consider the types of FDI inflows being drawn to the country, and carefully assess how inflows affect domestic communities.¹⁸⁰ The pursuit of socio-economic advancement in Pakistan must be a collaborative effort between the public and private sectors. The role of the Pakistani government in developing, maintaining and facilitating this collaboration is going to continue to be crucial.

¹⁸⁰ Shaista Khilji in discussion with the author, March 2016

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