Chapter – III

POST-REFORM CHANGES IN FDI POLICY

After the conceptual discussion and historical review the study now focuses on changes in foreign investment policy that have been initiated consequent to the structural adjustment program (SAP) in the two countries. As a background to this discussion it is essential to study, briefly, the implications of the economic crisis and consequent adjustment policies in the two countries. This is essential since the changes in foreign investment policies was not solely a response to the changing perceptions of the government and internal interest groups on foreign direct investment but also as part of the structural adjustment package. Section 3.1 would briefly assess the implications of this structural adjustment package on the formulation of foreign direct investment policy.

The changes brought about in policy vary according to their scope. Some provisions have an impact on all industrial sectors and their sub segments. Others are aimed at attracting foreign investment in a specific sector. Similarly, while some are intended as regulations, albeit liberalised, others are in the form of incentives. Section 3.2 would study the former. This includes the changes in approval requirements, equity limits and tax regime. Section 3.3 studies the nature of incentives offered to attract foreign direct investment in different sectors of the economy. It studies those sectors individually, where substantial incentives have been offered. Privatisation, in Pakistan, offers an important source for attracting foreign inflows. Section 3.4 studies the nature of the process in Pakistan and the reasons for the difference in India's and Pakistan's privatisation policy vis-à-vis foreign investment. Section 3.5 concludes the chapter.

3.1 IMPLICATIONS OF THE STRUCTURAL ADJUSTMENT PROGRAM

The International Monetary Fund (IMF) has since its inception, played the role of a saviour for countries faced with a balance of payments (balance of payment) problem. But as reasons for the manifestation of the balance of payments problem changed, particularly among developing countries, the IMF too adopted changes in its rescue package. This new approach involved insisting on policy changes in the concerned
country's policies particularly those which had an impact on foreign exchange reserves. The main features of this modified approach were the insistence on reducing internal and external deficits and, in the case of controlled exchange rate system, liberalising the determining mechanism of exchange rates. An implicit feature of the package as directed by multilateral financial institutions, including the IMF, was effecting changes in the tariff regime and including "liberalisation of policy towards FDI among the conditionalities attached with structural adjustment financing support provided by them to developing countries".

The IMF has been accused of adopting these conditionalities in order to promote the interests of the developed countries in the developing country bloc. While this is partly true, there is a sound economic logic behind these policy prescriptions. Most important, at a macro level, a balance of payment deficit indicates a shortfall in the supply of foreign exchange as compared to demand. Hence policies to encourage foreign exchange inflows are necessary to overcome this shortfall. Besides, a balance of payment problem in developing countries' generally arises out of faulty implementation of industrial policies where inadequate attention is paid to the need for generating adequate foreign exchange reserves from non-debt sources. Nor is the foreign exchange dependent mode of industrial development modified, creating the need for continuous foreign exchange inflows. This is true of both India and Pakistan, as has been discussed in chapter two. Therefore, there is the need for not only addressing the shortage of foreign exchange but also ensuring efficient utilisation of these resources. In order to safeguard the security of loans advanced it has become increasingly inevitable for the IMF to impose strict conditionalities.

The balance of payment crisis faced by India (1991) and Pakistan (1987-88) (which is taken as the reference point in this study) also brought about a change in the attitude


2 Critics of developing country governments have dubbed the entire liberalisation process where these conditionalities and the willingness of the host states' as a process of mortgaging the country to the MNEs. C.V. Gopalakrishnan, "Render Unto the State", *The Hindu* (New Delhi), 26 August 1995.
of the governments and intelligentsia of the two countries towards foreign direct investment. This change is not unique to the two countries but has been a general feature seen in most developing countries. FDI is now recognised as a reliable non-debt source of foreign exchange which also encouraged increased industrial efficiency in the two countries. While the IMF package requires a general commitment by the recipient country in terms of deregulation and reduction of public expenditure, it does not directly impose specific conditions vis-à-vis foreign investment policies. It was the changed attitude among economic policy makers in terms of the need for deregulation and lower public expenditures that had a favourable impact on the process of liberalising foreign investment policies.

An important implication of an agreement with the IMF is the restoration of foreign investors’ confidence in the recipient country. A balance of payments crisis prompts such an erosion of confidence and aggravates the problem. During the crisis period in India (end 1990 - mid 1991), foreign investor confidence had fallen to such an extent that while there was a drain on existing foreign exchange reserves particularly foreign currency bank deposits, there was no hope for fresh infusion in the capital or current account. It was only due to subsequent agreements with the IMF that confidence levels were boosted and foreign investment began flowing in. The supply of foreign aid has prevented the rise of an acute crisis in Pakistan comparable to 1991 crisis in India. This does not imply the absence of a problem since the country too has had to approach the IMF for funding attempts to bring about a long-term improvement in its confidence rating.

As can be seen from the preceding discussion, the IMF imposed program of structural adjustment has implications for foreign direct investment policy by two means. First, it changes national attitudes towards foreign capital and inculcates a national consensus for ‘pro integration’ (with the global economy) among major components of the recipient’s state structure. Second, it acts as an approval agency on

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3 Nagesh Kumar, n. 1, p. 2.
the basis of which major sources of international capital, including multinational enterprises (henceforth referred to as MNEs) and foreign entrepreneurs, take investment decisions. The link is not very direct. Difficulties of crisis ridden states with the IMF delays disbursement of funds to tide over the crisis. This creates problems for the country to honour its debt repayment commitments besides other commitments to holders of foreign exchange such as foreign currency deposit holders. Such difficulties lead to downward grading by international rating agencies and fresh inflows of foreign exchange resources dries up. Thus the link between all forms of foreign investment with the implementation of the IMF package though indirect, is very significant.

An agreement with multilateral funding agencies has another indirect implication for a country’s foreign direct investment potential. These agencies insist that continued ownership and control by government of loss making and inefficient public sector units has to be reversed which encourages privatisation of these enterprises. This is particularly true of infrastructure industries, since they have a magnified impact on all other sectors of economic activity. The magnitude of investment and complexity of control required in these infrastructure units is beyond the potential of domestic entrepreneurs. Therefore the need to involve foreign firms comes in and a potential for foreign direct investment inflows is created.

3.2 CHANGES IN FDI POLICY

As seen in chapter two, Pakistan had passed a legislation in 1976 aimed at protecting and promoting foreign direct investment. India, on the other hand, had,

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S.J. Burki provides two instances that prove this linkage in the case of Pakistan. Prior to his assuming charge as the economic advisor in the 1997 caretaker government in Pakistan he had met several international bankers in London who were interested in committing resources to Pakistan but were unwilling to do so in the light of Pakistan's downgrading by international rating agencies. This downgrading was, in turn, the result of disagreements between the IMF and the Benazir administration which led to suspension of the previously initialled Structural Adjustment Program. S.J. Burki also states that the disagreement between the Benazir government and the IMF had led, not just to drying up of fresh foreign investment flows but also major withdrawals of previous investments. See S. J. Burki, "Pakistan Growth Set Back by Structural Rigidities", *The Pakistan Development Review*, 35 (4), Winter 1996, p. 327 and p. 336. Manmohan Singh as finance minister in 1991 had also pointed out that IMF support was required to regain India's international creditworthiness which was very low during the 1991 crisis. *Reply of the Finance Minister to the Motion to consider the Amendments to Finance Bill, 1991, 14 September 1991*. <http://www.parliamentofindia.nic.in/lsdeb/ls10/1409.htm>.
through legislation and otherwise indicated a hostile and suspicious attitude towards foreign direct investment. To a large extent, this was the case even in the eighties. Therefore it was India which had to bring about major modifications in its legislation and attitudes towards foreign direct investment, whereas Pakistan had only to deepen the efforts begun in the seventies. This can be seen to an extent in the post-reforms policy changes.

At the policy level India required several changes. The first was in the attitude towards the utility of FDI. Rather than focus on its ability to bring better technologies, it had to be viewed in terms of its ability to infuse financial capital and superior management resources into the economy. This was recognised when the then Finance Minister Dr. Manmohan Singh stated that while domestic resource mobilisation would continue to be the main source for investment, "...at the margin, foreign investment can play an important role in augmenting investible resources and upgrading our technological and managerial resources".

It is now apparent that the Indian state recognises the additional benefits from adopting a liberal attitude towards foreign direct investment. This change, though substantial, also contains an element of continuity, since both pronouncements and policies of the government (since 1991) indicates that the process of foreign direct investment approvals would continue with emphasis on identified priority sectors and closing other sectors for foreign direct investment. Hence an elaborate policy structure governing the entry of FDI as is discussed next.

3.2.1 Approval Process and Equity Limits

The main policy instrument in Pakistan governing foreign direct investment continues to be the 1976 Foreign Private Investment (Promotion and Protection)
Act\(^8\) (herein after referred to as the 1976 Act). There has been no replacement of this legislation in the changing context of economic liberalisation of the eighties or nineties. Rather, there has been a series of new packages announced by the two Benazir Bhutto and Nawaz Sharief regimes. These packages, aimed at improving the general investment climate in Pakistan, has brought about major changes in Pakistan's foreign direct investment policy during this period.

The Protection of Economic Reforms Act 1992, in Pakistan, brought a major modification to the 1976 Act. While the latter had a provision for nationalisation of foreign owned/controlled enterprises after payment of just compensation, the 1992 Act guaranteed against nationalisation of any enterprise whether owned by domestic or foreign entrepreneurs. This includes any enterprise transferred by the government to the private sector\(^9\). This is relevant in the context of privatisation of several public utilities and banks with control and equity being transferred to foreign firms and offers the maximum degree of protection against appropriation that foreign firms can ever hope for. The Indian government continues to retain the right to nationalise any industrial or service firm, domestic or foreign, after payment of due compensation.

A major initiative taken by Pakistan in the late eighties was abolition of approval requirements to set up new industries in most sectors\(^10\). It was a major change from the 1976 Act whereby a case by case approval procedure for foreign direct investment proposals was the legal norm. The 1997 Industrial Policy opened up the agriculture, services and social sectors for foreign investment, areas hitherto closed for FDI\(^11\). In the new phase of foreign direct investment regulations, there is no maximum ceiling on foreign equity holding which implies that foreign equity ownership (in permissible sectors) to the extent of 100 per cent is permitted. Similarly a foreign owned limited

\(^8\) The text of the act is provided in Board of Investment (BoI), Government of Pakistan (GoP), *Pakistan: Investment Policies*, (Islamabad; June 1998), pp. 45-48. The features of this legislation have been discussed in chapter two.

\(^9\) Ibid., pp. 50-51. For the full text of the Act see pp. 49-51.

\(^10\) Except for a negative list of four categories i.e. arms, ammunition and explosives; radio active substances; security printing, currency and mint; and alcohol no prior government sanction is required to set up a new industrial project. Ibid. p. 5.

\(^11\) Ibid., pp. 9-11.
company is under no obligation to offer shares to the public or include local partners regardless of its size\textsuperscript{12}. These are features targeted at attracting companies which prefer wholly owned foreign subsidiaries rather than joint ventures.

India has brought about several major changes in its foreign direct investment policy. While the pre-reforms focus has been on permitting foreign direct investment only with the aim of technology infusion, it is now permitted even without technology infusion. The emphasis on joint ventures (which was the route to ensure technology infusion) has largely been reduced. An ordinance promulgated in 1993 facilitated foreign enterprises to invest in India without attracting all the provisions of the FERA\textsuperscript{13}. Going further, the erstwhile approach of regulating FDI via the Foreign Exchange Regulation Act (FERA) is now set to change with legislative sanction accorded to the Foreign Exchange Management Act (FEMA).

The attitude in India that FDI as a whole needs to be regulated (which was the spirit of FERA) has now been replaced with the policy of governing the control structure of firms with foreign investment through foreign equity ownership limits. There exists, now (ironically in a liberalised context), a complex system of rules regulating the extent of foreign equity ownership. The 1991 Industrial Policy Resolution embodies most changes made by the government. The dividend balancing provision for FDI was retained only for 22 specified consumer goods and abolished for the rest\textsuperscript{14}. The Resolution abolished the requirement of prior licensing in most industrial sectors for domestic industry and introduced four categories of industries based on permissible levels of foreign equity ownership and eligible for, what is termed as Reserve Bank of India (RBI) automatic approval (henceforth referred to as the RBI route)\textsuperscript{15}.

The four categories were based on levels of foreign equity ownership at 50, 51, 74 and 100 per cent. Besides the level of foreign equity ownership, four conditions apply i.e.

\begin{itemize}
\item \textsuperscript{12} Ibid., p.10 and GoP, Finance Division, \textit{Economic Survey}, p.35.
\item \textsuperscript{13} ESCAP, \textit{Foreign Investment Incentive Schemes: India} (New York; 1994), p. 6.
\item \textsuperscript{14} Government of India(Gol), Ministry of Finance, \textit{Economic Survey 1992-93} (New Delhi; 1993), p. 121.
\end{itemize}
• capital goods imported must be new and not second hand;
• foreign equity must cover the entire foreign exchange requirement for capital goods imports;
• in the listed 22 consumer goods industries, foreign exchange outflows for dividend payments must be balanced by export revenue over a period of seven years of production;
• payment of royalties and know how must conform to specified parameters.  

In November 1997, the following changes in the conditions for RBI automatic approval were brought about:

• The condition that foreign equity must cover the cost of capital equipment imports was removed. These imports would, however, continue to be governed by provisions of the Exim Policy.
• Existing ceiling of Rs. one cr. payable as lump-sum fee for technology collaboration was revised to $ two million.

If a foreign investment proposal satisfies these conditions and the level of foreign equity is within the permitted limit, the proposal is cleared by the RBI. If a proposal does not conform to any one of these requirements it has to be submitted for the consideration of the government. The nodal agency for accepting the applications is the Secretariat of Industrial Approvals (SIA) while the decisions are taken by a committee comprising secretaries to the government and termed as the Foreign Investment Promotion Board (FIPB) (henceforth this mode of entry for FDI will be referred to as FIPB route).

The FIPB was set up in 1993 with a view to create an agency for screening foreign direct investment proposals which do not satisfy the RBI automatic approval route provisions, i.e. the government would like to scrutinise the proposal before granting permission. As was common in most developing countries, the need to demonstrate a high level commitment towards attracting foreign direct investment, led the government to create the FIPB (which is essentially a committee of government secretaries) under the Prime Minister’s Office with the principal secretary to the Prime Minister as the chairman of the Committee. This centralisation led to several problems including a slow clearance process. In 1996 the FIPB was transferred to the industries.

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17 *Business Standard*, 7 November 1996.
ministry and the clearance process speeded up considerably. If a proposal is deemed acceptable by the FIPB, it is referred to either the industry minister or the Cabinet Committee for Foreign Investment (for proposals over Rs. 6 bn.) for final clearance.

The Congress government of 1991-96, which initiated the present phase of reforms, had, time and again, repeated its commitment to create conditions which would lead to enhanced foreign direct investment inflows. This commitment was not entirely reflected in its policies except for the creation of the automatic approval category and FIPB. 35 broad industry groups were identified where 51 per cent foreign equity ownership was permitted. This list broadly included manufacturing industries which required modern technology and service sectors with a potential to generate high foreign exchange earnings (hotels and tourism)18.

The United Front (UF) government which assumed office in 1997 adopted a relatively more liberal position on foreign direct investment. A new thrust was added i.e. in addition to the objective of ensuring technology infusion, the objective of increasing investment levels irrespective of the technology component was accorded equal priority. In addition to manufacturing, the government also decided to permit foreign direct investment in selected service sectors. Similarly the new regime also emphasised that transparency in the approval process was vital to increase foreign direct investment inflows. The fact that this principle was adopted in action is borne out by the controversies regarding differences of opinion within the cabinet over specific proposals which came out in the open (as shall be seen later in this chapter). Even though public pronouncements indicated a preference for foreign direct investment in the core and infrastructure industries, an assessment of the FIPB clearances indicates the policy inclination to increase investment levels, even if most of these flow into non-core and non-priority sectors.

The broad policy motive of regulating foreign direct investment inflows continued. While the FIPB route was retained, the sectors covered under the various equity limits of the RBI route was expanded. Nine categories of industries were added to the list of industries where foreign equity to the extent of 74 per cent is permitted under the RBI

automatic approval category. These industries were primarily in infrastructure, electronics and software sectors. There were 16 new categories added to the list of sectors eligible for RBI automatic approval with a limit on foreign equity ownership of 51 per cent. This included capital goods, metallurgical industries, entertainment electronics, food processing, support services for mining and other service sectors with high export potential. The identification of new sectors were carried out on the basis of an analysis of both the potential advantages to the domestic economy in terms of export growth and foreign direct investment inflow trends in other developing countries19.

In practise, the RBI route was extremely narrow since most foreign proposals failed to meet all the criteria20. As the FIPB route had to deal with most foreign proposals and consider each proposal in terms of individual merit there was a large scope for bureaucratic discretion and hence ambiguity in the government’s attitude. As a solution, the Cabinet, in 1997, laid down a series of guidelines to be followed by the FIPB while considering each proposal. These guidelines include some provisions that were sector/industry specific and are discussed in the next section. Provisions that had a general application across all sectors included21:

- 100 per cent subsidiaries to be allowed in the case of:
  * exclusively holding operations where actual downstream investment proposals would require subsequent government approval;
  * proposals where proprietary technology is sought to be protected or sophisticated technology is being introduced;
- Where a foreign firm has expressed inability to find a local partner, 100 per cent foreign investment is permitted subject to divesting 26 per cent in three to five years to nationals (without retrospective effect).
- Foreign firms will be permitted to hike their stake in existing ventures to 100 per cent if local partners cannot finance any proposed expansion and technological upgradation in these existing ventures22.


20 The statistical indicators which highlight the relative unimportance of the RBI route has been discussed in chapter four.

21 All figures pertain to permissible limit for foreign equity ownership unless otherwise specified.

22 Gol, n. 15.
The last provision assumes increasing relevance since in a number of joint ventures, expansion plans (seen by the foreign partner as vital for survival and growth of the projects) remain stuck due to the inability of the local partner to raise has the inability of the domestic partner to raise his required share of equity capital. This provision permits an increase in the equity ownership of the foreign partner when the capital base of the joint venture has to be increased and the local partner is unwilling or unable to raise the required funds to maintain his share. Thus the guidelines made it clear that limits on foreign ownership of equity would not hamper the performance of joint ventures in the event of financial inability of the domestic partner in raising the sufficient equity capital.

Proposals involving an investment of less than $1 million and not coming under the purview of automatic RBI approval, would be first considered by the concerned ministry and if the ministry has no objection, this proposal would be deemed sanctioned by the FIPB. Only in the case of any objections by the concerned ministry, would the FIPB take up the proposal for consideration\textsuperscript{23}. There are some exceptional cases where even 100 per cent foreign equity ownership is permitted. The UF government had announced, in August 1996, that it would have no objection to 100 per cent foreign owned ventures in non-core sectors so long as it fulfilled either of the criteria outlined below:

- the project leads to significant employment generation;
- had backward linkages with the agricultural sector;
- brings in modern technologies not available in the country;
- has significant export promotion potential\textsuperscript{24}.

In October 1996, the FIPB decided that approval for 100 per cent foreign owned units, where no new technology is brought in, would be conditional on divesting part of the equity to nationals over a specified time frame. This was to be without retrospective effect\textsuperscript{25}. Despite this, fears were expressed by the American Business Council that the disinvestment norms were being applied to already approved projects and they met the


\textsuperscript{24}Gol, n. 15.

\textsuperscript{25}Ibid.

FIPB chairman in this connection. They cited that these ventures were being asked to follow the new criteria, which were not in force at the time of initial investment, when they approach the FIPB for permission to expand investments. Other issues cited were restrictive clauses not allowing repatriation of dividends for a period longer than originally envisaged. In some cases the board has put in riders to force such ventures to go public after a certain period. This shows the confusion that surrounded the policy implementation process due to the multitude of provisions and frequent changes being carried out in these provisions.

The element of small scale sector’s protection was taken into consideration during the formulation of FDI policy in India. Any venture with foreign equity that envisages production of an item reserved for the small scale sector is not permitted under the approval process unless it is specifically categorised as a small-scale unit. It then has to satisfy all the other conditions specified for the small scale sector. Foreign owned equity is limited to a maximum of 24 per cent. The only exception provided is for ready-made garment units who export 75 per cent or more of their output though no ceiling for foreign owned equity has been specified.

A major contribution of the UF government to the foreign direct investment policy in India was the speeding up of the clearance process. As compared to the previous Congress regime the rate of clearance went up dramatically (a detailed analysis is provided in the next chapter). Similarly as part of its thrust to impart transparency to the clearance process, the FIPB was required to give, in writing the reasons for non clearance of any project.

As seen from the preceding discussion, there were two implications of foreign direct investment which the government sought to regulate. First, the element of control of a firm i.e. in foreign hands and second, the balance of payments implications in terms of inflows and outflows of foreign exchange. While 50 per cent share in the equity base gives the holder control over normal firm operations, the company act specifies that

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26 Business Standard, 3 December 1996.
27 EIU, n.16, p. 18.
special resolutions require the approval of holders of 75 per cent shares. By placing the equity caps at 51 per cent and 74 per cent in the RBI automatic approval route the government indicated that while it was in favour of permitting majority control of firms by foreign partners in some sectors, it was against giving absolute control. The 74 per cent equity cap was a psychological measure since a promoter with this share of equity would not find it difficult to get the support of some shareholders and pass special resolutions. It appears to be an initiative, whereby selected sectors are made attractive for foreign promoters and simultaneously appeasing concerns of a foreign take-over of the economy among domestic interest groups.

In Pakistan's new foreign direct investment regime, the requirement for a No-Objection Certificate from the provincial government has been done away (with an exception of notified areas where provincial government approval would be required)\(^{28}\). Generally such a requirement has only created an additional layer of bureaucratic hurdles for foreign investors. In principle it is a step closer to ensuring an approval free investment climate. In India on the other hand, several clearances by provincial governments are required even after a proposal receives the Union government's clearance. This has led to delays in a number of foreign direct investment projects and has created other problems, particularly in the power sector as shall be seen later.

3.2.2 Employment of Foreign Nationals and Repatriation Provisions

The policy on repatriation of equity, royalty and consultancy fees has two ramifications. First, the policy has to be liberal enough to attract foreign investment. Second, it has long term balance of payments implications which have to be taken into considerations. They thus determine the immediate inflows and long term outflows of foreign exchange. In order to manage the balance of payments account, a motive that each successive government was wedded to, it is imperative that the long term implications of dividend repatriation and other forms of repatriations such as technical consultancy fees and royalties too is monitored. Since it would be cumbersome to regulate each and every individual repatriation, the government, in India, permits small

\(^{28}\) Bol, n. 8, p. 5.
amounts without any regulation (50 or 74 per cent of dividends of a small equity base firm, royalties of 5 per cent), it monitors the larger payments at the investment stage.

There is no permission required, in the two countries, for employment of foreign nationals. In Pakistan, the ceiling on payment of royalties and technical fees have been abolished. The erstwhile work permit restrictions for expatriate employees has been abolished while regulations governing remittances by them has been eased. In India, on the other hand a multitude of regulations still exist to regulate these payments. Each foreign venture, at the time of approval is permitted a specified amount that can be paid as salaries in foreign exchange to foreign employees. Any payments beyond this limit has to be approved by the RBI. There are guidelines for these excess payments, which can be monitored by foreign exchange dealers. These guidelines set the limit for payment to individuals at $1000 and $200,000 for company to company payments.

A common criticism of MNEs in the dependency debate, has been that they siphon off excessive profits from subsidiaries through unduly high royalty payments and technical fees. The response from developing countries had been to regulate levels of royalties which in turn deters prospective MNEs. The abolishing of these ceilings in Pakistan has to be seen in the light of the eagerness to attract foreign direct investment despite these unfavourable practices. In contrast, India continues to regulate and monitor royalty payments and technical fees.

3.2.3 Taxation Policy

The 1976 legislation on protection and promotion of foreign investment in Pakistan had guaranteed that foreign firms would be taxed at the same rates as applicable to domestic companies. This left no scope for ambiguity, whatsoever. However India consistently followed a policy of imposing higher tax rates on foreign companies. Thus

29 Ibid.
30 In India, a nominal clearance is required from the Ministry of Home Affairs for foreign employees staying over three months.
31 Bol, n. 8, p. 10.
32 For a more detailed discussion on the restrictions see Tony Khindria, Foreign Direct Investment in India (Hong Kong; 1997), p. 335.
as fixed by the budget in 1997, while Indian companies are taxed at 35 per cent, foreign companies are taxed at 48 per cent. A redeeming feature is that foreign companies are entitled to all the deductions and tax shelters that Indian companies have been provided with. Similarly there is no discrimination in respect of other direct taxes like capital gains taxes, dividend tax et al.\textsuperscript{33}

3.2.4 Policy Promotion

The preceding discussion makes it clear that both India and Pakistan have gone a long way since the initiation of changes in foreign direct investment policy. While a detailed analysis of the outcome is undertaken in the next chapter, suffice to say that the response has not been satisfactory and government determined targets of foreign direct investment inflows have always remained unfulfilled. Several reasons have been attributed for this unsatisfactory performance, which includes increased competition for foreign direct investment from other developing countries; and lack of information among global foreign direct investors, particularly small and medium firms in industrialised countries (on these reforms effected in the FDI regime)\textsuperscript{34}. To redress this problem both countries have undertaken efforts to project information of their attractiveness as profitable destinations for foreign investment.

In the case of India, this dimension is more important for the provinces. At the federal level, after the issue of detailed guidelines to be considered by the FIPB, this route has been generally transparent and quick. After obtaining a federal level clearance, a project proposal still requires a number of clearances and legal requirements from the provincial governments before it can be launched. In the light of this, provincial authorities have realised the need to run a promotion campaign, independent of the Central government. Besides, as seen in several cases, provincial governments have identified key projects which are imperative for the development

\textsuperscript{33} The effective difference between domestic and foreign firms is not as large since domestic firms are charged a surcharge of 10 per cent, a surcharge from which foreign firms are exempt. \texttt{<http://www.maharashtra.gov.in/english/invest/directtax.htm>}. 

\textsuperscript{34} During a visit to US the surface transport secretary stated that a number of US firms lacked information on the extent of reforms carried out to attract foreign direct investment in road construction and the delegation helped in redressing this. See \textit{Business Standard}, 21 January 1997.
efforts of the state. These projects require a hard-sell campaign in industrialised countries to attract potential foreign investors. As a consequence of this new understanding, there have been a number of visits by province level delegations to attract foreign direct investment.

Pakistan faces a major image crisis in the global economy. Various factors have contributed to this image which include:

* two decades of financial crisis on the external account;
* an image of deepening Islamic orthodoxy\(^{35}\);
* serious internal strife in the economic capital Karachi;
* vicious political battles between the two dominant political forces and strategic vulnerability in an environment of constant military tension with India

Hence the federal government in Pakistan has had to undertake the primary responsibility for the major task of building Pakistan’s image in the global investor community. This has been conducted primarily through high level investment promotion tours to the developed countries\(^{36}\). But these efforts whether in India or Pakistan have rarely been matched by legislative or administrative reforms. Therefore most foreign investment projects that are proposed fail to take off or are grounded with frequent delays.

### 3.3 POLICY INCENTIVES

Most incentives discussed in this section have been formulated and implemented to spur industrial development and increase private sector participation in general. They are not targeted exclusively to benefit foreign direct investment. The improvements that these incentives bring in the general operating climate for industries act as a motivation for foreign direct investment inflows.

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35 The Supreme Court’s directive that the objective of an interest free economy be realised by the federal government has negative implications for foreign investment since interest is a major dimension to this economic activity. “Flight of capital feared as court terms interest un-Islamic),” *Times of India* (New Delhi), 25\(^{th}\) December 1999.

36 A prominent feature in each of the two alternating regimes of Pakistan is a regular prime ministerial visit abroad, most of which have been projected as investment promotion visits. Anjum Ibrahim, “Pakistani Premiers and Foreign Investment”, *Business Recorder*, 9 May 1991.
Pakistan has permitted imports of capital machinery and plants on concessional duty of 10 per cent for most industrial sectors with the rider that this applies only to those equipment not manufactured locally. For priority sectors such as engineering goods, biotechnology, et.al complete exemptions from customs duty and sales duties are offered\(^{37}\). For other sectors such as cement, leather products, tanning, textiles et.al., exemptions from customs duty is offered\(^{38}\). These exemptions have been offered for other sectors too, which will be discussed in the relevant sections on each of these sectors.

The government of Pakistan has followed a policy of encouraging increased use of local inputs. It has used tariff concessions rather than regulations for this process. In case of non-availability of local inputs, imports are allowed for an initial period, but require a subsequent increase in local content. In some sectors adherence to deletion requirements is promoted by the government. In this, the components that must be sourced in-house and those from outside are specifically identified. Companies that do not meet these requirements are levied penal import duties\(^{39}\).

In an attempt to remove regional imbalances in the industrial structure, the industrial regulations framework in Pakistan provides for tax cuts, and duty concessions for manufacturing units set up in specified industrially backward areas\(^{40}\). This has a potential for attracting foreign direct investment since it offers concessional tax rates as compared to the higher rates that prevail in the industrially developed regions of Pakistan. These tax incentives for industrial development of backward area exist in India too. Most provincial governments in India have adopted an active policy to encourage foreign direct investment inflows. Another major policy followed by state governments which have long terms negative consequences is the competitiveness with which each government offers tax and fiscal concessions which leads to significant fall in future revenue generation potential. These concessions at times also extends to low input prices for government supplied inputs, ignoring environment and social

\(^{37}\) BoI, n. 8, pp. 11-12.


\(^{40}\) For a detailed list of these incentives see Ibid., pp. 13-15.
concerns et al. This, in the long run leads to distortions in the economic structure and social fabric of these states.

Prime minister Nawaz Sharief, on 26 November 1997, announced a more liberal foreign direct investment policy. The new regime has set a target growth rate of six per cent for the year 1997-98. Given the shortfall between the required investment rate and the domestic savings rate (for lesser levels of growth rates), the government wanted foreign direct investment inflows to meet this gap. Foreign direct investment inflows had already slowed down in 1996-97 and the policy makers felt the need to liberalise not just policies governing foreign direct investment but also the general investment regime.

The highlight of this new policy regime was the inclusion of sectors other than manufacturing (which was the focus of the pre-1997 foreign direct investment policy). This includes politically sensitive areas of agriculture and real estate. In manufacturing, investment incentives have been provided to four categories of industries, namely: (a) value-added and export industry, (b) hi-tech, (c) priority industry, and (d) agro-based industry. Value-added and high-tech industries have been granted larger concessions. They are entitled to a First Year Allowance (FYA) on capital expenditure/investment at the rate of 90 per cent and Reinvestment Allowance (RA) at the rate of 50 per cent, admissible in balancing, modernisation, replacing and expansion. The net effect of these allowances will be that the profits will not be taxable until the capital expenditure is recovered.

After the assessment of policies that applied uniformly to all or most sectors of industry the discussion now turns to those set of policies which are limited in scope to a single sector of industry. This discussion would shed light on the corrections desired by the two governments in their existing industrial diversity. In India, different categories and channels for approval, by themselves contribute substantially to India's efforts at imparting a sector focus in the quest to attract foreign direct investment. In contrast, since Pakistan has an uniform foreign direct investment policy with no sector

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specific equity limits, there is the need to introduce other instruments. These incluc
selective customs and other duty relaxation as shall be discussed next.

3.3.1 Infrastructure

Broadly this term refers to three sectors i.e. energy (electrical power), transportation
(roads, rail, air and water transport) and communication (essentially telecommunication) which are vital for any industry. A related sector is construction of industrial townships, parks and estates. To sustain overall economic growth over a long term requires corresponding growth in infrastructure. Traditionally, development of infrastructure in the two countries has been an exclusive responsibility of the state and consequently dependent entirely on public investment. As in the case of other sectors dominated by the public sector, infrastructure in the two countries has consistently lagged behind both in terms of demand-supply ratio and quality. The crisis faced by the two countries severely curtailed the availability of public funds for fresh investments in infrastructure. A combination of two factors, the growing backlog of the demand-supply gap and the decreasing public expenditure in infrastructure has led to a situation of severe infrastructure bottlenecks, which act as an impediment to realising the full potential of the two economies. The shortfall in supply of infrastructure services to other sectors has also been a deterrent for foreign direct investment, particularly export oriented foreign direct investment.

In the post crisis scenario, increasing foreign direct investment investments in infrastructure has emerged as a major objective in foreign direct investment policies of India and Pakistan. This was due to both, a domestic realisation that capital requirements for setting up new infrastructure projects could not be generated internally, and pressure from international credit agencies which focused attention on the inefficiencies in existing public sector infrastructure projects. In India, the government has explicitly indicated that it accords priority to attracting foreign direct investment in infrastructure along with the export sector as compared to other sectors. Projects related to construction of roads, rail beds, bridges, tunnels, pipelines, rope-ways, ports, harbour and runways, water ways and water reservoirs, water transport, hydro-electric projects, and power plants have been placed under the 74 per cent
category for RBI's automatic approval while projects for power generation are permitted 100 per cent foreign equity ownership.

One important demand vociferously put forward by foreign investor lobbies relates to the establishment of independent regulatory authorities for individual sub segments of the infrastructure sector. There are two objectives that are sought to be achieved through such a body. Firstly, regulatory powers should be shifted from governmental agencies and ministerial bureaucracy to an independent body which would safeguard the interests of all participants i.e. the suppliers, the consumers and government bodies. Second, through independent control of the pricing mechanism, pricing of infrastructure services would not be a tool for populist objectives, rather it would be an outcome of market forces and would facilitate sustainable long term development of the infrastructure sector.

Populist objectives are not the only stumbling block for the maintenance and sustainable long term development of the infrastructure sector. Contradictory laws governing other inter-linked sectors\textsuperscript{42} and different levels of governments which do not work in symmetry\textsuperscript{43} too are major stumbling blocks. Since there has been interest among investors in the telecommunication sector and its consumers are predominantly upper middle class urban sections who demand efficient services, it has been relatively simple to set up the Telecom Regulatory Authority of India (TRAI) as will be discussed in detail later.

The infrastructure sector in Pakistan too, is characterised by the same problems as existing in India. Most important, the pricing factor and duties on imported inputs requires specific incentives to attract foreign direct investment in infrastructure services. A discussion now follows on the three different categories of industries and services which comprise the infrastructure sector.

\textsuperscript{42} For example in the case of power, the issue of fuel inputs, which is administered by a different ministry.

\textsuperscript{43} This is typical in the case of development of roads, where the federal government formulates an attractive package of incentives to bring in foreign investment, but problems are created at the implementation level, which is the primary responsibility of provincial governmental agencies.
Power has been an area of focus where substantial initiatives were undertaken in the two countries. Over the years, the industrial sector has had to bear the main burden of shortfalls in power supply. This has consistently been a disincentive to industrial investment. There are two common characteristics that mark the power sector in the two countries. Broadly these are the dominance of the public sector in power generation and distribution and the poor tariff realisation rate for power produced and supplied.

Since power projects and distribution systems require large volume of capital and a long break-even period, development of this sector has been restricted to the public sector. Pricing of electric energy is a politically sensitive issue in the two countries and has been used by political groups to further their interests. An artificially low price is supplemented by insufficient revenue generation due to a combination of subsidies on the consumer’s price for power, non-payments and waiver of dues, and theft of power.

The two countries have concentrated their focus on attracting foreign direct investment in power generation. Since pricing of electric energy is a politically sensitive issue a set of incentives different from what is generally given is required in order to attract private sector investment into the power sector. First, the populist nature of fixing tariffs and the political implications of levying economical tariff rates creates numerous hurdles in involving the private sector in power distribution. Second, the cross subsidies involved in fixing tariff rates for different categories of consumers also requires strong government presence in power distribution. Third, government presence in power distribution is also imperative due to the law and order implications of recovery of dues and prevention of power thefts which is, inevitably, a politically sensitive issue in the two countries.

44 There is some evidence to suggest that this is only a perception which is more false than true. It is mainly the phenomenon of competitive populism that creates this perception. The consumers in general do not react very strongly to an inefficient power distribution system. In contrast the reaction to a price hike is stronger which is generally restricted to urban consumers and prosperous peasants. These reactions are initiated and fuelled by groups opposing the ruling party. There is the trend among these urban consumers and prosperous peasants to opt for costly alternatives in the event of non-supply. Therefore the effective consumer resistance to a price hike is quite hollow in nature.

45 In most cases those involved in power thefts (industries and individual consumers), have close connections with ruling parties and therefore enjoy quasi state protection.
The outcome is that both governments have been concentrating on attracting private investment, particularly foreign direct investment, almost exclusively in power generation. In Pakistan the second Benazir government formulated a comprehensive set of incentives offering a regulation free environment for private sector power generation projects and a commitment to buy the entire output (this quantity was to be prefixed by the government for each project) at a fixed price guaranteeing profits for these projects.

The government of Pakistan initially announced a package for private sector power projects on a Build-Operate-Transfer basis. This was later acknowledged as a failure in mid-March 1994. The reasons cited were the lack of internationally competitive sales prices, confusion over the incentives available and the near certainty of getting bogged down in protracted financial and technical negotiations. This was replaced by a new package of incentives which included:

- a bulk tariff of US cents 6.5/kWh, to be paid in rupees, for the first ten years sales (and 5.9 cents subsequently) to the public sector distribution agencies;
- indexation of the bulk power tariff to take account of rupee/dollar exchange rate fluctuations, fuel price variations and inflation;
- possible accession to the World Bank-assisted Private Sector Energy Development Fund for up to 40 per cent of capital costs at 14 per cent interest and long term maturity;
- exemption from corporate income tax and customs duties on imports of plant and equipment;
- free repatriation of equity and dividends.

This package ensures that private sector producers can concentrate fully on setting up and maintaining efficient operations of their projects. The need to market the final output does not arise. Other associated risks like exchange rate too are absent for the investor. This makes it a very attractive proposal which was borne out by the enthusiastic response from private investors. Within three months, 30 proposals with a combined capacity of 7500 mw was received by the government (this was against the existing capacity of 10.800 mw). Subsequent events, as will be seen in the next chapter, were to create problems in this response.

In India too, several incentives were offered to attract foreign direct investment in power sector. These include:

- freedom to operate as licensees distributing power to the licensed area from own generation or from power purchased from other private or public sector generation plants;
- captive power plants can sell excess power to the national grid;
- five year tax holiday
- 16 per cent Rate or Return on equity guaranteed at 68.5 plant load factor (PLF) with higher returns for higher PLF levels;
- licenses provided for 30 years with a provision for subsequent renewal for 20 years;
- capitalisation of interest cost incurred during the construction period for new projects and expansions

In India, the responsibility for power distribution and realisation of tariffs lies with state electricity boards (SEB) which are bodies of provincial governments. Since bodies of provincial governments in India have a record of payment defaults, their financial credibility with foreign investors is low. Consequently, private investors have underscored the need for sovereign guarantees. Similarly, since the process of marketing the product in India is ridden with difficulties, private generating units have to be assured of a market for their output. While the latter problem exists in Pakistan, the former is non-existent primarily due to the fact that WAPDA and Karachi Electric Supply Corporation (KESC) are Central government agencies and therefore their financial commitments have an element of sovereign guarantee.

Given these problems, the nature of the package offered to foreign investors has had to contain special provisions. Primary among these is the guarantee that the concerned SEB (in India, and WAPDA or KESC as the case may be, in Pakistan)

48 These were applicable to the eight proposed fast track projects.
50 As pointed out by a Canadian power executive, even guarantees provided by SEBs under escrow accounts with irrevocable letters of credit are not readily acceptable by international banks financing private power projects. See *Business Standard*, 20 May 1997.
51 While foreign private investors are permitted to acquire power distribution and supply licenses, the pricing and revenue realisation implications ensure the non-viability of this facility.
would purchase the entire output at fixed prices. The quantity of output would be pre-
determined and the price, to a large extent would be pegged to the dollar. In India, to
initiate foreign direct investment inflows into this sector, the Narasimha Rao regime
also offered eight specific projects to foreign investors. These eight projects, which
were termed as fast track projects, were promised speedy clearances, liberal terms on
prices and Central government guarantee on payments. Ironically, seven years after
the initiation of these eight projects, only two (with comparatively lower capacities)
have begun generation. The others are mired in a series of problems, an issue which is
discussed in the next chapter.

The plan to initiate fast track power projects in India was prompted largely due to
the realisation that India was fast reaching a stage of severe power shortages and its
industrial development would be choked. As it became evident that these fast track
projects would take more time (than anticipated) to materialise, the government
announced that the private sector would be permitted to set up several low capacity
liquid fuel based generation plants (100-150 mw), projects that would take only a few
months to complete. While it was initially proposed that these would use naphtha,
later objections from the ministry of petroleum led the government to revise its policy
and permit only liquid ammonium based power generation plants. Therefore all
proposals invited on the initial criteria had to be shelved and the whole process had to
be restarted. This is an indication that the government is yet to wake up to the reality
of power shortages and move forward from mere enunciation of a desire to increase
power generation as is the trend now.

In India, most problems in private power project clearances arise at the level of the
provincial governments. Besides this, the Central government has also adopted the policy
that Central government guarantees would be done away with, particularly as the

52 The exact nature of incentives offered vary from project to project, but on the whole these
were liberal. For example, for the Dhabhol project, while Enron would have to supply a
minimum amount to the Maharashtra SEB with no responsibility for excess generation when
required, the MSEB had to guarantee purchase of any additional power generated over the
agreed minimum output. The most important feature of these eight projects was the concept of
Central guarantees where the Central government undertook the responsibility of paying the
dues of the respective SEB in the event of their failure to pay their dues.

53 Express Investment Week (New Delhi), 23 February-1 March 1998.

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implications of pricing the output were to be faced by the state and therefore was increasingly being decided by state governments. Delays were longer due to the increasing number of projects, not satisfying the RBI automatic approval route conditions, which were piling up with concerned Central agencies. Therefore the UF government decided to transfer the power of clearing projects with a maximum limit of Rs. 10,000 cr. to the concerned state. This did not have much relevance, since fuel inputs and some environmental clearances would be still be the responsibility of Central agencies.

The governments in India and Pakistan have given out clear indications that it would withdraw from power generation. The private sector is expected to step in and assume the responsibility for developing this vital sub segment of infrastructure. The drawback is that lack of adequate political commitment, competitive populism and a policy ridden not just with inherent shortcomings but implemented inefficiently and afflicted with corruption has derailed the process to a large extent. These drawbacks have negated the overwhelming interest among foreign investors and their enthusiastic response.

In the Indian case, it can be seen that as shortcomings become apparent in policy formulations and implementation, the response is ad hoc in nature and only leads to a series of fresh problems. The linkages that exist between the power sector with other controlled sectors like imports (of fuel), environment, et. al. requires a holistic approach in the policy formulation process itself, which is generally ignored. Therefore at the implementation stage, problems arise and an inefficient bureaucracy compounds these problems during the policy reorientation process. Similarly, the urgency shown by the two governments has not been matched with sincerity leading to several irregularities. These cause problems later when parties comprising the government changes. The policy of eight fast track projects also opened an opportunity for foreign investors to indulge in rent seeking given the absence of competition. Inflated cost estimates were permitted by the government and led to suspicions of corruption. The high prices promised to these investors also negates the advantage of efficient pricing that foreign direct investment normally offers.

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54 The Hindu, 2 December 1996.
55 A detailed discussion of these problems appears in the next chapter.
The telecommunications sector in India offers a good example where efforts to prepare the economy before opening up to the external sector met with comparatively good success. The initial thrust of the government, during the late eighties, was to improve the existing domestic telecom infrastructure. This included indigenous development of appropriate technology and importing required foreign technologies, restructuring of the monopoly public sector telecom body and improving the existing network. A new Telecom Policy was announced in 1994, permitting the private sector to provide basic and value added telecom services. As this sector is essentially a service provider and requires less time to set up, the domestic private sector showed enthusiasm in participating in the opening up process. Therefore, the government decided that the role of foreign direct investment in this sector would be more of a technology provider rather than an entrepreneur.

In the initial phase of liberalisation, an overall limit of 49 per cent foreign investment was permitted. In effect, it was essential that any telecom service firm had to have domestic owned equity to the extent of 51 per cent. In response to pleas from domestic firms, for greater access to foreign funds, in October 1996, the policy was further liberalised. Holding companies with external sources of funds were permitted to invest in telecom companies, with their investment being classified as domestic investment. This opened up a channel to source more than the directly permitted 49 per cent foreign equity. Simultaneously, it ensured that control would remain with domestic partners.

Several concessions have been offered to invite private sector investment (including FDI) in telecommunication. This includes:

- Under the RBI automatic approval process foreign investment of 49 per cent in telecom services and 51 per cent in manufacturing of telecom equipment has been permitted.

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56 A separate Dept. of Telecommunications was created from the existing Dept. of Post and Telecommunication, and a separate body, Mahanagar Telephone Nigam Ltd. was created to cater to the special needs of the metropolitan cities.

57 In addition to the 49 per cent direct ownership by foreign individuals and companies, a further 49 per cent of the remaining 51 per cent could be owned by foreigners through the holding company route. This would ensure that while control remained with domestic investors without having to invest 51 per cent in the telecom service company. For details see. Business Standard, 19 October 1996.
The sector has officially been granted infrastructure status which enables access to low cost funds from public financial institutions. It also enables telecom firms to go for external commercial borrowing (ECB) to the extent of 50 per cent of total project cost.

The maximum limit on technology fees payable to foreign technology partners without prior RBI permission has been fixed at Rs. ten million (net of taxes).

Higher foreign equity levels and technical fees are permitted through special approval.

All capital good imports permitted under Open General License (OGL)

License free imports of components and other telecom equipment (with the exception of consumer telecom equipment).

The opening up of this sector too has seen several problems as with the power sector. Since domestic firms are a major partner in telecom ventures, these problems have generally been limited to these domestic firms and have not affected foreign direct investment perceptions on the investment process in this sector. It is in the telecom sector that the government has accepted one major demand, not just of foreign investors but of other domestic interest groups, i.e. replacing direct government control through the bureaucracy and ministry with an independent regulatory authority, the TRAI. The impartiality of TRAI was evident in the verdict it gave on the controversy regarding long distance calls. In this dispute, the TRAI disregarded the Dept. of Telecommunication's plea that the private sector be banned from offering long distance tariffs which were lower than the department and ruled in favour of the private sector. This decision helped considerably in projecting the image that pricing of infrastructure services could be determined by market factors rather than considerations of protecting governmental monopolies or populist objectives.

In Pakistan, the Pakistan Telecommunication Corporation Ltd. (PTCL) has been a monopoly organisation in the telecom sector. The plans for divesting part of its equity and transferring management control to a foreign buyer has been discussed in the following section on privatisation. Besides this there has been no initiatives by the government to invite private sector participation in telecom services.

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58 The main argument of the public sector Dept. of Telecommunications was that the artificially high long distance tariffs were essential to cross subsidise local calls and that if cellular service operators were permitted to charge lower rates for long distance calls, the revenue generation of the department would be affected.
Transportation broadly covers four means of transport i.e. surface, rail, air, water and support services including ports, airports and amenities. While the means of transport in two segments, i.e. roads and water ways is dominated by the private sector, railways is monopolised and air transport is dominated by the public sector. Given this heterogeneous composition, each segment requires a different policy framework for attracting foreign direct investment.

The domestic private sector has been permitted to involve itself, marginally, in building support services for surface transport (mainly construction of toll bridges) in India. In 1995, it was first proposed that the private sector, including foreign direct investment, would be permitted to construct roads. Approximately 5,000 km. of roadways is under offer to the private sector for construction and maintenance. Permission to develop land along these roads and build commercial ventures was also proposed, in addition to levy of tolls, to enhance the viability of these projects. Rather than formulating a comprehensive policy for private sector participation, the policy thrust was to direct it in specified projects. Despite this element of arbitrariness, there was considerable interest expressed by potential foreign investors, particularly South-East Asian firms. The Enron controversy injected an element of hesitation in these potential investors as they foresaw problems in the absence of a consensus between the Central and provincial governments on the modalities for regulating private sector roads.

The UF regime took an important initiative in encouraging private investment in this sector. Rather than targeting specific projects, the government included the construction of transport infrastructure, including roads, in the RBI automatic clearance scheme with a foreign equity cap of 74 per cent. In an attempt to specifically attract foreign direct investment in the construction of roads, the process of formulating special provisions to insulate foreign investment from exchange rate risks and other risks beyond the control of the investing company, was begun in January 1995.

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59 This is not inclusive of urban elevated stretches and bypasses, the length of which is not yet comprehensively estimated. Govt, Ministry of Industries, Roads, [http://www.indmin.nic.in/vsindmin/publicat/roads.htm](http://www.indmin.nic.in/vsindmin/publicat/roads.htm).

60 The Hindu, 4 February 1996.
1997\(^{61}\). The government had mooted the idea of offering financial incentives and public financial participation in mega projects\(^{62}\). On the whole, the government had designed the proposed package to ensure about 20 per cent returns to the investor, a rate of return (ROR) that is extremely attractive. The fall of the government had frozen this process.

In Pakistan, the policy of specifying projects for attracting FDI was adopted by the first Nawaz Sharief government. An ambitious project to invite private investment in the construction of super highway between Lahore and Islamabad was proposed. Due to the lack of consensus among political parties and changes in governments the initiation of this project was delayed. Very little government attention has been paid to attracting foreign direct investment in building of roads and other transport means. There have been tentative proposals which are still in the formulation stage, for inviting private investment in ports in India\(^{63}\). A few projects offered to the private sector for building railway lines met with poor response and had to be abandoned.

There has been a considerable degree of controversy regarding foreign direct investment in the air transport sector. This has its genesis primarily in the desire among sections of political leaders and the bureaucracy to protect the national domestic airlines. The Congress regime maintained, in 1995, that foreign airlines could not be permitted to operate on domestic routes until the required infrastructure was set up to support the projected increase in flights\(^{64}\). The application by a proposed joint venture between the Tatas and Singapore International Airlines opened up a major controversy. Proposed initially during the Congress regime, it was put on hold citing the above mentioned reason.

The FIPB under the new UF regime, too initially dithered on this application. While the FIPB and other several cabinet members including the prime minister I.K. Gujaral

\(^{61}\) These risks included fall in projected traffic due to public construction of alternative roads, consumer resistance or law and order problems. For details on the proposals see *Business Standard*, 17 January 1997.

\(^{62}\) The then minister for surface transport had proposed a series of governmental measures to attract foreign direct investment in the road construction sector, including loan assistance to tide over temporary cash shortages, sharing risks with the entrepreneur. Ibid.


\(^{64}\) This logic was advanced by the then Civil aviation minister. See *The Hindu*, 7 January 1995.
supported the proposal, the civil aviation ministry put up a stiff resistance. Under the aviation policy, finally formulated by the ministry and approved by the cabinet, a maximum of 40 per cent foreign equity is permitted in airlines and airports (100 per cent for NRIs). There is a condition, namely that foreign equity in a domestic airline company cannot be owned, directly or indirectly, by a foreign airline. This signifies that while capital deficiency in air transport expansion can be redressed through foreign sources, transfer of better management and operational skills, achieved by efficient foreign airlines companies, is not permitted. The main logic behind the changed approach of developing countries towards foreign direct investment, i.e. the advantages it brings in terms of better management skills and efficiency imparted in the domestic economy, was negated in the case of the air transport sector.

The lack of adequate infrastructure particularly in terms of uniform spread across the country has prompted the need for establishing industrial concentrations where all the required facilities can be provided. This process had been initiated before the present reforms phase and targeted at domestic industry in the two countries. Having understood the potential of such sites in providing a low cost alternative to the option of universal spread of infrastructure, the two governments have actively encouraged the setting up of such sites and FDI too has been targeted as a source. In India, the guidelines to FIPB envisage permission for 100 per cent foreign subsidiaries who intend to undertake such construction projects.

At a broad policy level, the two governments have undertaken substantial liberalisation in order to attract infrastructure. This was necessitated by domestic compulsions which prevent measures to create an environment of efficiency in this

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65 In September 1996, first the civil aviation minister announces that foreign equity holding would be banned in domestic airlines and with retrospective effect. See Business Standard, 8 September 1996. The project was put on hold by the FIPB following this announcement. Business Standard, 18 September 1996. In January 1997 the FIPB and the Industry Ministry cleared the project Business Standard, 8 January and 21 January 1997. In end-January 1998, the cabinet approved the new aviation policy wherein foreign equity would be permitted but this could not be owned by airline companies. In June 1998, both the then finance minister and prime minister indicate their dissension, the finance minister states that there may be a review of the rejection of the Tata-SIA proposal while the prime minister openly criticises the government's civil aviation policy (Business Standard, 9 June and 11 June 1997). The cabinet also recommends that the ministry review the policy but the minister was firm in his decision that the policy would not be reviewed (Business Standard, 31 January 1998).
sector. The initiatives taken make it apparent that the governments are attempting to compensate the lack of a conducive operating environment with policy measures, strategy that has failed as the statistics on inflows indicates and which is discussed in the next chapter.

3.3.2 Mining and Petroleum

Mining had been kept out of the automatic clearance list during the initial phases of India's foreign direct investment liberalisation. In the 1993 mining policy, private investment including foreign investment to the extent of 50 per cent was permitted on a case by case approval route. In 1996 the mining ministry proposed inclusion of mining in the 51 per cent automatic approval category, a proposal that was resisted by the left oriented political parties. In the January 1997 phase of reforms, mining in non-coal sector was included in the RBI automatic approval list with a foreign equity cap of 50 per cent. Three sub segments, namely gold, silver, diamond and other precious stones were kept out of the automatic approval category. Similarly, foreign equity to the extent of 74 per cent was permitted for firms involved in mining support services.

While the permitted foreign equity limits appear attractive for foreign investors, other important issues raised by them have not been addressed. These include the ceiling of 25 km. for prospecting, permission for low altitude surveillance flights over long periods and rates of royalty payable to the state and Central governments. In several cases, the government has gone to the extent of approving mining projects with 100 per cent foreign equity but the failure to attend to the above mentioned issues has hampered the full realisation of foreign equity inflows in mining. In Pakistan, mining companies have been granted concessional provisions in accounting procedure to cushion the risks involved in this sector.

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67 Ibid.

68 The main risk is that exploration at a particular site, even while requiring an investment, may prove to be commercially unviable. Therefore these firms need to set off this expenditure against profits from other sites. For details on these incentives see Ministry of Industries, Government of Pakistan, Pakistan Investment Guide, (Islamabad; 1991), pp. 115-16.
The petroleum sector, particularly exploration of new fields, was a priority for the Narasimha Rao regime in the aftermath of the 1991 crisis. This crisis had exposed India’s vulnerability on account of excessive oil imports. Two factors i.e. pressure from the World Bank and Asian Development Bank and lack of domestic resources, led the government to present involve the private sector in the move to expand oil exploration activities. Several potential oil fields were offered for bidding and extensive road shows and presentations were made in the US, Singapore, London and Tokyo. The government appears confused on the nature of incentives to be offered to increase investment in this sector. On one side these ventures have been granted customs duty waivers and royalty and cess freezes, concessions that have not been offered to public sector firms. In contrast, the royalty and cess charges, when levied are arbitrary and considered high by potential investors. As a consequence of the failure to attract the attention of international oil majors in exploration and extraction, the government gave up the intensive efforts to attract foreign direct investment in oil exploration.

Pricing being a politically sensitive issue, the main grouse of potential foreign investors in the refining and distribution sector, i.e. lack of deregulation in the administered pricing mechanism, has not been attended to by the government. Similarly, the policies of the government indicate that the present monopoly enjoyed by the public sector will continue to be protected. Therefore except for production of minor petro-products, refining and distribution has been kept totally out of the ambit of RBI automatic clearance list. Rather, the thrust is on encouraging foreign investment in these fields, only in joint ventures with public sector oil majors. Consequently the response of foreign investors in the petroleum sector has been marginal.

In Pakistan too, the government has formulated a comprehensive package of incentives to attract foreign direct investment in oil and gas exploration. These include:

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69 Branding and marketing of petro-products, a field that has attracted the attention of major international firms due to the size of the Indian market, is permitted with a maximum limit on foreign equity ownership of 74 per cent. In refining a foreign venture is compelled to limit the foreign equity ownership to 26 per cent, and a minimum share of 26 per cent from a public sector firm. GoI, Ministry of Industries, Most Frequently Asked Questions, <http://www.indmin.nic.in/vsindmin/publicat/mostfrequently.htm>. Similarly the refinery proposals approved by the FIPB have permitted only a minority stake for the investing foreign partner. For details see The Hindu, 30 October 1995 and 2 February 1996.
• Reduced obligatory sales to the government at 15-25 per cent (depending on level of risk).
• Pricing of output fixed at 67.5-77.5 per cent of a basket of Gulf crude graded according to three risk zones.
• A guaranteed minimum ROR of 25 per cent on paid up capital in new refineries using local crude. This provision can act as an inducement for downstream investment by refining companies in exploration and extraction of Pakistan's crude reserves.
• Duty free import of capital goods at the exploratory stage and concessional import duty of three per cent once the field is declared commercially viable\(^70\).

Besides these, given the special nature of this sector, the government has also permitted an accounting procedure for these companies which takes the special characteristics of operating in this sector into account\(^71\).

The duty structure of imported inputs, in Pakistan, has been structured to encourage increasing downstream production of inputs\(^72\) in the PVC industry. The machinery for this industry is subject to concessional import duty of ten per cent. Tariff on import of paraxylene, an input in the production of PTA (used in the synthetic textile industry) has been fixed at a concessional rate of 5 per cent for a period of five years or till it is manufactured locally (whichever is earlier) after which it will be subject to a tariff rate of ten per cent while the rate on PTA will be 25 per cent (this again is intended to encourage upstream production of intermediate inputs). The terminal year for levy of concessional duty of ten per cent on machinery not produced locally was advanced from June 1999 to June 1996\(^73\).

On the whole, as these incentives show, even as the government in Pakistan is trying to encourage foreign direct investment into the petro-chemicals sector, there is an effort to induce increased value addition by the industry. This extends to both production inputs and capital equipment. In contrast, India has a vibrant public sector

\(^70\) EIU, n. 38, p. 30.
\(^71\) For details see, Bol, n. 8, p. 114.
\(^72\) The basic input i.e. ethylene is subject to import duty of ten per cent while the intermediary input, Vinyl Chloride Monomer attracts 15 per cent and the final product namely PVC attracts 45 per cent. See Bol, n. 8, p. 20.
\(^73\) Ibid.
well established in the petroleum sector (which is the major source for the meagre public sector surpluses). Hence any initiatives towards attracting FDI in this sector has to ensure an element of protection to this sector. Similarly a strong domestic lobby among political parties exists against substantial opening up of the mining sector. Hence the meagre initiatives in this sector which are restricted to attracting capital equipment and service providers.

3.3.3 Manufacturing

This is a sector which requires considerable attention has to be paid by the two governments. In India, this sector holds great attraction for foreign manufacturers. The large size and resource base of the country encourages indigenous manufacture rather than imports to service the domestic market. The opening of a sheltered environment, which fostered the growth of a large variety but inefficient domestic entrepreneurs, is bound to generate threats to the vested interests of this group, from efficient foreign manufacturers. Hence the government has to exercise extreme caution and perform a balancing act between two contradictory forces. First the need to inject efficiency into the manufacturing sector, create a positive image among the global entrepreneur community and realise the vast potential FDI which exists in this sector. The counter force emanates from the vested interests of domestic manufacturers and the element of economic nationalism.

For Pakistan, the ground realities are different. While the element of an inefficient domestic manufacturer base exists, it is not as large or varied as in India. The country is yet to evolve as an attractive location for manufacturing aimed at global markets. This is compounded by a constraint in attracting FDI namely small size, for some products, of the domestic market which encourages imports rather than indigenous manufacture. Protection for domestic manufacturing can have adverse consequences. Pakistan, which needs to access all available non-debt creating sources of foreign capital has to ensure that it can realise whatever potential it has for attracting FDI and hence manufacturing assumes importance.

Some instances of foreign companies (such as Gillette), closing domestic operations and opting for the route of imports have come to light and are discussed in chapter five.
The broad thrust of incentives offered in electronic manufactures by Pakistan, is directed at promoting the growth of small firms. Features of this package relevant to the manufacturing sector include:

- Developing Technology Parks where fully developed production facilities (including production equipment) will be made available for quick development of new firms by private entrepreneurs.
- Differential tariff on imports whereby raw material, sub-components and components will attract 10, 20 and 30 per cent duty respectively. This implies that the government wants to encourage domestic production of components rather than its imports and thus increasing the value addition of the electronics industry.
- Equity support to be provided by the government.
- R&D support from government research labs and institutions.
- Price preference in government purchases to domestic manufacturers.
- Income Tax relief to be provided for a period of 10 years.

Since the global electronics industry is characterised by large firms, these initiatives do not appear to be targeted at foreign firms directly. Rather they are targeted at the export market. These initiatives can at most encourage some firms to invest in Pakistan in order to overcome the tariff barriers or take advantage of the price preference. A spin-off of this package is that the growth of an internationally competitive small sector electronics industry, particularly if focused on component and sub-assembly manufacture, will in the long run, attract large and well established foreign firms to set up assembly line based production units for their global markets.

In contrast, India has yet to determine its priorities vis-à-vis foreign direct investment in the electronics sector. After initial attempts to build an indigenous industry based on demand generated by the growing telecom sector failed, the government decided on opening up imports of telecom equipment. This had a negative impact on the policy to encourage domestic electronics growth. Despite the permission given to the foreign partners to increase their stake in joint ventures (involved in electronic components and equipment manufacture), the opening up of the telecom imports discouraged fresh foreign direct investment inflows in the manufacturing sector (this was true of domestic investment too).

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75 The level of equity support is not specified. The last incentive of the list is applicable only to units set up before 30th June 1997, see Bol, n. 8, pp. 15-16.

76 The Hindu, 26 February 1996.
Two major manufacturing segments that have linkages and which are important in the context of foreign direct investment are consumer durables and industrial electronics. Industrial electronics and its sub sectors like scientific equipment have been placed in the category where foreign equity ownership of upto 51 per cent is eligible for RBI automatic approval\(^7\).

Consumer goods is, globally, an important sector for foreign investment. In developing countries like India with a protected and inefficient consumer goods industry, there is large potential market for technologically superior and branded consumer goods. The demonstration effect of consumption patterns in Western countries has served to increase the market potential for branded goods manufactured by Western firms. In the event of liberalisation, depending on the market size, companies take the decision to either supply these markets through local production or imports. In contrast, governments of these countries (on the threshold of liberalisation) have to design their policies to suit the primary objective of attracting foreign consumer goods firms, not to service the local markets but develop a production base for global markets and contribute to the export growth efforts of the government.

As seen in South-East Asia, this can be achieved by granting liberal tax, import and industrial regulatory regimes and a positive labour regulatory regime\(^8\). This has to be accompanied with required reliable infrastructure facilities. In the absence of such an environment in India, an alternative policy framework is required. High tariff walls alone can bring in foreign investment but the absence of the need to be globally competitive\(^9\) negates the export potential of such foreign investment. The alternative, as formulated in India, is that high tariff walls and import restrictions are accompanied by the requirement that foreign firms have to balance their foreign exchange outflow (in the form of dividends and royalties) through export revenues. This balance has to be brought about in a block of seven years of production\(^10\).

\(^7\) IIC, n.49, p. 35.
\(^8\) Such a regime has to have a bias towards the interests of the entrepreneur rather than labour with the priority being on maintaining labour discipline and facilitating uninterrupted production.
\(^9\) This linkage has been discussed in chapter one.
\(^10\) Gol, n. 15.
There is considerable opposition, from domestic pressure groups, to opening up the consumer industry. The resistance against consumer electronics is rather sharp, given the strong presence of large domestic manufacturers. Yielding to this pressure and other imperatives such as controlling the balance of payment deficit, the government has retained compulsory licensing for consumer electronics. Foreign automobile giants (particularly passenger car manufacturers) have, in the wake of liberalisation, evinced considerable interest in investing in India. In this sub segment, the government has imposed the Memorandum of Understanding (MOU) route for entry of foreign firms. This route specifies investment volume, capacity and a time frame for indigenization of inputs. These are over and above the dividend balancing norms imposed on consumer goods industries.

As a consequence of partial liberalisation and attractive domestic market size, consumer durables is one segment which, in India, has fulfilled its potential for attracting large volumes of foreign direct investment despite restrictions. It has been only four years or so since this specific policy (for consumer goods industries) has come to force and the effectiveness of this policy is yet to be clear. One possible drawback which was seen in the late eighties\(^\text{81}\), is that these firms would export traditional items rather than their own output. In such an event the economy would only see a shift in exporters and not a growth in exports. There is scope for further research based on surveys of foreign ventures in this segment before the success of the policy can be determined.

In Pakistan, the government has repeatedly stated that the country offers an excellent base for consumer goods industries, not just for servicing the domestic market but also markets in West Asia. There have been no additional incentives offered to this sector. In the case of passenger cars and other consumer goods industries, the government has insisted on framing, after mutual discussions by the government and investors, a time frame for indigenization. In industries that are classified as non-essential consumer goods, the

\(^{81}\) The condition that capital imports had to be balanced through exports saw engineering and other firms souring and exporting traditional items. TISCO which imported capital goods for its plant expansion, met its export obligation through marine products and Hindustan Lever exported shoes, shirts and other goods. *Financial Express* (Bangalore), 28 May 1990.
government has insisted on local sourcing of raw material and other inputs. The government also offers special incentives to encourage indigenous value addition in this sector, particularly passenger cars. Pharmaceuticals has historically been one of the most protected sectors in Pakistan and has a substantial concentration of foreign direct investment. The incentives include concessional import duty for plant and machinery not manufactured locally, duty and tax free import of raw material and chemicals (subject to tariff protection for domestically produced raw material and chemicals, against similar foreign products), loans for setting up manufacturing units and tariff protection against import of finished drugs. Since some of these incentives have been offered for several decades now, this industry has witnessed the tariff jumping variety of foreign direct investment and has led to very high prices of drugs in Pakistan. Despite this, there has been no measures to induce efficiency in the pharmaceutical industry even while retaining the large levels of foreign direct investment. This mainly due to the fact that without such incentives it would be difficult, with Pakistan's limited domestic market, to ensure the presence of a domestic pharmaceutical industry.

In India, this sector has been placed in the category where foreign equity ownership of upto 51 per cent is eligible for RBI automatic approval. Since the patent regime loophole (absence of product patent) has been effectively utilised by Indian firms, the government has seen no need for any special incentives to attract foreign direct investment in this sector and consequently most foreign players in this industry are those that have set up operations before the eighties.

Pakistan has offered several incentives to attract foreign direct investment in the fertiliser industry. This includes:

- assured supply of feed stock gas at existing prices for ten years from date of operation.

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82 Higher rates of duty are imposed proportionate to the degree of processing that imported inputs have undergone. See ESCAP, n. 39. p. 19.
83 Bol, n. 8, pp. 16-17.
84 IIC, n.49, p. 35.
• assured supply of feed stock gas for nine months per year.
• duty free import of rock phosphate.
• if price controls are fixed, a minimum of 20 per cent post tax return on equity at 90 per cent capacity utilisation assured by the government.
• permission to import second hand machinery.
• no discrimination between local and foreign firms.
• expansions to be treated as new plants for entitlement of concessions.

Given the existing shortfall of gas in Pakistan, the first two incentives go a long way in assuring foreign investors of freedom from input bottlenecks and price fluctuations in an uncertain international petroleum market. It also makes a provision for the viability of private firms in the event of the government’s perception that price controls for fertilisers are required. Since large farmers, who are the main consumers of the fertiliser industry, are a powerful lobby, government intervention to reduce fertiliser prices is a serious threat.

In contrast, since India already has a dominant domestic private sector presence in the fertiliser industry besides public sector units, it has not felt the need to offer extra incentives to attract FDI in this sector. Therefore the only incentive on offer is that foreign investment in certain categories of nitrogenous and phosphatic fertilisers to the extent of 51 per cent is eligible for approval through the RBI automatic approval route. To attract investment into this sector from all sources i.e. domestic and foreign private entrepreneurs an incentive granted is that imports of capital equipment is exempt from import duties.\(^5\)

India has adopted a policy of encouraging investments, including foreign direct investment, in food processing, other agro-based industries and industries with backward linkages to agriculture. Under the present policy 51 per cent foreign equity is permitted in food processing and 74 per cent in warehousing of agro-products through the RBI automatic clearance route. The FIPB is also permitted to clear proposals with 100 per cent foreign ownership in units with backward linkages to agriculture.\(^6\)

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\(^5\) Fertilisers is the only industry which is permitted this concession. Gol, *Economic Survey 1994-95*, p. 104.

\(^6\) Gol, n.15.
Given the importance of agriculture in Pakistan's economy a thrust on attracting foreign direct investment into the agro-processing sector is only natural. The incentives on offer include:

- Imported plant and equipment, not manufactured in Pakistan is subject to a concessional import duty of 20 per cent. This includes parts and spares imported along with capital equipment.
- Projects in this sector are permitted a debt-equity structure of 70:30 and are entitled to financing from all banks and development finance institutions.
- Expatriate employees are permitted to duty-free import of personal effects and other consumables (with a limit of US $ 600 per person in the case of the latter).
- Imports of breeding stock permitted at ten per cent customs duty.
- Projects are exempted from provincial and Municipal taxes for five years\(^87\).

The only feature unique to this industry is the liberal terms offered to expatriate employees which indicates the intention to attract foreign direct investment into this sector. In the latest policy announcement, industries falling in the categories of agro-based industry will be entitled to First Year Allowance at the rate of 75 per cent and will also be entitled to re-investment allowance at the rate of 50 per cent\(^88\).

Pakistan maintains a non-discriminatory treatment to FDI in manufacturing and has concentrated on measures like the deletion, taxation and tariff policies to increase indigenization of operations. In contrast, India continues to maintain discrimination against FDI through foreign equity ownership limits, higher taxation rates, placing some segments of manufacturing in the category where licensing is essential, imposition of dividend balancing norms and limits on repatriation of dividend, royalty and technical fee payments. The two countries have used selective incentives to attract investment in priority industries.

3.3.4 Services

This sector, for long, remained outside the priority of the two governments in the FDI liberalisation policies. In India, tourism related services was included in the RBI route with a foreign owned equity cap of 51 per cent during the initial round.

\(^{87}\) Bol, n. 8, pp. 19-20.
\(^{88}\) Dawn, 1 December 1997
of liberalisation (Congress government’s tenure). The UF government included renting & leasing and business services in this category. In the guidelines issued to the FIPB, foreign investment to the extent of 100 per cent was permitted in hotel and tourism related services.

Liberalisation of FDI norms in services was ignored during the FDI liberalisation phase of the late eighties and nineties in Pakistan. The 1997 policy, in a major departure, paid specific attention to this sector, opening it foreign investment to the extent of 60 per cent with a minimum foreign currency inflow of US $ one million. This emphasised the approach of the government in attempting to tap all sources of direct investment to augment the foreign exchange inflows into the country.

Software has been a major focus for the two countries. The low cost but high revenue potential of this sector makes it a target for promotion of domestic enterprises. Hence this sector has a low priority in FDI policy. Most incentives are oriented towards encouraging domestic small entrepreneurs in this sector. In India, a vast educational infrastructure in this sector has ensured that the human resource availability is by itself an important incentive for FDI. Therefore this sector has been placed in the 51 per cent foreign owned equity category for RBI approval. In Pakistan, measures such as deregulation of data communication, financial assistance for purchase of computers and preparation of rosters of professionally skilled personnel, are primarily targeted at boosting software exports and do not have any significant bearing on the foreign direct investment promotion policy.

3.3.5 Agriculture

This sector has consistently been a politically sensitive issue vis-à-vis liberalisation in the two countries. It has been argued that given the high rate of risks associated with agriculture, the low capital base of most farmers and the general backwardness that characterises the rural sector, exposing domestic farmers, not just to foreign direct investment, but also domestic corporate entities is detrimental to the interests of these

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89 The list of sectors opened up for FDI by the UF government appears in Business Standard, 1 January 1997, p. 3.

90 Gol, n. 15.
farmers. Therefore most proposals emanating with a view to modernise agriculture through corporatisation is met with domestic criticism. This is despite the fact that agriculture, particularly commercial agriculture in the two countries is dominated by large farmers.

To an extent this is changing and there have been initiatives to change the pattern of agriculture. The first issue to be addressed is the limit on land ownership which is a constraint for corporatisation of agriculture. In Pakistan, agriculture has been thrown open to foreign direct investment consequent to the November 1997 investment reforms initiated by the second Nawaz Sharief government. The activities permissible under the agriculture sector will be land development/reclamation of barren, desert and hilly land; farming/integrated agriculture (cultivation and processing of crops); modernisation & development of irrigation facilities/water management; plantation/forestry and horticulture. Proposals related to foreign investment in agriculture will be processed by the Board of Investment (BoI) in consultation with respective provincial government and approved by the competent decision making forum. Conditions include a minimum foreign equity investment of $1 million, and a minimum 40 per cent equity to be held by a Pakistani company or individual in such projects.

Import tariff on plant and machinery (not manufactured locally) used for agriculture will be zero-rated. There will be no upper ceiling of land for registered agricultural companies which are involved in production, processing and marketing of agricultural products on commercial lines. However, the income of these companies would be taxable (agricultural incomes of Pakistani nationals are normally non-taxable). To facilitate FDI land for agriculture purpose will be available on lease for long periods, i.e. initially up to 30 years, extendible for a further period of 20 years\(^1\).

In contrast, India has yet to initiate such drastic reforms. The UF government did take an initiative in 1996. The then prime minister had proposed that the Karnataka model, which he pioneered in 1995, be applied to the country as a whole. While this model did not envisage permitting entry of foreign direct investment into agricultural

\(^1\) *Dawn*, 1 December 1997.
operations, it proposed that Indian corporate firms could own and operate large farms (56 to 104 acres). Similarly the model also envisaged the formulation of the contract farming system\(^\text{92}\). The contract system was already in operation in Punjab and Andhra Pradesh but had certain problems, which the government was unwilling to seriously address\(^\text{93}\). The government’s policy framework for attracting foreign direct investment in infrastructure has ignored irrigation.

3.3.6 Export Promotion.

Following the success of the South-East Asian countries who used foreign direct investment as the primary vehicle for rapid export expansion, both India and Pakistan too have been attempting to emulate this strategy. As part of this a number of incentives have been provided to expand exports. While these incentives are offered to all potential exporters, hopes are pinned on a positive response from foreign investors to these incentives. Common to India and Pakistan is the setting up of the Export Processing Zones (EPZs), which offer several concessions not available to firms in other areas. In Pakistan these incentives include:

- complete exemption from domestic taxes, foreign exchange controls and insurance regulations as applicable in other areas;
- tax holiday until 2000 AD and thereafter 25 per cent in perpetuity;
- losses if any can be carried on indefinitely;
- imports of capital equipment and inputs are exempted from all levies, duties and taxes;
- exemption from Pakistan's labour laws.\(^\text{94}\)

Similarly Special Industrial Zones (SIZs) too have been set up to provide ready-made infrastructure and support services to attract foreign direct investment. Incentives provided in these Zones indicates the government’s desire to implement its locational

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\(^{92}\) This was mooted by the then prime minister Deve Gowda in the "India Economic Summit". For details see *The Hindu*, 6 November 1996.

\(^{93}\) As voiced by an executive of Pepsi, the lack of administrative and legal support to ensure that farmers fulfill their contracts impeded the smooth functioning of this system. Rather than trying to propose measures on the part of the government to remedy this, the response of the Food Secretary advised that it should be through trust and incentives that corporate entities should ensure the smooth functioning of this system. For details see, *The Hindu*, 25 October 1995.

\(^{94}\) Bol, n. 8, p. 11.
policies and encourage small industries\textsuperscript{95}. Besides providing infrastructure facilities like communication networks, priority for power and water supply, permission to install captive power generation units and the option to sell surplus power to the Water and Power Development Authority (WAPDA), relatively small size of plots with standard design buildings are on offer (which are attractive for small foreign firms), in both the EPZs and SIZs. This indicates the government's desire to encourage small firms in combining modern foreign technology, management and imported inputs with Pakistan's raw material and labour resources as a base for high-technology exports\textsuperscript{96}.

India too, has provided special incentives to encourage export units. These include Export Promotion Zones (EPZs) which provide infrastructure facilities and industrial plots. Besides this, concessions have been provided to Export Oriented Units (EOUs), which include tax free operations for the first five years, duty free import of capital goods and spares, refund of excise duty, sales taxes and duty drawback on domestic inputs et. al\textsuperscript{97}. EOU's which achieve a minimum value addition of 30 per cent are granted automatic approval (within two weeks) for duty free imports of capital goods (other exporters are permitted capital goods imports at a concessional import duty of 15 per cent) and duty free import of all components and inputs which are included in the Open General List for imports\textsuperscript{98}. While these are applicable to all EOU's irrespective of domestic or foreign ownership, certain concessions on permissible foreign equity limits have been provided to attract foreign direct investment into the export sector. The FIPB permits 100 per cent foreign equity holding for firms that export 50 per cent or more of their output\textsuperscript{99}. In the telecom manufacturing sector a firm which exports 30 per cent of its output is eligible for EOU status whereby automatic approval is granted within two weeks for imports of capital goods. These

\textsuperscript{95}ESCAP, n. 39, p. 7.

\textsuperscript{96}Even while large Trans National Firms account for the major share of Global foreign direct investment, small firms, particularly ancillary suppliers from home countries too are emerging as a major source for foreign direct investment and provide vital support required by the large firms in their foreign ventures. Incentives targeted at assisting these small firms to set up operations quickly are helpful in attracting foreign direct investment.

\textsuperscript{97}For a detailed list of incentives provided for export promotion, see ESCAP, n. 13, pp. 32-39.

\textsuperscript{98}IIC, n. 49, pp. 4-5.

imports are permitted without customs duty. Similarly all OGL components are eligible for duty-free imports\textsuperscript{100}.

3.4 THE PRIVATISATION PROGRAM

As discussed in chapter two, the Zia regime in Pakistan, had decided to reverse the priority given to the public sector by the Z.A. Bhutto regime. Due to populist concerns, the initiative to privatise existing public sector units did not gather momentum. In order to reduce public expenditure and shore up revenues, the Benazir regime decided to speed up the privatisation program. This provided an additional potential to attract foreign direct investment particularly in the banking and infrastructure sectors.

Two main industrial sectors have been identified for this process. These are existing power generation units (running on losses due to outdated technology and inefficient management) and telecommunications. A 26 per cent stake in the Kot Addu thermal power plant has been transferred to National Power (UK) while the privatisation of the Jamshoro thermal plant is under consideration. Also under consideration is the privatisation of FAEB and the KESC\textsuperscript{101}. Given the inexperience of the indigenous entrepreneurial class, this program, in the interests of its long term viability, has to involve foreign firms.

The privatisation of the Pakistan Telecom Corporation was under active consideration of the Benazir regime. The first phase of selling a part of the stake to the general public was completed in 1994. It was decided that the Corporation would be converted into a limited company and 26 per cent of its stake along with management control would be sold to a strategic buyer (the target date for transfer of management control was end-1995)\textsuperscript{102}. Numerous responses were received from foreign firms but the process is yet to be completed.

\begin{footnotes}
\item[100] IIC, n. 49, pp. 4-5.
\item[101] ESCAP, n. 39, p. 35.
\end{footnotes}
In the hydro carbons sector, the Privatisation Committee had announced the decision to privatise the SNGPL by off loading 25 per cent stake and management control to a 'strategic investor'\textsuperscript{103}. Despite responses from foreign firms, the transfer of equity and management is yet to be completed. A major lacunae, which the government is yet to address, in this privatisation process is the creation of an open and clear regulatory framework for the operation of these privatised units. This is important more so, since most of these units are mass utility services and the pricing of these services is a politically sensitive issue. Therefore this issue has to be insulated from frequent changes, arising from the situation of political instability that has marked Pakistan in the nineties\textsuperscript{104}.

The banking sector in Pakistan too is a prime sector for privatisation. Several small nationalised banks have been handed over to domestic buyers The privatisation of relatively larger banks is yet to materialise, though the government is firm in its decision to do so. The size of these banks (which include Habib Bank and United Bank) and complex nature of operations, again, requires the involvement of foreign banks. Due to lack of clear information (which conforms to international standards) on the accounts of these banks, foreign banks were hesitant to involve themselves in the privatisation policy\textsuperscript{105}.

India has initiated a disinvestment policy rather than privatisation. Unlike Pakistan, India has adopted a policy of retaining government control on the units. A part of the equity is being sold, but to a large extent, this is transferred to public sector financial institutions. In the long run the motive is to ultimately transfer these shares to the market, but the percentage of disinvestment indicates that the government has no plans to privatise existing public sector units. Some sick units are being transferred to the private sector through the Board for Industrial Restructuring. These have been mainly transferred to the domestic private sector.

\textsuperscript{103} Ibid.

\textsuperscript{104} The implications of this is most clearly felt in the power generation sector, where firms licensed by the Benazir regime are now under serious investigation and severe pressure to reduce the prices of their product.

\textsuperscript{105} EIU Country Report: Pakistan, 2\textsuperscript{nd} Quarter, 1993, pp. 32-33.
The main difference between the policy in India and Pakistan is that, Pakistan has chosen certain high profile and important public sector units where in addition to equity transfer, management control too is being transferred. In this, foreign companies are preferred, given the lack of required expertise within the domestic entrepreneur community. There is a distinct thrust to involve foreign promoters in the privatisation process particularly in large industries and infrastructure. This is not so in India.

3.5 CONCLUSION

It is clear from the preceding discussion that Pakistan has one of the most liberal policies on foreign direct investment not just compared to India, but also with other countries in South-East Asia. Features such as permission for foreign direct investment to operate in real estate, agriculture and other services besides industry are an advancement, since these sectors are normally reserved for domestic entrepreneurs in most countries. Similarly the non discrimination in terms of licenses, taxation et. al. too mark out Pakistan's foreign direct investment policy. It is not that Pakistan lacks a powerful domestic industrial lobby, a factor that ensures these areas are their exclusive privilege. The reasons why this class has not opposed liberalisation of the FDI regime will be seen in chapter five. Unlike Pakistan, India still follows a rigid policy. From a near total ban it has now moved to guarded entry vis-à-vis foreign direct investment. Several restrictions on foreign direct investment and discrimination (compared to indigenous entrepreneurs) against them vis-à-vis state attitude continue to apply.

The two countries, through different means, continue to impart a sector thrust to their efforts to increase foreign direct investment inflows. Pakistan has moved away from a regulation oriented foreign direct investment policy to an inducement oriented policy to achieve its goals. India continues to emphasise the role of regulations in realisation of its goals. The major difference brought about by India is that new agencies have been set up to regulate and promote foreign direct investment inflows. In a sense, India's new policy thrust i.e. increasing foreign direct investment inflows but also simultaneously regulating it through the approach of a case by case method, is a replication of Pakistan's foreign direct investment policy that existed between 1976
(when the Foreign Private Investment Act was passed) and the late eighties (when approval requirements were abolished).

Pakistan has done away with approval requirements completely and India has simplified the process substantially. There is, in Pakistan, an attempt to attract FDI in all potential industries in manufacturing without any limits on extent of foreign equity ownership. Even while maintaining an equity cap on FDI in services, the policy stipulates a minimum foreign exchange inflow in each project in this sector. These imply a clear policy orientation towards according the motive of using FDI as a source of foreign exchange resources, with the same status as that of using FDI to aid the economic restructuring process. In contrast, the policy framework governing FDI entry in India limits foreign equity ownership on a large number of sectors and does not stipulate any minimum foreign exchange inflow norms. This indicates that India considers the motive of using FDI as a source of foreign exchange as secondary and not as important as its role in aiding the restructuring process.

The two countries have introduced far reaching economic liberalisation measures. These are aimed at reducing policy distortions and policy induced limits on the economy’s growth potential. Despite this, several controls on the economy still continue. It is from these controls that bureaucratic regulation of foreign direct investment from the investment stage through to the production stage continues.

The professed motives for attracting foreign direct investment in the two countries are common, namely to bridge the savings investment gap for the targeted rate of growth and improving resource allocation in the economy and resource utilisation by productive factors. Therefore the reasons for the divergence in the policy and operating environment for FDI is to be traced to factors other than these professed motivations of the governments. This has been traced out in the following chapters.