Journal of Contemporary Issues in Business and Government Vol. 26, No. 02, 2020
https://cibg.org.au/

P-ISSN: 2204-1990; E-ISSN: 1323-6903
DOI: 10.47750/cibg.2019.26.02.261

Impact of Political Setups on Foreign Direct Investment in Pakistan

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ABSTRACT

This paper analyses the impact of different political setups on foreign direct investment (FDI) in Pakistan and examines whether different political setups has any effect on FDI. The time series data from the period 1971-2018 is used. Ordinary least square regression model is run to check the significance of the data and relationship between dependent and independent variables. Gross domestic product, gross capital formation, inflation rate, indirect taxes, exchange rate, trade openness and dummy variable for dictatorship or autocratic regime in Pakistan are taken as an independent variables and FDI as dependent variable. The results of study indicate that in the long run GDP is the major determinant of FDI in Pakistan and is followed by gross capital formation or domestic investment and inflation. The results also indicate that during dictatorship or imperialistic regimes there are less FDI into Pakistan.

Keywords: Political setups, Foreign direct investment, Pakistan

INTRODUCTION

The International Monetary Fund (IMF) defines Foreign Direct Investment (FDI) as when one individual or business owns 10% or more of a foreign country's capital. Financial transactions afterwards are considered by the IMF as an additional direct investment. If an investor owns less than 10%, it is considered as an addition to his stock portfolio. With only 10% ownership the owner may or may not have control in the foreign business. The investor usually has significant influence on the company's management, policies and operations even with just 10% share in the business (Demirhan and Masca, 2008; Samimi et al., 2011)

P-ISSN: 2204-1990; E-ISSN: 1323-6903
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Developing countries are facing the problem of low national savings. Due to low savings, they do not have enough funds to finance their investments. So, developing countries are in constant need of capital to finance their investments (Graham et al., 2014; Asif et al., 2017; Rafique et al., 2020). Countries can raise capital either from local sources by raising the level of savings or either borrowing or attracting foreign capital in the form of both direct and indirect investments. Initially developing countries took loans from international commercial banks but, due to debt crisis, it forced many countries to reform their investment policies so as to attract more stable form of foreign capital (Uygur, 2005; Ali et al., 2020). FDI's appeared to be one of the easiest ways to get foreign capital without any risks linked to the debt. So, FDI's became an alternative to bank loans as a source of raising capital (Jafari and Britz, 2020).

FDI can be a tremendous source of external capital for a developing country, which can lead to economic development. Countries which invite FDI can gain access to a wider global and better platform in the world economy. FDI increases the level of competition in the host country. Other companies will have to improve on their processes and services in order to stay in the market (Asiedu and Lien, 2011; Asif et al, 2020). It enhances the quality of products and services in the host country. Governments invite FDI's because they get additional expertise, technology and products. To welcome these benefits the governments provide great tax incentives for foreign investors which ultimately suit all parties (Frenkel et al., 2004). FDI exposes national and local governments, local businesses and citizens to new practices, management techniques, economic concepts and technology that will help them develop local businesses and industries. It has also ensured a number of employment opportunities by aiding the setting of new industrial units in the developing countries (Azam and Lukman, 2010; Khan et al., 2020). FDI is the investment decision of profit-maximizing firms facing world-wide competition and where significant differences in cost structures (due to say, factor productivity, wage differential) justify cross-border investment and production. This study analyses the impact of different political setups on foreign direct investment in Pakistan.

LITERATURE REVIEW

The main determinants of FDI generally used are GDP, trade openness, inflation, taxes, domestic investment and exchange rate etc. There is a vast empirical literature on the determinants of FDI inflows, however, only a few of the studies like Busse (2003), Li and Resnick (2003), Jensen (2003), Asiedu and Lien (2010) includes democracy as an explanatory variable. Extensive literature review revealed that the empirical research on FDI and political regimes is scant and also recent. Some of these studies found a positive and significant relationship between democracy and FDI and some studies found a negative effect.

Busse (2003) in his paper tried to examine empirically the complex relationship between democracy and FDI inflows. He used cross-sectional and panel data analysis. The results indicated that investments by multinationals are significantly higher in democratic countries,

P-ISSN: 2204-1990; E-ISSN: 1323-6903
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thereby refuting the hypothesis that political repression fosters FDI inflows. Even this positive link does not hold for 1970s, when a considerable share of FDI flowed to countries with repressive regime. Li and Resnick (2003) studied the impact of democracy on FDI inflows to less developed countries. They used time series, cross-sectional statistical tests of fifty three developing countries from 1982 to 1995. The empirical findings indicated that property rights protection and democracy related protection encourage FDI inflows while democratic institutions improve property rights. Jensen (2003) used both cross-sectional and time tests of the determinants of FDI for more than 100 countries. Based on his empirical findings, he argued that democratic political system attract higher levels of FDI inflows both across countries and within countries over time. Democratic countries are predicted to attract as much as 70 percent more FDI than their authoritarian counterparts. Yasmin et al (2003) studied and analyzed the volume and determinants of FDI inflows in developing countries. They followed panel data model and applied three approaches, common intercept model, random effects and fixed effects model to clearly identify the factors affecting FDI in developing countries. The results showed that urbanization, standard of living, inflation, GDP per capita, current account and wages are affecting FDI significantly in low income, urbanization, labour force, domestic investment, trade openness, standard of living, current account, external debt and wages in lower middle income and urbanization, labour force, GDP per capita, domestic investment, trade openness, and external debt in the sample upper middle income countries. Frenkel et al. (2004) examined the determinants of FDI inflows to emerging economies by analyzing data set of bilateral FDI inflows. By using a panel approach, they found out that distance and both home and host country characteristics played a significant role in determining FDI and FDI inflows are inversely related to the distance between the home and host country. On the side of host countries, the results suggested that GDP growth rate, extent of risk, market size and distance played an important role for FDI inflows. Economic growth and risk in host countries are crucial for attracting FDI inflows. Aqeel et al. (2004) empirically identified the determinants of FDI inflows in Pakistan over the period 1961 to 2003. They used the Co-integration and error-correction techniques to identify the variables in explaining the FDI inflows in Pakistan. They used FDI inflows as dependent variable and exchange rate, tariff rate, tax rate, credit to private sector, index of general share price, wages and per capita GDP as independent variables. The results indicated that all the variables indicated correct signs and are statistically significant except for wage rate and share price index. This study emphasized the role of these variables in attracting FDI inflows. Uygur (2005) investigated the determinants and importance of FDI inflows for Turkey for the period of 1992 to 2004. He applied the VAR model. In the model the dependent variable is FDI inflows and inflation rate, real interest rate, export rate, investment atmosphere, growth rate and budget deficit rate as independent variables. The results showed that the real interest rate of official treasurer department and consolidated budget balance are the main determinants of FDI inflows for Turkey. Azam and Lukman (2008) examined the various economic factors effects on FDI inflows into Pakistan, India and Indonesia over the period 1971 to 2005. They used log linear regression model for each country and the method of least squares to estimate the

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various economic determinants effect on FDI inflows. The results revealed that market size, external debt, trade openness, domestic investment and physical infrastructure are the important determinants of FDI inflows. This study further found out that the results of determinants of India matched with the results of Pakistan excluding two determinants viz, trade openness and government consumption. The results of Indonesia didn't match with the results of determinants of FDI inflows of India and Pakistan. Erdol and Masca (2008) explored the determining factors of FDI in developing countries over the period of 2000 to 2004. This study was based on a sample of cross-sectional data of 34 developing countries. They used average value of all data for the 2000 to 2004 period. In the model the dependent variable is FDI and independent variables are growth rate of per capita GDP, inflation rate, telephone lines per 1000 people measured in logs, labour cost per worker in manufacturing industry measured in logs, risk and corporate tax rate, degree of openness. According to empirical results, growth rate of per capita, tax rate and telephone main lines present negative sign and are statistically significant, and labour cost has positive sign ad risk has negative sign, but both are not significant. Asiedu and Lien (2011) examined whether natural resources alter the relationship between FDI inflows and democracy. They estimated a linear dynamic panel-data model using data from 112 developing countries over the period 1982 to 2007, and they found out that there is some critical value of the share of minerals and oil in total exports below which democracy enhances FDI inflows and above which democracy reduces FDI inflows. They identified 90 countries where an expansion of democracy may enhance FDI inflows and 22 countries where an increase in democratization may reduce FDI inflows. Jafari and Britz (2020) investigated the impact of political stability in organization of Islamic conference countries. They used FDI inflows as dependent variable and population, GDP, trade openness and political stability as independent variables. They used panel data and applied ordinary least squares (OLS) technique to run regression. The results indicate that trade openness, population, and GDP have positive impact on FDI inflows and political stability has detrimental effect on FDI inflows in OIC countries.

METHODOLOGY & ANALYSIS

This study uses the variables of GDP, inflation, indirect taxes, trade openness, domestic investment or gross capital formation, exchange rate, dummy variable for dictatorship and foreign direct investment in Pakistan for empirical analysis from 1971 to 2018.

Economic Relation

FDI = f (GDP, INF, IT, TO, DI, ER, PS)

Model

$$FDI = \delta_0 + \delta_1 GDP + \delta_2 INF + \delta_3 IT + \delta_4 TO + \delta_5 DI + \delta_6 ER + \delta_7 PS + \varepsilon$$

Where

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Foreign Direct Investment (FDI)

Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows net inflows (new investment inflows less disinvestment) in the reporting economy from foreign investors.

Gross Domestic Product (GDP)

GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data is used in constant local currency unit (LCU).

Inflation (INF)

Inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals, such as yearly.

Indirect Taxes (IT)

Net taxes on products (net indirect taxes) are the sum of product taxes less subsidies. Product taxes are those taxes payable by producers that relate to the production, sale, purchase or use of the goods and services. Subsidies are grants on the current account made by general government to private enterprises and unincorporated public enterprises. The grants may take the form of payments to ensure a guaranteed price or to enable maintenance of prices of goods and services below costs of production, and other forms of assistance to producers. Data are in constant local currency.

Trade openness (TO)

Trade is the sum of exports and imports of goods and services measured as a share of gross domestic product.

Gross capital formation (DI)

Gross capital formation (formerly gross domestic investment) consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Fixed assets include land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. Inventories are

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stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales, and "work in progress." According to the 1993 SNA, net acquisitions of valuables are also considered capital formation. Data are in constant local currency.

Official exchange rate (ER)

Official exchange rate refers to the exchange rate determined by national authorities or to the rate determined in the legally sanctioned exchange market. It is calculated as an annual average based on monthly averages (local currency units relative to the U.S. dollar).

Political Setup (PS)

Dummy Variable for Political Setup has been categorized into two categories, 1 for democratic setup and 0 for autocratic setup

Data Sources

Data for the variables of gross domestic product, inflation, indirect taxes, trade openness, gross capital formation, exchange rate and foreign direct investment has been taken from World Development Indicators (WDI) online database by World Bank (2020).

RESULTS AND DISCUSSIONS

We have used Augmented Dickey Fuller (ADF) unit root test to check the stationarity of the data. According to these results the variables of gross domestic product, indirect taxes, gross capital formation, foreign direct investment and exchange rate are not stationary at level because p-value is greater than level of significance 10%. This implies that null hypothesis of unit root at level cannot be rejected for these variables but the variables of inflation and trade openness are stationary at level because the p-value is less than level of significance 10%. However the variables of indirect taxes, FDI inflows and gross capital formation are stationary at 1st difference and the variables of GDP and exchange rate are stationary at 2nd difference. This shows that the null hypothesis of unit root for all the variables is rejected when we use the 2nd difference of the variables.

Table No: 1
Augmented Dickey-Fuller (ADF) Unit Root Test Results at Level

Variables	Intercept			Intercept Time Trend		
	D-F test statistic	p-value	No. of lags	D-F test statistic	p-value	No. of lags
GDP	-2.605836	0.9999	1	-3.192902	0.9875	1

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Inflation	-2.604867	0.0222	0	-3.191277	0.0738	0
Indirect taxes	-2.604867	0.3190	0	-3.200320	0.9391	5
To	-2.604867	0.0002	0	-3.191277	0.0038	0
Gcformation	-2.604867	0.8664	0	-3.194611	0.0356	2
ER	-2.614300	0.9979	8	-3.202445	0.9485	6
FDI	-2.615817	0.9999	9	-3.202445	0.0023	6

Table No: 2

Augmented Dickey-Fuller (ADF) Unit Root Test Results at 1st difference

Variables	**Intercept**			**Intercept Time Trend**		
	D-F test statistic	**p-value**	**No. of lags**	**D-F test statistic**	**p-value**	**No. of lags**
GDP	-2.605836	0.2261	0	-3.192902	0.0748	0
Indirect taxes	-2.610263	0.0910	4	-3.200320	0.0791	4
Gcformation	-2.605836	0.0000	0	-3.192902	0.0004	0
ER	-2.614300	0.8754	7	-3.212361	0.4006	9
FDI	-2.612874	0.0001	6	-3.212361	0.0030	9

Table No: 3

Augmented Dickey-Fuller (ADF) Unit Root Test Results at 2nd difference

Variables	**Intercept**			**Intercept Time Trend**		
	D-F test statistic	**p-value**	**No. of lags**	**D-F test statistic**	**p-value**	**No. of lags**
GDP	-2.606857	0.0000	0	-3.194611	0.0000	0
ER	-2.614300	0.0000	6	-3.207094	0.0003	6

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Johansen co-integration test has been applied to test the co-integration among the variables of foreign direct investment, GDP, exchange rate, gross capital formation, inflation, indirect taxes and trade openness.

The results of the test have been reported below. Trace statistics *trace* λ and maximum eigen statistics are used to check the number of co-integrating vectors. Both statistics test the null hypothesis of no co-integration against the alternative of co-integration, starting with the null hypothesis of no co-integration ($r \leq 0$) among the variables.

Table No: 4
Unrestricted Co-integration Rank Test (Trace)

H_0	H_1	Trace statistic	0.10 Critical value	Prob.
R = 0*	R ≥ 1	198.7919	120.3673	0.0000
R ≤ 1*	R ≥ 2	135.5814	91.11028	0.0000
R≤ 2*	R ≥ 3	84.37045	65.81970	0.0022
R≤ 3*	R ≥ 4	54.24768	44.49359	0.0112
R≤ 4	R ≥ 5	26.99815	27.06695	0.1017
R≤ 5	R ≥ 6	9.554556	13.42878	0.3166
R≤ 6	R ≥ 7	1.998427	2.705545	0.1575

Trace test indicates 4 co-integrating eqn(s) at the 0.1 level
* denotes rejection of the hypothesis at the 0.1 level
**MacKinnon-Haug-Michelis (1999) p-values

Table No: 5
Unrestricted Co-integration Rank Test (Maximum Eigenvalue)

H_0	H_1	Max-Eigen Statistic	0.10 Critical value	Prob.
R = 0*	R ≥ 1	63.21058	43.29404	0.0004
R ≤ 1*	R ≥ 2	51.21091	37.27779	0.0019
R ≤ 2*	R ≥ 3	30.12277	31.23922	0.1316
R ≤ 3*	R ≥ 4	27.24952	25.12408	0.0551
R ≤ 4	R≥ 5	17.44360	18.89282	0.1521
R ≤ 5	R ≥ 6	7.556129	12.29652	0.4256
R ≤ 6	R ≥ 7	1.998427	2.705545	0.1575

Max-eigenvalue test indicates 2cointegratingeqn(s) at the 0.1 level

* denotes rejection of the hypothesis at the 0.1 level
**MacKinnon-Haug-Michelis (1999) p-values

P-ISSN: 2204-1990; E-ISSN: 1323-6903
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The trace-test statistics is 198.7919, which is above the critical value of 120.3673 at 10% significance level. Hence it rejects the null hypothesis $r \leq 0$ in favour of alternative hypothesis $r = 1$. Similarly, the null hypothesis of $r \leq 1$, $r \leq 2$, and $r \leq 3$, can also be rejected in favour of alternative hypothesis of $r = 2$, $r = 3$, $r = 4$. But null hypothesis of $r \leq 4$ cannot be rejected in favour of alternative hypothesis of $r = 5$ because trace statistics 26.99815 which is less than the critical value of 27.06695 at 10% significance level. All of this shows the existence of four co-integrating vectors. Same is the case when we use maximum eigen test statistics, which also confirm the existence of four co-integrating vectors.

Thus the analysis of data confirms the presence of long run relationship among GDP, FDI inflows, Inflation, trade openness, gross capital formation, indirect taxes and exchange rate in Pakistan.

As co-integration exists among the variables used in the study, therefore, the results presented for long run are reliable. The long run results are reported below.

Table No: 6
Long Run Relationships

Dependent Variable: FDI			
variable	**Coefficient**	**t-statistic**	**p-value**
GDP	4.80E-13	1.815377	0.0780
GCFORMATION	2.85E-12	3.055961	0.0043
INFLATION	0.036832	2.497966	0.0173
TRADE	-0.060565	-2.371615	0.0233
EXCHANGE	-0.065814	-4.113958	0.0002
TAXES	-1.43E-12	-1.668924	0.1041
DM0	-0.431369	-3.273018	0.0024
constant	0.474669	0.719465	0.4766
R-squared	0.815878		
Adjusted R-squared	0.779054		
F-statistic	22.15592		
Prob(F-statistic)	0.000000		
Durbin-Watson stat	1.347089		

The results reported in the above table shows that GDP, Gross Capital Formation or Domestic Investment and Inflation have positive and statistically significant impact on Foreign Direct Investment inflows (FDI) which means that with the increase in country's GDP growth rate, Domestic Investment and Inflation, FDI inflows in the country will increase and these variables have significant impact on FDI inflows. The variables of Trade (% of GDP), Exchange Rate and

P-ISSN: 2204-1990; E-ISSN: 1323-6903
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Indirect Taxes have negative impact on FDI inflows in Pakistan, which means that with the increase in our currency's exchange rate, increase in indirect taxes and increase in trade (% of GDP), there will be less Foreign Direct Investment (FDI) in Pakistan and out of these three variables Exchange Rate and Trade (% of GDP) have significant impact on FDI inflows and Indirect Taxes has insignificant impact on FDI inflows. The Dummy Variable for Dictatorship Regime (DM0) also has negative impact on Foreign Direct Investment inflows (FDI) and its impact on FDI inflows is also significant which means during the Imperialistic or Dictatorship regimes in Pakistan there was less FDI inflows in Pakistan. The results also shows that in Pakistan GDP has the highest 4.80E-13 impact on FDI inflows, followed by Gross Capital Formation 2.85E-12 and Inflation 0.036832. The Indirect taxes has lowest -1.43E-12 and insignificant impact on FDI inflows in Pakistan.

The value of R-squared 0.815878 indicates that 82% variation in the dependent variable is explained by the independent variables.

The value of Prob(F-statistic) is less than level of significance 10%, so we will reject Ho and accept H1 that is the overall model is significant.

Table No: 7
Short Run Dynamics

Dependent Variable: Δ FDI			
variable	**Coefficient**	**t-statistic**	**p-value**
Δ GDP	1.02E-12	2.338773	0.0256
Δ GCFORMATION	2.18E-12	2.362592	0.0242
Δ INFLATION	0.008645	0.714570	0.4799
Δ TRADE	0.007479	0.350131	0.7285
Δ EXCHANGE	-0.069514	-3.933019	0.0004
Δ TAXES	-1.23E-12	-1.526239	0.1365
Δ DM0	-0.184703	-1.085433	0.2856
ECTt-1	-0.364131	-2.148998	0.0391
constant	-0.098381	-0.945813	0.3511
R-squared	0.580627		
Adjusted R-squared	0.478960		
F-statistic	5.711104		
Prob(F-statistic)	0.000138		
Durbin-Watson stat	1.920725		

Once co-integration among the variables is proved, we can use VECM to study the short run dynamics. The purpose of ECM is to check the short run dynamics of the long run equilibrium

P-ISSN: 2204-1990; E-ISSN: 1323-6903
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and to check the stability of the long run equilibrium. Table above shows the short run dynamics of the variables.

The result shows that GDP, Gross Capital Formation, Inflation and Trade have positive impact on FDI inflows in the short run but the impact of GDP and Gc formation is significant and the impact of Inflation and Trade is insignificant in the short run. The variables of Exchange Rate, Taxes and DM0 have negative effect on FDI inflows in the short and Taxes and Dummy Variable for Dictatorship regime (DM0) have insignificant impact on FDI inflows in the short run and Exchange rate has significant impact on FDI inflows in the short run.

The estimates present in the above table shows that the coefficient of Error Correction Model has negative sign and is significant which means that our long run equilibrium is stable, if there is any shock the variables will converge towards long run equilibrium with the speed of 36% per year and the long run equilibrium will be restored in (1/0.3641) = 2.47 Years.

Table No: 8
Diagnostic Tests

Normality Test (Jarque-Bera Statistics)	Jarque-Bera Statistics =2.144100	Probability =0.342306
Serial Correlation (Breush-Godfrey Serial Correlation LM Test)	F-statistics = 3.213184	Probability = 0.0531
ARCH Test (Autoregressive Conditional Heteroskedasticity Test)	F-statistics = 0.659483	Probability = 0.4215
Heteroskedasticity Test (White Heteroskedasticity Test)	F-statistics = 6.358028	Probability =0.0050

The purpose of Jarque-Bera test is to check the normality of the error term. The result shows that based on J-B stats the p-value is greater than level of significance i.e. 10%, so we will accept null hypothesis of normality and conclude that the residual is normally distributed. The purpose of this test is to check the serial or auto correlation. The result shows that there is problem of serial correlation or there is auto correlation. The purpose of both ARCH and White tests is to check the Heteroskedasticity of error term. The results of White test shows that there is presence of Heteroskedasticity and the results of ARCH test shows that there is problem of Autoregressive Conditional Heteroskedasticity.

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CONCLUSION AND POLICY IMPLICATIONS

The results indicate that in the long run GDP is the major determinant of Foreign Direct Investment inflows (FDI) in Pakistan as it has the highest coefficient and is followed by Gross Capital Formation or Domestic Investment and Inflation. The results also indicate that the Dummy Variable for Dictatorship (DM_0) has negative sign which means that during dictatorship or imperialistic regimes there are less FDI inflows into Pakistan.

The results of present study have profound policy implications. The empirical findings suggest that if we want to attract foreign investors to invest in Pakistan then we must increase our GDP growth rate because when foreign investors will see that economy of the country is growing then they will have the prospects of earning higher profits and they will invest more. Another factor which directly affects the FDI inflows is the volume of domestic investment. If the volume of domestic investment will be higher this means that local investors will prefer to invest in Pakistan because of better investment conditions. So, if we want to attract foreign investors to invest in Pakistan then we should formulate such policies that local investors will prefer to invest in their home country and incentives should be given to local investors because with the increase in domestic investment Foreign Direct Investment inflows will increase. Another important point which has been proved above is that political setups also have effect on Foreign Direct Investment inflows (FDI) in Pakistan. So if we want to attract foreign investors, then, there should be a stable democratically elected government in Pakistan because the democratic institutions provide both the commitment and credibility in the market friendly environment. Foreign Investors or Multi-national Corporations will also favour democratic environments where the firms or MNCs can influence policy through lobbying efforts. MNCs choose to enter countries with minimal political risk and stable economic policy.

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