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Investigating the Impact of Political Stability, Trade Liberalization, and Investment Incentives on the FDI Inflows in Pakistan

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ABSTRACT

This study examines the impact of the political stability and trade openness, trade liberalization and investment incentives on the FDI Inflow of Pakistan. FDI in all over the world has been growing at a spectacular pace and Pakistan as an emerging economy has been successful in attracting more FDI compared to developed countries. The data for this study were collected through the World Bank (World Bank Indicator Database) and The Global Economy from the period of 1995-2018. The procedure of ARDL bound testing was applied to observe the association between FDI and political stability alongside other indicators such as trade openness, and incentives to investments in Pakistan. Tests were carried out to observe short-run and long-run relationships. FDI inflow were found to be significantly and positively influenced by trade openness and incentives in the long run. For the policymakers, the implications in our research underlie improvements to political establishments and a stable democratic system along with investor's friendly long term policies that are central to attracting more FDI in Pakistan. Moreover, the Government should focus on removing uncertainties which lead to instabilities. Stable government may manage credible trade reforms to further liberalize its trade to enhance FDI inflows and reduce tariffs with the motive of providing incentives on investments.

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Introduction

In the context of Pakistan, the structure in private universities of Pakistan is autonomous, and have been facing continuous changes (Zulfqar & Valcke, 2014). The changes such unnecessary authority is given to the registrars and the vice-chancellors (Sial, Jilani, Imran, & Zaheer, 2011), and poor governance of universities lack of accountability have also been prevailing in the higher-education institutes (Sial et al., 2011).

FDI plays a significant part in a country's economic growth by the way of transferring knowledge, expertise in technological and management advancement (Hansen & Rand, 2006).

The connection between the openness of the trade with regards to FDI inflow is not as simple as it seems. First of all, it is contended that determinants of FDI and exchange are comparable; in this way, what decides the exchange likewise decides FDI inflow (Ekholm & Södersten, 2002). Also, appraisals to in which FDI econometric models fares, the imports are resolved that they are endogenous factors at the same time contended (Hejazi & Safarian, 2003). Last but not the least, concerning studies shows at the blow of trade agreements of the region on FDI inflows show some impact. The impact shows that FDI inflows influenced by trading agreements. So that the territorial integration accompanied to the risk attached with the investments decline.

However, the FDI inflows with regards the global trends have not been persuading and require more consideration over the globe of drivers that are important for FDI inflow. According to Global Investment Competitiveness Report 2017, there was a substantial decrease in the FDI inflow global FDI. The substantial decrease is 23 percent to $1.43 trillion in 2017. The host governments pose challenges by such a substantially decrease in FDI inflows to devise foreign investors are attracted by suitable policies of industry and investment because the expert's characteristics FDI inflows considerable decline over the world to variables of policy-relation (OECD Report 2018; UNCTAD Report 2018). There have furthermore declined by 19% in the FDI inflow to $1.2trilion; some of the developed nations got such fall majorly while due to market liberalization policies, FDI inflow in China was the highest and it was the largest recipient of FDI inflows and developing countries remained stabilized (UNCTAD Report 2019). However, the property and contractual rights related policies depending upon the several types of institutional quality and the political regime for foreign investors(Clague, Keefer, Knack, & Olson, 1996; Duanmu, 2014; Harms & Ursprung, 2002).

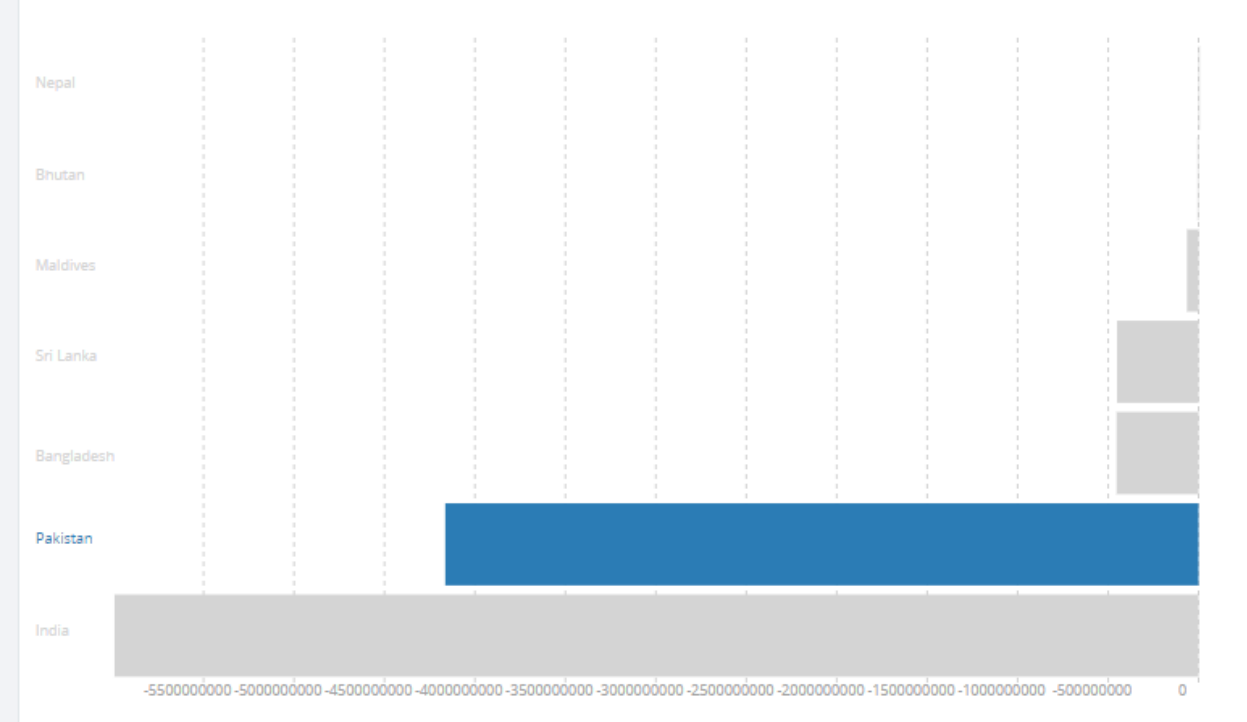
Various incentives as tax/tariff incentives provided to the foreign and local investors during the last 2 and ½ decades. There is the existence of Tariffs or CTR with a relationship to the domestic investment and FDI is not evidenced in Pakistan. Apart from this, no significant study or research demonstrate if there have had impacts on the investments (FDI and domestic) of tax incentive in Pakistan. The focus of this study is to identify that domestic investment and FDI are affected by non-tax factors.

Husain (2009) noted that a beneficial business environment relies heavily on political stability in a country. The probable downturn of business activities could result from political risk that comes from change in governments, change in legislative bodies and military control.

Normally, it is obvious to understand that the governments of democracy reign are having less political risk because of better provision contractual and property rights. The tenure of 2000 to 2007 is considered to be the most successful era with regards to the economic policies (Lodhi, 2017). According to the military reign period, Pervaiz Musharraf former president of Pakistan introduced the Economic Regulations Program (ERP). By opening the international trade the economy of Pakistan's increases as the objectives of principal trade policy became a rapid reduction in anti-export and import biases. Regulatory duties, import surcharges, and quotas were removed by the government of that such successful era.

It is a successful era and before 2008 tenure was the best tenure in Pakistan history. According to previous years of FDIs, Pakistan was successful in that region.

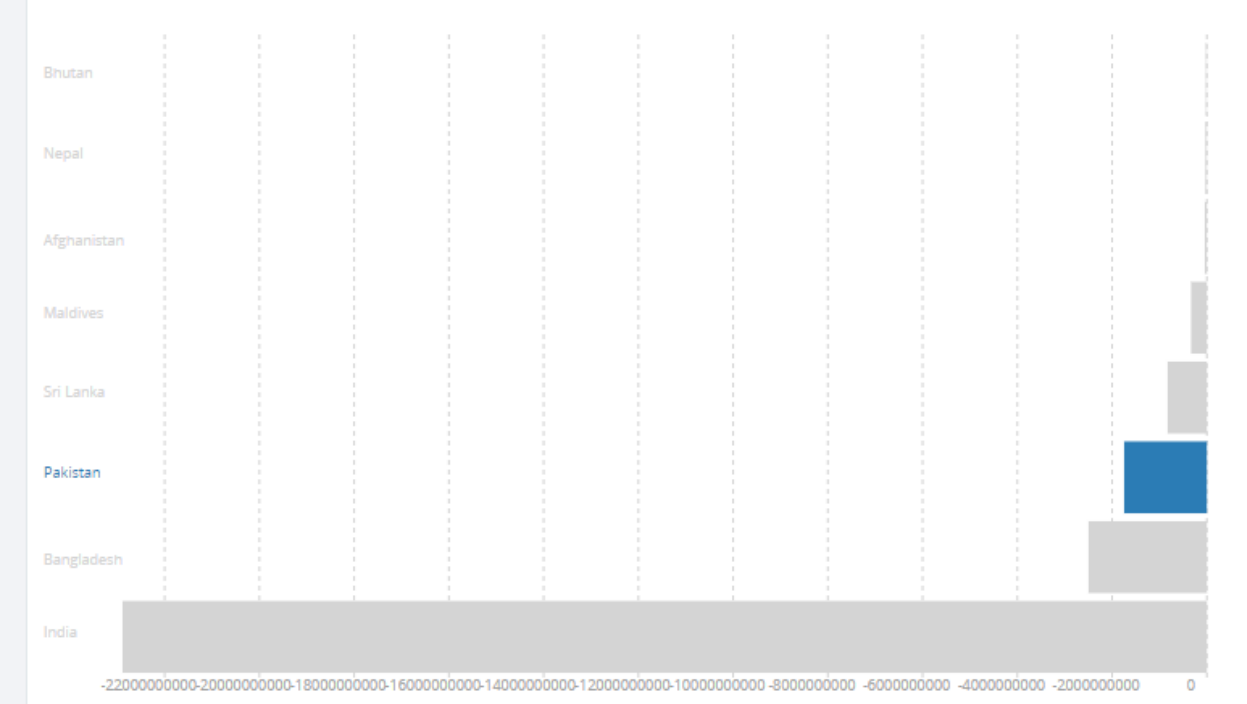
Table 1: FDI inflow of Pakistan and along with its Regions- 2006



Source: World Bank Indicators

If we see FDIs of any other year, for example, we consider the trend of 2014 during the political government of Nawaz Sharif, the FDI of Pakistan in its region is so down that can be seen in the BAR table given below:

Table 2: FDI inflow of Pakistan and along with its Regions- 2014



Our consequences suggest that as compared to democratic governments, the military authorities have been better able to address to attract more FDI inflow in Pakistan.

In developing countries, FDI is the source of providing to gain access to market competition, an increase in capital formation, and technology transfer. Such factors are the main attributes to the increasing level of economic growth. By making perfect combinations of openness in trade and high macroeconomic policies, FDI can work in those ways. The government has to need FDI in such a phenomenon it is the critical source of is assisting the pool of resource creation and capital formation that leads to socio-economical advancement.

FDI: Economic theory suggests in developing countries FDI is the main source of boosting their economic growth. By getting as many benefits from foreign investment some of the countries such as Malaysia, China, Singapore, and South Korea became the Asian Tiger. This is because the capital accumulation gets energized by FDI inflows through the addition to the efficiency in recipient raising and domestic savings. Through the improvements in job creation, allocation of resources, job, industrialization, competition arising and imitation of economies of scale, technology spillovers, reduction in capital costs locally, improving human capital and strengthening financial markets domestically, firms are motivated to invest in host countries. (Athukorala & Wagle, 2011; Haider, Gul, Afridi, & Batool, 2017; Koojaroenprasit, 2012).

Political Stability, Trade Liberalization, Investment Incentive

Many factors like the political system, macroeconomic factors, and development strategy of a country affect the host country's FDI. There are some important factors that motivate foreign investors that can happen through strategies as trade openness and some investment incentives given by the host countries.

Incentives seeking hypothesis, in such a case new markets must be explored by the foreign firms increase profitability and sales in the host country. Due to cheaper factors of production are the sources of motivation that rent-seeking factor states(Zakaria, Naqvi, Fida, & Shahzad, 2014).

Trade liberalization reduces the cost that occurred in export-oriented investments to which multinational firms are engaged to lead to a higher probability. This will attract efficiency-seeking and cost-reducing FDI as the foreign firms can take advantage of importing cheap intermediate goods produced in some other country and exporting the finished products to a third or home country. Open markets allocate resources more efficiently and thus may significantly create economic welfare gains. There are more chances that foreign businesses get attracted due to an economically conducive environment. As a result of this, FDI inflows may substantially increase(Popescu, 2014).

Firms seeking Efficiency use few countries to serve a larger market. Location, resources endowments, and regulations are the key factors that drive such behavior. The efforts to maintain the firm's international status and competitiveness are part of the strategic asset approach which motivates foreign firms to invest in host countries. FDI inflow to developing countries like Pakistan I s mainly vertical because their markets are not matured i.e. they do not have well-established institutions.

This study reconnoiters the particular case of Pakistan and analyzes the factors like Political stability, openness to the trade as liberalization and incentives of investment affecting FDI inflows to the country.

The objectives of the research are to discover the actual elements which can allow FDI in Pakistan by examining the following factors:

- To identify the factors that influence FDI inflow in Pakistan.
- To investigate the impact of political stability over the FDI inflow in Pakistan.
- To analyze if (conduct a detailed analysis to identify the motives of Investment incentive that explore whether) tax holidays/tax exemptions, the incentivized tax policy, and changes in customs tariff rate affect the FDI in Pakistan.

Literature Review

Political Stability and FDI

Many economists from a different region of the world have asserted that the attractiveness of FDI inflow for a country has key ensuring due to political stability. In a series of papers, Kraay, Kaufmann, and Mastruzzi (2010) contended that in order to achieve a higher level of investments by the foreign investors it is important for such countries to that they should focus on considering political stability and some other factors like control of corruption and infrastructure. In this way, these countries will have good chances of attracting more FDI towards the corresponding countries as there high competition and a great environment of global business.

There are some factors among which political stability is the most important according to the economist arguments which states that the large extent of growth and economic progress of a country is committed by the stability in its political and democratic system and effectiveness in regulation quality and transparency (Globerman & Shapiro, 2003). The political stability and violence are the risk factors or attracting and expelling the FDI inflow. A better system of political stability is the sources of attracting FDI inflow and political instability of a country that have higher risks of expelling FDI inflow. These arguments are noted down in the literature of international business that refers to the commonly specific factors of a country as risk factors either attracting the FDI inflow or expels the inward FDI (Knack & Keefer, 1997).

There are many scholars who had done the empirical studies to investigate the associated relationship between political stability and inflow of FDI. Asif, Majid, Yasir, and Ali (2018) found that FDI inflow is highly encouraged by the stability in the government and low level of of external conflicts by using ARDL testing procedure to see long-run relationship in the perspective of Pakistan. Nazeer and Masih (2017) also investigated the short-run and long-run association between the political stability and inflow of FDI by using the co-integration approach through the Autoregressive distributed lag (ARDL) model. Kurecic and Kokotovic (2017) find a long-run relationship between the FDI inflow and political instability for the small economies work on panel basis by using Vector Autoregressive estimates (VAR) and the Granger Causality test. These results are applied only on small economies but there was no relationship existed in larger economies. In addition, Nadeem also studies the long-run impact of political stability with FDI inflow with the help of using Granger multivariate causality Test.

Further we are going with more arguments that country have chances that continues on improving FDI inflow consistently through the vital role political stability. Globerman and Shapiro (2003) concluded that there are several factors advanced education, low level of violence , infrastructure keep on improving by the key role of political stability. These improvements lead to the well defined provision of human capital. This is the key source of attracting inflow of FDI in a country.

It is obvious that MNCs never risks their capital in unstable counties but they prefer work in a stable environment so that they are always willing to invest in those countries that are politically stable. The reason behind the bar is that systems donot works properly in unstable political countries and investors can experience many hurdles and difficulties. A wide range country factors specifically studied related to FDI inflow by the scholars of international business (Allen & Aldred, 2013; Habib & Zurawicki, 2002; Torriti & Ikpe, 2015). The main motive here is that a progress of a country is facilitated by the political stability. The governments are enabled on settling their

plans and keeps on implementation so that it will help in improving country's infrastructures. The governments with stable political conditions develops the unruffled and stimulated atmosphere. This atmosphere engages the political system that enables in establishing the strategies aimed at country's development. This concludes that a country's economic development boosts up with the political stability significantly.

Kim (2010) explores the association between political stability and FDI inflow, as well as the level of corruption. He proposed that by using the political rights measuring the political stability, there exists negative relationship of political stability and FDI inflow. Moreover, he found some interesting results that there is positive relation of FDI inflow with the corruption. He defended these results by giving arguments that high level of corruption among the government leads to more FDI inflow and less FDI inflow with the low level of corruption. The fact is that this happens because non residential companies due to superior treatment in those countries are more likely to invest. Consequently, it remarkable that these results and relationship could be recalled whether there is positive affect of corruption on FDI inflow and significant affects of political stability on inflows of FDI. Is considerably noticeable that the measurements of variable political stability were different from what he was taking into consideration.

Political risks largely depend on political stability and good governance of the government (Husain, 2009). Political stability enhances the probability of attracting more FDI inflows into the developing countries. Pakistan has been suffering from the instability of the political system, this in turn; may adversely affect the inflow of FDI into Pakistan and discourages the international investment. The ever changing political system and the unstable government can cause political risks which, in turn; will adversely affect the level of foreign and domestic investment in the country. If the country's Political Stability condition is not good, foreign investors will hesitate to bring any projects until they are assured that the business environment would to be conducive and favorable (Jawad-ul-Hassan) (Brada et. A.l, 2005; Word Bank, 2011; UNCTAD, 2010). In the case of Pakistan, World Bank report, published in 2011 categorically mentioned that the private sector low investment in the country is because of political instability and corruption.

In today's world there are many features that are considered to be significantly important for investors to establish their business in any environment, one of these is the degree of the political stability of the country in which they are planning to enter for business. This is the more significant factor in determining the flow of FDI into any country (Lambsdorff, 1999). Tuman and Emmert (2004) however, traced that political instability and riots and regular constitutional changes in government significantly affected FDI inflows in the developing country. Political stability is essential for the country's smother economic growth. Recently in Pakistan since the year 2008, political stability has registered a declining trend. As a result, foreign investments are declining in Pakistan. The report of UNCATD (2011) in Pakistan less domestic sector investment the main reason is the political stability of the county. Data in Table 10 highlights that Pakistan political stability index is going down, this is obviously critical for foreign investors to invest.

Anwar, Saeed, Khan, and Ahmad (2013) investigated the determinants of foreign direct investment in Pakistan for the period of 1980 to 2010. The impact of cost of war against terrorism, electricity generation, political stability, inflation, GDP, incentives offered to investors, trade openness and exchange rate with inflows of foreign direct investment was estimated by applying ARMA and ordinary least squares (OLS) regression techniques. The results revealed that electricity generation, GDP, exchange rate, incentives provided to investors and trade openness had significant and positive relationship, whereas, political instability and cost of war against terrorism had significant and negative relationship with FDI inflows in Pakistan.

H1: Political stability has a significant positive effects on FDI inflows in the host country.

Trade Liberalization and FDI

Trade openness, that means the gradation of trade liberalization of a host country, is regarded as a vital component that promotes FDI (Afridi, Gul, & Haider, 2018). Aizenman (2005) found a relationship in the case of FDI and trade. He investigated that in developing countries to what extent the linkage between FDI and international trade exists. For the different categories of FDI and trade, several methods were used for the purpose of investigation of two-way feedback. For the investigation of Manufacturing trade and FDI, strong feedback occurred in order to investigate a two-way response. Such results happened after the control of institutional and macroeconomic effects. The same kind of results was found in order to see the association between FDI inflow and TOI. Antras and Caballero (2009) mainly focused on studies to check the relation between capital inflow and trade. According to their arguments, the diversification of financial development in this world with the economies of less developing countries has the supplements of capital inflow mobility and trade. the complementarily occurs over to financial capital flows in a dynamic framework. This interaction is important in such a way of gaining excess to the capital flows and it implies that strengthening in trade integration raises net capital inflows in developing economies.

When the restriction in trade is minimized in the host countries, it happens because removing trade barriers such as the decrease in import quotas and duties. So it is obvious to perceive that such countries are the motivation of investors to invest to get benefits of trade. And hence such countries are highlighted as they tend to increase the trade openness as the trade liberalization. Aizenman and Noy (2006) founded the two-way dimensional association between FDI and openness in trade. Vijayakumar, Sridharan, and Rao (2010)distinguished the negative impact of FDI and liberalization of trade as openness in trade. Liargovas and Skandalis (2012) use an instrument to check the effect of openness in trade in attracting FDI. By using eight measures in the developing countries he got the results that openness in the trade has a positive impact on FDI of a country in the developing economies. Belloumi (2014) from Tunisia develop results to see the associations between FDI and openness in trade. R. E. A. Khan and Adnan Hye (2014) stated that if there are fewer tariff rates and restrictions in the trade that implied by the liberalization then investor for the sake of benefits gets cost efficiency in investing such kind of hosting countries. This study is mainly focused to check the impact on political relations of Pakistan with international economies from the span of 1972-2009. It is estimated that Pakistan has less or no influence by the US territory policies with regards to the flow of capital in the long run. In the same context, U.S failed policies of diplomacy have resulted that influenced negatively to the inward flow of FDI in Pakistan. So that in the short term as well as the long term we got some conclusions. There is a significant positive relation of FDI with domestic investment. Also, studies explained that the impact of utilization of natural resources and the financial devilment exerts a significant positive impact on FDI. Infrastructure is also seen as important with respect to FDI flows.

M. H. Shah and Samdani (2015)conducted a study in D-8 countries and explains the associations of openness of trade with regards to the inflow of FDI in such countries. He explained that trade liberalization is positively impacting the inflow of FDI. Donghui, Yasin, Zaman, and Imran (2018)keenly studied the GDP, and other economic indicators as inflation, and exchange rate. He studies to explain the positive impact of openness on trade with FDI along which such determinants. Nieman and Thies (2019) and Camarero, Gómez-Herrera, and Tamarit (2018)found relations in EU countries and built a consensus that trade liberation has significant impacts on FDI.

The studies explained that Pakistan's FDI must be promoted by the activities like domestic investment improvements in local infrastructure and continuity of trade openness as the trade liberalization. This shall have happened when strengthening all such resource-based activities.

H2: Trade Liberalization has a positive effect on FDI inflows in the host country.

Investment incentives and FDI

Etim, Onyebuchi, and Udo (2014)researched on FDI determinants and the impacts such determinants on the Nigerian economy. There study explained that in what ways different investment determinants like political risks, openness, and exchange rate affect the FDI inflow in Nigeria during their mentioned period. Their study also explained that exchange rate, market size (GDP), and openness emit a foremost impact on FDI while the political risk was not a momentous factor.

In the Nigerian Oil and gas sector, trade openness, tax incentives and natural resources available to the required had a major impact on foreign direct investment. Such factors did not affect market size, political risk, and economic stability (Babatunde & Adepeju, 2012).To support FDI this explores the focused novel trend that objectives of economy attention should attract FDI and economic growth from the perspective of Nigeria's economy. In the oil and gas sector in Nigeria, such a study provides the discernment to then FDI determinants, that availability of natural resources and openness to trade that follow the incentives of tax policy.

While there were several studies conducted in Pakistan and a major study, Majeed and Ahmad (2009)explained that investors' friendly environment and enabling safety are the important frequent part of FDI. The investment and capital formation are successful in Pakistan when the impacts of some allowances were observed. Such observed allowances include concessions need in depreciation allowances and tax incentives such as tax holidays. Aid (2014) studied Ghana's policies of incentives given on investments: the earnings exports of a country can be increased the tax incentives. Such incentives are the attraction towards FDI discovered by The Cost of Social Development. Due to the decrease in the tax rate, it unveils the increase in benefits from competition. And meanwhile, in Sub-Saharan economies, investment and trade synchronization become weakened of trade and investment. Bano and Tabbada (2015) gave description about the overall overseas investment and FDI in Pakistan have an indication of facts and figures that in overall overseas investment showed an increasing trend of 133.3% per annum that in 2014 an increase occurred from $1277 million to $2979 million, on the other side there was an increase in FDI to $750 million. Alvarez et al. (2000) investigated the impacts of investment with regard to the expected changes in taxes. He commented in his study that there is a rapid increase in investment when the tax rates are reduced. He concluded that reduction in tax rate encourages investment and similarly if there is low reduction normally in tax rates the impacts have totally become inverse.

Rabushka (1987) drawn attention to the relationship between taxes and economic growth and said that there is a direct relationship between them. He emphasized that most of the use of efficiency in labor adversely impacted by high tax rates and entrepreneurship have last confidence by the capital. In this way, there's become a straight decrease in the growth. On the other hand, the World Bank gave a description about the level of taxation. According to this, the economic developments of developing countries have a positive association with taxation. Bond and Samuelson (1986) stated that in the short run, there is a straight decrease in tax revenue while in order to attract more FDI inflow when host countries focused on tax holidays. Brander and Spencer (1987) distinguished that for the home countries that seeking to entre to gain access to more FDI should minimize trade barriers. If home countries reduced tariffs on imports and tax then they can attract more FDI inflow. Effiok and Eton (2013) studied the relationship between economic growth and FDI and found that there is a significant relationship between them.

Gastanaga, Nugent, and Pashamova (1998) argued that the steam of investments can be used in a particular direction of the host country that bears the impact on FDI. CTR, trade, bureaucracy delay, nationalization risk, exchange rate distortions, tariff rates, contract enforcement, and corruption are different variables in the study context.

Fahmi (2012) studied the impacts of incentives of tax holidays over FDI in Indonesia from a time period of 1980 t0 2010. Some indicators such as gross fixed capital formation, inflation, trade openness, and tax rate were observed as a source of significantly attracting FDI. While on the other hand, some negative effects established by poor policies, instabilities in political and economic structures, and a lake of infrastructure cannot be mitigated by the tax holidays. Demirhan and Masca (2008) concluded that economic growth, liberalization, physical infrastructure cast a positive impact in boosting FDI, whereas inflation positively affects the inflow of FDI while tax rates harm attracting FDI. Z. Shah, Ahmed, and Siddiqui (2003) analyzed that capital is dependent on various factors such as tax rates, prices of capital goods and bank markup while calculating the cost of capital. The cost of capital will be lower if the tax holidays are for a long time period or there is a greater reduction in the tax. Zenjari, Wahabi, Haj, and Drissi (2012) distinguished the impact of taxation on the profitability of investing and to that on competitiveness. Munongo (2015) studied that in different sectors to what extent the tax incentives impacted. His study explained that there is the insignificant effect of tax incentives such as exemption in customs duties but the tax holidays are as much significant. Oniyewu and Shareshta (2005) explored that an increase in taxation demoralizing the inflow of FDI. Hussain and Kamuli (2012) explained in his studies in the developing countries some factors are the source of high attraction in FDI such the microeconomic indicators, stability in the financial sectors, the size of the market, and the high availability of factors of production. Anyanwu (2012) disnguished that there is the association of FDI inflow with openness in trade, market size, law and order situation. Bolnick (2004) recognized in some of the countries with external factors, the incentive given on the regimes have not been successful in many countries e.g. Factors like political undue pressures.

In this theoretical literature, it is essential for us to assess the economic scenarios and analyzing the relationships and linkages between the foreign investment and tax policies in Pakistan. So that we can analyze whether incentives given on taxes in the form of rebates, tax cuts, tax holidays or tariff reductions offered in the host country have any positive impact on investments.

H3: Investment incentives offered by the host country have a positive effect on the FDI flows and their performance.

Methodology

The research methodology is the process to solve the research problem. The problems are solved by the collection, evaluation, and assembling of the data. The tools in this study are used in a specific study to gather the information that is relevant to the study.

A research methodology is divided into two parts. One is qualitative and the other one is quantitative. In this thesis, we are using a quantitative research method. We collect data from different sources.

There are three types of research design. First is Exploratory, Explanatory and last is Descriptive. These research methods are usefully related to the research study in a way of answering the research question. According to this research study, the research design of our research is the Causal research design. In this research design, we can use the Regression or Vector error correction model.

There are two types of sources of data. One is primary and the other one is secondary. We are are secondary sources of data in our research study.

The data about foreign direct investment, trade openness, and investment incentives will be extracted by using the sources of the **World Bank** (World Development Indicators), from the followings years 1972 to 2018. In such a time period the required data for all variables is available.

All variables of our study are with their measurements descriptions and proxies are explained in the variable operationalization table given below.

Two types of variables are discussed in our study, dependent and independent. FDI inflow is used as the dependent variable. Political stability, Trade liberalization, and Investment incentives are used as independent variables

Basically, it is the relationship between values assigned to the variables. The effect of the political stability upon the FDI is documented in this study. FDI inflow is dependent variable, and political stability, trade openness as trade liberalization, and investment incentives are our independent variables. Table 3 given below describes the variables, their respective proxy, and coding used for their measurement.

Table 3: Description of Variables

Variables name	Variable Code	Proxy/Formula
Foreign Direct Investment	FDI	The inflow of FDI as %age of GDP
Political Stability	PS	Index (-2.5 weak; 2.5 strong)
Trade Liberalization	TL	The ratio of Export and Imports to GDP
Investment Incentives	INVI	In the form of tariff reduction as a dummy variable 1 represents increase in tariff rates and 0 indicates decrease in tariff rates in Pakistan

Co-integration among time series variables, the long-term relationship is established (Engle and Granger 2015). A combination of I(0) and I(1) are the time series, in that case, the most appropriate approach is the Autoregressive Distributive Lag (ARDL). ARDL id used basically in case of small sample and is used to produces consistently long-run estimates (Pesaran & Shin, 1998). In establishing the long-term relationship, bounds testing procedure among variables have been developed. Time-series econometric model can explain: -

$$\Delta \text{In FDI} = B0 + \sum B1 \Delta \text{In FDI}t\text{-}i + \sum B2 \Delta \text{PS}t\text{-}i + \sum B3 \Delta \text{In TL}\ t\text{-}i + \sum B4\ \Delta \text{INCI}\ t\text{-}I + y1\ In\ FDI\ t\text{-}i + y2PSt\text{-}i + y3\ In\ TL\ t\text{-}i + y4\ In\ INCI\ t\text{-}i + \varepsilon 0$$

Here in this equation, FDI indicates the foreign direct investment that is our dependent variable.

PS represents the political stability, TL as Trade Liberalization; INCI indicates Investment Incentives. These are all our dependent variables.

The relationship of the short-run is described through Sigma sign in those variables while long-run relationships are connoted through without sigma sign variables.

Findings & Discussion

First of all, it is most important to see that if individual time series are stationary at the point of level or the first difference so before applying the co-integration test, the order of co-integration must be identified. For this purpose, AIC Augmented Dickey-Fuller and have been applied for checking data stationery. We state the unit-root equation as follow:-

$$\Delta Y_t = \alpha_0 + \delta_1 Y_{t-1} + \sum_{j=1}^{p} d_j Y_{t-j} + \varepsilon_t$$

Here Y is the individual time series and t is the time, ΔY shows the change in time series over time. Y_{t-j} Indicates the lag value of the variable, α_0 and δ_1 indicates the estimation coefficient and ε_t is the residual or error term. P specifies the maximum lag length of the individual variable.

Table 4: Checking Data Stationary-Unit Root Test

	Level	**First difference(*)**	**conclusion**	**p-value**
FDI	-2.595669	-3.192342	I(0)	0.0336*
PS	-6.437405	-2.148329	I(1)	0.0003
TL	-3.050208	--6.027685	I(0)	0.0001*
INVI	-1.260716	-6.841053	I(1)	0.0000

Critical Value	**FDI**	**PS**	**TL**	**INVI**
1%	-3.752946	-4.200056	-3.769597	-3.920350
5%	-2.998064	-3.175352	-3.004861	-3.065585
10%	-2.632752	-2.728985	-2.642242	-2.673460

From the above table, it can be seen that some of the variables are stationary at the level and some are stationary at first difference. These results are taken by using intercept. Those models are always best-fit that contain stationary data at the level and first difference.

FDI inflow is stationary at first difference as its p-value is less than 0.05. In this case, we reject the null hypothesis. The absolute value is higher than 5% of the critical value that is -2.998064. We got such a result with the intercept.

Political Stability (PS) In this case the p-value value is desirable that is 0.0003 less than 0.05 so we reject the null hypothesis H_0which means that model is significant with that variable. The absolute value is higher than the critical value at 5% and the Data is stationary at level

Trade Liberalization (TL) has a unit root. It is more significant at the First difference with 2 lags. The absolute value is higher than 5% of the critical value and its p-value is 0.0008 less than 0.05. So we conclude that data is stationary at first difference.

Investment Incentive (Invi) is stationary at first difference. P-value is less than 0.05 which shows data is significant and we reject the null hypothesis.

Table 5: Lag Length determination

Variable	Lag 1	Lag 2
FDI		1.615209*
PS		-1.290322*
TL	4.768818*	
INVI	1.478332*	

Source: Determinations of lags are by using VAR estimates using SBC and AIC values.

In the above table, FDI inflow and political stability variables are arranged with appropriate lag 2 while trade liberalization and investment incentives have lag 1. By using VAR estimates optimal lag values are determined that are listed in the above table. For this purpose, Akaike info criterion (AIC) values have been reported in the table.

Table 6: Descriptive statistics

	FDI	TL	PS	INVI
Mean	1.257167	32.62111	-2.156911	0.333333
Median	0.869000	32.90500	-2.415587	0.000000
Max	3.668000	38.54000	-1.103032	1.000000
Min	0.375000	25.36000	-2.810035	0.000000
S.D	1.023029	3.458058	0.556534	0.483046

ARDL bound test for co-integration

From here now proceed to test for co-integration. By using the bounds test for co-integration we want to know if there exists a long-run relationship among these variables. Therefore, the Autoregressive Distributive Lag (ARDL) approach is the most appropriate when time series is a combination of I(0) and I(1). ARDL produces consistent long-run estimates and is particularly used in the case of small samples (Pesaran and Shin 1998). Pesaran, Shin, and Smith (2001) have further developed the bounds testing procedure for establishing long-term relationships among variables.

After investigating and confirming the long-run relationship, the Error-Correction Model (ECM) is applied to check the short-term fluctuations in variables and restoration of short-term shocks to long-run equilibrium. The coefficient of ECT, Ɵ represents the speed of adjustment by which the short-term fluctuations in variables move towards long-run equilibrium; its value should range from 0 to 1 and must be statistically negatively significant.

We ran the ARDL model in EVIEWS to determine the short term and long term relationships between the FDI inflow and the variables in our model. Before running the ARDL model there are some pre-requisite conditions with must be fulfilled. So these conditions are first if any of the variables are stationary at 2nd difference then the ARDL model cannot be run. The best condition

for running the ARDL model is some of the variables are stationary at 1st difference and some of the variables are stationary at the level and if all of the variables are stationary at 1st difference or all of the variables are stationary at level then still we can run ARDL model. These conditions must be fulfilled in order to run the ARDL model to get our desired results.

For running the ARDL model we have already concluded data stationery at the level and 1st differences and from the Table, we found optimal lag for our model. We have selected one specific criterion that is the Akaike Info criterion (AIC) for choosing optimal Lag.

Dependent Variable: FDI
Method: ARDL
Date: 08/16/20 Time: 16:20
Sample (adjusted): 2004 2016
Fixed repressors': C
Number of models evaluated: 54
Selected Model: ARDL(2, 2, 2, 2)

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
FDI(-1)	0.293954	0.254060	1.157027	0.4537
FDI(-2)	-0.414021	0.103845	-3.986894	0.1565
PS	1.939945	1.107206	1.752109	0.3302
PS(-1)	-2.617482	0.905874	-2.889457	0.2121
PS(-2)	3.288214	0.732547	4.488741	0.1395
TL	0.100181	0.033901	2.955148	0.2077
TL(-1)	0.065880	0.063306	1.040666	0.4873
TL(-2)	0.102493	0.079660	1.286632	0.4206
INVI	0.948199	0.355075	2.670419	0.2281
INVI(-1)	0.718079	0.255249	2.813248	0.2174
INVI(-2)	0.425341	0.472087	0.900980	0.5331
C	-1.911370	2.320249	-0.823778	0.5613

R-squared	0.998144	Mean dependent var	1.482462
Adjusted R-squared	0.977723	S.D. dependent var	1.123781
S.E. of regression	0.167729	Akaike info criterion	-1.451725
Sum squared resid	0.028133	Schwarz criterion	-0.930233
Log-likelihood	21.43621	Hannan-Quinn criteria.	-1.558915
F-statistic	48.87948	Durbin-Watson stat	2.885163
Prob(F-statistic)	0.111150		

These are the results of the short-run results of independent variables in this selection model. R-

square is high which means that the model is best fit but there is insignificance in the short-run relationship that the p-value is not less than 5%. Another way of checking significance is that we conclude the absolute values of t-statistics. If t-statistics is 2 or above 2, then we can say that the variable is significant. In our model, some of the variables have t-stat absolute value 2 or more than 2 in their optimal lags. Further, we will conclude the results in chapter five in detail.

Short-run Relation and ECM

The Error Correction Model is used to show how the Long term equilibrium is restored by the short term shocks or any fluctuations.

ECM Regression
Case 2: Restricted Constant and No Trend

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(FDI(-1))	0.414021	0.036295	11.40700	0.0499
D(PS)	1.939945	0.205715	9.430234	0.0673
D(PS(-1))	-3.288214	0.272719	-12.05715	0.0527
D(TL)	0.100181	0.011814	8.479584	0.0747
D(TL(-1))	-0.102493	0.017425	-5.881780	0.1072
D(INVI)	0.948199	0.058058	16.33199	0.0389
D(INVI(-1))	-0.425341	0.077986	-5.454093	0.1154
CointEq(-1)*	-1.120067	0.064192	-17.44870	0.0364

R-squared	0.995890	Mean dependent var	0.026308
Adjusted R-squared	0.990137	S.D. dependent var	0.755302
S.E. of regression	0.075011	Akaike info criterion	-2.067110
Sum squared resid	0.028133	Schwarz criterion	-1.719448
Log-likelihood	21.43621	Hannan-Quinn criteria.	-2.138570
F-statistic	62.57940		
Prob(F-statistic)	0.000618		

The important part of the result is that the value of ECM is negatively significant that is CointEq (-1)* -1.120067. In some cases, we call it adjustment terms or the adjustment coefficient and it must be negative in order to get the long term equilibrium. If this value is positive it means that our model exhibit an explosion. Another main thing is that the p-value of this coefficient is 0.0364 that is less than 0.05 or 5% which means that it is statistically significant. We are happy with this result that the co-integrated coefficient is negatively significant and significant at 0.0364 less than 5%. So how we conclude the results from above that political stability and trade liberalization are

positively related to FDI inflow and investment incentives are also positively related to the FDI inflow as a 100% increase in incentives leads to approximately 95% of the increase in FDI inflow. Investment incentives encourage foreign investment in Pakistan that foreign investors should get benefits from incentives like tariff reduction.

Long-run Equilibrium Relation and ARDL Bound Testing Results

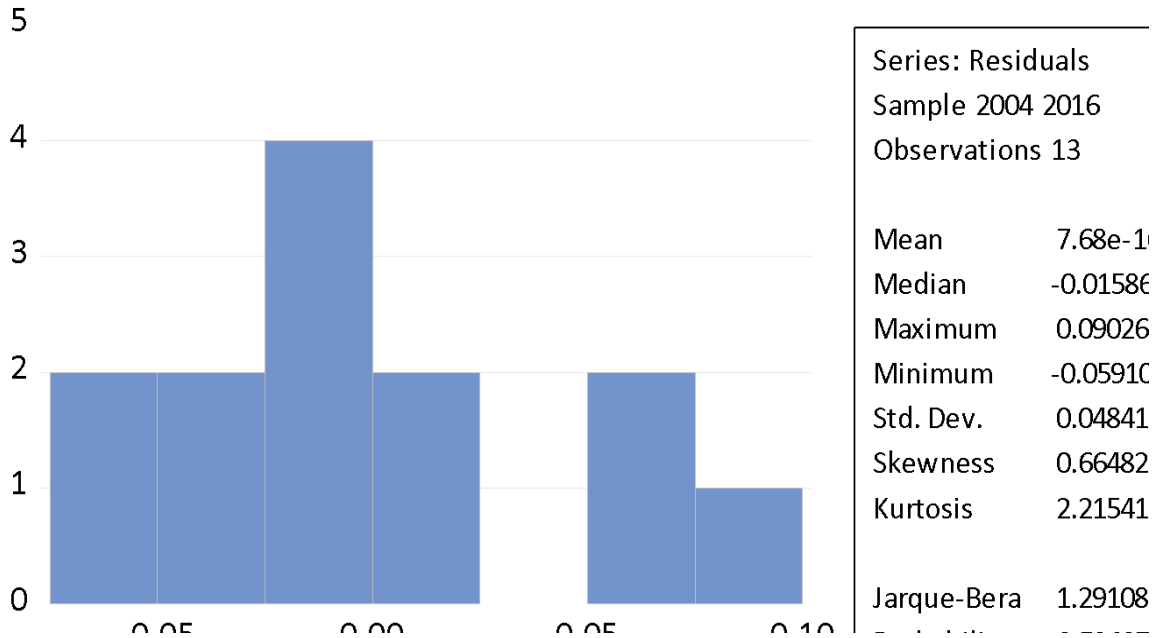
From here now we proceed to test for co-integration by using the bound test co-integration. We actually do this in order to find out that if there exists a long term relationship among these variables. We use coefficient diagnostics in EVIEWS to perform the bound test.

F-Bounds Test		Null Hypothesis: No levels relationship		
Test Statistic	Value	Signif.	I(0)	I(1)
			Asymptotic: n=1000	
F-statistic	12.17829	10%	2.37	3.2
K	3	5%	2.79	3.67
		2.5%	3.15	4.08
		1%	3.65	4.66

These are the outcomes of the results of the ARDL long-run Bounds test. In the above table, I(1) show the upper level of bounds while the I(0) shows the lower level and we check mostly through the 5% of values. The main focus of attention is the F-statistics of the bound test. The null hypothesis shows that there is "no levels relationship" which simply means that there is no long-run relationship. But in our actual results, the null hypothesis is not true at all since there is a long-run relationship among the variables. Here we explain the rejection criteria that we reject the null hypothesis if the value of F-statistics is higher than the I(1) bound statistics. If the value of F-statistics is lower than I(0) bound than we cannot reject the null hypothesis. If in case the value of F-stat is in between the I(1) and I(0) bound, it means the result is inconclusive and we will start our analysis all over again. In favor of alternative, our stat is higher than the I(1) bound is an indication that we have to reject the null hypothesis. Hence we conclude that is in this model there's exists a long-run relationship among the variables because we can see from the above table that the F-statistic value is 12.17 that is higher than the value of I(1) at 5% level. So we are fine with these results.

Diagnostic Tests

Table 7: Normality test



The probability p-value is 0.524378 which is higher than 0.05 so we cannot reject the null hypothesis. Now here a question is that what is our null hypothesis? Our null is the residual is normally distributed and that is desirable. Here in our diagnostic test model, we cannot reject the null hypothesis meaning that residuals are normally distributed.

Heteroskedasticity Test:-

Heteroskedasticity Test: Breusch-Pagan-Godfrey
Null hypothesis: Homoskedasticity

F-statistic	0.159078	Prob. F(11,1)	0.9709
Obs*R-squared	8.272483	Prob. Chi-Square(11)	0.6887
Scaled explained SS	0.029747	Prob. Chi-Square(11)	1.0000

We are happy with this result as the null, in this case, is that there is Heteroskedasticity in this model. We can see in the above table that the obs*R-squared, the corresponding p-value is higher than 0.05 which is 0.6887 meaning that we cannot reject the null hypothesis. In this model, F-statistic is also very high which a good sign is. So we conclude that is no Heteroskedasticity in our model.

Serial Correlation LM tests:-

This residual test is used to check if there is autocorrelation among the variables in the model. Our null hypothesis in this case is that there is no autocorrelation. If the p-value of the value of Obs*R-square is higher than 0.05 it means that we cannot reject the null hypothesis and the result of the Serial Autocorrelation test is insignificant (p>0.05).

Breusch-Godfrey Serial Correlation LM Test:
Null hypothesis: No serial correlation at up to 2 lags

F-statistic	2.093366	Prob. F(2,12)	0.1660
Obs*R-squared	4.655737	Prob. Chi-Square(2)	0.0975

In the above table, the result shows that the p-value is 0.09 which is higher than 0.05 and it means there is no autocorrelation in the data.

Conclusion & Recommendations

We conclude our results that that foreign investors in Pakistan consider political stability, trade liberalization, and investment incentives while making an investment decision because these are mainly work in the long-run. Mainly investors are attracted by the long term beneficial conditions and these all the factors are combined to give high precision to give significant positive relations with the FDI inflow. The policymakers should not only improve the macroeconomic policy of the country but also strengthen the political conditions. The democratic government has already played a good role in stabilizing and improving the institutional quality in the country but in developing countries democratic government is not so significant as compared to military government as Pakistan's FDI inflow was highest in 2007-2008. Due to the immature democratic system, the cause of the gap of leadership that are duly eradicating the wave of terrorism by the military government (Uddin, Chowdhury, Zafar, Shafique, & Liu, 2019)

We have some important policy implications in our results.

- First, the government should focus on removing the uncertainties or macroeconomic instability in the country.
- Second, Pakistan should inaugurate credible trade reforms to further liberalize its trade to enhance FDI inflows.
- Thirdly, Pakistan needs to increase the investment incentives as tariff reduction should be the main focus so that
- Fourthly, Pakistan should resolve the problems related to the trade so that there's needs to enhance FDI inflow
- Finally, the law and order situation in Pakistan needs to improve to attract foreign investment.
-

One of the issues not discussed in this paper is the effect of the efficiency of institutions on FDI. There is also a need to explore the effects of capital account openness on FDI. Further, there is a need to research the detailed industry or even firm-level, given that the FDI-trade linkage can be industry and even firm-specific. All these issues are left for future research. Our study has the limitation that we are not investigating the moderating effect of the association among the FDI inflow and political stability alongside other factors. Further researches can include such factors to draw a clearer image of the underlying phenomenon.

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