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Factors Affecting Foreign Direct Investment in Pakistan

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Abstract

Foreign Direct Investment (FDI) plays a crucial role in speeding up the development and economic growth of a country. In developing countries rely on FDI to promote their economy as they face capital shortage for their development process. The strong growth performances experienced by Pakistan economy greatly depends on the FDI. FDI generates economic growth by increasing capital formation through the expansion of production capacity, promotion of export and creation of employment in Pakistan. FDI inflows of Pakistan started fluctuating from 1990s to 2015, there the purpose of this study is to evaluate the factors affecting Foreign Direct Investment in Pakistan from 2005 to 2015. For this study the regression model is used to measure the affects of factors on FDI. This study considers the social, economic, and infrastructure factors in which different other factors are considered e.g. trade, exchange rate, GDP, Per capita income (economic factors), health & education (social factors), roads, railway, telephone, internet (infrastructure factors). Data of the study have been collected from state bank of Pakistan and economic survey of Pakistan (secondary sources). The results show that there is a significant and positive effect of social and economic factors on FDI. On the other hand, there is an insignificant and positive relation between infrastructure and FDI from the period of 2005-2015. The study concluded that government should focus on the enhancement of growth rate and promote political stability in the economy to bring more FDI inflow in the country

Keywords: FDI, Social Factors, Economic Factors, and Infrastructure Factors

Introduction

The word investment refers to the accumulation of some kind of assets in hope of getting a future return. In the broad sense, investment provides the mechanism needed to fiancé the growth and development of an economy. Investment has been categorized into foreign direct investment and portfolio investment. Foreign direct investment (FDI) is real investment and can be defined, as a medium to long-term investment (Khattak & Khan, 2012). According to Ragazzi, (1973) foreign direct investment is the amount invested by resident of a country in a foreign enterprise over which they have effective control.

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Vreeland (2003) stated that direct investment is a long term commitment to engage in economic activities in the host country and has been proven to be less volatile compared to other forms of international capital flows. Also foreign investors are not reacting a drastically to changes in the investment climate as others do. They usually aim at long term profit and are unlikely to withdraw investment in short period due to high transaction costs. Usually, FDI made by large multinational corporation (MNC'S) through a merger and acquisition, or through the formation of a new ability.

Globalization has posed serious challenges to the developing countries, lacking in knowledge and skills, which undoubtedly from the basis of productivity and competitiveness in the ever-increasing integrated world economy. The integration of global markets and emergence of international trade bodies like World Trade Organization (WTO) has channelized foreign direct investment (FDI) from developed to developing and underdeveloped countries. It is widely recognized that FDI produces economic benefit to the recipient countries by providing capital, foreign exchange, technology and by increasing competition and access to foreign markets (World bank, .2014; Crespo & Fontura, 2007; Romer, 1993).

Foreign Direct Investment (FDI) has historically contributed to the development of host countries by way of improving their infrastructure, technical skills, entrepreneur abilities and financial resources In terms of government revenue and foreign exchange. Foreign investment not only brings investment and employment opportunities in the host country but also new technology. Foreign investors use a variety of resources for the benefit of the host country. FDI leads to the high quality of that supports the economic development of the host nation. Foreign investment offers, integrated supply chain, the economies of scale, and cost benefits through the coordination with the local investors. While the government expenditures play an important role in the attraction of FDI. The increase government spending push up the economic growth, jobs, and incomes follow (Foster & Magdoff, 2009). When the growth of a country increases it's attract foreign investors to invest in the growing economy. So the government expenditure can stimuli FDI, but is also necessary to find the right sector on which the government spends in order to attract foreign investors. FDI contributes its expenditure a lot on social factors such as education, health, public safety and defense sectors in order to increase efficiency and economic growth of a country. That's why this present study focuses on social factors. Foreign Direct Investment plays a very important role in the development of a country and becomes a vital element of any economic system, because FDI brings not only huge amount of foreign capital inflow but also creates new job opportunities. In addition to these, FDI has great attraction for host countries especially for developing

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countries like Pakistan because FDI enables the host countries to enhance production capabilities and technology diffusion (Adam & Tweneboah, 2009).

The acting part of FDI plays an important role in the progress of the economy. Today's, Pakistan's economy needs a large amounts of funds for developing of various sectors like energy, telecom sector, banking sector, transportation and infrastructure sector, health and education sector and many other related sectors that are directly connected with the economic growth (Aizenman & Noy, 2006) since independence 1947, Pakistan has traveled a long way making strides in various directions. The economic progress is concerned according to many researcher thinks as a mixture of success and failure. Thus, it can be said that the current situation of Pakistan is a developing country as compared to other countries. The developing country needs foreign direct investment to improve the internal structure of the economy (Asiedu, 2002). The rate of GDP share of Pakistan sector is increasing day by day, which is also creating number of problems regarding the establishment of the economy. The distribution share of sector in GDP calculated in terms of percentage, according to the research data year from 2011-2015., Pakistan spends 20% on service sectors, 18% on trade, transportation and communication sectors are 11%,gas & electricity construction mining sectors are 7%, manufacturing are 20%. These services sectors include defense, public, administration, education, health etc. Transportation sectors include communication, storage etc., banking activity, finance make 6% aspect of the overall economy (Hanson, 1996). The increase in the economic development rate of Pakistan is the main element of the gross domestic product which is increasing, in real terms has increased around about eleven times. On the other hand, the growth of national income has not increase up to the requirements. The main variable used in this research study is the foreign direct investments simply defines as the investments or funds that come or approve in the form of loans from abroad country for the developing of the sectors which really need the investments (Hanson, 1996). This is the main responsibility of the current government to use the investment in the right directions and properly monitor the flow of money circular. Many researchers think that foreign direct investments are utilized on the right direction. It creates new opportunities of business activity in the economy. With the passage of time, the economy of Pakistan is transformed into established economy (Shabbir, Mahmood, & Niazi, 1992).

Problem Statement

The inflow of foreign direct investment in Pakistan is very low compared to other part of the world. The question is why it is very low and what are the factors that determine affect FDI? By doing panel data analysis, it is important to find out which factors are the most significant from 2005-2015.

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For countries like Pakistan that tends to be more open and globalized in terms of receiving foreign inflows, FDI is of huge significance. The goals like that of economic growth, eradication of poverty, enhancement in the rate of labor force participation, proliferation in the overall export quality product range, and other macroeconomic objectives cannot be achieved unless there is presence of significant and persistent flow of FDI. However, in this regard the intent of economic and social problems that are in association to physical infrastructure must be empirically investigated in terms of confirming that for how much intensity these problems affect the persistent flow of FDI to Pakistan. FDI being an important factor for addressing the economic issues of its recipient country is affected by the prevailing economic atmosphere in a certain country. Past trends on account of the flow of FDI into Pakistan show that Greenfield investment has been prevailing in the range that exceeds USD1000 million, in the year 2004-05 to 2010-11. It gained highest peak in the year 2010-11, standing at the level of USD1634million. It is alarming to notice that such privatization proceeds came to nil during 2008-09 to 2011-12. Private portfolio investment, since 2001- 02 till 2012-13 has been seen changing dramatically i.e. reaching its highest peak of USD1820 million in the year 2006-07 but turned to negative in couple of years like in 2002, 2004, 2009 and 2012.

However, according to the economic survey of Pakistan 2013-14, foreign private investment witnessed a decline of 15 percent mainly emanating from FDI which reduced by 12.9 percent. Inflows of FDI were USD1604 million during first ten months of financial year 2013-2014. FDI from July to April, 2014 remained depressed at USD750.9 million as compared to USD862.3 million during the same period last fiscal year. As stated in the Economic Survey of Pakistan, issued by the Ministry of Finance (2014); that foreign investment has posted some surge, however, it feels that adverse law and order situation and energy crisis are still major hurdles in bringing up sufficient level of foreign investment. "We are expecting more foreign investment in oil, gas and energy sector as the country is facing energy crisis and uncertain economic situation from last few years" (Ministry for Finance, Government of Pakistan, 2014).

On account of trade, Pakistan suffers from the problems in respect of unachieved targets of exports. It is mainly because of the prevailing high inflationary pressures in a country, insufficient FDI and indeed the energy crises in term of severe shortage of electricity and natural gas. This altogether is resulting in firstly not enabling Pakistan to meet the export order and secondly high cost of production makes the products unattractive in foreign market. All these situations alter the mind of foreign investors who wish to invest in Pakistan. There are problems of volatile foreign exchange market (FOREX). The propensity of variability in FOREX market is very rapid and frequent.

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This is of a serious concern for the foreign investors who have to bear all the burdens while they ought to import some raw material or intermediate goods from abroad.

From theoretical back ground, it is found that FDI helps in boosting the economic growth rate of the host country more than that of the contribution in the same regard by the local firms. In this case, if economic and social disturbance prevail in a country, such dilemma will not only depress the smooth and persistent flow of FDI rather promoted the existing firms to think of investing their capital abroad. Nonetheless, all of these aspects together enable the particular state to carry-on with the progress in economic growth. It is because of the fact that all these variables affect level of FDI flows to a particular country (Wheeler & Mody, 1992; Singh & Jun, 1995; Mehmood & Faridi, 2013). Therefore, it really becomes a matter of question that "In the presence of such vulnerable situations on account of some of the socio-economic indicators, would it be sufficiently possible for Pakistan to still be attractive for the foreign investors"?

Literature Review

Foreign Direct Investment

According World Development Indicators, "Foreign Direct Investment is defined as a 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. In line with the approach used in the FDI literature, the dependent variable used in this study FDI is measured as the net foreign direct investment inflows as a percentage of GDP".FDI creates employment opportunities, promotes economic growth, and facilitates technology transfer (UNCTAD 2010, Agrawal & Khan 2011).In addition to these, the foreign direct investment is seen to fill the gap between domestic investments and savings in most developing countries as their income and savings are very low (Odenthal 2001; Mottaleb & Kalirajan, 2010).

Economic Indicators

Economic indicators are key statistics that indicate the direction of an economy. While the indicators can be numerous, there are three broad categories of economic indicators: leading indicators, coincident indicators and lagging indicators (Sullivan, Arthur Sheffrin, & Steven, 2003). Leading indicators, such as consumer durables, net business formations and share prices, are used to predict the future movements of an economy. Coincident indicators, which include such things as GDP, employment levels and retail sales, are seen with the occurrence of specific economic activities. Finally, lagging indicators, such as GNP, CPI, unemployment rates and interest rates, are only seen after a specific economic activity occurs. Most of these economic indicators have a specific schedule for release, allowing investors to prepare for and plan on seeing certain

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information at certain times of the month and year (Sullivan, Arthur, Sheffrin, & Steven, 2003).*In this study market size, inflation rate, trade openness, GDP and exchange rate as an economic indicator have taken which is more frequently used.*

Market Size

Market size is a fundamental determinant of FDI. The wealth and development of a country can be used as proxy to measure the size of the domestic market. It is believed to be one of the significance determinants that have been used in empirical studies to explicate the inflow of FDI to a host country. Because if the hosts countries have large market size it will have investment opportunities that will in turn to generate high profit for the foreign firms (Baltagi, 2008). Many studies have used real Gross Domestic Product (GDP) growth rate as an indicator of the "size" of an economy. This study follows them and uses this variable as an indicator for market size, and expects to have a positive impact on inward FDI.

Trade Openness

Trade openness, meaning the degree of liberalization of trade regime of the host country, is regarded as a very important factor that promotes FDI. Open economies mean greater market opportunities. From the perspective of financial development, trade openness means the ability of an economy to obtain funds from other economies, and willingness to invest its surplus fund to other countries. Trade openness is considered to be a significant FDI determinant in many literatures. Much FDI is export oriented Trade openness promotes FDI and it is measured as the ratio of export to GDP. FDI is expected to have positive relationship. Here we measured trade openness by the sum of import and export, as a percentage of GDP (Baltagi, 2008).

Inflation Rate

Inflation is used as an indicator of macroeconomic instability (Buckley *et al.*, 2007) as it is defined in world development indicator (World Bank, 2014) the calculation of inflation is measured by the consumer price index which indicates the annual percentage change of the average consumer cost in acquiring a basket of goods and services over the interval time. Inflation rate is one of the variables which measures the given countries macro-economic stability. According to Kinyanjui (2014), through its effect on the cost of inputs and the price of outputs, inflation reduces the real return on investment and firms" competitiveness. Hence, countries that pursue policies that reduce inflation rate have better chance in attracting FDI. Low and predictable inflation rate is central for the long-term investment of both domestic and foreign companies. Therefore, higher and unpredictable inflation will decrease the inflow of FDI (Kinyanjui, 2014)). Low inflation rates are expected to have a positive impact on FDI.

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Exchange Rate

Exchange rate is defined as the price of currency in term of another currency. Exchange rates are regularly quoted between all major currencies, but frequently one important currency (e.g. the dollar) is used as a standard in which to express and compare all rates .The exchange rate of all fully convertible currencies is determined, like any price, by supply and demand conditions in the market in which it is traded (i.e. the foreign exchange market). More fundamentally, such supply and demand conditions are determined by whether the country's basic balance of payments position is in surplus or deficit. Simply Exchange rate is determined by the demand and supply position in the foreign exchange market. Here we measured it in Rs/ US Dollar. It has positive effect to economic growth of a country (World Bank, 2014).

Gross Domestic Product (GDP)

The gross domestic product (GDP) or gross domestic income (GDl) is one of the measures of national income and output for a given country's economy. GDP is defined as the total market value of all final goods and services produced within the country in a given period of time (usually a calendar year). It is also considered the sum of value added at every stage of production (the intermediate stages) of all final goods and services produced within a country in a given period of time, and it is given a money value. The most common approach to measuring and understanding GDP is the expenditure method: GDP = consumption + gross investment + government spending + (exports - imports), or GDP = C+I+G+(X-M). We measured it in Rs. Millions.

Infrastructure Indicators

Infrastructure covers many dimensions ranging from roads, ports, railways and telecommunication systems to the level of institutional development (Haile & Assefa, 2006). The availability of well-developed infrastructure will reduce the cost of doing business for foreign investors and enable them to maximize the rate of return on investment (Morriset, 2000). Therefore countries with good infrastructures are expected to attract more FDI. Gross fixed capital formation (percent of GDP) has been included to proxy infrastructure development. FDI is expected to have positive relationship with infrastructure of the host countries.

Social Indicators

Social factors consist of family, education, institution, and religion that affect the society. It also includes culture factors culture factors in which people interact with each other including languages, consumption habits of people, preferences and customs etc (Remla, 2012) but this study focused on the health and education factors that affect FDI in Pakistan from the period of 2005 to 2015. Sathe & Handley, 2006 stated that there has significant and positive affect of social factors on FDI.

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Health Expenditure

These are expenditures by government to provide health facilities to people and other expenses on vaccinations, medicines, hospitals, dispensaries etc. Shah & Iqbal (2016) showed that a positive and significant relationship between government health expenditure (HLT) and foreign direct investment (FDI) exists. Health expenditures show the highest change among all variables which means that it is the most important government's expense that increases with FDI inflows. This implies that if in the country, there are healthy and productive workers it will also attract foreign investors because healthy local workers can encourage investors to invest in their country for the reason that local than the foreigner worker. Workers are cheaper than the foreign workers.

Education Expenditure

The indicators cover expenditure on schools, universities and other public institutions. Delivering or supporting educational services (Shah & Iqbal, 2016). The relationship between government education expenditure (EDU) and foreign direct investment (FDI) is also found positive. This implies that educated people are the asset of the country. Literacy directly related to human capital and development, and as a host country, education is very essential to attract foreign investors. Foreign investors invest in those countries where highly potential human capitals are available (Shahrudin, yusof & Satar, 2010).

Relationship between FDI & Economic Factors

The relationship between Foreign Direct Investment (FDI) and economic growth has been a major issue for several decades. The policy makers of a large number of countries engaged in studying and providing incentives to attract the inflow of investment, because it is assumed to effect the economic growth and development of the host country positively. The inflow of foreign direct investment (FDI) has been increased in almost every region of the world for the past two decades. There has been a long debate over the benefits and associated costs of FDI both in academia and policy spheres (Lee, 2013). Alam *et al*. (2015) determined that FDI positive has a relationship between economic growth and foreign direct investment in case of Pakistan. It can therefore be determined that inflow of FDI to Pakistan help in increasing economic growth and economic growth will in turn lead to the ultimate survival of the economy.

Relationship between FDI & Social Factors

Shah & Iqbal (2016) stated that there is a positive and significant relationship between social factors and FDI in Pakistan. In this study education and health taken as a social factor to calculate effect on FDI. Shah & Iqbal (2016) suggested that expenditure in education and health sectors attract the foreign investment while the development

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expenditure is the key element for the attraction of foreign investment in Pakistan. Mehmood & Hassan (2015) determined that there is positive relationship between social factors and FDI.

Relationship between FDI & Infrastructure Factors

Rehman, Ilyas, Alam & Akram (2011) revealed that a strong positive impact of infrastructure in attracting foreign direct investment, in short and in long run, in case of Pakistan. On the other hand, Ahmad, Ismail & Norrdin (2015) suggested that infrastructure also had positive impact on FDI in Malaysia. The findings suggest that the reduction of business cost through improvement of infrastructure helped to increase competitiveness in attracting FDI.

Theoretical Framework

Below the theoretical frame work shows the dependent and independent variables of the study. In which one side foreign direct investment is a dependent variable and another side the independent variables are economic, social, and infrastructure that affect the FDI flow in Pakistan. It is shown in figure:

Independent Variables **Dependent Variable**

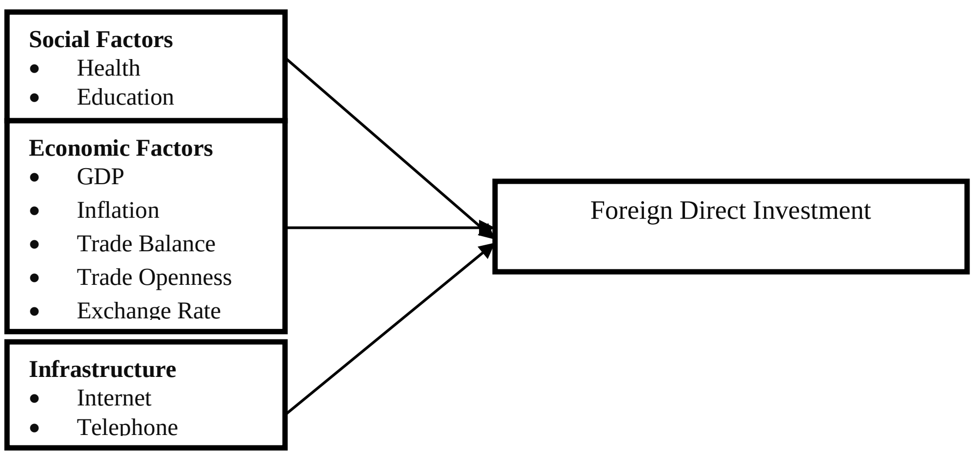

Figure: 1 Theoretical Framework of the factors affecting FDI in Pakistan

Hypotheses

H*$_1$*: *There is a positive & significant effect of Social factors on FDI.*
H*$_2$*: *There is a positive & significant effect of Economic factors on FDI.*
H*$_3$*: *There is a positive & significant effect of Infrastructure factors on FDI.*

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Research Methodology

The type of this study based on descriptive and quantitative in nature. Data for this study collected from secondary source like economic survey of Pakistan, World Bank, World development Indicators. The SPSS tool is used to calculate the results of this study by applying regression model.

Model:

$FDI_i = \alpha + \beta_1 \text{(Infrastructure)}_i + \beta_2 \text{(Social)}_i + \beta_3 \text{(Economic)}_i + e_i$

Empirical Results of the Study

In Table 1 summary statistics of all the variables that were used in the study are reported. The mean value of FDI is 3.2691with minimum value of .86 and maximum value of 9.10 during the period 2005-2915 and standard deviation is 2.54833. The minimum value of social factors is 5.080 and maximum value is 6.0500 with mean value 5.27691and standard deviation is .278746. The mean value of economic factors is 3.327825 with 2.56741 minimum and 3.9000 maximum values and standard deviation is .266858.The mean value of infrastructure factors is .0725454 with the minimum value of 1.664000and the maximum value of 1.51800.on the other hand the standard deviation of infrastructure factors is 1.088626.

Table 1: *Descriptive Analysis*

Variables	N	Min.	Max.	Mean	Std.Deviation
FDI	11	.86	9.10	3.2691	2.54833
Social factors	11	5.080625	6.05000	5.27691	.278746
Economic factors	11	2.56741	3.9000	3.327825	.266858
Infrastructure factors	11	1.664000	1.51800	.0725454	1.088626

Table 2: *Results of Variables Used in Regression Model*

Variables	Beta	T-test	P-Value
Social factors	.500	4.72	.002
Economic factors	.334	2.764	.028
Infrastructure factors	.177	1.300	.235
R –Square	.994	F-Value	416.291

Table 2 shows the regression results. This table provides the R and R^2 value. The R value is .994, which represents a high degree of correlation. The R^2 value indicates that 99% of social, economic, and infrastructure factors explain FDI in this study. The regression model signifies the results of regression demonstrate the value of p is 0.000, which is less than 0.05 therefore the H_O is rejected that indicates the overall applied model can statistically be highly significant**.** The table above provides the information on

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each predictor variable. In which there is a positive and significant effect of social factors and economic factors on FDI. It indicates that P- value is greater than significance level (0.05). On the other side, infrastructure has also a positive impact on FDI, however the association ids statistically in-significant.

Discussion

The result revels that social factors, economic factors are significant determinants of FDI flow in Pakistan. The result in Table 2 show that a one dollar increases in social factors increases the flow of FDI by 0.500 percent; a one percent increases in economic factors increases the flow of FDI by .285 percent and a one percent increases in infrastructure factors increases the flow of FDI by .158 percent

Social factors

The relationship between social factors and foreign direct investment (FDI) is also found positive and significant effect in which education and health taken as sub factors. This implies that educated people are the asset of the country. Literacy directly related to human capital and development, and as a host country, education is very essential to attract foreign investors. Foreign investors invest in those countries where highly potential human capitals are available Shahrudin,Yusof & Satar (2010). Health expenditure shows the highest change among all variable which means that it is the most important government's expense that increase FDI inflow in Pakistan. This implies that if in the country, they're healthy and productive workers it will also attract foreign investors because healthy local workers can encourage investors to invest in their country for the reason that local worker are cheaper than the foreigner worker. The results are shown in Table-2.

Infrastructure factors

Infrastructure has been widely acknowledged as one of the key factors that could influence the flow of FDI into the host country. A country that is well equipped with infrastructures such as airports, water supply, power supply, roads, telephone, and internet would be able to minimize the cost of doing business for the investors and allow them to maximize the rate of return on their investments. Therefore, countries that are very well equipped with efficient infrastructure would receive higher FDI. For the purpose of the present study, the number of telephone line per 1000 people was used as the proxy for infrastructure and internet line per 1000 people. There is a positive relationship between infrastructure factors and FDI flow, but it is insignificant. Because this study has taken only telephone and internet factors as sub factors, it can be extended through railway, roads, posts etc due to which it would be significant in future. This

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result is unexpected. Since most findings show that the infrastructure development leads to more FDI inflows. However, the finding is supported by previous study (Aseidu, 2002; Gichamo, 2012; Thangamani, Xu,., & Zhong (2011); Ramasamy & Yeung, 2010; Demirhan & Masca, 2008; and Ang, 2008).

Economic factors

There is a significant and positive relationship between economic factors and FDI. In which exchange rate, GDP, inflation, trade openness, and trade balance have taken as sub factors in the study. The results found that there is a positive and significant effect of trade openness, GDP, trade balance and exchange rate on FDI. This finding is supported by the previous studies Aseidu (2002), Liargova & Skandalis (2012) and Frenkel, Funke & Stadtmann (2004). Aseidu (2002).But inflation has negative and insignificant effect on FDI (consistent with the findings of Gichamo, 2012).

Conclusion

Foreign direct investment contributes a significant role in the economy of developing countries like Pakistan, it gives a number of assets e.g. technology transferring, managerial knowledge, increase level of trade etc. it has a direct impact on Pakistan’s economy due to unstable political situations and worst government policies are in operation since the inception of Pakistan. The study was carried out to investigate the factors affecting FDI inflow in Pakistan from 2005 to 2015. Through this study there were a number of factors that affect the inflow of FDI but examined the social, economic and infrastructure factors that affect the flow of FDI in the economy. Secondary source was used to collect data e.g. world development indicators, economic survey of state bank of Pakistan and World Bank etc. The regression model was used to calculate the data of this study from 2005 to 2015. The results of this study have been indicated that economic, social factors have significant and positive effect on FDI. On the other side infrastructure factors has positive but statistically insignificant effect on FDI.

Limitation and Future Research

This study is restricted to economic, social and infrastructural factors only. Future research may consider other variables such as; political, Technological and environmental factors. The current study focused on internet and telephone as the sub variables of infrastructure. However, future research may consider other aspects of infrastructure such as; energy, railways, roads and human capital. This study has taken GDP, Inflation, exchange rate and trade openness to measure economics factors. However, other aspects of economic factors such as, GDP per capita, trade balance and balance of payment should be consider for future research.

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