

# **SOCIAL AND POLITICAL FACTORS EFFECTS ON FOREIGN DIRECT INVESTMENT IN PAKISTAN (1971-2005)**

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## **ABSTRACT**

The present paper empirically evaluates the effects of social and political factors on the inflow of Foreign Direct Investment (FDI) in Pakistan. Secondary data over the period from 1971 to 2005 have been used. A simple semi log linear regression model and the method of least square for estimation have been applied. Firms investing abroad want the opportunity to choose educated, skilled and trained workers to produce more efficiently. Further, multinational corporations always prefer to choose a location that is economically and politically stable for their investment. This study found a positive and statistically significant relationship between human capital and FDI inflow. The result of political instability indicates though an inverse relationship with FDI but insignificant. Thus it has been concluded that trained and skilled labour force and stable political environment are indispensable for enhancement of FDI inflow.

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## **INTRODUCTION**

Various forms of foreign capital inflow i.e., Foreign Direct Investment (FDI), grant, loans, and portfolio investment is welcomed by developing countries to bridge the gap between domestic saving and investment and therefore, to accelerate growth (Chenery and Strout, 1966). Since international capital inflows become important economic activities among different countries due to world globalization. Many studies have highlighted the role of FDI on economic growth and found that FDI from developed countries has positive effect on economic growth in less developed countries through the process of technological diffusion (Borensztein, *et al.*, 1998).

World inflow of FDI increases as the inflow in 1971-75 was US\$ 20450.61 million, where US\$ 15262.08 million went to the developed countries and the remaining amount of US\$ 5188.5 million went to less developed countries, where US\$ 1160.16 million went to Asia and only US\$ 8.6 million came into Pakistan. In the year 2004, the World FDI inflows increased to US\$ 648146 million, out of which US\$ 38002 million, US\$ 233227 million, US\$ 147611 million, US\$ 1117 million came into developed, less developed countries, Asia and Pakistan respectively (World Investment Report, 2005).

Obviously majority of the developing countries including Pakistan want to attract more FDI in order to achieve desirable level of economic growth. FDI not only bridge the gap between saving and investment, foreign exchange, but also providing more jobs opportunities, management skill, and technology etc. Due to the shortage of capital and other limitations, Pakistan also actively seeks to enhance foreign investment and for this purpose three distinct government investment liberalization initiatives began in 1992, 1997 and 1999 have progressively opened Pakistan to foreign investment. In this regard Pakistan offering many incentives to enhance new capital inflows mainly FDI and have created an investment-friendly environment in the country.

The purpose of the present research paper is to analyze the effects of social and political factors i.e., human capital and political instability on FDI in Pakistan. Though there are several factors determining FDI inflow such as economic, social and political factors but this study focuses only on the social factor (i.e., human capital) and political factor (i.e., political instability) of FDI in Pakistan.

## **LITERATURE REVIEW**

Several studies have been carried out on various factors effect on FDI in developed and developing countries. Many studies

examined only economic variables, while social and political variables have been ignored or given limited consideration (Schneider and Frey, 1985). Such as, Hanson, (1996) acknowledged that human capital is an important indicator of the availability of a skilled work force is a significant determinant of the locational advantage of a host country. Tallman (1988) found positive and significant results of political risk on FDI but Akhtar (2000) found political instability insignificant in the analysis. Singh and Jun (1995) empirically analyzed that socio-political instability has a negative impact on investment flows. Quazi and Mahmud (2004) also found that human capital significantly increase FDI inflow into South Asia, while political instability depresses it. Asiedu, (2005) suggests political instability have a negative impact on FDI to Africa.

#### **Justification of The Social and Political Factors of FDI**

Obviously there are a number of social and political determinants of FDI but only human capital and political risk would be analysed in the present study.

##### ***Human Capital***

Human capital is an important explanatory variable of FDI. Obviously almost all multinational corporations (MNCs) intend to hire more skill labour force in order to earn maximum profit. A number of researchers used human capital as a determinant of FDI and found different results, as Cheng and Kwan, (2000), found positive significant result, however, Banga, 2003; Ioannatos, 2003, found positive insignificant results. A plant locating abroad would want the opportunity to choose workers from an educated pool. The level of workers quality would be important to a firm that is locating in a host country primarily to use their labor as a less expensive input than the labour in their home country. Even those firms locating in a country to serve that country's domestic market would need to hire local workers and thus see high quality workers as an advantage. Taveira, 1984; Schneider and Frey, 1985, used the percentage of

population in secondary education, but found no evidence of its significance. Thus expecting positive relationship between human capital and FDI inflows and utilizing primary school enrollment as proxy for the level of human capital in this study.

##### ***Political Instability***

Jun and Singh (1996) argued that political instability is a qualitative phenomenon and the exact measurement of which is a complicated issue in terms of what investors perceive as politically risky and a constraint to their investment. Econometric studies frequently fail to establish a relationship between political risk and FDI flows (Cahse *et al.*, 1998). Lucas (1993) evaluated that due to political risk capital does not move from developed countries to developing countries.

Multinational corporations prefer to choose a location that economically and politically stable for their investment. Therefore a country's political stability is an important consideration for MNCs when choosing the destination for their investment. A safer and more stable environment will help to minimize the risk for the MNCs (Poon, 2000). Akhtar (2000) mentions that political instability in Pakistan has been a frequent phenomenon. In literature political instability were measured by different variables that all are proxy variables like number of strikes and riots, workdays lost, etc., have proved significant in some studies, but these quantitative estimates can capture only some aspects of the qualitative nature of political instability. However, due to the non-availability of appropriate data on political risk rating for Pakistan, employing dummy variable for political risk and using one (1) and zero (0) for stability and instability. In this study by political stability mean democracy in Pakistan and vice versa. As it is argued that a democratic government is more conducive to foreign investors and dummy variable used by many such as Akhtar, 2000; Shah and Ahmad, 2003. Using D=0 (political instability), and D=1 (otherwise)

## MATERIALS AND METHODS

In analyzing the socio-political factors effects on FDI, secondary data have been used over the period from 1971 to 2005. The data on human capital have been obtained from Federal Bureau of Statistics, Pakistan (various issues) and dummy variable for political instability was utilized. A simple semi log linear regression model was used and the method of Least Square (OLS) was used for estimation. Minitab statistical software was used for the analysis.

### *Econometric Model*

Certainly, the host country social position is considered a viable factor of FDI inflow (Ioannatos, 2003). Schneider and Frey (1985) were also in favour of the human capital development because of momentous impact of human capital on FDI. Such as in the study of FDI, political factor is equally important determinant of FDI (Jun and Singh, 1996; Asiedu, 2005). Due to non-linearity of the data log linear model was used. The following simple linear equation was used;

$$\ln(FDI) = \beta_0 + \beta_1 \ln(HK) + \beta_2 (Prisk) + \varepsilon \quad (1)$$

Where FDI=foreign direct investment, HK=human capital, Prisk=political risk and  $\varepsilon$ =error term

The explanatory variables and error term ( $\varepsilon$ ) followed the least square assumptions.

The above equation (1) states that human capital measured by primary school enrollment has positive impact on FDI inflows and the impact of political instability on FDI inflow is negative.

## EMPIRICAL RESULTS

Empirical results of the present study are reported in the Table 1.

The estimated regression equation is:

$$FDI = - 32.3657 + 4.4137HK - 0.5814PRISK \quad (2)$$

**Table1 Ordinary Least Square Estimates**

Dependent Variable: FDI	
Independent Variables	Coefficients (t-statistics)
HK	4.413782 (12.26313)*
PRISK	-0.581445 (-1.500336)
Constant	-32.36572 (-9.808710)
R-squared (R <sup>2</sup> )	0.828884
Adjusted R-squared	0.818190
S.E. of regression	1.140558
Akaike info criterion	3.182729
Schwarz criterion	3.316045
F-statistic	77.50396
Durbin-Watson statistic (D-W)	1.696268
Observations (N)	35

Note: (i). The asterisks \*, shows that estimates are significant at 1% level of significance.

(ii). The figures in parenthesis are t-statistics

The results indicate that human capital is positively significant at one percent level of significance. The coefficient size found 4.413, which show that one unit change in human capital will bring 4.413 unit changes in FDI inflow. As multinational locating plant abroad want the opportunity to choose workers from an educated pool and the level of worker quality is important to a firm that is locating in a host country primarily to use their labour as a less expensive input than the labour in their home country.

The estimated coefficient size of political instability found as -0.581 showing though an inverse relationship with FDI inflow but statistically insignificant. When there is any political instability foreign investors feel unwell to invest in that country.

## CONCLUSION AND POLICY IMPLICATION

The main objective of this study was the evaluation into effectiveness of the socio-political factors of FDI in Pakistan. Though there are a number of variables affecting the inflow of FDI but this study examined only the affect of human capital and political instability on FDI inflow. Secondary data from 1971-2005 and a simple linear model were used. This study is more relevant with socio-political determinants and their affect on FDI in Pakistan.

This study found that human capital is positively significant, while political instability has been found insignificant. It has been observed that multinational locating plant abroad want to employ educated, skilled and trained workers in order to increase productivity and earn maximum profit. Further multinational corporations always prefer to choose a location that is politically stable for their investment.

The Government of Pakistan should make efforts to improve Pakistan's image in the international community. More attention is required to make Pakistan more progressive. Thus, it has concluded that maintaining stable economic and political environment, promoting trained, skilled and disciplined labour force, peace and security, law and order because these factors are indispensable for enhancement of FDI in Pakistan.

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