



RESEARCH PAPER

Investigating the Impact of Economic Freedom on Foreign Direct Investment in Pakistan

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ABSTRACT

Inward Foreign Direct Investment (FDI) is well established as a vital factor in improving economic growth. Several developed and developing countries are implementing more conducive policies to promote foreign direct investment and create favorable investment conditions within their borders. In this study, economic freedom is examined at a disaggregated level in Pakistan using Heritage Foundation indices. A short- and long-term association was determined by an autoregressive distributed lag (ARDL) model. The current study indicates that FDI is affected differently by each component of economic freedom. In spite of this, regulatory efficiency and the rule of law are significant determinants. It is also important to note that market size affects FDI positively. To reduce taxes and stabilize the economy, it may be recommended that the government implement policies that promote the rule of law. These policies may include transparency, favorable investment policies, and price stabilization.

KEYWORDS Economic Freedom, Foreign Direct Investment, Market Openness, Regulatory Efficiency, Rule of Law

Introduction

A number of economic theories have demonstrated that FDI has several advantages for the host country. The benefits include capital accumulation, human capital development, and a better allocation of resources through competition, a reduction in local capital costs and consolidation of local financial markets (Todaro, 1977). A majority of development economists agree that the growth dynamics of recipient countries can be dramatically affected by foreign direct investment. By transferring FDI to developing countries, three types of 'development gaps' can be filled; first, the 'investment gap' can be filled by providing domestic investment capital; the second method of filling the "foreign exchange gap" is through pre-investment investments and subsequent export earnings; and a third method is to increase taxes through various economic activities in order to close the "tax revenue gap." (Smith, 1997). In accordance with the existing literature, more effects of FDI can be expected if the recipients are more flexible and spongier than their counterparts. With the help of foreign direct investment, countries can increase their growth by transmitting skills. Therefore, inward foreign direct investment benefits the countries that receive it (Crespo & Fontoura, 2007). Sabir and Khan (2018) suggest that the gap between savings and investment can be filled by foreign direct investment. Foreign direct investment serves as a backbone for developing countries by transferring skills and technologies.

Lipsey (2001) found that FDI can also diminish unemployment and improve worker efficiency by transferring skills and knowledge. Due to the lack of modern technology and resources in recipient countries such as Pakistan, the transfer of skills capital and

technology can benefit the country's economic growth. Moreover, local investors may also be motivated to invest in the country after foreign direct investment inflow (Awan et al., 2011; Brooks et al., 2003). Pakistan was not a prominent investment target for FDI until the 1990s. Pakistan faced many problems to survive when it came into being in 1947. The economy of Pakistan began to attract economic growth drivers after that. As soon as Ayub Khan became president in 1960, economic growth increased, but foreign direct investment was still low due to unskilled labor and limited education. In addition, the nationalization system was implemented early in 1970 that discouraged investors from investing in Pakistan. Over the period 1995-96 to 2005-06, foreign direct investment increased by \$10.93 billion, the annual average was \$994 million, and the amount reached US\$ 2.849 billion in July-April FY2018. In contrast, it declined by 51.7% in July-April FY2019 and was worth US \$ 1.376 billion.

Bénassy-Quéré et al. (2007) presented that low economic freedom would create additional costs for multinational corporations, and as a result, it will lead to a decrease in FDI. The basic assumption of economic freedom is often considered the concept of private possession. In the same way. The authors of Gwartney and Lawson (2003) assert that economic freedom means that no one has the right to utilize the skills, resources, or abilities of another individual or company without their permission. The rank of economic freedom can be used to determine the presence of a low-restrictive economic environment. It is important to emphasize that Pakistan is still experiencing difficulties in attracting latent foreign direct investments despite the presence of the liberalization process. However, it has sufficient potential to attract foreign direct investment. Pakistan is still one of the countries which are overregulated for multinational corporations. Trade restrictions create a barrier in the way of inward FDI and then economic growth. So to fill this investment gap, and to pave the path of growth, Pakistan is required to liberalize and privatize itself to acquire sufficient competitiveness. With the relevant experience, and existing literature suggests that economic freedom can play a vital role to attract FDI. The score of Pakistan in the economic freedom index ranking in 2019 is 55.0, and it is the 131st freest country in the world. The overall score increased by 0.6 points in the current year. Which is under the global average rankings. The Asia-Pacific region consists of 43 countries, the rank of Pakistan is 32nd. In 2018, with a score of 54.4 Pakistan stood on the 131st freest country globally. In comparison to 2017, when Pakistan was the 141st freest country according to the report, it improved its ranking on the scoreboard from 52.8 to 54.4. Previous literature identified different determinants that can encourage and discourage FDI inflows in the host countries. Researchers employed various factors in their studies. In addition to macroeconomic variables, they also considered other factors. However, there has been little research on the impact of each factor of economic freedom on foreign direct investment inflows into Pakistan. As such, the purpose of this study is to analyzing the impact of economic freedom at a disaggregated level on foreign direct investment in the absence of other macroeconomic factors. To examine the impact of economic freedom in the short-run and long-run, the ARDL method is used in the current study, which is different from previous studies.

Literature Review

FDI is influenced by a variety of factors, including political, macroeconomic, and location-specific factors. As part of a comprehensive analysis, (Hooda, 2011) examined the impact of various factors on inward FDI in India. Foreign direct investment in the country are significantly impacted by inflation rate. Azam and Lukman (2010) studied the factors influencing foreign direct investment flows into India, Pakistan, and Indonesia from 1971 to 2005 and concluded that inflation has an insignificant impact in the case of Pakistan and a significant impact in the case of Indonesia and India and FDI is positively impacted by market size in India and Pakistan but not same for Indonesia. Boateng et al. (2015) analyzed to check the impact of locational factors and concluded that the inflation rate influenced negatively FDI because investors often discourage due to uncertainty in prices.

A recent study by Bano et al. (2019) examined the factors of FDI in Pakistan before and following the global financial crisis by using the ARDL model, as well as adding structural breaks to check the impact and concluded that foreign direct investment is positively impacted by inflation. Bitar et al. (2019) investigated in the Lebanon economy the causes of FDI and the results showed in the Lebanon economy, inflation has an insignificant impact. Nistor (2015) conducted analyses empirically of BRICS countries and found that a large market size attracts more FDI. In the same direction, Asongu et al. (2018) concluded that market size attracts more investors in the MINT and BRICS countries. Similarly, Economou (2019) concluded that large markets are a key determinant of foreign direct investment in both OECD and non-OECD countries. A study conducted by Sajilan et al. (2019) examined different factors affecting foreign direct investment in the area of the Organization of Islamic Cooperation and concluded that market size is an important determinant of inward capital flows.

Political instability is an important factor as it shows the political situation in any country. A political party's interference in economic affairs and decision-making, corruption, and other policy-making decisions could discourage international investors from investing. Gangi and Abdulrazak (2012) assessed the correlation between FDI and good governance of African countries and found a positive correlation between government effectiveness, voice and accountability, and rule of law. However, the other three indicators are not significant, namely government quality and corruption control, political stability and violence. (Mushtaq, Muzaffar, & Ali, 2017)

Bakar and Afolabi (2017) argued that political instability discouraged investors in Nigeria for the period 1981 to 2014. Sabir et al. (2019) directed a panel study on emerging economies as well as the developed countries to check the nexus between FDI and quality of institutions and found interesting results that stable political systems favorable to foreign direct investment in developed economies than emerging economies. Younsi and Bechtini (2019) examined the correlation between foreign direct investment and institutional quality in emerging economies over the period 1996-2014 and found FDI to be positively correlated with political stability.

Some country-specific factors also have a major impact on foreign direct investment. These situations may vary from country to country so their impact may also. FDI may be affected by the recipient country's investment environment (Quazi, 2007) and he peroxide Economic freedom as an investment environment in his research. There have been several studies that have examined the relationship between economic freedom, foreign direct investment, and economic growth (Azman-Saini et al., 2010). They selected 85 countries from which the results indicated that economic growth is not directly affected by foreign direct investment, but that there is long-term integration between growth and economic freedom. And FDI is dependent on economic freedom to promote economic growth. Saini and Singhania (2018) examined the relationship between important determinants of foreign direct investment in 11 developed countries and 9 developing countries, and concluded that economic freedom has a positive impact on FDI in developed countries, but does not have a significant impact in developing countries.

Sooreea-Bheemul et al. (2020) examined the impact of economic freedom in 40 countries in Sub-Saharan Africa on foreign direct investment found that, on a decomposed level of regulatory efficiency, economic freedom is more important to foreign direct investment than economic freedom itself. FDI is a very small percentage of total foreign direct investment in terms of monetary freedom and financial freedom. Nevertheless, there is a mixed impact of property rights and rule of law on FDI.

Material and Methods

A study of inward foreign direct investment to Pakistan from 1990 to 2019 analyses the impact of macroeconomic factors and economic freedom. For the purpose of verifying the stationary nature of the data, the study uses a unit root approach as well as augmented Dickey-Fuller and PP tests. In order to analyze the effect of four different categories of the Economic Freedom Index on foreign direct investment in Pakistan, we have used the Economic Freedom Index as an independent variable. The following methodological framework is used in this study.

$$FDI_t = f(RL_t, RE_t, MO_t, GS_t, I_t, POLIN_t, MSt) \dots\dots\dots(1)$$

As shown in the equation, function of foreign direct investment (FDI_t) inflows, equation (1) takes into account several factors, including rule of law (RL_t), regulatory efficiency (RE_t), market openness (MO_t), government size (GS_t), other control variables, such as inflation (I_t), political instability (POLIN_t), and market size (MSt). A logarithmic transformation is performed on the time-series data, except for ratios and indices, to eliminate the problem of heteroscedasticity. Here are the details of the log-linear model:

$$LFDI_t = \beta_0 + \beta_1 RL_t + \beta_2 RE_t + \beta_3 MO_t + \beta_4 GS_t + \beta_5 I_t + \beta_6 POLIN_t + \beta_7 LMS_t + e_t \quad (2)$$

In this model, β is intercepted, LFDI_t is the natural log of FDI in BOP US \$, RL is rule of law in index form, RE is regulatory efficiency in index form, MO stands for market openness in index form, GS is government size in index form, I stand for inflation in, POLIN is political instability, and LMS stands for market size. A time is indicated by t and an error term is indicated by e_t.

A variety of methodologies have been used in the literature to examine the determinants of inward FDI in Pakistan. To test the robustness of the model, many scholars used the ordinary least squares method. Variables are examined to determine their relationship, we use the ARDL approach. For small time-series data, this method would be useful for verifying the variable’s long-run cointegration (Narayan, 2005). The advantage of this method is that it can measure the data when it is integrated in a variety of ways, unlike methods used in the literature. The integration of time series at level 2 may lead to confusion or spurious results.

$$LFDI_{2t} = \beta_0 + \beta_1 \sum_{t=0}^p \beta_2 \Delta LFDI_{2t-r} + \sum_{t=0}^p \beta_2 \Delta RL_{t-r} + \sum_{t=0}^p \beta_3 \Delta RE_{t-r} + \sum_{t=0}^p \beta_4 MO_{t-r} + \sum_{t=0}^p \beta_5 \Delta GS_{t-r} + \sum_{t=0}^p \beta_6 \Delta polin_{t-r} + \sum_{t=0}^p \beta_7 \Delta I_{t-r} + \sum_{t=0}^p \beta_8 \Delta LMS_{t-r} + \beta_9 LFDI_{2t-1} + \beta_{10} RL_{t-1} + \beta_{12} RE_{t-1} + \beta_{13} MO_{t-1} + \beta_{14} GS_{t-1} + \beta_{15} polin_{t-1} + \beta_{16} I_{t-1} + \beta_{17} LMS_{t-1} + \varepsilon_t \dots 3$$

For ARDL bound test, certain characteristics were analyzed. In order to perform the bound test, time-series data must be stationary at both the level and at the first order (Ahmad et al., 2016). To determine if the data is stationary, we must apply unit-root tests.

Data Sources

For the purposes of this study, data was collected over the period of 1990-2019 in order to be able to conduct the research. As the title suggests, this study examines the foreign direct investment inflows for the purpose of analyzing the effects of the rule of law, the size of the government, the efficiency of regulations, the openness of the market, the inflation rate, political instability, and the size of the market on inflows of foreign direct

investment. A net inflow of foreign direct investment (balance of payments) is measured as an inflow of USD into the country. Economic freedom is one of the components that are incorporated into the model. Typically, inflation is measured by the Consumer Price Index (CPI), which is calculated by taking the natural logarithm of the real GDP per capita and multiplying it by the inflation rate. The Economic Freedom Heritage Index 2019 provides data on the components of economic freedom (Miles et al., 2006), while the World Development Indicators provide data on other tools that can be used to measure a country's development. It was obtained from the Integrated Network for Societal Conflict Research (INSCR) that we obtained data related to political instability in order to create this study.

Results and Discussion

We first applied unit-root tests to the time-series data in order to determine their unit roots, which was the first step in the analysis. A table displaying the results of the expanded Dickey Fuller test as well as the Phillip Person test is provided in tables 1 and 2. As can be seen from the PP and unit-root tests, all variables show stationary behavior when the first difference is made; only government size exhibits stationary behavior when the first difference is made in the unit-root test. It is now possible to employ the ARDL model to examine relationships between variables on a long-term and short-term basis, since all results satisfy the requirements of the ARDL model. This is due to the fact that the data has now been modified in order to meet ARDL's requirements.

Table 1
ADF unit root test results

Variables	At level		First difference	
	t-state	Prob. value	t-state	Prob. value
LNFDI	-1.656699	0.4418	-4.343340	0.0020
RL	-1.955995	0.3034	-3.037201	0.0436
RE	-0.626807	0.8495	-5.282278	0.0002
OM	-0.693558	0.8326	-7.464791	0.0000
GS	-1.076227	0.7079	-4.916692	0.0006
I	-2.110092	0.2423	-5.248367	0.0002
POLS	-1.385163	0.575	-4.715760	0.0008
MS	-0.143133	0.9349	-3.351592	0.0219

Table 2
Test results for the PP unit root

Variables	At level		First difference	
	t-state	Prob. Value	t-state	Prob. Value
LNFDI	-1.794932	0.3754	-4.338166	0.0020
RL	-1.627527	0.4562	-2.969742	0.0502
RE	-0.792833	0.8062	-7.925012	0.0000
OM	-0.854742	0.7879	-7.464791	0.0000
GS	-3.012453	0.0455	-5.428998	0.0001
POLS	-1.578541	0.4804	-4.753066	0.0007
I	-2.216102	0.2051	-5.256341	0.0002
MS	0.212712	0.9687	-3.351952	0.0218

ADF test results are summarized in table 1. During the first difference, all variables are stationary. Therefore, it fulfills the ARDL condition. The stationarity test in Table 2 is conducted using PP. As of the 1st difference, all variables except GS are stationary. The other approaches for cointegration cannot be used since all data should be stationary on a unique level. ARDL is a suitable method for analyzing cointegration due to the mixture of stationarity in our data (Ahmad et al., 2023).

After the stationarity attributes of the variables, the optimal lag length was selected. There are various kinds of lag selection criteria in the model. Different criteria are existing for the selection of optimal lag length but the most popular among them are the Schwarz information criterion (SC) and Aikaike information criterion (AIC). These two are suitable to estimate small samples and they give reliable results to estimate. However, the autoregressive distributive lag approach also sets the lags by itself according to the econometric model (Parveen & Ahmad, 2020).

Table 3
Bound test for Co-integration

F-Statistics= 4.291028		
Critical Values	Lower bound values	Upper Bound Values
10%	2.22	3.17
5%	2.5	3.5
2.5%	2.76	3.81
1%	3.07	4.23

Consequently, to identify whether F-statistics are significant, one should perform the ARDL bound test for the following variables: FDI, the rule of law, the efficiency of regulation, the size of the government, the openness of markets, inflation, political instability, and FDI. We can use the ARDL technique to analyze the impact of variables on FDI in the long run as a result of the high value of F stats in comparison with the upper bound of F stats, and we can use the ARDL technique to analyze the effect of variables on FDI in the short run.

Table 4
Short-run and long-run results

Independent variables	Long-term dependent variable =LNFDI_t		Short-term dependent variable = ΔNFDI_t	
	Long run analysis		Short run analysis	
RL(-1)	1.647457	0.0034	1.514863	0.0058
RE(-1)	1.801417	0.0439	1.656431	0.0830
OM	0.897954	0.0211	0.825683	0.0259
GS(-1)	0.214177	0.0710	0.196939	0.0530
POLIN(-1)	1.095240	0.0020	1.007091	0.0026
I	-0.018167	0.4896	-0.016705	0.4654
MS	7.696844	0.0100	7.077369	0.0128
ECT _{t-1}	-0.089			
Diagnostic test				
R²	0.945662			
Adjusted R²	0.895206			

A significant result revealed that the error correction term in the model had a negative value, indicating the existence of a long-term relationship. There is a significant difference of 1% between the ECT value in this case and 0.0089 in the previous case. The value represents the speed at which the model adjusts from a short run to a long run model. It is necessary to have a negative value in order to accept this value.

According to the results of the short-run analysis, all variables are significant except inflation. It is also indicated in the following table, no. 5.5 that these results are also provided for your reference. FDI can be measured based on the fact that every one unit improvement in the rule of law will result in an increase in FDI of 1.5%, so a single unit improvement will have a one-unit impact on inward foreign direct investment. A one unit increase in regulatory efficiency results in a 1.6% increase in FDI. A rise in the open market will result

in a 0.8% increase in foreign direct investment in the short term. An increase in government size, as well as a rise in taxes and expenditures, has been shown to have a significant impact on FDI, and it has been shown that a one-unit increase in government size leads to a 0.2% increase in FDI within a short period of time in FDI.

These all variables attract FDI in the short run because investors encourage investing in a country where the freedom is high either in the short run. And the low intervention of the government also encourages investors. Rule of law, regulatory efficiency, and low tax burden all encourage multinational corporations. Inflation remains negatively insignificant in the current study and also high inflation hinders investors because a hike in inflation and fluctuations demotivate the investors. Inward foreign direct investment can also be influenced by a country's market size, as results indicate that FDI increases by 7.07% when the market size increases by 1% when a country's market size increases. As a consequence, if a country has a large market size, it will attract more foreign direct investment into that country as a result of the larger market size. FDI is also positively impacted by political instability in the short term. FDI increased more than during any period of civil democracy during the period of dictatorship, when Parvez Musharraf came to power.

In this study, we examine the influence of economic freedom and other factors affecting FDI in Pakistan between 1990 and 2019. There are three sub-components to the rule of Law, in addition to property rights and judicial effectiveness: government integrity, judicial effectiveness, and judicial efficiency. The study does not include judicial effectiveness due to a lack of data. In this regard, the results of this research are based on the importance of protecting property rights as well as the integrity of government. Consequently, Rule of Law has a positive impact on foreign direct investment in Pakistan over the long term, because an increase of 1.6% in Rule of Law will result in an increase in foreign direct investment inflows of 1.6%. In light of the fact that institutional quality is heavily influenced by the rule of law, these results confirm that foreign direct investment is positively correlated with the rule of law. As with previous studies (Júlio et al., 2013), the results of this study are in agreement with previous studies.

A foreign investor may attract with surety of protection of property by the institutions, the improvement in the integrity of government. The concept of regulatory efficiency refers to the establishment and conduct of business without any unnecessary intervention by the state. Foreign direct investment will increase by 1.8% if regulatory efficiency is increased one unit. If the state is efficiently regulating its laws and making doing of business and implementing labor laws, this will encourage foreign investors to invest and make other entrepreneurial activities. These results are matching with the results of (Van Wyk & Lal, 2010). In addition, Albuiescu and Ionescu (2018) found that monetary uncertainty hinders foreign direct investment. FDI is positively impacted by regulatory efficacy in this study. Government size refers to low taxes and a reduction in unnecessary government spending. A high tax discourages foreign investors because it is concerned with the high business cost so profit will reduce. According to the previous literature, FDI is negatively correlated with high tax burdens (Bellak & Leibrecht, 2009). A high level of government spending may also indicate an unstable macroeconomic environment, and high and unnecessary government spending want high tax which will in turn lead to discouraging foreign firms (Abdel-Gadir, 2010). If the freedom is high in government size it means low taxes and low and necessary government spending. A one-unit increase in the government size will lead to an accelerating FDI of 0.2%. Government size is significant at 10% and its coefficient is quite low in the case of Pakistan. According to the economic freedom index, trade is governed by tariffs (limits on exports) as well as non-tariff barriers imposed by governments. Economically free countries reduce regulations to increase investment in the country, but still, a lot of countries impose restrictions and high regulations on this. The economic freedom index considers less interference as a positive factor. Pakistan's market openness has reliable positive impact on FDI. Foreign direct investment inflows in Pakistan

increase by 0.89% for every unit increase in market openness. But 25.8% of GDP in Pakistan is made up of imports and exports, and an average tariff rate of 10.1% is applied to it. According to World Trade Organization (WTO), about 66 non-tariff barriers are on import and export to impede them.

Political instability in Pakistan has a positive impact on foreign direct investment into Pakistan. Foreign direct investment will increase by 1.09% when political instability increases by 1%. Depending on these findings, we can conclude that there were more FDI inflows during the years of Pervez Musharraf than during other studied periods. The results of this study are in accordance with those of (Khalid, 2017). We know that in the era of Pervez Musharraf, Pakistan received FDI of about 3.8% of GDP which was more than in civil governments. The variable Inflation significantly affect the foreign direct investment in Pakistan. In the current years, it increases which is worse for the economy. Inflation discourages the confidence of investors. Because it leads to high input prices which leads to a reduction in profits. In my study inflation rate remains negative and also insignificant through the years. The results of the study are supported by (Tsaurai, 2018). And also, in line with the study of (Oman Khan, 2011). The market size is an important determinants to determine the level of FDI inflow, as well as the amount of foreign direct investment in the country. As a result of the fact that the market size provides a great deal of potential for investors, it encourages them to invest in the market. There is a positive correlation between inward foreign direct investment and the size of the market. Foreign direct investment is more likely to be attracted by a larger market in terms of GDP. When the market size of a country increases by 1%, foreign direct investment increases by 7.6% as well. For foreign direct investment to be successful, the market size of a country plays a significant role in attracting the investment. In accordance with (Azam & Lukman, 2010).

Conclusion

Economic theory suggests that FDI can play a significant role to economic expansion in a number of ways. Capital accumulation, human capital growth, more efficient resource allocation, coordination of local financial markets, and a decrease in capital costs are among these factors (Todaro, 1977). According to the literature on development economics, foreign direct investment (FDI) role is accepted significant for country's growth dynamics. There are three 'development gaps' in developing countries that can be filled by foreign direct investment. By providing capital for domestic investments, the government can fill this investment gap. A second option is to plug the foreign exchange gap through preliminary investments and export earnings, and to plug the tax revenue gap through a range of economic activities (Smith, 1997). It is predicted by the existing literature that, there will be more effects of FDI if the recipients are more flexible and spongier. Foreign direct investment is a major network of transmission of skills, and the growth of the receiving countries can increase with the help of it. So, inward foreign direct investment is positive for the receiving countries (Crespo & Fontoura, 2007)

In developing countries including Pakistan, there is high external debt, low wages, lack of investment, low industrialization, rapid growth in population, the balance of payment deficit, lack of professional and managerial skills, and dependency on the export of raw materials rather than final goods. Domestic financial resources are not enough to feed the economy. So, in the presence of all these problems, FDI is an injection, with its help we can boost our growth by overcoming our problems which are the main obstacles to economic growth. The purpose of this study was to determine if economic freedom has any influence on the inflow of FDI into Pakistan between 1990 and 2019. For the purpose of capturing the extent of foreign direct investment, macroeconomic variables and political factors were considered. This analysis is based on time series data. The economic freedom index is based on four main categories. In this paper index of economic freedom is used at disaggregated levels to achieve more ample understanding. High economic freedom attracts foreign investors because it generates a favorable climate to invest in a country. Economic

freedom helps to increase foreign direct investment because a country with less corruption, low burden of taxes, strong institutions, pellucidity, and reduction in briberies will seek the interest of investors. They feel free to invest in a country where property rights are secure, prices are determined, and where there is freedom in investment and entrepreneurial operations. In this study, political instability shows significant results, and these results have evidence because we know that in the era of Pervez Musharraf, Pakistan received FDI of about 3.8% of GDP which was more than in civil governments. The projected results are notable for various reasons. In the first place, this study extends the existing literature on the determinants of inward foreign direct investment, which takes into account a variety of factors. According to the findings of the study, foreign direct investment is significantly influenced by the freedom of the economy. As the investment climate is captured in the presence of economic freedom, so government and policymakers should focus on the improvement of the investment environment in the country. This environment can be improved if the government focuses on the transparency of policies, by reducing the level of corruption and by introducing tax reforms and reduction in the tax system.

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