

EXAMINING TAX RATES, TERRORISM, AND TRADE OPENNESS AS DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN PAKISTAN: AN EMPIRICAL ASSESSMENT

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Abstract: Foreign direct investment is crucial for economic development, particularly in emerging economies. Recently, developing countries has seen a rise in the rate of foreign direct investment (FDI) inflows on an annual basis. Tax holidays, investment allowances, exemptions, deductions, and other tax breaks are some of the incentives that a number of countries are providing in an effort to attract more foreign direct investment (FDI). The purpose of this study is to investigate how decisions about foreign direct investment (FDI) are affected by Pakistan's tax system. Specifically, researchers analyzed the impact of the statutory corporation tax rate, the real effective exchange rate, terrorism, and trade openness on foreign direct investment, with GDP growth serving as the controlled variable. Data from time series covering the years 1986 to 2021 are used. The data was compiled using the World Development Indicator (WDI) and the Economic Survey of Pakistan. Researchers used the empirical methods of Auto-Regressive Distributed Lag (ARDL) and Error Correction Model (ECM). The findings indicated that low taxes encouraged long-term FDI relationships between Pakistan and international investors. The statutory corporate tax rate, the real effective exchange rate, and the threat of terrorism are all independent variables that have a negative and significant influence on foreign direct investment. In addition, the findings showed that a significant and favorable influence on foreign direct investment (FDI) was achieved by an increase in both trade openness and GDP growth. It is suggested that developing countries decision-makers implement measures that reduce taxes in order to attract foreign direct investment. In this context, the government must review its foreign direct investment formulation goals.

Keywords: Foreign Direct Investment, Trade openness, Taxation, Tax Holidays

Introduction

The state of the country's economic growth at the present time will determine its path in the years to come (Ahmad et al., 2022). Foreign direct investment and tax revenue are few of the factors that affect a country's economic growth and development. Nearly every government is keen to attract foreign direct investment (FDI) for their country (Camara, 2022). According to the International Monetary Fund (IMF), foreign direct investment (FDI) is defined as an investment that is made with the intention of securing the investor's long-term stake in businesses that are located in a different country. Foreign direct investment (FDI) is an investment made directly by a foreign company in a foreign organization, individual, or set of organisations that the foreign company may rule or manage (Coulibaly & Camara, 2022). Over the course of human history, technological progress has allowed for the establishment of more efficient means of communication and transportation, both of which have contributed to the free flow of capital across national boundaries (Temouri et al., 2022). Foreign direct investment is an essential component of an external finance strategy for developing countries since it enables these countries to get financing from more developed countries (Yang & Shafiq, 2020). In addition, foreign direct investment (FDI) provides the country with a number of advantages, such as the provision of the long-term capital that is essential for the economic growth of the host nation. The creation of new jobs, the dissemination of innovative technologies, the expansion of access to international markets, the dissemination of advanced management techniques, the attraction of businesses specializing in cutting-edge fields, the dissemination of "clean technologies" that may ameliorate environmental deterioration, the expansion of employment and wages, and the correction of a negative trade balance are all possible

outcomes (Siregar & Patunru, 2021).

Foreign direct investment (FDI) adds to a nation's economic development through enhancing the human capital of that country. In research and development, human capital is the most significant factor. It results in an increase in inventive activity and competitiveness, both of which contribute to higher levels of technological development and output. Additionally, it helps to the growth of the nation's economy as a whole (Tham et al., 2021). Economy of scale, which reduces manufacturing costs, is one of the key motivations for foreign direct investment (FDI) in any nation, according to globalization theory. Other factors include product quality and a shorter lead time. However, there are a number of factors that support the investment of one nation in another. These factors include manufacturing cost, product quality, and decreased lead time (Kamal et al., 2021).


Tax income is another aspect that plays a significant role in the development of the country's economy. Taxes are a kind of compulsory payment that the government levies on its citizens. People's incomes, properties, and a variety of other criteria are taken into account while calculating the tax (Ojeka et al., 2021). Governments have to levy taxes in order to bring in money for essential services and programme that benefit everyone in the nation. Reduced tax rates, the ability to carry losses forward, tax vacations, and tariff reductions are some examples of the tax incentives that may be offered (Vaz da Fonseca & Nascimento Jucá, 2020). In contrast, tax expenditures are the costs the government absorbs when it provides favorable tax treatment in the form of breaks like tax credits, deductions, and exemptions. Reduced or zero tax rates, charitable contributions, and military service members all fall under the category of preferential tax rates. These are only a few examples of the many types of tax expenditures available (Kyari, 2020).

Businesses and individuals may often take advantage of four distinct types of tax holidays: tax holidays, tax credits and investment allowances, timing variations, and reduced tax rates. Investment tax credits are reductions in the amount of tax owing, while investment allowances are reductions in the amount of taxable income. New businesses are free from paying taxes for a period of time during tax holidays. Variations in timing may include claiming the deduction in the first year or shortening the asset's depreciation period (Bouchoucha & Benammou, 2020). Because of the possible advantages of FDI, officials continually examine their tax approaches to see how they might entice the most foreign investment.

Tax policies favour foreign direct investment (FDI) because outward investment provides the path for successful entrance into global markets and generates sufficient capacity to achieve economies of scale. At the same time, taxation is widely recognized as an important issue to consider when selecting a destination for an investment. As a consequence of this, foreign direct investment is drawn to countries that provide access to global markets and opportunities for profit, a legal framework that is predictable and free from discrimination, stable macroeconomic conditions, highly skilled and productive labour markets, and developed infrastructure. The long-term profitability of a project was significantly impacted by each of these criteria (Pratomo, 2020).

The International Monetary Fund and the World Bank provide loans to developing countries like Pakistan, who run budget deficits most of the time and hence need these loans to keep their foreign reserves afloat and fund their development programme. Increasing government taxation on businesses and utilities to repay the public debt will slow economic development in the long term. Foreign direct investment (FDI) is the most attractive choice since it allows you to get foreign cash without having to repay it, as well as reap the advantages associated with doing so. In 1984, Pakistan's government made a public disclosure of its industrial policy statement, marking the beginning of the country's liberalization of FDI. To stimulate FDI, the government enacted many regulatory and tax adjustments. In 1990, the Office of the Prime Minister established the Board of Investment to expedite the process of establishing new firms (Sohail & Mirza, 2020).

Pakistan's government has signed investment protection and promotion treaties with the governments of 46 other nations. As of 1997, Pakistan has been using a new investment strategy to attract FDI (FDI). Expanding manufacturing, infrastructure, electronics, software, agriculture, textiles, tourism, and construction are all part of a new agenda that also includes the service and agricultural industries. Attractive tax and tariff rates were provided to entice investors from outside. An investor was allowed to get back 100% of their original investment with any interest, dividends, or profits they made (Saleem et al., 2020). From 1993 to 1998, Pakistan was able to bring its business tax rate down from 44% to 33%. In 2003, a 2% rise in the tax rate was implemented, and



the rate remained at 35% from 2003 to 2013. In 2014, the government made the decision to implement a scheme that would lower the corporation tax rate by 1% per year, bringing it down to 30% in 2018 (Azam et al., 2019).

Attracting foreign direct investment is a big problem for governments in developing nations. It is also critical to evaluate how taxes affect FDI. What role do exchange rates have in promoting FDI growth? Where should the emphasis be placed when designing policies that permit the taxation of foreign direct investment? How do governments respond to calls to lower taxes on foreign direct investment? Even though Pakistan's economy has risen by an average of around 5% per year over the previous three decades (World Bank, 2018), it still requires financial resources in order to continue growing. Therefore, it is crucial to examine the driving forces for FDI in Pakistan. Investment forecasts for Pakistan show a rise in foreign direct investment from \$1.74 billion in 2018 to \$2.22 billion in the year 2019. However, foreign direct investment fell to \$1.395 billion in 2021 as a direct result of the worldwide health crisis. Therefore, the purpose of this research is to analyse how taxes affect FDI in Pakistan and to provide policy recommendations based on the findings.

Literature Review

Evidence suggests that FDI greatly benefits host economies in many ways, including growth, transfer of expertise, increased productivity, influx of capital, and the generation of new employment opportunities. Due to this, the tax rate is the single most influential factor in attracting FDI from outside (Omodero et al., 2022). Several nations provide various financial inducements (or incentives) to foreign firms that would otherwise not invest in their economies. Hartman (1984) reviewed the preceding 15 years' worth of data on the topic of the tax impacts of foreign direct investment in the United States (1965-1979). The findings of the aggregate time-series model demonstrate a robust and statistically significant connection between changes in domestic tax policy and the inflow of foreign investment into the United States.

The same line of research carried out by Wang (2011) in the United States of America by making use of a standard model. According to the findings of the research, the US efficient tax rate is detrimental to FDI. Aqeel et al. (2004) conducted research on the variables that influence foreign direct investment (FDI) in Pakistan. They demonstrated that a variety of variables, including openness of the trade, fiscal, and banking sectors, had an effect on FDI in Pakistan. The research concluded that a low tariff rate on imports as well as a corporation tax rate significantly affect the growth of foreign direct investment (FDI). The research used co-integration and error-correction techniques to analyze secondary data collected between 1961 and 2003. Moreover, the exchange rate coefficient was positive, indicating that an increase in FDI is associated with a rise in the value of the rupee, since investors see an appreciating currency as a favorable sign for the economy and predict increased profits.

The authors Du et al. (2014) investigated the many shifts that occurred in China's industrial policy between the years 1998 and 2007. In the beginning, hundreds of public sector firms decided to either alter the lone trader ship or liquidate it. Second, in order to entice more foreign direct investment (FDI), the corporate tax rate was lowered from 33% to 15% for foreign firms while staying at 33% for local companies. This was done in an effort to attract more FDI. The average tariff rate has been reduced by 9.4 percentage points ever since the nation became a member of the World Trade Organization in 2001. As a direct and immediate result of the fact that the country's corporation tax rate is lower for foreign companies than it is for local companies, China has quickly climbed to the top of the list of countries that are most attractive to foreign direct investment (FDI).

Mandinga (2015) shown, via the use of panel data for 22 (SIDS) Small Island Developing States over the period of 2004-2013, that an increase of 10% in the corporation tax rate resulted in a reduction in foreign direct investment (FDI) of 3.5% in the short run and 4.7% in the long run. In light of this, the research suggested that Small Island Developing States (SIDS) should lower their corporation tax rate in order to attract more foreign direct investment (FDI). Ang (2008) conducted research that followed a similar line of inquiry and came to the conclusion that an increase in the corporation tax rate results in an unfavorable reaction from foreign direct investment inflows.

Gastanaga et al. (1998) conducted a multivariate study on data from 49 developing countries during the period 1970-1995 in the case of less-developed countries. They found, after analysing the effect of many factors on FDI, that the corporation tax rate had a considerable

negative and linear effect on FDI. In this sense, the location of investments has become a crucial issue that affects tax rates. In the existence of several production possibilities, it is not unexpected that selections are substantially influenced by the area with the lowest tax rate. There is little question that foreign tax rules have a considerable influence on the magnitude and location of FDI and are accountable for tax evasion. International data indicated that FDI investment choices are more sensitive to tax rate variations (Hines Jr, 1999). In order to attract FDI, according to Buettner and Ruf (2007) the race to reduce corporate tax rates among industrialized countries began in the 1980s. Prior to the year 2001, corporate tax rates in OECD countries have decreased from 50% to around 35%. In 1992, the Ruding committee of the European Union proposed a 30% tax rate, which was lower than any other rate in Europe at the time. After a decade, one-third of European Union members had a corporation tax rate below this threshold.

Economou et al. (2017) investigated the factors that determined the amount of foreign direct investment (FDI) flowing into 24 OECD countries and 22 developing nations from 1980 to 2012. In addition to market size, labour cost, and institutional variables, a lower tax rate was found to be a significant factor in determining foreign direct investment (FDI) in developing countries. In contrast, trade openness, education, market size, labour cost, gross capital development, and taxes were cited as the most influential predictors of FDI in industrialized countries. In another study, Abdulla and Ali (2022) revealed that between 2002 and 2012, foreign direct investment (FDI) from 23 OECD nations to 113 developing and transition economies rose by up to 97% due to tax saving agreements. Recent research conducted by Esteller-Moré et al. (2020) found that a 10% increase in the corporate tax rate decreased FDI by between 3.4% and 1.9% in non-OECD countries in 2004.

Emerging countries are more dependent on foreign direct investment (FDI) than developed countries are because of their need for cash from other countries, economic development and growth, technological advancement, and the transfer of corporate know-how. However, a large number of prior studies have been conducted in order to determine the factors that contribute to FDI in developed economies; however, research on this topic in developing economies is still in its infancy. In this article, the current study analyses the most essential aspects of foreign direct investment in Pakistan, which policymakers in Pakistan may change in order to promote more foreign direct investment in Pakistan.

Data and Methodology

Developing an effective approach and adequate procedures is essential for every research endeavour. Consequently, this part describes the methods and strategies used in the present investigation. In order to investigate the effects of Pakistan's taxes on foreign direct investment (FDI), researchers look at time-series data spanning from 1984 all the way up to 2021. Their focus is on both the short-time and the long-term implications of these findings. The World Development Indicators (WDI, 2021) is researched for data on all variables, with the exception of the tax rate, which is investigated using the Economic Survey of Pakistan. The functional form for this analysis is as follows:

$$FDI = f(\text{Real Effective Exchange Rate, Terrorism, Statutory Corporate Tax Rate, TRADEO, GDP Growth}) \dots (1)$$

The dependent variable in this case is Foreign Direct Investment (FDI), while the primary independent variables are Real Effective Exchange Rate, Terrorism, Statutory Corporate Tax Rate, and Trade Openness. In addition, the growth of GDP serves as the control variable (GDPG). As a result, equation 1 may be expressed in a form suitable for time series as:

$$FDI_t = Q_0 + Q_1 REER_t + Q_2 T_t + Q_3 TRADE_t + Q_4 SCTR_t + Q_5 GDP_t + s_t \dots (2)$$

The intercept in the following equation is zero, whereas each of the other values represents a change in FDI resulting from a change in tax rate, GDP growth, trade openness, exchange rate, or interest rate. T symbolizes the years 1986 through 2021, whereas s_t denotes an error.

Multiple methods for calculating the variables' integration relationship have been offered in the existing literature. Two of the most well-known ways are the residual-based strategy developed by Dritsaki and Dritsaki (2012) and the maximum likelihood approach developed by Johansen and Juselius (1994) are two of the most well-known methods. Both of these techniques have seen considerable use in the real world. In order for any of these methods to be applicable, it is necessary for all variables to have the same order of integration. Nevertheless, a problem occurs when the order of integration is

changed as it is in the present study. For the purpose of finding a solution to this problem, the Autoregressive Distributed Lag (ARDL) technique developed by Rehman et al. (2011) is used in the study. ARDL may be used for integration orders of 0 and 1, as well as for mixed order integration.

In order to eliminate the possibility of erroneous regression, the first step in time series analysis is to validate the stationarity of the data. In order to determine whether or not the data are stationary, the Augmented Dicky Fuller test is carried out. While the Error Correction Model (ECM) is employed in the process of capturing short-run dynamics, the Autoregressive Distributed Lag (ARDL) is used in the process of identifying long-run interactions between variables in co-integration.

As a result of the bound test, we may distinct the lags of each model variable individually. Rejection of null hypothesis ($\gamma_1 = \gamma_2 = \gamma_3 = \gamma_4 = \gamma_5 = \gamma_6 = 0$) indicates the existence of co-integration then move to check short-run and long-run dynamics. T the F-test used to determine if a long-term connection exists between the variables. When the F-statistic result exceeds the upper bound's critical value, the variables are co-integrated. However, if the critical value of a lower limit exceeds the F- statistic, the model's variables are not co-integrated. Additionally, the F-statistic number is inconclusive due to its position between the upper and lower boundaries.

Results and Discussion

In this part of the article, descriptive data and empirical findings are reviewed in order to determine the effect that Pakistan's taxation system has on foreign direct investment.

Descriptive Statistics

The importance of descriptive statistics cannot be overstated since, if the data are just presented in their raw format, it is very challenging to understand the pattern that the data is exhibiting. In light of this, the abridged version of the descriptive statistics presents the information in a way that is both more significant and simpler to understand. In addition, the table of descriptive statistics includes a representation of the total observations and other values which are all helpful in further estimating the data. The summary statistics of all the variables that were chosen to participate in the study are shown in Table 1.

Table 4.1 Descriptive Analysis

Variables	Obs.	Mean	Std. Dev.	Min	Max
Dependent Variable					
Foreign Direct Investment	36	0.89	0.68	0.4	3.67
Independent Variable					
Real effective exchange rate	36	122.47	27.51	89.96	346.29
Terrorism	36	43.71	4.71	2	211
Statutory corporate tax rate	36	33.76	2.19	29	35
Trade openness	36	31.098	2.97	25.31	35.59
Control Variables					
GDP growth	36	5.761	1.81	0.89	8.07

Econometric Analysis

The results of the Augmented Dicky Fuller test are shown in Table 2, where all variables are integrated at either zero or one order. Since F-statistics become more involved when a variable is integrated at order 2, the ARDL Bound test is used instead.



Table 2: Augmented Dickey Fuller Test

Variables	Level of Integration	t-Statistic	Prob.*	Decision
FDI (Foreign Direct Investment)	First Difference	-3.72	.001**	I (1)
Real effective exchange rate	Level	-8.19	.000**	I (1)
Terrorism	First Difference	-3.89	.041*	I (0)
Statutory corporate tax rate	First Difference	-6.81	.009**	I (1)
Trade openness	Level	-7.37	.001**	I (0)
GDP growth	First Difference	-5.71	.033*	I (0)

Note: "The asterisks ** and * indicate that the coefficient differs considerably from zero at probabilities of 1% and 5%, respectively."

The first thing you need to do for ARDL is locate the lag length criterion, and minimal delays are appropriate for time series analysis since they prevent the loss of degree of freedom. The parameters for selecting the lag order are shown in Table 3.

Table 3: VAR Lag Order Selection Criteria (TAX AND FDI)

Lag	AIC	SC
0	31.811	32.19
1	25.72	28.63
2	24.09	27.09

*Denotes the lag order determined by the criteria, which may be either the Akaike Information Criterion (AIC) or the Schwarz Information Criterion (SC)


The results of the ARDL model's calculations are shown in Table 4, which reveals that the computed value is 5.19, which is more than a crucial value for the upper limit. In light of this, the fact that the null hypothesis was refuted provides evidence that a long-run link does in fact exist. The ARDL model's coefficients are shown in the table 5's top section, which can be found here. The coefficient of the Error Correction Model, which reflects the short-run influence between variables, may be found in the area of the table that is located below the header. The actual effective exchange rate, the terrorisms, the statutory corporation tax rate, all have a negative relationship with foreign direct investment (FDI) which suggests that when the tax rate is raised, FDI in the country will fall. In addition, it was shown that trade openness had a positive and significant influence on foreign direct investment (FDI). In conclusion, the control factors, such as a growing GDP, have a positive relationship with FDI. In addition, foreign direct investment is linked, in the long term, to taxation, GDP growth, the real effective exchange rate, and trade openness.

Table 4: ARDL bounds Testing Analysis

Estimated Model	Model
F-Statistics	5.19
Selected Lag Length (Criteria)	1 (SC)

Pesaran et al. (2001)

Critical bound values	Lower Bound Value	Upper Bound Value
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10%	2.19	3.19
5%	2.73	3.82
2.50%	2.87	4.91
1%	3.82	4.72

Table 5: ARDL Model Long-run and Short-run Results


Variables	Long-run Results		
	Coefficient	t-Statistic	Prob. Value
FDI (Foreign Direct Investment)	-0.781	-1.834	.016**
Real effective exchange rate	-0.791	-2.194	.046*
Terrorism	-0.291	-1.081	.019*
Statutory corporate tax rate	-0.519	-3.764	.037*
Trade openness	0.197	1.094	0.289
GDP growth	0.973	-2.049	.004**
	Short-run Results		
ECM	-0.261	-2.638	0.01***
FDI (Foreign Direct Investment)	-0.853	-2.192	.016**
Real effective exchange rate	-0.833	-3.583	.046*
Terrorism	-0.279	-1.824	.001**
Statutory corporate tax rate	-0.437	-2.834	.000**
Trade openness	0.527	1.541	.005**
GDP growth	0.772	-372	.05*

Table 6: Diagnostic Tests

Test	F-statistic value	Prob. value
J-B Normality Test	1.44	0.512
Breusch-Godfrey Serial: Correlation LM Test	0.42	0.613
Heteroskedasticity Test: ARCH	0.081	0.692

The high tax rates are the source of the adverse impact that the statutory corporation tax rate has on FDI. These rates discourage investors from putting their money into firms since they cut into the investors' earnings (Mandinga, 2015). As a result, tax is the primary factor that investors consider when making decisions on foreign direct investments (FDI), since they compare tax rates in different countries.

Other independent factors, such as the real effective exchange rate and terrorism, have a



considerable negative impact on the overall amount of foreign direct investment (Ojeka et al., 2021; Omodero et al., 2022; Pratomo, 2020; Saleem et al., 2020; Siregar & Patunru, 2021). According to Pata et al. (2022), trade openness has a positive effect on foreign direct investment (FDI). The appearance of a negative sign at a level of significance of 5% demonstrates that the error correcting term has significant importance from a statistical perspective. In a similar vein, the table presented above displays that the coefficient of ECM is -0.2614, which can be found above the table.

Conclusion and Policy Suggestions

The findings indicated that statutory corporate tax rate, the real effective exchange rate, and the threat of terrorism are all independent variables that have a negative and significant influence on foreign direct investment. The results of current research are in line with previous research as most of the authors are agreed that different tax rates effect foreign direct investment in developing countries (Camara, 2022; Moraghen et al., 2023; Zagler, 2023). In addition, the findings showed that a significant and favorable influence on foreign direct investment (FDI) was achieved by an increase in both trade openness and GDP growth. The research findings are validated through multiple researchers (Bassey et al., 2022; Gasparéniené et al., 2022).

The research suggests that FDI's multi-sector investments considerably contribute to GDP expansion and technological progress. Based on the evidence and the available literature, we may form this conclusion. Indirectly, it promotes the growth and sustainability of host economies by influencing the flow of technological know-how, skilled labour, and educational opportunities. In this context, the adoption of tax adjustments or the provision of tax incentives is a crucial aspect of attracting foreign direct investment. According to the evidence provided, cutting tax rates is the method that should be emphasized the most due to its simplicity of implementation. However, it cannot be disputed that there are other critical variables that are deemed essential for attracting foreign direct investment (FDI). This includes the country's political climate, its infrastructure, the circumstances of the labour market, the availability of resources, financial elements, government and legal issues, and so forth.

The goal of this research was to assess the impact of Pakistan's tax rate on FDI from 1986 to 2021. The ARDL method is used to analyze the stability of a model's parameters over time. There is a relationship between Pakistan's tax rate and the amount of foreign direct investment in the economy, as shown by the study. The control variable, GDP growth, has a considerable effect on FDI, but other independent factors, such as the real effective exchange rate, terrorism, and trade openness, also have a role.


Pakistan should prioritize attracting more foreign direct investment. To encourage FDI to Pakistan, it has been suggested that tax rates should be reduced. When establishing policies conducive to FDI, the government must rethink its goals. Priority must be given to categorizing areas with the potential to attract more FDI. There is no one development strategy that will benefit all nations at all times. In the process of establishing policies, it is necessary to examine and assess the government's capabilities. These findings also suggest that a reduction in the corporate tax rate would only be beneficial if the democratic government permitted more economic openness. Tax incentives may be more successful if they are supported by a stable energy supply, enhanced infrastructure, social peace, and a labour pool. Numerous industrialized and emerging nations have higher corporation tax rates and FDI inflows than Pakistan, which may be a result of Pakistan's improved business climate. In addition, enhancements to the aforementioned characteristics may contribute to the formation of an investment-friendly atmosphere.

Due to a lack of relevant data, the research that is being addressed here has a restricted scope since it does not take into account factors such as political stability or levels of corruption. This study should be broadened to include a logical and comparative investigation of the factors that attract horizontal, vertical, and conglomerate (Greenfield or brown field) foreign direct investment in Pakistan throughout the same time frame. This study will assist policymakers in analysing prior policy responses and formulating suggestions for future FDI strategies.



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