GOVERNANCE AND CURRENT ECONOMETIC EFFECT OF MACRO ECONOMIC VARIABLES ON FOREIGN DIRECT INVESTMENT IN PAKISTAN: AN EMPERICAL STUDY

Muhammad Shahid, [1] Mahmood Shah, [2] Farhat Parveen[3] and Khalid Mehmood[4]
[1] Department of Economics, Govt. Post Graduate College Bhakkar, Punjab, Pakistan
[2] Department of Economics Gomal University D.I Khan
[3]Government College for Woman Darya Khan, Pakistan
[4] Economocs Department, University of Punjab Lahore, Pakistan
Corresponding author: Muhammad Shahid, *shahidamir77@gmail.com*

ABSTRACT: *This paper debated and conducted the co integration and econometric regression analysis to examine the impact of Governance, foreign exchange rate,the real GDP growth rate on Foreign Direct Investment in Pakistan by using the time series data for the period of 1984 to 2012. Augmented Dickey-Fuller (ADF) test suggests the most appropriate econometric technique to co integration is Auto Regressive Distributive Lag (ARDL). The most prominent tests of ARD technique Bound Test, Diagnostic Test, CUSUM and CUSUM sum of squares and Error correction adjustment coefficient test were applied to investigate the effect of Governance and macroeconomic variables on FDI. The results revealed that impact of governance, foreign exchange rate and real GDP growth rate have been found statistically significant and positive effect on FDI. The study emphasizes to improving governance indices like a terrorist, violent crime and political stability to encourage the more inflow of FDI to Pakistan. This will be proved a great work for economic literature, policy makers, researchers because it has used a paid data of a wide range of governance index introduced by International Country Risk Guide (ICRG).*

Key words: Governance, FDI, Foreign Exchange Rate, Real GDP growth rate; Pakistan.

1- INTRODUCTION

Better economic Governance has *been* established first objective by developed and developing countries for creating investment environment. It has achieved more importance in economic literature for researcher and policy makers. Many indicators of governance like political instability, corruption, terrorism, energy crisis, worst law and order situation, weak institution, high inflation, exchange rate, crimes ratio and less effective government are not only discouraging foreign investment but also deteriorating domestic investment World Development Report (2005).

The World Bank (2007) says that governance is norms through which govt. officers, institutions and power are exercised to formulate policies to provide public goods and services. **Asian Development Bank** has stated factors of effective governance, (1). Answerability (2) Contribution (3)Transparency (4) Predictability

Governance is the traditions, norms and institutions that determine how the rule of law and political power is exercised by govt. in a country. In present time it has revealed that FDI flows to region, which is characterized by good governance and many studies have investigated the empirical relationship between governance and FDI **[1, 2].** FDI flourished on the land of good governance and is an engine to initiate the business process and productivity of the domestic country by supplying economies in the form of capital investment, business transaction, foreign exchange, technological & managerial skills, employment opportunities, expand the size of exports & imports and innovation to the *d*omestic market. All these factors participate in the process of economic growth and improve the quality of stock of capital so FDI encourage economic development. In the modern age, many developed and developing countries are offering more economic incentives to the foreign investors in the form good governance, low tax rate, less tariff, stable inflation & exchange rate, a large market size, human capital, better infrastructure, more degree of openness. These economic incentives have a positive impact on productivity and growth which leads to path of development and provide financial support to the developing countries which are facing saving and foreign exchange gaps and they can overcome such gaps. Hence IMF and World Bank prefer FDI for developing countries rather than foreign aid. IMF and World Bank (2005) It is fact that foreign investors analyze the reports of Political Risk Rating Agencies published in the form of corruption index, terrorism index, rule of law index, civil justice index, criminal justice index, order and security index, regulatory enforcement index, political stability index, law and order situation before making investment in any country. These governance indicators create economic, investment climate and stimulate investment, business activity in a country. Investment is a key factor to encourage growth and puts economy on the path of development. In such economic atmosphere foreign investors can earn high returns on their capital. So governance raises the level of FDI debated empirically in many empirical studies **[3, 4].** They found a positive correlation between FDI and governance while negative relationship was also found in many studies by Chang, Weller and Ulmer [5, 6].

Furthermore, after 9/11 attacks on America, USA initiated global war on terror and asked Pakistan to provide Air Space and Logistic support. Pakistan was the single county in the World, which has the direct approach to land locked country. All attacks on Afghanistan and food supply through NATO were made possible with the help of Pakistan. Against this response TTP and Al Qaeda organized themselves and started attacks on civilian, military forces and deteriorated good governance of Pakistan. The result of that governance indicator like Terrorist Activity, Violent Crime, Political Instability indices rises which reflect the less peaceful position of the country in the world shown by the figure.

Three most important indicators of governance Terrorist Activity, Violent Crime and Political Instability are debated to depict a real picture of Pakistan economy. The sub indicators of the GPI Terrorist Activity Index is at 4.5, Violent Crime index at 4.0 and Political Instability Index at 3.25 reflects the most less peaceful position of Pakistan after Afghanistan in the world ranking economy in 2013. Furthermore the GPI is also high at 3.16 and the global Ranking score is 157th out of 162 countries response the most risk facing economy among the world ranking shown also by table. The above figure reflects that the graph of the terrorist activity index is at peak point and touching the highest terrorism figures. It is damaging the credibility before the world and discouraging foreign investment inflow. While the further two indices position like violent crime and political instability position were also worst. Moreover, earthquake of 2005 and flood of 2010 have destroyed public and private properties and assets of Pakistan. Before flood and war on terror the growth rate of Pakistan was 4% on average, but later turned down to 2%. Agriculture production reduced more than 15% and two million of bales of cotton destroyed completely. Before 9/11, FDI was 5.4 billion $ in 2007-2008 and came down to just 741 million in 2011-12 Mahmood and Ehsanullah [7] and caused more saving, foreign exchange gap. The assessment Report of Doing Business 2013 shows that Pakistan slips 5 points down from 166 to 171 in getting energy, loses 3 points in doing business out of 185 countries, given up 2 points in protecting foreign investors from 34 to 32 out of 189 countries and in trading business beyond borders, the position of India is better than Pakistan. In raking India is at 33 while Pakistan is just at 17 points out of 189 countries. So, against this background, more attention was paid to governance problems to determine the following objectives.

1.1 The Main Objectives of Research

* Analyze governance, which affects FDI in short run and long run and find relationship of governance and FDI with the inclusion of some important variables.
* Investigate FDI determinants in Pakistan and check the causality among foreign direct investment and governance along with inclusion of macroeconomic variables in Pakistan.
* Recommend the policy options that will lead to enhancing the level of FDI and improve governance conditions in Pakistan.

2. LITERATURE REVIEW

The importance of good governance for FDI has been increasingly recognized over the last three decades. Many studies have investigated the empirical relationship between governance and FDI. Governance has six dimensions, i.e., voice and accountability, political stability and lack of violence/terrorism, government effectiveness, regulatory quality, rule of law and control of corruption. Chandra and Yokoyama said that good governance encourages FDI and presumably private domestic investment as well as.

Malik and Ali examined the rule of law, energy supply, and safe security system, and law and order situation, communication infrastructure and show their effect on FDI. They used the data ranges from 1971 to 2009. They applied many tests for the data analysis, *i.e.,* Augment Dickey Fuller, Philip Peron and Johnson Co-integration Test and OLS econometric technique was employed on data. The results have showed positive impact of governance on FDI except Inflation and Foreign Exchange Rate. Finding of this study also revealed that high inflation and exchange rate is the sign of bad governance **[8].**

Shazad analyzed the relationship between FDI and governance factors like political certainty, infrastructure, degree of openness, labor cost, rule of law and macroeconomic indicators by taking annual data for the period from 1991 to 2011. In the model, the variables like macroeconomic variable growth rate of GDP, degree of openness (DOP), Infrastructure, labor cost (LC), political stability, rule of law and their impact on FDI. The researcher used Hierarchical Regression on data to show the result. He concluded that political certainty, the rule of law, the degree of openness, macroeconomic stability, degree of openness and macroeconomic stability showed positive effects on FDI **[9].** Ahmad and Malik evaluated the relationship between FDI and violence factors like law and order, riots and political situations by taking data for the period from 2003 to 2011 on a monthly basis due to non-availability of violence data before 2003. The effect of violence, exchange rate and Stock exchange Rate on FDI was shown by employing Linear-regression econometric technique was used to found the result that violence, Unstable Stock Exchange and Foreign Exchange Rate affects FDI negatively **[10].** Dixit revealed relation between FDI and governance by taking data for the period from 2008 to 2010. Three governance indicators neutral procedure, effective government and elimination of corrupted activities and the impact was shown on FDI. He also showed algebraic function and introduced two types of costs. First is the cost which the foreign firm has to face due to bad governance and the second is the cost which firm bears to take up new technology with domestic firm. He explained if the value of r = 0 there is good governance and the cost of the foreign firm were low, then the profit of the firm will be maximized. On the other hand, if the value of t = 0 and the cost of the foreign firm becomes low, the firm's profit will be high. As a whole, the value of (r, t) = 0, there will be perfect governance and foreign firms' profit will be maximized. So it is governance, which caused high profit and attracts FDI **[11].** Nasir *and others have* studied the determinants of FDI. Macroeconomic variables like economic freedom, Economic stability and exchange rate are used in study by taking data from 1995 to 2006 and showed their impact on FDI. Macro economic factors, good governance, economic situation, law and order condition, monetary and fiscal measures, safe property ownership system, market size, physical infrastructure and exchange rate are included as factors of Economic Freedom. The results show that economic freedom variables are very important factors to attract FDI inflow to South Asian Countries. Besides this effective regulated government, the transparent machinery of officials and macroeconomic stability variables plays an important role in attracting FDI to South Asian Region **[12].** Bissoon evaluated political certainty, the efficient rule of law, anticorruption policy, independent role of media, institutional quality and shown their impact on FDI by taking data for the period from 1996 to 2005 of 45 countries from African, Latin America and South Asian Region. On data OLS econometric technique was employed to show the result. The researcher concluded that political certainty, the rule of law, the independent role of media has a positive impact on FDI while terrorism, corruption and political violation have a negative impact on FDI **[1,3].** Shazad, Mthani, Swdi and Fadzil examined the impact of inflation rate, control of corruption, political stability, degree of openness and GDP on FDI by taking panel data from 2001 to 2011 in case of India, Malaysia, Pakistan, Thailand, Indonesia and Sri Lanka. On data, Random Effect econometric technique was used to explain the effect of FDI on governance. The research concluded that the governance indicators like political stability, control of corruption, degree of openness and GDP positively affect FDI while inflation and exchange rate are correlated to FDI negatively **[14].** Agravwal revealed new aspects of governance like terror activity, political violation, real gross Domestic Product per capita, population and showed their effect on FDI by taking data for the period from 1985 to 2009 of 34 countries. Terrorism was explained by a number of the wounded persons affected from terrorist activities, but alive and those who killed from these activities was represented by nr. On data, Individual Sector Model Technique was employed and found that terrorism, political violation, low real Domestic Product per capita has a negative effect on FDI **[15].** Abdul and many researchers tested the effect of trade openness, macroeconomic stability, and quality of infrastructure on FDI. Data is used from 1970 to 2009 of 53 countries of Africa. Econometric technique shows that trade openness; macroeconomic stability, political certainty, and market size, return on investment has positive effect on FDI. The research also reveals that bad governance has a negative effect on FDI **[16].** Raheem studied the effect of globalization, stock of human capital, good governance, inflation, GDP growth rate, government expenditure, and showed their impact on FDI by taking data for the period from 1996 to 2010 of seven African countries and Linear, Non-linear OLS econometric techniques were adopted and showed that Good Governance had importance a lot to attract FDI **[17].** Azam *et. al* studied the relationship between FDI and human capital and political factors. They used the data from 1971 to 2005. The human capital was measured by enrollment in primary and secondary education while political stability was measured by democracy and .The results were found by using Simple OLS econometric technique. The result of the study shows that there is correlation between FDI and human capital and political stability. The empirical results of study show a positive significant effect on FDI **[18].** Wash and his companions examined the inflow of FDI. Data was used 10 years due to unavailability of the data. Data of 27 developed and developing countries is taking from the period of 1985 to 2008 of Macroeconomic factors like the degree of openness secondary and territory. Effect of all macroeconomic factors and qualitative factors like independent judiciary, standard of infrastructure, effective legal system were shown on FDI. The results of econometric technique show that macroeconomic factors and qualitative measures have a positive effect on FDI **[19].** Lederman *et. al* from World Development Bank Research group found a relationship between FDI and rule of law, control of corruption, govt. quality, institutional performance represented by Government Track record, growth trend and showed their impact on FDI by measuring over the last five years' GDP of South African Developing countries (SADC). The data was used for the period from 2005 to 2009 and applied econometric regression to illustrate the result. The result was somewhat different from other research. They found that rule of law; corruption and quality of government did not attract FDI inflow to the South African developing countries, while the degree of openness had a positive effect on FDI inflow to South Africa developing countries **[20].** Rui and Zha showed the role of Lucas Paradox and institutional factors in determining FDI. Lucas philosophy focus on that across the countries FDI flows from rich countries to poor economic countries, while across the provinces of country Lucas philosophy is somewhat different; explain FDI flows to the region which is attached with higher level of GDP. They took data for the period from 2000 to 2004 of 30 provinces. On data OLS, GMM econometrics techniques were employed and found that FDI flows to Eastern region, which was attached with high level of GDP and institutional factors like fair legal system and control of corruption caused more FDI inflow while such things were absent in Western region, hence FDI inflow was low **[21].** Sadig explained that the degree of openness corruption, human capital, government institutions, democratic institutions, inflation, and growth rate of population and growth rate of GDP were such variables which attract the FDI inflow. Data was used from 1984 to 2004 of 117 countries. The Research found that governance variables like corruption, institutional quality, stable inflation; degree of openness has a positive effect on FDI **[22].**

Fan *et al.* explained nature of government, position of property right, corruption control, govt. Infrastructure, checks on executive authority measured by institutional quality, enforcement of contracts and government path (measured by previous five years) and their impact on FDI by taking data for the period of 1990 to 2003. On data Mean Prediction econometric technique was used to show the result. The research revealed that the provinces of China where control of corruption, better rule of law, enforcement of contracts attracts more FDI than those provinces where such requisits were absent **[23].** Anyanwu revealed corruption, rule of law, government effectiveness, GDP growth rate, annual inflation, and human capital, mobile user as per thousands, fixed infrastructure, exchange rate, openness level, and their impact on FDI. On data three econometric techniques OLS, FGLS and GMM were employed on lagged data and concluded that the governance infrastructure represented by enforcement of rule of law, institutional quality and legal system not only attract FDI inflow to American Region and also caused investment in foreign countries **[24].** Zhang *et.al* examined that Governance and private infrastructure have an attractive impact on FDI. Governance, measured by infrastructure includes gas, telecommunication, electricity, water, sewerage projects of foreign investment and transport. Data was taken from 1990 to 2002 of 67 developed and developing countries. The results of the study show that Governance has a positive effect on FDI **[25].** Shepotyle evaluated local governance, infrastructure and geographic difference and showed their effect on FDI by taking data from 1993 to 2003 over the period of 11 years of Eastern

European and Central Asian Regions. On data GMM econometric technique used in three stages to show the results and concluded that governance has positive effect on FDI. He also investigate that geographical differences also affect FDI. The countries of Eastern European which are located close to European Union had attracted more FDI than those countries were located in farther areas **[26].** Buss and Hefeker evaluated Political Risk and Institutions with 12 different Indicators named stable Government, social pressure to keep away from work , investment estimate, internal conflicts like riots, terrorism, strikes, civil wars, and political mishaps, external conflict like diplomatic rivalry, foreign threat, corruption, role of military, religion problems, enforcement of law and order , quality of bureaucracy, tension between racial groups and showed their effect on FDI by taking data from 1984 to 2003. On cross section data Fixed Effect econometric technique used and concluded that political risk and institutions (governance) have a positive effect on FDI **[27].** Biglaiser studied the relationship between good governance, macro-economic variables FDI and their impact on FDI by taking data for the period from 1980 to 1996 of 17 countries. Econometric technique showed the positive relationship between FDI and good Governance indicators **[28].** Teskos explained corruption, rule of law, Governance and economic freedom raises the confidence of investors and caused more inflow of FDI to the Latin American countries. Rule of law, political uncertainty, law and order, and other control variables like institutions, consumer price Index at an inter market price level and geographic difference and their impact on FDI by taking data from 1995 to 2000. On data 2SLS econometric technique was used and concluded that governance has a positive effect on FDI but corruption affect negatively on FDI **[29].** Globerman and Shapiro took six indicators of governance indicators (1) People's Participation in Govt. and Answerable Government (2) Political Certainty and No violence (3) Regulated Government (4) controllable Authority (5) Rule of Law (6) Constraints on corruption and their impact on FDI by taking data for the period from 1995 to 1997 of 143 countries. On data econometric technique was employed to show the effect of indicators on FDI and concluded in two stages. Stage (1)- The countries which failed to achieve good governance, they were unable to receive any amount of US FDI. Stage (2)-The countries with good governance infrastructure attracts more US FDI. So governance affects FDI positively **[27]**.

Model and Data Source

FDI = f (GOV, TOP, ER, RGDPGR, GRPI)

FDI = β0 + β1GOV + β2TOP +β3ER+ β4 RGDPGR+ β5 GRPI + ui

FDI = Foreign Direct Investment, GOV = Governance Index

TOP = Trade Openness, ER = Foreign Exchange Rate to measure the stability of economy.

RGDPG = Real Gross Domestic Production Growth Rate.

GRPI = Growth Rate of Public Investment in US million dollar. Data has been taken from International Country Risk Guide (ICRG) and WDI data for the period from 1984 to 2012.

Governance

Governance is explained with the help of 12 components; political stability, social economic conditions, investment portfolio, internal conflict, external conflict, control of corruption, religious tension, ethnic tension, military in policy, law and order situation, democracy accountability and quality of bureaucracy and made a composite whose values are from 0 to1. The low value of the composite shows high risk and high value represents low risk. Governance composite was made and measured by ICRG. Many studies investigate empirical relationship between governance and FDI. Dixit, Rodrick, Aseidu, Nasir and Hassan, St. Lious **[30, 31]**

Unit Root Test

The Unit Root test is applied only for checking the stationary of the variables that none of the variables should be at second difference I (2). The technique can be applied when all variables are at 1^{st} difference or at the level or mix of both.

Co integration

Equations Pesaran and Pesaran (1997) and Pesaran and Shin (1999), analyzed the Error Correction Version of ARDL econometric Technique. This study applied Error Correction Version to explain Governance and macro economic variables in short run and long run, as

$$\begin{aligned}\Delta logFDI_t =& \propto_0 + \sum_{i=1}^{N} \propto_1 \Delta logFDI_{t-i} \\ &+ \sum_{i=0}^{N} \propto_2 \Delta GOV_{t-i} + \sum_{i=0}^{N} \propto_3 \Delta TOP_{t-i} \\ &+ \sum_{i=0}^{N} \propto_4 \Delta ER_{t-i} + \sum_{i=0}^{N} \propto_5 \Delta RGGR_{t-i} + \\ &+ \sum_{i=0}^{N} \propto_6 \Delta GRPI_{t-i} + \beta_1 logFDI_{t-1} \\ &+ \beta_2 GOV_{t-1} + \beta_3 TOP_{t-1} \\ &+ \sum_{i=0}^{N} \propto_4 \Delta ER_{t-i} + \beta_5 RGGR_{t-1} + \beta_6 GRPI_{t-1} \\ &+ \gamma ECT_{t-1} + \mu_t\end{aligned}$$

The first step in the ARDL approach to co-integration is to examine the long-run relationship among the variables by carrying out a familiar F-statistic on the differenced variables components of Unrestricted Error.

The first step in the ARDL approach to co-integration is to examine the long-run relationship among the variables by carrying out a familiar F-statistic on the differenced variables components of Unrestricted Error Correction Mechanism (UECM) model for the joint significance of the coefficients of the lagged level of the variables. In this first step, the regression equation estimated for the dependent variable foreign direct investment is defined as

$$\Delta logFDI_t = \propto_0 + \sum_{i=1}^{N} \propto_1 \Delta logFDI_{t-i} + \sum_{i=0}^{N} \propto_2 \Delta GOV_{t-i} + \sum_{i=0}^{N} \propto_3 \Delta TOP_{t-i} + \sum_{i=0}^{N} \propto_4 \Delta ER_{t-i} + \sum_{i=0}^{N} \propto_5 \Delta RGGR_{t-i} + \sum_{i=0}^{N} \propto_6 \Delta GRPI_{t-i} + \mu_t \quad (1)$$

To create error correction mechanism in this equation, first lag of the level of each variable is added to the equation (B) and a variable Addition Test is conducted by calculating F-test on the joint significance of all the added lagged level variables.

$$\Delta logFDI_t = \propto_0 + \sum_{i=1}^{N} \propto_1 \Delta logFDI_{t-i} + \sum_{i=0}^{N} \propto_2 \Delta GOV_{t-i} + \sum_{i=0}^{N} \propto_3 \Delta TOP_{t-i} + \sum_{i=0}^{N} \propto_4 \Delta ER_{t-i} + \sum_{i=0}^{N} \propto_5 \Delta RGGR_{t-i} + \sum_{i=0}^{N} \propto_6 \Delta GRPI_{t-i} + \beta_1 lo\beta_2 GOV_{t-1} + \beta_3 TOP_{t-1} + \beta_4 ER_{t-1}\beta_5 RGGR_{t-1} + + \beta_6 GRPI_{t-1} + \gamma ECT_{t-1} + \mu_t \quad \mathbf{(2)}$$

RESULT INTERPRETATION

BOUND TEST/ F-Statistics for Co Integration

F-Calculated	95% confidence interval		90% confidence interval	
	Lower Limit	Upper Limit	Lower Limit	Upper Limit
6.078	3.231	4.720	2.634	3.936

Source: Author's own calculations

The value of F-Statistics 6.078 is above from the lower bound value 3.231and upper bound value4.720 at 95% and from the lower bound lower value2.634and upper bound value 3.936 at 90% confidence interval, rejects the null hypothesis H0: Long run co integration does not exist among variables exists and accept alternative hypothesis H1: Co integration among variables exists in long run.

GOODFIT MODEL EXPLATION

Table 5presents that the value of R^2 is 0.939 reflects that 93.9 % variation is due to explanatory variables, while other variation corresponds from residual term. The value of R^2 explains good fit of the model while adjusting R^2 shows that model is significantly adjusted with degree of freedom and the value of Durban Watson is 2.206 shows no autocorrelation because it is close to 2.

Diagnostic Test

The Lagrange multiplier test concludes absence of serial correlation as the probability value of LM-version and F-version is higher than 0.1 or 10%. Ramsay's RESET Test confirms correct functional form as LM and F-version value is .167, .271 respectively more than 10 % in the model. Data is normally distributed and error term has constant variance.

Stability Test

Both graphs of commutative sum of recursive residual (CUMUS) and CUSUM sum of squares are lying in between 5 % critical bound values which states absence of structural breaks in the model.

LONG RUN ESTIMATION OF THE MODEL:

The most important finding of this model is long run results that governance, foreign exchange rate, real GDP growth rate, growth rate of public investment and are statistically significant at 1% and 5%. As one unit increases in governance the FDI level raises relatively by 2.45 and statistical significant as the P-value is 0.01 and other macro economic variables like TOP, ER, RGDPGR and PUB encourage FDI relatively and respectively by 2.11, 0.05, 0.04 and 0.48 and all variables affect FDI positively in case of Pakistan. These results also concluded by Sadiq and Ahmad *et. al* **[32, 33].**

ERRORCORRECTIONMODEL FOR SHORT RUN RESULTS EXPLANATION

The error correction model reflects the picture of short run result as absolute one unit rises in governance GOV raises relatively FDI by 2.459 and the other economic variables as TOP, ER, RGDPGR, PUB expands FDI relatively by 2.119, 0.01, .046 and 0.483 respectively. All variables show statistically significant representation at 1% and 5%. The adjustment coefficient with negative sign reflects the model highly significant at t 1 % level and confirms long run relationship among variables. The value of adjustment coefficient is 0.583 represents the adjustment per year proved long run relationship among variables. The ecm (-1) term illustrate 58 % disequilibrium in previous years will converge to equilibrium in the current year.

CONCLUSION

ARDL-SIC econometric technique was employed and concluded statistically significant positive effect of governance on FDI in the short run as well as long run, in case of Pakistan. In short, run FDI leads to increase relatively by 2.459 as an absolute one unit change in governance and in long run absolute one unit change in governance brings about relatively change in FDI by 4.214 While other important variables like Foreign Exchange Rate, Market Size and Infrastructure has also a significant positive effect on FDI inflows. The results of empirical research recommend four policy measures and implications

* First the empirical research suggests to enhance more FDI Pakistan should pay more attention to improve indicators of governance.
* Second, to encourage Foreign Direct Investment, Pakistan needs to stabilize the economy and raises credibility before world to attract more amount of FDI.
* Third, extend the Market size by increase level GDP and imports, exports of country.
* Fourth, Infrastructure network of roads, electricity, gas, sewerage, communication be improved to attract more level of FDI to Pakistan.

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