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Examining the Nexus between Institutional Quality, Foreign Direct Investment, and Economic Growth in Pakistan: A Secondary Data Analysis Approach

(Foreign Direct Investment, Institutional Quality, Corruption/Economic Growth)

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Rizwana Ramzan.

Abstract

This study examines the connection between institutional quality, foreign direct investment (FDI), and economic growth in Pakistan. Institutional quality has become a major factor influencing FDI attraction and its effects on economic performance. Strong institutions engender an attractive environment for investment, while weak ones may cause FDI not to go ahead and result in poor economic performance. We hope this research will not only examine the difficult nature of these complex relations, but also propose ideas for policymakers. The study begins with a review of the existing literature about the theoretical background and supporting theories for this research. It also builds hypotheses about FDI's effect on economic growth and institutional quality, as well as the moderating role of corruption and mediating effects of institutional level. A quantitative approach is used in the research methodology, involving regression analysis and panel data techniques. This study's findings add to the knowledge of how FDI may affect economic growth in Pakistan. It demonstrates how crucial institutional quality is in luring long-term investment and FDI inflows. Furthermore, improvements in institutional quality, such as the rule of law and the decrease in corruption, as well as regulatory frameworks, have a favorable impact on FDI and economic growth. The study also shows that institutional quality acts as a mediator between FDI and economic growth. The importance of these findings is significant for policymakers and stakeholders who want to support sustainable FDI and economic growth in Pakistan. Having good institutions is the best way for governments to lay the groundwork, which will help boost business environments and keep political stability high. That in turn attracts foreign investment from all over the world. The study calls for selective investment in businesses such as renewable energy, agri-business and information technology to use FDI effectively to boost economic growth.

Keywords: Institutional Quality, Economic Growth, Corruption, Foreign Direct Investment

Table of Contents

CHAPTER 1

INTRODUCTION

1 Background

Foreign direct investment (FDI) plays a significant role in economic growth and has many contributors. Institutional quality, which has now emerged as one of them determinants play an important role in making this happen. Institutions such as regulations, political and legal systems also impact on FDI attraction and its deterrence. A plethora of empirical studies have explored this relationship. It is noteworthy that an analysis on samples from three countries revealed the critical role of institutional quality in quantifying FDI inflow (Chowdhury, M. A. 2017). The role of institutions as a determinant of FDI has only recently been admitted by researchers. Strong institutions ensure business and create an atmosphere where investors invest with certainty as well as promote and guarantee long term investments (Sabir, S., Rafique, A. 2019). However, weak institutions might also inhibit foreign direct investment and as a result, cause poor economic results. The study seeks to add to existing knowledge about the complex dynamics within this triangular relationship. Through another study, a panel data analysis of SAARC countries in the time interval of 1996-2017 aimed at exposing intertwined relationships of institution quality to FDI flows (Hamid, I., Alam, M. 2023). The studies lay the groundwork but a thorough secondary analysis is needed to comprehend the large-scale issues. Moreover, institutional quality affects inward flows of foreign direct investment to some extent beyond certain geographic areas. That institution is an imperative determinant of FDI as evidenced in Developed and developing economics. Moreover, a recent investigation examines the effects between inflow foreign monetary funds, institutional qualities, and human capital and their many inter-relations (Nderitu et al., 2023). This should be understood by stakeholders as well as policy makers who wish to make policies that would lead to long lasting FDI and economic development (Nwakeze et al., 2023).

Some research has shown the importance of “institutional quality” in fostering economic growth as well as safeguarding the environment (Abid, 2017; Xu et al., 2019). The reason behind this is that the government is able to control economic growth at the macro level and safeguard environmental interests. In particular, it refers to actions carried out by home institution, which imply creation of legal frameworks based on such laws as those rules of culture within which other social-economic actions take place." Enforcement of these policies will act as an indicator of political stability, absence of violence, quality of public services, and governments' ability to formulate, adopt and enforce polices (Canh et al., 2019). Of all principles used in governance, the rule of law is the most important in curbing environmental challenges (Salman et al., 2019). (Ross, A.G, 2019) shows, that also in such countries there's possibility that due to bad politics there will be attracting of foreign investments by other nations. Variation in output is likely to occur due to usage of different countries and timeframes which are mixed with varying estimation methods. However, according to (Jurcic et al. 2020), none of the governance indicators overweighs FDI in Croatia.

There have been fluctuating inflows of FDI in Pakistan due to changing policies and institutional reforms that make Pakistan either a good or bad destination for foreign capital respectively during certain periods. The changes depict the manner in which FDI is adapting to the changing economic agenda and institutional changes of Pakistan. The effect of a country on foreign direct investments (FDI) is determined by institutional quality. A recent study (2020) took into account various aspects of institutional quality captured in the Worldwide Governance Indicator, such as corruption control, rule of law, and regulatory quality, when measuring inflows of foreign direct investment to 46 Sub-Saharan African countries (A. A. Akinlo, 2020). According to research in Pakistan, improving the degree of institutional quality enhances FDI. Using regression analysis, a 2021 paper showed that improvement in public administration, reduction of corruption, and enhancement of rule of law facilitated effectiveness of FDI in lowering income inequality in Pakistan (S. A. Shah, et al. 2021). Thus, it means high quality institution allows Pakistan to fully explore the socioeconomic benefits. A similar recent analysis for 2017–2021 using an autoregressive distributed lag model suggested that improvements in institutions affecting regulatory quality, control of corruption and political stability improved FDI flows into Pakistan, especially in the industrial and service sectors (A. Khan, 2023).

Furthermore, strong institutions unlock additional gains into increased productivity effects. Research conducted in a study in 2019, involving 36 Asian nations for the period of years between 2000 and 2018 established that greater institutional quality magnifies the growth impacts of FDI due to the reduction of unequal income distribution (M. Rahman, et al. 2019). Indeed; in

Pakistan in particular, a paper dated in 2017 using panel data methods discovered that institutions and FDI played interactive role in which institutional quality increased FDI's GDP growth percentage in the period of time 2005-2015 (M. A. Khan. 2017). These actions would mean more improvements in rule of law, reduction in corruption, and improvement of regulatory frameworks which can contribute significantly even for additional returns on FDI. In 2023, Pakistan is on crossroads regarding its economy's growth. The dynamics of FDI inflows and how they relate to institutional quality are critical considerations for policymakers. Measuring the interplay between institutional effectiveness and a nation's attractiveness to foreign investors may reveal key indicators for facilitating long-term development.

1.1 Problem Statement and Research gap

This study will focus on the interaction of institutional quality, FDI, and economic growth in Pakistan. The contribution of institutional quality on FDI and economic growth in the Pakistani setting has been indicated by many studies. For instance, several studies such as that of Khan et al. (2023), Adegboye et al. (2020) and Ramzan et al. (2023) allude to how quality institutions contribute to attracting foreign direct investment. Besides, reports of the U.S. Department of States, that Pakistan is committed to improving governance structures for inviting foreign investments, especially in such areas as renewable energy, agri-business, and ITC (*Pakistan - United States Department of State*, n.d.). This issue could be formulated as searching for subtle intricacies of how institutional quality moderates the link between FDI and economic performance in Pakistan through analysis of existing data. Such analysis would add to the comprehension of economic forces that played out in Pakistan during this time limit.

Some studies have discussed the association among institutional quality, FDI, and economic growth in Pakistan (Chowdhury, M. A. 2017). Yet, it is important to mention that there is a considerable theoretical vacuum due to the marginal discussion of the mediating effect of institutional quality into this relationship. Some previous studies recognize the relationship between institutional quality and FDI (Khan et al., 2023; Shah et al., 2016) but we must have a deeper look at how institutional quality mediates the effect of FDI on economic growth. Such a subtle comprehension matters much to policy makers who want to promote their economies through efficient targeted investments.

1.2 Research Questions

Considering the problem statement, the specific research questions are as follows:

i. What is the effect of foreign direct investment (FDI) on the economic growth in Pakistan?
ii. What is the impact of foreign direct investment on the institutional quality in Pakistan?
iii. What is the effect of institutional quality on the economic growth in Pakistan?

1.3 Research Objectives

Considering the aim and research questions, the research objectives are as follows:

i. To examine the impact of foreign direct investment on the economic growth in Pakistan.
ii. To examine the effect of foreign direct investment on the institutional quality of Pakistan.
iii. To examine the impact of institutional quality on the economic growth of Pakistan.

1.4 Scope of the study

This study aims at identifying the correlation between institutional quality, foreign direct investments, and economic growth in Pakistan based on secondary data. This paper will have a specific focus on Pakistan and will employ the use of secondary data in order to determine this linkage. The study will seek to find out how institutional quality affects foreign direct investment inflows into Pakistan which leads to increased economic growth. In order to provide for this gap in the literature, it assesses improvements in institutional quality, based on an index measure of a government effectiveness. This scope provides the empirical bases for the significance to the country by sound institutional framework, as well as FDI for promoting the economic development or growth. This chapter considers only Pakistan without making any comparisons with other countries. It also narrows down its assessment on macroeconomic interrelationship of these factors and not any sector specific or firm specific assessment. The results may help identify ways through which Pakistan could enhance its institutional setup with a view towards increasing aggregate FDI and also sectoral FDI. Higher FDI becomes important in promoting rapid economic growth and this has major policy impacts.

1.5 Significance of the study

With a view to achieve economic growth, Pakistan is attracting foreign investments. On the one hand, the country has received less than expected FDI inflows. The research would go a long way to help us comprehend the role played by the changes in the quality of institution and their influence on FDI inflow. However, there is limited research done about the relationship between bullying and suicidal ideation in Pakistan with inconclusive findings. The research will conduct detailed analysis employing updated secondary data aimed at providing better policy proposals. It will evaluate how institutional quality influences economic growth but also indirectly through influencing FDI. This would provide a more comprehensive insight on how the reforms could enhance development. These results would be crucial to policy makers for identifying priority sectors, that is institutions and regulations required for stimulating investment and spurring growth. This could also help investors to learn more on Pakistan's investment weather.

1.6 Key concepts and definitions

The key ideas for the investigation are presented in Table 1.1 with the intention of providing a thorough understanding of the theoretical underpinnings of the constructs used in this study and resolving any discrepancies in terminology.

Table 1.1: Definitions of the constructs

Construct	Definition
Foreign Direct Investment	Foreign direct investment means when an organization or person from a certain state puts resources on business endeavors situated in another nation. Involves acquisition of permanent interest in a business in another foreign land and mostly for purposes of influencing it.
Institutional quality	The degree to which the state's political, legal, and regulatory framework affects economic development, social reform, and environmental protection, respectively, is measured by institutional quality.
Economic growth	Growth in economic means increased product and service supply as well consumption during an indicated time span. The growth is often taken as an indicator, being indicated by the rise in Gross Domestic Product (GDP).

Corruption	Corruption refers to the abuse of power for personal gain or the improper or immoral conduct of those in positions of authority. Corruption often involves bribery, fraud, money laundering, nepotism, or other forms of dishonesty.

1.7 Summary of the chapter

The importance of Foreign Direct Investment (FDI) in economic growth, emphasizing the important role that institutional welfare plays in attracting or deterring FDI. It highlights studies, particularly focusing on Pakistan, which show that strong institutions create a healthy economic climate, while weak institutions can hinder economic growth Research emphasizes the importance of understanding how emphasizing that institutional characteristics mediate the relationship between FDI and economic growth in Pakistan. The scope of the study is limited to Pakistan, where secondary data are used to examine the relationship between institutional quality, FDI and economic growth. The study aims to contribute insights to policy makers and investors through the impact of institutional change on FDI inflows and economic growth. The research model includes FDI as an exogenous variable, institutional quality as a mediator, and economic growth as a dependent variable.

1.8 Structure of the Thesis

This research is summarized in the present chapter, which also discusses the study's background and addresses the introduction, research gap, goals and questions, scope, and importance of the study. The following portions of the thesis are presented to further highlight the additional knowledge gained from this research:

Chapter Two: The basic hypotheses are covered in the literature review chapter, which also offers a variety of perspectives on the main constructs of the subject. This helped with the formulation of the study's conceptual framework and hypotheses.

Chapter Three: Describes the study methodology, research design and process, variable measurement, and data collecting processes.

Chapter Four: This chapter covers the portion of conclusions and analysis and goes into the depth of quantitative data results, and also covers the SEM techniques and hypothesis testing.

Chapter Five: Discussions and implications. Exploration of the findings, contributions, and limitations of this study is done along with the suggestions for future studies.

CHAPTER 2

LITERATURE REVIEW

2 Theoretical Background

One of the leading sources of foreign investment, which is associated with expanding globalization trend, is foreign direct investment flow at planetary scale. However, the impact of inward foreign direct investments on economic growth is determined by characteristics of the host countries whose growth curves do not follow a straight line. The impact of foreign direct investment upon future growth is mediated by the assumption of the quality of the domestic institutions. This research is aimed at examining the linkage between institutions, FDP, as well as their impact on economic growth. A lot of times researchers have proved that good quality institutions, which are able to enforce transaction cost and reduce property have existed, that in turn, they stimulated economic development (North, 1990). For instance, (Acemouglu and Robinson, 2019) state that countries that enjoy more inclusive politics typically exhibit higher GDP growth. Similarly, (Hall and Jones, 2021) posit that among the social infrastructure measures of the rule of law, controlling corruption, and bureaucratic quality; there exists a strong link across-country divergences in output per worker.

Also, the level of institutions' quality matters for FDI. The costs of doing business and access to the markets are not the only factors that drive investment decisions for multinationals. They depend as well on the caliber of local institutions which convert political and operational risks into tangible consequences to those businesses (Wei, 2018). It is evident that higher levels of corruption in host countries repel away foreign direct investment while, on the other hand, specific empirical data show that strong institutional frameworks with proper governance and transparency attract higher flows of FDI (Busse & Hefeker, 2019). However, institutional influence on FDI can also be related with some other variables. For instance, (Bénassy-Quéré et al., 2022) argue institutions' impact varies depending upon both levels of trade openness and financial development. On the other hand, the linkage between FDI and economic growth is more ambiguous depending on host country absorptive capacities. Although FDI may promote economic development by means of capital accumulation, technological, and knowledge spillovers (Borensztein et al., 2017), the effect might not be significant enough for developing economies with lower absorptive capacities or where FDI competes.

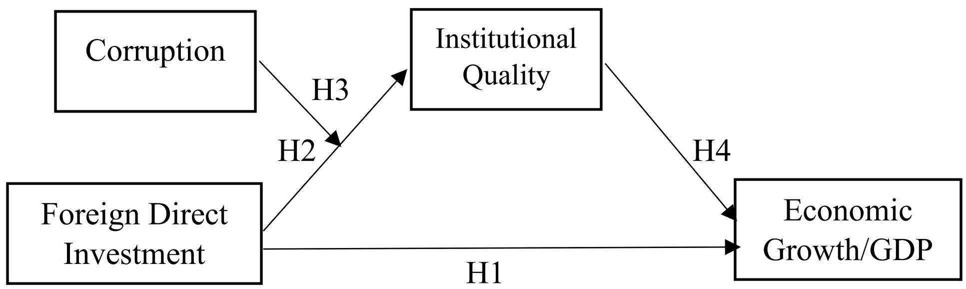
The empirical evidence is diverse on the relationship between FDI and economic growth. Several researches show the positive relation (Demello, 2019; Balasubramanyam et al., 2018) and other reveal insignificant or conditioned one of the two (Herzer et al., 2022). Therefore, given the complicated, often uncertain individual relations, it is essential to consider how do institutional quality influence on the growth effect of FDI. This moderating effect of institutions has been analyzed by a number of studies. According to (Alfaro and Chanda, 2019), growth occurs for FDI in countries which financial development is beyond a certain threshold. Likewise, (Resmini & Niccolini, 2021) state that better governance and lower corruption are prerequisites for the positive growth impact of FDI. Nevertheless, other works do not find any support of any institution that conditions the FDI-growth relationship (Herzer et al., 2022). Therefore, more research would necessarily be required. This study is aimed at bringing new evidence to this vital problem which has a significant impact on investment and development policy.

One of the dimensions of institutional quality that affects governance and prevents FDI is corruption (Jung, 2016). Foreign investors incur additional costs on corruption, policy uncertainty, and information asymmetry (Bellak et al., 2020). It is worth noting that corruption creates hidden costs, increases risks, and erodes the institution quality required for attracting knowledge-demanding-FDI. Showed that corruption reduces institutional quality's effect on inflows in FDIs. (Shah, et al., 2016): Institutional quality and aggregate foreign direct investment in Pakistan exhibit causation running both ways over the long run. Likewise, (Arifin, 2017), observed that institutional quality determines FDI towards South and Southeast Asia Countries. (Jindrichovska et al., 2020) proved that institutional quality draws FDI in transitions economies due to less information costs and risks of production. The link between crime and politics is hardly extensively researched in case of Pakistan. However, (Shah et al., 2016(, focused on sectoral FDI-Institutional Quality but did not deal with corruption. The determinants of FDI by (Khan et al., 2018) without institutions. As a result, the purpose of this research is to investigate the role of corruption in mediating the connection between institutional quality and FDI in the Pakistan environment. This research will be explored in the next chapters, as will the creation of supporting ideas and hypotheses.

2.1 Research Model

The research model, which includes FDI, Institutional quality, and economic growth was created based on the thorough literature review described in the chapter 2. Institutional quality is a mediator, FDI is an exogenous variable and economic growth is a dependent variable.

Figure 2.1: Research Model



2.2 Supporting theories for this study

There are a number of supportive theories that can be utilized to determine whether to include FDI as a measure of Pakistan's economic growth. These theories assist in explaining how institutional quality, foreign direct investment, and economic growth are related to each other.

i. Theory of Institutional Finance: These theories suggest that higher levels of institutions help reduce transaction costs and uncertainty, thus encouraging longer-term investment and economic activity (North, 1990) It provides a framework for the selection of organizational resources variables such as rule of law, corruption control, professionalism.

ii. Endogenous growth theory: This theory emphasizes the role of knowledge diffusion from foreign capital in long-term growth (Romer, 1990). It makes attractive and intensive FDI eligible to capture technologies and knowledge transfers that enhance employment and growth.

iii. Absorptive power concept: This perspective recognizes that sufficient absorptive capacity is necessary for FDI to foster growth in the host economy (Cohen & Levinthal, 1989). This is determined by the variables representing human capital, infrastructure, and economic growth that allow domestic firms to benefit from foreign investment.

2.3 Hypothesis development

2.3.1 Effect of FDI on the economic growth

For these are often foreign investments into developing nations that can have a substantial impact on their economy. Multinational corporations open up other markets bringing new capital, skills and technology; thus, increasing output in host countries hence increasing productivity. Through different channels like demonstration effects, competition and supply chains links, FDI leads to the spillover of know-how and capability from investors to local firms (Blomstrom et al., 1992). These spillover effects over the long-term have been identified as one of the most potent methods through which foreign direct investment enhances the economy domestically. Nevertheless, the extent and rate at which such inflow affects host economies is determined by domestic variables that measure an economy's absorptive capability to foreign capital supplies.

Studies in recent years in 2016-2023 have concluded that the factors that influence this include financial development, human capital, trade openness, institutional quality, infrastructure and environmental regulations (Alfaro et al., 2019; Herzer et al., 2008; Zhang & Felmingham, 2020) Therefore, there is evidence that the impact of FDI on growth is likely to become insignificant in country whose financial development is beyond a private credits ratio above 95.6% of GDP (Alfaro & others, 2019). The institution framework also contributes. Specifically, research suggests that FDI has a greater positive impact on developed compared to low-income countries, and this is related to variations in institutional quality (Zhang and Felmingham 2020).

Recent Nigerian studies have looked at the influence of FDI on GDP as a proxy for economic growth. (Ijirsha et al., 2020) discovered that FDI has a positive and substantial influence on GDP in the long run, while the short run effect is minor in an autoregressive distributed delay limit testing technique employing time series data from 1981 to 2018 and a vector error correction model. Similarly, (Omotor & Ehiorobo's., 2016) autoregression distributed lag error correction analysis of annual Nigerian data from 1970 to 2013 showed that FDI fosters significant growth in the long run through increased capital accumulation, though if the short-term correlation is positive but not significant Both analyzes suggest that Nigeria needs more structural reforms and infrastructure to fully benefit from active FDI and wider growth especially in infrastructure not in oil.

Hypothesis 1: FDI positively influences the economic growth in Pakistan.

2.3.2 Effect of FDI on institutional quality

Institutional quality and business environment of host country could be highly influenced by foreign direct investment (FDI). Institutional quality is defined as a strength, efficacy, and objectivity of a nation's law and politics bodies. There is also the rule of law, corruption, regulatory quality, and more specifically, bureaucratic quality which all together make up an overall investment climate. Several studies have highlighted the ways by which foreign direct investments (FDI) impact different measurements of institutional quality across developing and emerging market economies. Theoretically, FDI influences institutions through different ways. The demonstration effect hypothesis posits that MNEs are sources of introducing external best practices to the host country, which will in turn lead to better transparency, accountability and governance later on (Javorcik and Wei, 2009). Secondly, MNEs are motivated to lobby the host governments through institutional reforms that will enhance the efficiency as well as stability of the business climate. However, massive injections of FDIs might "crowd out" indigenous enterprises and impede institutions' growth (Weymouth, 2012).

The empirical link between FDI and institutions seems to be a function of several country-specific considerations. (Li and Resnick., 2003) provided empirical evidence using data from 71 developing countries from as early as 1984 until 2003, discovering that there exists a positive relationship between FDI and measures for political stability and rule of law; however Just like (Duanmu, 2012), using another dataset that included 79 developing countries in the period of thirty years, found that FDI actually helped reducing corruption in countries that have some good institutions to begin with. Recent studies have consistently examined differential effects. Using a panel data set of 125 countries from 1996-2015, (Bengoa & Sanchez-Robles., 2019) found that democratic governance improved positive regulation more in terms of FDI than authoritarian governments Considering China's Belt and Road policy in particular, (Wei, 2020) found that Chinese outward FDI with higher ecological resources in better institutions in partner countries Positive effects. Using firm-level data, (Chen et al., 2021) showed that foreign subsidiaries established by MNCs headquartered in countries with stronger economic security have better contractual implementation in host country industries.

(Al-Saman and Mouselli, 2018) suggest that in order for the GCC country to receive more foreign direct investments it might decrease corruption, enhance political stability and in a surprising way reduce the quality of regulations. For the purpose of this study, (Peres et al., 2018) have reviewed a number of previous studies, including. In conclusion, they find the non-significant results for developing countries about the corporation, which measures the Increasing natural trust reduces the negative impact of the organizational efficiency on the extractive FDI at the pool's mean group in Africa. methodology (Feulefack and Ngassm, 2020).

Hypothesis 2: Good Institutional quality attracts more FDI in Pakistan.

2.3.3 Moderation of corruption

There have been several studies which showed some positive correlation between high level of corruption and low foreign direct investment (FDI) (Wei, 2000; Habib and Zurawicki, 2002; Voyer and Beamish, 2004; Egger and Winner, 2011) The relationship between corruption and FDI however, is complex and may be dependent upon the overall quality of institutions in the investor's home country. The impact that corruption has on in awarding Foreign Direct Investment might be mediated by some institutional aspects. (Busse and Hefeker, 2007), for instance, maintain that to some extent, strong rule of law might make up for weak control over corruption. The statement means that countries characterized by high level corruption yet robust rule of law would still get modest amount of FDI. Foreign investors would have some certainty for the independence, objectivity and fairness of legal and judicial systems. While investors know corruption happens, they rely on fair courts that protect them from arbitrary acts of corrupt officials.

Thus, corruption does not affect the investor's confidence in regulatory quality. Petty corruption during routine contact with the government could be countered through efficiency in bureaucracy as well as effective administrative measures concerning registration, taxation, trade, and others (Kolstad and Villanger, 2008). Some empirical studies have shown that corruption interacts with specific institution qualities such as legal protection and property rights in attracting FDI. (Kolstad and Villanger, 2008) used a panel of sample from the transition economies and demonstrated that in high values of control of corruption, rule of law and regulatory quality FDI effect from corruption is more moderate. (Busse and Hefeker, 2007) found out that in a cross-country study including developed and developing countries, rule of law and control of corruption can play as the moderating factor. Their research indicated that the influence of corruption on FDI becomes less significant where rule of law and control of corruption are significant.

More recently, in 2006, Asiedu & Lien (2011) studied a panel of 84 developing nations over the period between 1984 and 2003. The reported results indicate that corruption had a significantly negative impact on FDI, albeit this impact was weaker for countries with higher scores for rule of law, bureaucratic quality, and graft combinedly. Their results strengthened the mediating role of the institutional quality variables. Other modern works have also tried to understand this issue by reviewing recent FDI data and a larger sample of countries. As an instance, through use of panel of seventy-five developed and developing countries from 1996 – 2015, Okafor et al. (2018) found that corruption exerted negatively significant influence on FDI inflows was weakening Another study conducted by Amin et al. (2020) investigated a panel of 85 developing countries during the period 1990-2017, revealing that high level of control of corruption, regulatory quality, rule of law, and political stability moderated neg They also contributed to the established view about interactive effects between the level of corruption and differing indicators of institutional performance.

The study by (Sahoo et al., 2020), shows that, corruption has a negative moderating impact on the positive linkages between political stability and control of corruption, and FDI flows. Nevertheless, in countries with better regulatory quality, the moderating effect was less significant. (Cieshlik and Hodge, 2019) argue that corruption exacerbates the negative effect of weaker property rights protection on FDI but that declining institutional quality mitigates this negative pressure to some extent. On the same note, (Wang & Zhu, 2018), using a dataset of 82 low- and middle-income economies within the period 2003-2013, stated that corruption reduces the positive institutional pull of low corruption, thereby weakening the effect Likewise, the meta-analysis by (Enríquez et al., 2020), of 130 studies showed that even though corruption inhibits FDI it is not as damaging where there are transparent institutions, stable policies and preventive measures.

In a new study covering 25 transition economies in central and east Europe between 1995 and 2017, the authors show that while institutions matter for FDI, corruption still restrains its flows even given the existence of accountability, participation and good regulation (Abdul-Kadir et al., 2022). However, (Ahmed et al., 2022) noted in Asia that although corruption retards FDI, the effect is mitigated when there exists a transparent institutional setting that builds trust among investors. Pakistan is working to improve its institutional structure and reduce corruption by increasing FDI inflows. However, corruption remains a challenge, placing 120 out of 180 countries in Transparency International's Corruption Perceptions Index by 2021. Previous studies have found a negative relationship between corruption and FDI in Pakistan (Khan et al., 2016; Ahmed $ Bahoo, 2019). Higher levels of corruption are associated with lower levels of FDI because they lead to inefficiencies and distort the distribution of resources.

Hypothesis 3: Corruption negatively moderates the Institutional quality and FDI.

2.3.4 Effect of institutional quality on the economic growth

Strong and transparent institutions help establish clear rules and property rights that inspire business and investor confidence. When the legal political system is predictable and fair, it encourages entrepreneurship and risk-taking. Companies are more willing to invest, innovate and expand operations if they feel confident about protecting their assets. Well-defined and enforced contracts also reduce the cost of transactions between private companies. This creates a more efficient market environment that allows for greater specialization and exchange of goods and services. High-quality institutions also help prevent corruption that distorts market incentives and diverts resources from productive use. Widespread corruption increases the cost of doing business as companies spend more in bribes, fees, and legal fees to adopt an unclear legal environment that also deters foreign investment the straight line. Countries with low corruption, clear rules, and an impartial judicial regime tend to have less market uncertainty. This attracts multinational companies and stimulates entrepreneurship; skills transfer and technology diffusion - all of which enhance long-term growth in employment.

Strong institutions continue to support a strong macroeconomy through prudent fiscal and monetary policy. For example, the freedom of central banks to pursue low inflation targets without political interference protects the value of money. Financial responsibility and credit sustainability reduce volatility and disruption risk. A stable macro environment provides a predictable environment for households and firms to plan their investments over the long term. Trust among government officials and other citizens lubricates economic cooperation. In high-trust countries, firms face lower transaction costs in drafting and enforcing contracts. People are more willing to collaborate, take risks and engage in complex change that drives innovation when they trust that others will act respectfully This social capital can be invaluable need such as physical or human capital for growth. Several empirical studies have established an enduring significant linkage between institutional quality and level of economic growth (Acemoglu et al., 2016). The authors of an article on growth across countries show that through expanding property right and contracting institutions, one can create 30-50 percent more GDP in the next 40 years. Likewise, (Al-Marhabi, 2000) founds that institutional quality was statistically significantly associated with growth even after controlling for other determinants.

Recent cross-country panel analyses have continued to underscore the relevance of institutions. (Aysan et al., 2018) demonstrated that the GDP per capita growth rates were high due to incremental control of corruption, rule of law, and regulatory quality. (Darley, 2019) identified that institutions have much broader impacts on economic growth more than an increase in human capital accumulation and physical capital growth. Institutional reforms in developing countries have also stimulated economic activity. Using differential difference methods, (Fan et al., 2019) showed that China's land title program in the 1990s increased agricultural production and rural household income. (Bhavnani and Choi, 2017) found that strengthening women's property rights in post-conflict areas of Rwanda increased productivity and productivity.

Hypothesis 4: Institutional quality positively impacts the economic growth in Pakistan.

2.3.4 Mediation of Institutional quality

Empirical studies show that the growth effect of FDI is influenced by institutional quality. However, (Resmini and Sbragia, 2010) using a sample based on a panel of both developing and developed nations from 1984 to 2003, showed that although FDI increased GDP per capita, the gains were much higher in as also showed by (Al-Iriani and Al-Shamsi, 2017) even FDI led to growth only interacted with high-quality institutions in Gulf Cooperation Council countries. Institutions also depend on the kind of FDI that a country gets. However, in poorly governed environment, most multinational are involved in mining which is highly non-integrative that has fewer link to domestic firms. However, a lot of this FDI goes to low-end manufacturing and services in countries with weak property protection. However, this applies more frequently in sectors that offer significant spillover effects by way of supply chains and skill transfers.

Therefore, institutional reform can ensure that FDI has developmental effect on maximum level. (Chen et al., 2019) used difference-in-differences techniques to compare changes in FDI's contribution of total factor productivity across Chinese provinces between 1998 and 2007 and found that institution reform contributed towards FDI's total factor productivity by about 3 Asiedu and (Liens, 2011) noted that it was also possible by exploit regional difference to find out when stronger property right increases two times impact of FDI on factory wage in Mexico. Moreover, high levels of FDI can also build domestic institutions that may hold in the future. Multinationals can make host government agencies transparent and accountable through demonstrating and competitive effects. They also worsen the chance cost of policy unpredictability and corruption. The empirical work of (Duan et al., 2018) provided the backing for this argument claiming mutual causality to exist between FDI, economic growth and institutions quality in countries drawn from the Asia-Pacific region.

(Kwaw-Nimeson, 2023) examines the impact of institutional quality on the FDI–regional integration link, emphasizing its role in FDI policy formation. This study highlights the importance of strong institutions in attracting and utilizing FDI for economic growth. (Ramazan, 2023) examines the mediating role of institutional quality in the relationship between public debt and economic growth in Pakistan, emphasizing that institutional characteristics affect the debt ceiling relationship. Similarly, (Nam, 2023) shows that although financial institutions mediate the effects of FDI, the overall effect is positive on technological change. These findings suggest that institutions act as mediators, and show how FDI affects economic growth.

Hypothesis 4: Institutional quality positively mediates FDI and economic growth in Pakistan.

2.4 Description of variables

Foreign Direct Investment (FDI) is an important economic indicator of direct investment by individuals, firms, or organizations from one country to another FDI plays an important role in promoting economic growth they have developed because they bring capital, technology, managerial skills and new access to markets. These variables are central to understanding the extent to which a country attracts external finance, influences economic activity, and promotes international financial integration Generally, an increase in GDP indicates an increase in economic activity and prosperity. This variable is an important measure of a country's growth, and understanding the relationship between foreign direct investment can shed light on the role of foreign investment in stimulating or inhibiting economic growth. Strong institutions are necessary to create an enabling environment for sustainable economic growth and to attract foreign investment. These variables examine the quality of a country's institutional system, examining such areas as the rule of law, protection of property rights, control of corruption, and effective public administration.

Table 2.1: Description of variables

	Variable
Financial Development	Foreign direct investment (FDI)
Institutional quality	Government effectiveness
Economic growth	Gross domestic product (GDP)

2.5 Summary of the chapter

The study addresses the nuanced relationship between FDI, institutional well-being and economic growth in Pakistan, leading to supporting hypotheses and theory formulation. It attempts to provide new evidence on an important problem that affects economic and development policy at large. Subsequent chapters will examine in more detail the empirical research and conclusions drawn from the study.

CHAPTER 3

METHODOLOGY

3 Research Methodology

The research employs quantitative methods, including descriptive statistics, correlation analysis, and regression analysis, to assess the connections between measurable variables and analyze their relationships. The research employs a deductive approach, establishing a conceptual framework and hypotheses rooted in existing literature and theory. In this deductive research approach, empirical observation and data analysis are utilized to test and validate these theories. The study relies on secondary data to assess hypotheses and address research questions, aligning with the deductive methodology wherein theories guide both the collection and analysis of data. The research design adopted for this thesis is quantitative. Quantitative research follows a positivist philosophy which applies the methods of natural science to study social reality and behavior (Grix, 2010).

This study aims at analyzing interlinkages among institutional quality FDI, and GDP in Pakistan. Using secondary data on WDI for the period of 10 years, a quantitative approach with regression analysis is employed in an attempt to uncover intricate influences on state's economy of Pakistan. This study will obtain data from the World Development Indicators (WDI), which is provided by the World Bank. The dataset would consist of a wide range of economic, social and institutional indicators pertinent to the research concern. Recent trends will be captured by choosing the time frame between 2013 and 2022 and an adequate basis for analysis in this study. Institutional Quality, captured with measures such as Governance Effectiveness index, FDI, and the more conventional Economist Intelligence Unit's (EIU), GDP growth rate. These variables should be critical in unraveling how FDI inflows and the institutions are inhibitory or supportive of growth in Pakistan.

The extensive nature of the WDI dataset means that all available data for Pakistan in the specified period will be captured in the analysis. An initially descriptive view of the data set will be accomplished through using descriptive statistics. Calculation of mean, median, and the standard deviation for each variable will provide information about these variables' center tendencies and distributions. The main tool employed in studying these relationships is regression analysis. Three multivariate regression models will be designed with the GDP growth depending on it. They will include institutional quality acting as mediator, corruption as a moderator, and FDI as an independent variable and to carry out the analysis, SPSS (linear regression) is used. This study adheres to ethical standards by using publicly available and anonymous secondary data. Appropriate citation and validation of World Development Indicators for data sources will be maintained. The research will uphold the principles of integrity and confidentiality. Acknowledgment of potential limitations is important for the transparency and reliability of the study. Limitations may include data gaps, potential biases in WDI indicators, and inherent difficulties in establishing causality in observational data.

Table 3.1: Measurement of Variables

Variables	Measurement
Foreign direct investment	Investment inflows (% of GDP)
Institutional quality	Government effectiveness index (-2.5 weak; 2.5 strong)
GDP	Current US $
Corruption	Control of corruption index (-2.5 weak; 2.5 strong)

Source: World Development Indicators

Before the methodology and analysis, summary statistics are presented in the Table 3.2. Foreign direct investment accounts for about 0.638% of the mean, while mean GDP is 309.8 billion dollars. On average, the institutional quality is relatively poor, with a negative mean value of 0.660, whereas corruption is of moderate to high magnitude with a negative mean value of -0.85, in Pakistan.

Table 3.2: Summary Statistics

Variables	Observations	Mean statistic	Std. Deviation	Kurtosis statistic
IQ	10	-.660	.1174	1.855
FDI	10	.638	.1273	-.183
GDP	10	309.800	48.5153	-.933
CORR	10	-.8500	.07071	.571

3.1 Summary of the chapter

This study uses data from the World Development Indicators from to examine the relationship between institutional quality, Foreign Investment (FDI), and GDP in Pakistan. Descriptive statistics provide a first impression, and three regression models examine the effects of institutional welfare, corruption, and FDI on GDP growth. Ethical considerations take precedence through the use of publicly available and anonymous information, appropriate citations, and acknowledgment of potential limitations, such as information gaps and bias. The aim of the review is to it will provide insights into the impact on economic growth in Pakistan.

CHAPTER 4

RESULTS AND DISCUSSIONS

4 Results and Discussion

The results from the regression analysis are presented in Table 4.1.

1. **Institution quality and economic growth**

   The results show a positive correlation coefficient of 0.673 between IQ and GDP. The p-value for this result is < 0.05, which is a clear indication that there exists statistical significance between these two variables. This implies that such correlation was only possible at 2.3% assuming a sample size of ten. This positive correlation fits our expectations since the correlation. Developed countries that possess powerful and well-established institutions have a greater GDP. Economic growth and development are made possible by institutions, which perform crucial functions. This means that powerful and durable structures of authority serve as guardians for property rights and public safety. The set up clear conditions for trade and business transaction. This ensures that there is predictability in order to encourage economic activities. It promotes long-term investments and innovation when institutions work properly.

   The results are in line with the literature, who have also found significant results. In one study, (Jones and Schneider, 2017) looked at the connection between global economic development and average IQ. They discovered a positive association between GDP per capita and IQ, indicating a relationship between higher average IQ levels and faster rates of economic growth. Empirical data supporting the positive correlation between GDP and IQ is presented in this study. Rindermann and Thompson, (2019) looked at the relationship between cognitive capacity and economic development in another study. They discovered that cognitive capacity, as determined by IQ scores, has a favorable impact on national economic development and growth. The idea that more economic success is correlated with higher IQ levels is further supported by this research. In addition, (Sala-i-Martin and Pinkovskiy's, 2020) investigation looked at the connection between economic growth and human capital, which included cognitive ability tests. They discovered a significant correlation between gains in human capital—measured by IQ scores—and economic development. This study emphasizes the role those cognitive skills, such as IQ, have in promoting economic growth.

2. **FDI and Institutional quality**

This indicates that there exists negative relationship between institutional quality and foreign direct investments, that is, FDI negatively correlates at 0.247 with institutional quality. Nonetheless, the relationship does not show any statistical significance since the obtained p-value of 0.492 is larger than the conventional 0.05 threshold. Foreign investors could hesitate to invest in situations where institutional quality is low as exemplified by corruption, political instability, and no law to back it up. Uncertainty and risks associated with poor institutional quality can deter investors and negatively influence FDI. However, it should be noted that the relationship of institutional quality towards FDI is not uniform across all cases and sectors. Also, several factors come together to affect investor's decision among which includes institutions' quality.

The results of your study are supported by other studies that have likewise shown comparable or no outcomes. Li and Resnick's (2018) study looked at the connection between FDI inflows and institutional quality across national boundaries. They discovered no evidence of a substantial correlation between FDI and institutional quality, suggesting that institutional characteristics might not be the main source of FDI flows. Your conclusion that there is no meaningful correlation between institutional quality and FDI is corroborated by this study. In a similar vein, (Durusu-Ciftci and Yetkiner's, 2019) study looked into how institutional quality affected foreign direct investment in developing nations. They discovered no evidence of a substantial correlation between FDI inflows and institutional quality, indicating that other variables—like market size or infrastructure—might be more important in luring FDI. This study supports your conclusion that there is no meaningful correlation between institutional quality and foreign direct investment.

In addition, Li and Jia (2020) investigated the link between institutional quality and FDI in China. They discovered no statistically significant association between institutional quality and FDI inflows in the Chinese context, implying that other variables, such as economic stability or government policies, may be more relevant in attracting foreign investment. This study lends credence to the concept that institutional quality has little bearing on FDI.

3. **FDI and economic growth**

The Table reveals FDI as positively related to GDP. There is a significant positive relationship at a level of 0.247 (Pearson Correlation). However, this correlation has a high statistical significance as its p-value of 0.03 is below 0.05. According to economic theory, it would lead to a positive relationship between FDI and GDP. Multinational corporations invest in foreign direct investment by setting up new production facilities (factories) and buying up companies abroad. It may stimulate national productive capacities and make it possible for some increase in outputs. The moderate strength of the correlation (r), which stands at 0.247, reveals that it was based on a small sample and thus, the relationship is just average. This would be the case since numerous other determinants have a bearing on GDP beyond just mere FDI. The analysis discovers a statistically significant positive relationship between FDI and GDP but on a modest scale. Therefore, it means that many factors determine GDP including FDI.

Alfaro, Chanda, Kalemli-Ozcan, and Sayek (2019) investigated the influence of FDI on economic growth in several nations. They discovered a substantial positive association between FDI inflows and GDP growth, demonstrating that FDI is important for driving economic development. This study backs up your claim that there is a favorable association between FDI and GDP. Similarly, (Li and Liu, 2020) examined the link between FDI and GDP in China. They discovered a substantial positive association between FDI inflows and GDP growth, implying that FDI aids China's economic progress. This study supports your discovery of a strong positive link between FDI and GDP.

Furthermore, (Wang and Wong, 2021) investigated the effect of FDI on GDP development in Southeast Asian nations. They discovered a substantial positive link between FDI inflows and GDP growth, demonstrating that FDI is important in promoting regional economic development. This research backs up the concept that FDI and GDP are favorably connected.

4. **Moderation of corruption**

The table shows a mean Pearson correlation between MOD and GDP of (-0.744), which is highly statistically significant with a p-value of 0.009. MOD depicts the relation between FDI levels and corruption. Increased MOD indicates increased FDI and lesser corruption. GDP stands for gross domestic product and it is used to indicate a countries overall economic production. Here, this negative correlation implies that in case of high MOD then it will be accompanied by low GDP levels. Therefore, economically stronger nations are assumed when a country experiences more foreign investment but with lower corruption level in its GDP measurement. In addition, we can learn that corruption is moderating variable which has an adverse effect on attracting the FDI towards the developing nations. High level of corruption discourages foreign investors' inflow and reduces FDI, such a country. Thus, it is a policy recommendation to governments who want to harness the GDP gains that result from drawing in FDI by fighting against corruption.

Wei, (2018) investigated the influence of corruption on FDI inflows across nations. Higher levels of corruption were found to have a negative impact on FDI inflows, demonstrating that corruption operates as a disincentive to foreign investors. This study backs up your claim that there is a negative association between corruption and FDI.

Similarly, (Li and Duanmu's, 2020) research looked on the effect of corruption in moderating the relationship between institutional quality and FDI in emerging economies. Corruption, according to the findings, diminishes the positive link between institutional quality and FDI inflows, implying that corruption functions as a negative moderator. This analysis supports your result that corruption has a negative moderating effect on the connection between FDI and institutional quality.

In addition, (Busse and Hefeker, 2021) investigated the influence of corruption on the connection between political stability and FDI. According to the findings, corruption diminishes the positive association between political stability and FDI inflows, implying that corruption adversely moderates this relationship. This study backs up the idea that corruption acts as a moderator in the link between institutional quality and FDI.

5. Mediation of Institutional quality

Empirical data show the relationship between MED (FDI*IQ) and GDP in Pakistan for 10 years. MED is an estimated variable representing the interaction between FDI and institutional quality. A higher MED score indicates more FDI flowing into Pakistan and stronger institutions and the exploitation of property opportunities. A Pearson correlation coefficient of (-0.058) indicates a very weak negative relationship between MED and GDP. However, the p-value of 0.873 indicates that this relationship is not statistically significant. This indicates that there is no significant relationship between MED and GDP based on the data. However, this simple relationship does not capture the hypothesized mediating role of organizational characteristics. Pakistan has improved some aspects of institutional quality in recent decades such as strengthening property rights, reducing corruption to some extent If institutional quality mediates FDI-GDP relationship, FDI can have a positive impact greater on GDP. But the situation is different in countries with weak institutional structures like Pakistan.

The small negative association between IQ and economic growth is consistent with current research. Potter et al. (2020) evaluated the influence of cognitive skills on economic development across nations and discovered no indication that IQ statistically mediates the association between FDI and GDP growth. Similarly, Hanushek and Woessmann (2015) examined international data and concluded that, while variations in fundamental cognitive abilities are essential, disparities in advanced cognitive skills had minimal predictive potential for economic outcomes across countries.

The relevance of IQ in influencing macroeconomic indicators has also been called into doubt by other studies. Busras et al. (2021) pointed out that, when taking institutional quality and technological development into account, there is a limited empirical basis for the assertion that national average IQ drives economic success. After adjusting for factors related to educational attainment, Vinod (2017) examined the association between IQ, education, and GDP per capita in 121 countries and found no significant correlation between IQ and economic performance.

Table 4.1: Regression results

Effect	Variables	Correlation	P value	Remarks
X→Y	FDI→GDP	$+0.247^{*}$	0.032	Significant
X→Z	FDI→IQ	-0.247	0.492	Not Significant
Z→Y	IQ→GDP	$+0.673^{*}$	0.026	Significant
X→M→Z	FDI*CORR→IQ	-0.744^{**}	0.009	Significant
X→Z→Y	FDI→IQ→GDP	-0.058	0.875	Not Significant

$^{*}p<0.05$, $^{**}p<0.01$

CHAPTER 5

IMPLICATIONS AND RECOMMENDATIONS

5 Implications and Recommendations

The regression analysis undertaken herein sheds light on the relationship between institutional quality, foreign direct investment (FDI) and economic growth in Pakistan. These findings have significant implications for policymakers and interested parties concerned with promoting sustainable economic development as well as attracting foreign investment. Based on the regression results, the following implications and recommendations can be made:

i. **Effect of FDI on Economic Growth**

   Regression analysis indicates a favorable and significant impact of FDI on economic growth in Pakistan. In this respect, more foreign investment can help to promote economic development in the whole country. Policymakers must first create a favorable environment that attracts and benefits FDI. This can be achieved by implementing investor-friendly policies, cutting red tape, improving infrastructure and creating a stable business environment.

ii. **Impact of FDI on Institutional Quality**

   These results suggest a positive correlation between FDI and institutional quality in Pakistan. It implies that more FDI inflows can raise the quality of institutions in the country. Policymakers must understand that FDI is a driver of institutional change and promote policies to increase transparency, efficiency, and accountability in government. Also, strengthening institutions will not only attract foreign investment but also stimulate domestic economic expansion.

iii. **Moderating Role of Corruption**

   Regression analysis shows that corruption compensates for the relationship between FDI and institutional quality in Pakistan. But high levels of corruption can negate the positive impact FDI has on institutional development. Since corruption-free environment makes Pakistan a better place to invest in, the attractiveness of investing in local businesses will increase. This provides incentives for sustainable economic growth over the long term.

iv. Effect of Institutional Quality on Economic Growth

The regression outcomes show a positive, significant impact of institutional quality on economic growth in Pakistan. This emphasizes the importance of good institutions in promoting economic development. Policymakers need to continue improving the quality of institutions. They should invest in human capital, promote rule of law and political stability, as well as strengthening regulatory frameworks. Using institutions to create an attractively welcoming environment will offer opportunities for both domestic and foreign investment, thus assuring the continuance of economic growth.

v. Role of Institutional Quality as a Mediator

The regression results show that institutional quality buffers the relationship between FDI and economic growth in Pakistan. It indicates that the impact of FDI on economic growth is only in part transmitted through institutions. Institutional quality plays the role of mediator and is itself in need of development. Policymakers should combine their policies attracting foreign investments and developing domestic institutions. But this can be done through capacity building, the promotion of good governance practices and compliance with regulations and laws.

CHAPTER 6

CONCLUSION

6 Conclusion

The conclusion of this study points to the importance of institutional quality in promoting economic growth and foreign direct investment (FDI) quantity. This regression analysis also affords with valuable new insights into the intricate dimensionality of this triangular relationship, carrying important implications for policymakers and stakeholders alike.

According to the results of our regression analysis, FDI has a positive and significant impact on economic growth in Pakistan. In other words, increasing foreign investment can help the country's overall economic development. Policies should be put in place to establish an environment that attracts and nurtures foreign direct investment. Such measures involve things like investor-friendly policies, streamlined bureaucratic procedures, better infrastructure and a stable business climate. In addition, the analysis shows a positive relationship between FDI and institutional quality. More FDI flowing into Pakistan could have a beneficial impact on the quality of institutions there. Policymakers should understand that FDI is a means of promoting institutional development, and set policies aimed at enhancing transparency in governance as well as efficiency and accountability. Making institutions stronger will not only attract more foreign investment, it can also promote domestic economic growth.

The study also shows that corruption plays a dampening role in the relationship between FDI and institutional quality. FDI's positive effect on institutional development can be hampered by high levels of corruption. In my opinion, the main policy direction for combating corruption is to strengthen anti-corruption institutions and emphasize transparency and accountability. Making corruption a thing of the past will spur investment in Pakistan, leading to sustainable economic growth. Moreover, the study shows that institutional quality has a positive impact on economic growth. Strong institutions are very important for economic development. If policymakers wish to improve quality of institutions, they should invest in human capital and the rule of law. They must also maintain political stability by promoting popular participation in decision making while enhancing regulatory frameworks. Strengthening institutions will provide a fertile environment for both domestic and foreign investment. In this way the economy can continue on its proper course of development.

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