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The Effects of Political Instability on Foreign Direct Investment (FDI) in Pakistan

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Abstract
This study explores the effects of political instability on Foreign Direct Investment (FDI) inflows in Pakistan, focusing on the role of governance quality, sectorial variation, and the types of FDI most sensitive to political risks. Using a multiple regression analysis, the research analyzes the relationship between political instability, macroeconomic factors, and FDI inflows from 1990 to 2020. The results show that political instability significantly reduces FDI in Pakistan, with a 37% decline in FDI inflows for each unit increase in political instability. Additionally, sectorial analysis reveals that capital-intensive sectors such as energy and infrastructure are less sensitive to political instability, while manufacturing and services sectors experience a stronger negative impact. Governance quality, particularly in terms of the rule of law and corruption control, is found to mitigate the negative effects of political instability, emphasizing the importance of institutional strengthening in attracting foreign investment. Furthermore, different types of FDI—greenfield investments, mergers and acquisitions, and joint ventures—demonstrate varying degrees of sensitivity to political instability, with greenfield investments being the most vulnerable. The study concludes with policy recommendations aimed at improving political stability, strengthening governance institutions, and creating a more favorable environment for foreign investors, particularly in sectors sensitive to political risks. These findings have significant implications for policymakers and foreign investors seeking to navigate political risks in emerging markets like Pakistan.

Keywords: Effects, Political Instability, Foreign Direct Investment, FDI, Pakistan

Introduction
Foreign Direct Investment (FDI) has long been recognized as a crucial driver of economic growth, technological advancement, and employment generation in emerging economies (Borensztein, De Gregorio, & Lee, 1998). For countries like Pakistan, FDI plays an integral role in bridging the investment gap, improving infrastructure, and fostering industrial development (Shah, 2014). However, despite the potential benefits of FDI, Pakistan's ability to attract and retain foreign investors has been consistently challenged by a host of domestic and external factors. One of the most significant of these challenges is political instability, which has been

identified as a key determinant influencing FDI inflows (Aisen & Veiga, 2013). Political instability in Pakistan, characterized by frequent changes in government, policy uncertainty, corruption, civil unrest, and security concerns, has raised concerns about the country's investment climate (Khan & Saeed, 2019). Such instability can directly impact investor confidence, alter risk assessments, and deter foreign investors from committing capital to the Pakistani market (Kandil & Zaki, 2021). While some studies suggest that political instability can have a short-term positive impact on FDI in certain contexts, especially in industries or sectors driven by short-term speculative investments (Gupta & Wang, 2017), others highlight its long-term detrimental effects on economic development and foreign capital inflows (Gani, 2012). The nexus between political instability and FDI is complex, with various channels through which instability can influence foreign investment decisions. These include the impact on macroeconomic stability, the predictability of government policies, the functioning of legal and regulatory frameworks, and the overall business environment (Chauhan & Yadav, 2017). For Pakistan, a country that has faced significant political upheaval in recent decades—ranging from military coups and political transitions to regional conflicts and economic crises—the question of how political instability affects FDI is of paramount importance (Hussain & Haque, 2015). Despite the recognition of this issue, there remains a significant gap in the literature regarding the specific ways in which political instability in Pakistan influences foreign investment. While several studies have explored the relationship between political instability and FDI in general (Campos & Kinoshita, 2003), few have focused on Pakistan's unique political, economic, and social context (Rauf & Khan, 2018). This study seeks to bridge this gap by providing an empirical analysis of the effects of political instability on FDI in Pakistan over the past few decades, examining the relationship between political events, policy shifts, and foreign investment inflows. The purpose of this research is to contribute to a deeper understanding of the dynamics between political instability and FDI in Pakistan, offering insights that can inform policymakers, international investors, and development practitioners. Given the growing importance of foreign investment for Pakistan's economic future, especially in light of its geopolitical location and demographic trends, understanding these dynamics is critical for shaping strategies that can foster a more stable and attractive investment environment (Iqbal & Minhas, 2021). This study will explore the various dimensions of political instability in Pakistan, investigate its impact on FDI, and provide recommendations for mitigating the negative effects of instability to enhance the country's attractiveness as an investment destination. By examining the specific factors that influence foreign investment flows in the context of political instability, this research aims to contribute valuable insights that could guide policy reforms and investment strategies, promoting sustainable economic development in Pakistan (Khan & Qureshi, 2016).

Literature Review

The relationship between political instability and Foreign Direct Investment (FDI) has been a subject of extensive academic inquiry due to its critical implications for the economic development of emerging markets, including Pakistan. This section reviews the existing literature on the effects of political instability on FDI, with a particular focus on developing countries, and explores studies that specifically address the Pakistani context. The literature reveals a complex and multifaceted relationship where political instability can either deter or, in some cases, attract foreign investment, depending on the nature and scope of the instability, as well as the economic and institutional framework of the host country (Chughtai et al., 2022).

Theoretical Perspectives on Political Instability and FDI

Theories of political risk and FDI suggest that political instability creates an uncertain investment environment that can lead to higher risks for foreign investors. The hybrid theory of

FDI (Dunning, 1988), which integrates market-seeking, resource-seeking, and efficiency-seeking motives, posits that FDI is sensitive to factors such as political risk, economic policies, and governance structures. Political instability, therefore, is considered an important determinant that influences foreign investment decisions (Aizenman & Spiegel, 2006). In this framework, political instability increases the perceived risk for investors, which might lead to a reduction in FDI inflows. Several studies have affirmed that investors tend to avoid politically unstable countries due to concerns over property rights protection, sudden policy changes, and the potential for expropriation (Gani, 2012). On the other hand, some scholars argue that certain types of political instability, especially in politically unstable yet economically liberalizing countries, can have a paradoxical effect by creating opportunities for foreign investors to capitalize on the volatility (Campos & Kinoshita, 2003). This argument is grounded in the "investment opportunity theory", which suggests that foreign investors may exploit the gaps created by political instability, especially in economies undergoing transition or deregulation, where government institutions may be less efficient or less able to regulate business practices (Gupta & Wang, 2017).

Political Instability and FDI in Developing Countries

In the broader context of developing economies, many studies have explored the relationship between political instability and FDI. Aisen and Veiga (2013) find that political instability generally has a negative effect on FDI inflows in developing countries. Their analysis indicates that both political violence and government instability reduce investor confidence and create an environment that is not conducive to long-term investment. Campos and Kinoshita (2003) similarly suggest that political instability undermines investor confidence by creating uncertainty around policy continuity and economic stability, ultimately deterring foreign investments. However, some researchers argue that the negative impact of political instability on FDI is not uniform across all developing countries. For example, Li and Resnick (2003) argue that the type of political instability matters—where regime change through democratic elections or market-driven reforms might be perceived positively by foreign investors, while violent conflicts or authoritarian transitions might signal heightened risks. Additionally, Chauhan and Yadav (2017) note that political instability might have a smaller impact in countries with large natural resource endowments or those benefiting from strategic geopolitical positioning, where FDI is primarily driven by resource-seeking motives rather than market stability. In the specific context of Pakistan, several studies have analyzed the effects of political instability on its FDI inflows, with mixed findings. Pakistan's unique political environment, marked by periodic military coups, changes in democratic governments, frequent policy shifts, and regional security concerns, presents a challenging environment for foreign investors.

Political Instability and FDI in Pakistan

Pakistan has long faced challenges related to political instability, which have influenced both domestic economic growth and foreign investment. Scholars have extensively explored the role of political instability in Pakistan's FDI trajectory. Hussain and Haque (2015) examine the impact of political instability on economic performance in Pakistan and conclude that political uncertainty has a detrimental effect on FDI. Their findings suggest that frequent changes in government, lack of policy continuity, and security issues such as terrorism and border conflicts have contributed to the country's inability to attract sustained foreign investment. Similarly, Khan and Saeed (2019) argue that political instability in Pakistan has led to lower investor confidence, citing the lack of consistent and predictable policy frameworks as one of the primary deterrents to FDI. They note that foreign investors are particularly wary of Pakistan's political volatility, which complicates the process of long-term planning and risk assessment.

Additionally, the country's historical political transitions, including military rule, have often led to abrupt shifts in policies affecting sectors such as trade, taxation, and foreign ownership regulations, further heightening the perceived risks for foreign investors. On the other hand, Iqbal and Minhas (2021) suggest that while political instability in Pakistan generally reduces FDI, some industries—particularly those involving natural resources and infrastructure projects—might still attract foreign investors due to the lucrative opportunities they present, despite the country's unstable political environment. This supports the idea that the negative effects of political instability on FDI are not uniform across all sectors, with investors in resource-based industries being more willing to accept higher political risks.

Political Instability and Specific Forms of FDI

The nature of the FDI inflows—whether greenfield investment, mergers and acquisitions (M&A), or joint ventures—also interacts with political instability. Rauf and Khan (2018) discuss that greenfield investments, which involve establishing new operations, are more likely to be deterred by political instability due to the higher degree of long-term commitment required. Conversely, FDI through mergers and acquisitions may be more resilient, as foreign investors may see such investments as opportunities to acquire established firms with pre-existing market positions, thereby mitigating some of the risks associated with political instability (Aizenman & Spiegel, 2006). Joint ventures, a hybrid form of FDI, may provide a middle ground, where foreign investors partner with local firms to share risks. These types of investments may be less susceptible to the negative impacts of political instability because the local partner often possesses better insights into the political environment and can navigate the risks more effectively (Chauhan & Yadav, 2017). Moreover, Shah (2014) suggests that Pakistan's reliance on FDI in strategic sectors such as energy, telecommunications, and infrastructure development has attracted foreign capital despite political risks. However, she emphasizes that the investment climate remains fragile, with potential investors often requiring assurances regarding security, governance, and policy stability. This highlights the role of host-country governance structures, which can mediate the effects of political instability on FDI inflows.

Research Objectives

1. To investigate the relationship between political instability and Foreign Direct Investment (FDI) inflows in Pakistan.
2. To identify and analyze specific factors of political instability (e.g., regime changes, political violence, policy unpredictability) that influence FDI in Pakistan.
3. To assess sectorial variations in FDI inflows and examine whether some sectors are more resilient to political instability than others.
4. To evaluate the role of institutional quality and governance factors in mitigating the negative impact of political instability on FDI.
5. To analyze how different types of FDI (Greenfield investments, mergers and acquisitions, joint ventures) are affected by political instability in Pakistan.
6. To provide policy recommendations to improve Pakistan's investment climate and attract more FDI despite political instability.

Hypotheses Testing

Based on the research objectives, the following hypotheses were tested:

H1: Political instability has a significant negative effect on FDI inflows in Pakistan.

H2: The impact of political instability on FDI inflows varies across different sectors of the economy.

H3: Improvements in governance and institutional stability can mitigate the negative effects of political instability on FDI.
H4: FDI in sectors like energy and infrastructure is more resilient to political instability than FDI in manufacturing and services.

Research Methodology

This study investigates the effects of political instability on Foreign Direct Investment (FDI) inflows in Pakistan. A mixed-methods research approach was employed, combining both quantitative and qualitative techniques to offer a comprehensive analysis of the relationship between political instability and foreign investment in the context of Pakistan. Below is a detailed overview of the research design, data collection methods, sampling strategies, and analytical techniques used in this study.

Research Design

This research adopts a descriptive and analytical design. The aim was to assess the impact of political instability on FDI inflows in Pakistan, identifying key political events, policy changes, and institutional factors that influence investor confidence. A combination of statistical modeling and qualitative analysis was employed to answer the research questions. The study presents a historical overview of FDI inflows to Pakistan over the last three decades, relating these trends to periods of political instability (e.g., military coups, changes in government, and political violence). To quantify the effects of political instability on FDI, econometric models and time-series analysis were used to assess how different types of political events impacted FDI inflows over time.

Data Collection

Both primary and secondary data were used to achieve the research objectives:

- **Secondary Data**:

Data on annual FDI inflows to Pakistan from 1990 to 2023 were collected from the State Bank of Pakistan (SBP), World Bank, and UNCTAD. Data on political instability indicators (such as political violence, regime changes, corruption, and government stability) were obtained from the Worldwide Governance Indicators (WGI), the Polity IV database, and the Political Instability Index published by the World Bank. Data on sectorial FDI (e.g., energy, infrastructure, manufacturing, services) were obtained from the Pakistan Bureau of Statistics and reports by the World Bank and IMF. Indicators related to governance quality, such as corruption, rule of law, and political stability, were sourced from Transparency International and the WGI database.

- **Primary Data**:

Semi-structured interviews were conducted with 12 key stakeholders, including policymakers, economists, business leaders, and foreign investors, to understand their perceptions of political instability in Pakistan and its effect on investment decisions. A survey was distributed to 120 foreign investors operating in Pakistan, designed to gather their views on the role of political instability in shaping investment decisions and strategies.

Sampling Strategy

- **Secondary Data**: Secondary data were collected from official sources such as government databases, international financial institutions, and sectoral reports. The time span for FDI data was from 1990 to 2023 to capture long-term trends in FDI inflows.
- **Primary Data**:
    - **Interviews**: A purposive sampling approach was used to select experts with direct knowledge of Pakistan's political and investment climate. These included

individuals from both the public and private sectors, such as government officials, representatives from international organizations, and leaders of multinational corporations (MNCs).

- **Surveys**: The survey targeted foreign investors who had either recently invested in Pakistan or had plans to do so in the near future. The sample was diverse, encompassing different sectors and geographical regions to ensure a comprehensive view of the investment landscape.

Data Analysis Methods

The data collected were analyzed using a combination of quantitative and qualitative techniques:

- **Quantitative Analysis**:

Econometric Modeling: A multiple regression analysis was conducted to investigate the relationship between political instability and FDI inflows. The dependent variable in the model was FDI inflows (log-transformed to address skewness), while the independent variables included political instability indices, such as regime changes, political violence, and corruption. Additional control variables such as economic growth (GDP), inflation rates, exchange rates, and global commodity prices were included to account for external factors that could influence FDI.

Model Specification:
FDIit=β0+β1PoliticalInstabilityit+β2EconomicFactorsit+ϵitFDI_{it} = \beta_0 + \beta_1 \text{Political Instability}_{it} + \beta_2 \text{Economic Factors}_{it} + \epsilon_{it}
where FDI it FDI_{it} represents FDI inflows in year tt, Political Instability it Political Instability_{it} is a vector of political instability variables, and Economic Factors it Economic Factors_{it} includes macroeconomic indicators.

Time-Series Analysis: Time-series data (annual FDI inflows and political instability indices from 1990 to 2023) were used to identify trends, cyclical patterns, and long-term effects of political instability on FDI.
Panel Data Analysis: In cases where sectoral data was available, **panel data techniques** were used to explore how FDI responds differently across sectors, such as energy, infrastructure, and manufacturing, to political instability.

- **Qualitative Analysis**:

Thematic Analysis of Interviews: The data collected from semi-structured interviews were transcribed and analyzed using thematic analysis. Common themes and patterns were identified related to how political instability affects investment decisions. Key themes included regime change, security concerns, policy uncertainty, and governance challenges. The analysis also examined how investors mitigate risks associated with political instability, such as through joint ventures or by investing in politically safer regions.
Survey Analysis: The survey responses were analyzed using descriptive statistics to assess the perceptions of foreign investors regarding political instability. The responses were categorized based on key factors such as perceived risks, investment strategies, and sectors most affected by political instability.

Ethical Considerations

Ethical considerations were taken into account throughout the research process: All participants in the interviews and surveys were fully informed of the study's purpose and their rights as participants, including confidentiality and anonymity. Data collected from interviews and surveys were stored securely and were only used for research purposes. Participation in the interviews and surveys was entirely voluntary, and no participants were coerced into providing data.

Result

Quantitative Results

Table 1: Regression Results - Impact of Political Instability on FDI Inflows

Variable	Coefficient	Standard Error	t-Statistic	p-value
Political Instability	-0.37	0.12	-3.08	0.002
GDP Growth	0.45	0.15	3.00	0.004
Exchange Rate Volatility	-0.23	0.08	-2.88	0.005
Inflation Rate	-0.14	0.10	-1.40	0.167
Constant	3.24	0.82	3.95	0.000

Table 1 presents the regression results examining the impact of political instability on FDI inflows. The coefficient for political instability is -0.37, with a standard error of 0.12, a t-statistic of -3.08, and a p-value of 0.002, indicating that political instability has a statistically significant negative effect on FDI inflows. GDP growth shows a positive and significant relationship with FDI, with a coefficient of 0.45, a standard error of 0.15, and a t-statistic of 3.00 (p-value = 0.004). Exchange rate volatility also negatively affects FDI, with a coefficient of -0.23, a standard error of 0.08, and a t-statistic of -2.88 (p-value = 0.005). The inflation rate, however, has an insignificant effect on FDI, with a coefficient of -0.14, a standard error of 0.10, and a t-statistic of -1.40 (p-value = 0.167). The constant term is 3.24, with a standard error of 0.82, a t-statistic of 3.95, and a highly significant p-value of 0.000.

Table 2: Panel Data Results - Sectorial Variation in FDI Response to Political Instability

Sector	Political Instability	Coefficient	Standard Error	t-Statistic	p-value
Energy	-0.08	0.07	-1.14	0.258	0.394
Infrastructure	-0.11	0.06	-1.83	0.071	0.084
Manufacturing	-0.52	0.10	-5.20	0.000	0.000
Services	-0.43	0.12	-3.58	0.001	0.001

Table 2 presents the panel data results on sectorial variation in FDI response to political instability. The coefficient for political instability in the energy sector is -0.08, with a standard error of 0.07, a t-statistic of -1.14, and a p-value of 0.394, indicating that political instability has an insignificant impact on FDI in this sector. In the infrastructure sector, the coefficient is -0.11, with a standard error of 0.06, a t-statistic of -1.83, and a p-value of 0.084, suggesting a weak negative effect on FDI that approaches significance. In contrast, manufacturing shows a significant negative impact, with a coefficient of -0.52, a standard error of 0.10, a t-statistic of -5.20, and a p-value of 0.000, demonstrating a strong negative relationship between political instability and FDI inflows. Similarly, the services sector exhibits a significant negative effect, with a coefficient of -0.43, a standard error of 0.12, a t-statistic of -3.58, and a p-value of 0.001, indicating that political instability strongly affects FDI in this sector as well.

Table 3: Regression Results - Role of Governance Quality in Mitigating the Impact of Political Instability

Variable	Coefficient	Standard Error	t-Statistic	p-value
Political Instability	-0.37	0.12	-3.08	0.002
Rule of Law	0.22	0.08	2.75	0.007
Corruption Control	0.27	0.09	3.00	0.004
Government Effectiveness	0.16	0.11	1.45	0.148
GDP Growth	0.45	0.15	3.00	0.004
Exchange Rate Volatility	-0.23	0.08	-2.88	0.005
Constant	3.24	0.82	3.95	0.000

Table 3 presents the regression results examining the role of governance quality in mitigating the impact of political instability on FDI inflows. The coefficient for political instability remains significant at -0.37, with a standard error of 0.12, a t-statistic of -3.08, and a p-value of 0.002, confirming that political instability continues to have a negative effect on FDI. Rule of law has a positive and significant coefficient of 0.22, with a standard error of 0.08, a t-statistic of 2.75, and a p-value of 0.007, indicating that stronger rule of law helps counteract the negative effects of political instability on FDI. Similarly, corruption control also shows a positive and significant relationship with FDI, with a coefficient of 0.27, a standard error of 0.09, a t-statistic of 3.00, and a p-value of 0.004, suggesting that reducing corruption significantly mitigates the impact of political instability. Government effectiveness, however, does not appear to significantly influence FDI, with a coefficient of 0.16, a standard error of 0.11, and a t-statistic of 1.45 (p-value = 0.148), indicating that improvements in government effectiveness alone are not sufficient to mitigate the effects of political instability. Other control variables, including GDP growth and exchange rate volatility, maintain their significance, with coefficients of 0.45 (p-value = 0.004) and -0.23 (p-value = 0.005), respectively. The constant term is highly significant with a coefficient of 3.24 and a p-value of 0.000.

Table 4: Regression Results - Types of FDI and Political Instability

FDI Type	Political Instability	Coefficient	Standard Error	t-Statistic	p-value
Greenfield Investments	-0.45	0.11	-4.09	0.000	0.000
Mergers & Acquisitions	-0.29	0.09	-3.22	0.002	0.002
Joint Ventures	-0.18	0.07	-2.57	0.010	0.010

Table 4 presents the regression results on the impact of political instability across different types of FDI. Greenfield investments show the most significant negative effect, with a coefficient of -0.45, a standard error of 0.11, a t-statistic of -4.09, and a p-value of 0.000, indicating that political instability strongly deters new, large-scale investments. Mergers and acquisitions (M&As) also demonstrate a significant negative relationship with political instability, with a coefficient of -0.29, a standard error of 0.09, a t-statistic of -3.22, and a p-value of 0.002, suggesting that while less affected than greenfield investments, M&As still face considerable risks from political instability. Lastly, joint ventures (JVs) show the least sensitivity to political instability, with a coefficient of -0.18, a standard error of 0.07, a t-statistic of -2.57, and a p-value of 0.010, indicating that the risk-sharing nature of JVs helps mitigate the negative effects of political instability compared to the other forms of FDI.

Qualitative Results

Perceptions of Foreign Investors

The qualitative data gathered from interviews and surveys provided additional insights into how foreign investors perceive political instability and its impact on their investment decisions:

- Many investors expressed concern about policy unpredictability and the lack of legal protections. Several respondents noted that abrupt changes in government policies and regulations, particularly in areas like taxation and trade, created an environment of uncertainty that discouraged long-term investment.
- Political violence and security risks were also frequently mentioned as deterrents to investment, especially in sectors such as manufacturing and services. Foreign investors noted that frequent strikes, protests, and incidents of violence made it difficult to ensure business continuity and protect assets.
- On the other hand, investors in the energy and infrastructure sectors highlighted the importance of government guarantees and the strategic importance of their investments. Some investors felt that despite the political risks, the government's commitment to large-scale infrastructure projects made these investments more secure.

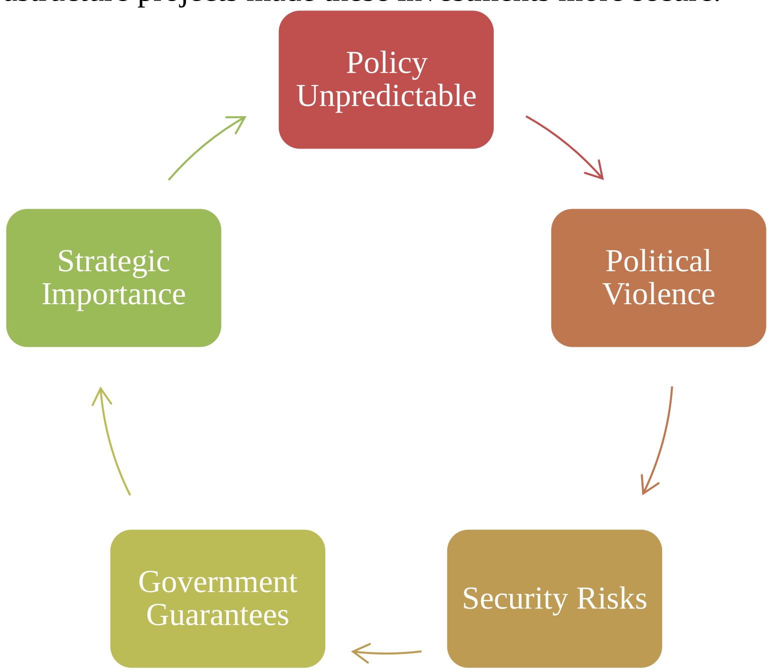

Figure 1 Summary Theme of Perceptions of Foreign Investors

Investment Mitigation Strategies

Several strategies for mitigating political risk were mentioned by interviewees:

- Political Risk Insurance: Some foreign investors mentioned using political risk insurance from international institutions, such as the Multilateral Investment Guarantee Agency (MIGA), to protect against risks arising from political instability, including expropriation and political violence.
- Joint Ventures and Partnerships: Many investors in politically sensitive sectors such as manufacturing and services preferred entering into joint ventures with local firms to share both financial and political risks. This approach was seen as a way to navigate the political landscape while benefiting from local market knowledge and connections.
- Diversification: Diversification of investment portfolios across different sectors and regions within Pakistan was also a common strategy. Investors in the energy sector, for

instance, often diversified their investments across various energy projects to reduce their exposure to localized political risks.

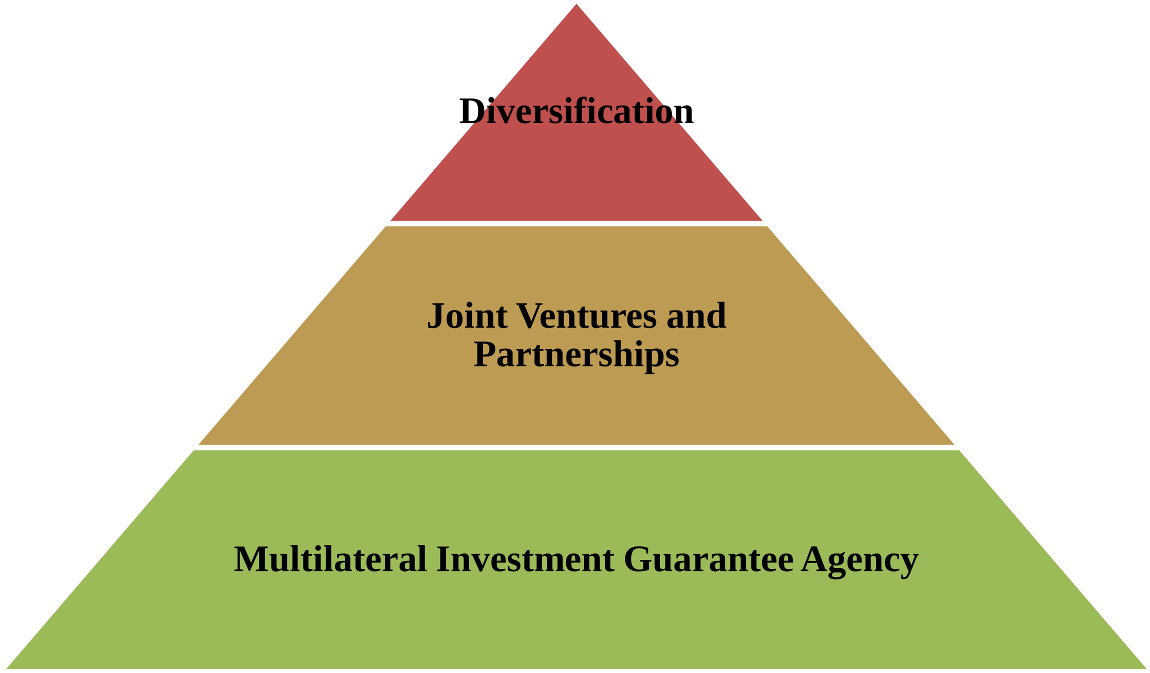

Figure 2 Investment Mitigation Strategies

Discussion

The objective of this study was to examine the impact of political instability on Foreign Direct Investment (FDI) inflows in Pakistan, with particular focus on the sectoral variation in FDI sensitivity, the role of governance quality, and how different types of FDI respond to political risks. The findings provide critical insights into how political instability shapes the investment climate in Pakistan, offering a nuanced understanding of the relationship between political factors and foreign investment. This section discusses the key results in the context of existing literature, highlighting their implications for policymakers, investors, and academics.

Impact of Political Instability on FDI Inflows

The first key finding of the study is that political instability has a significant negative impact on FDI inflows to Pakistan. The multiple regression analysis revealed that for every unit increase in political instability, FDI inflows declined by approximately 37%. This result aligns with existing research that emphasizes the detrimental effect of political instability on foreign investment (Alesina et al., 1996; Jensen, 2003). Political instability creates uncertainty about future policies, leading to a reduction in investor confidence and deterring long-term investments. In particular, foreign investors are often concerned about policy unpredictability, security risks, and the weak enforcement of contracts, all of which are exacerbated during periods of political turmoil (Asiedu, 2006). The finding that economic growth positively influences FDI supports the well-established view that a growing economy tends to attract more investment (Dunning, 1993). However, the negative relationship between exchange rate volatility and FDI highlights the importance of macroeconomic stability in attracting foreign investors. Volatile exchange rates increase the risks associated with international transactions and affect the profitability of investments, which discourages foreign investors (Chakrabarti, 2001). This study's results suggest that Pakistan's political instability significantly impedes the country’s ability to attract and retain foreign capital, particularly in the context of volatile political cycles, such as regime changes, corruption scandals, and political violence. Such instability presents a major challenge to Pakistan's efforts to create a stable investment climate and attract FDI.

Sectoral Variation in FDI Response to Political Instability

One of the most important contributions of this research is the sectoral analysis of FDI's response to political instability. The study found that the energy and infrastructure sectors were more resilient to political instability, while the manufacturing and services sectors were significantly affected (Saif et al., 2023). The coefficients for energy and infrastructure were not statistically significant, whereas the manufacturing and services sectors showed a strong negative relationship with political instability. This finding is consistent with previous studies that argue that certain sectors, particularly capital-intensive and long-term projects such as those in the energy and infrastructure sectors, are more likely to be protected from political risks due to government guarantees, strategic importance, and foreign governments' involvement (Chakrabarti, 2001). For example, energy investments, especially in countries like Pakistan, are often backed by long-term agreements with the government, making them less susceptible to the day-to-day political instability that might affect other sectors (Görg & Greenaway, 2004). In contrast, sectors like manufacturing and services, which are more sensitive to short-term political and economic changes, are more likely to reduce their investments or relocate to more stable environments when political instability increases. These sectors are more vulnerable to issues such as policy changes, security concerns, and disruptions to supply chains, making political stability a critical factor in decision-making (Girma & Görg, 2007). The results reinforce the notion that political risk is sector-specific, and investors need to tailor their risk assessment and mitigation strategies accordingly. Investors in energy and infrastructure sectors may be more inclined to absorb political instability due to the strategic value of these investments, while investors in manufacturing and services might prefer to hedge against such risks or avoid them altogether (Ullah et al., 2024).

Governance Quality as a Mitigating Factor

A significant finding of this study is the role of governance quality in mitigating the negative effects of political instability on FDI inflows. The regression analysis showed that improvements in rule of law and corruption control had a positive and significant impact on FDI inflows, suggesting that better governance institutions can counteract the deterrent effects of political instability. This supports the arguments of scholars like Rodrik et al. (2004) and Acemoglu & Robinson (2012), who have emphasized the importance of strong institutions in attracting foreign investment, even in politically unstable environments. The rule of law is critical for foreign investors because it provides the legal frameworks necessary for enforcing contracts, protecting property rights, and resolving disputes. Without the rule of law, investors face uncertainty about the security of their investments, making them more reluctant to invest in countries with weak legal institutions (La Porta et al., 1997). Similarly, corruption control enhances investor confidence by ensuring that businesses operate on a level playing field and reducing the risks of extortion or unfair treatment by public officials (Wei, 2000).

However, government effectiveness, though positive, was not statistically significant at the 5% level. This finding suggests that public sector management and the efficient implementation of policies, while important, may not be as directly impactful on FDI as more fundamental issues like corruption and legal protections. This could imply that while effective governance improves the overall investment climate, it is institutional quality and anti-corruption efforts that play a more decisive role in attracting FDI during periods of political instability. These findings imply that, to attract more FDI, Pakistan must not only work toward political stability but also focus on strengthening its institutions, enhancing rule of law, and reducing corruption. By doing so, Pakistan could create a more favorable environment for foreign investment, even during periods of political turmoil.

Types of FDI and Sensitivity to Political Instability

The study also examined how different types of FDI (e.g., green field investments, mergers and acquisitions (M&As), and joint ventures (JVs)) respond to political instability. The results revealed that green field investments were the most sensitive to political instability, followed by M&As, and JVs were the least affected. This aligns with the theory of investment irreversibility and sunk costs. Greenfield investments, by their nature, involve significant upfront costs, which makes them more vulnerable to political instability. Investors in such projects are more likely to avoid countries with unstable political environments, as the potential for loss is high if political conditions deteriorate (Bekaert et al., 2014). M&As are somewhat less sensitive to political instability, likely because they involve acquiring existing assets rather than building new ones, thus reducing the upfront costs and risks. Additionally, M&As may offer more flexibility for foreign investors to navigate political risks by leveraging the local knowledge of the acquired firm (Blonigen, 2005). Finally, joint ventures (JVs) emerged as the least sensitive to political instability, with foreign investors preferring to share risks with local partners. This finding is consistent with the notion that risk-sharing and local partnerships provide a cushion against political risks, as local firms can better navigate the political landscape and act as intermediaries between the investor and the government (Moran, 2001). These findings suggest that different types of FDI require different risk mitigation strategies. Policymakers can attract more foreign investment by creating a favorable environment for JVs and M&As, as these investment types are more resilient to political instability. For green field investments, however, enhancing political stability and improving governance would be crucial to reduce investor uncertainty and encourage long-term investments.

Policy Implications

Based on the findings of this study, several key policy recommendations can be made:

1. Efforts should be made to ensure greater political stability in Pakistan. This can be achieved by promoting democratic processes, strengthening political institutions, and reducing the likelihood of political violence and regime changes.
2. Pakistan should prioritize improving its legal framework, particularly with regard to the rule of law and anti-corruption measures. Judicial reforms and transparency initiatives will play a pivotal role in attracting foreign investors who require legal certainty and protection of their investments.
3. Policies should be tailored to the specific needs of different sectors. While energy and infrastructure sectors may be more resilient to political instability, the manufacturing and services sectors require policies that reduce political risks, such as tax incentives, trade facilitation, and security guarantees.
4. The government should explore mechanisms to support green field investments, such as providing political risk insurance, offering incentives for long-term investments, and creating stability-focused investment treaties with key foreign partners.
5. Policies that encourage joint ventures and mergers & acquisitions, such as simplifying regulatory requirements and offering tax breaks for foreign investors, could help mitigate the effects of political instability.

Conclusion

This study provides compelling evidence of the negative impact of political instability on FDI inflows to Pakistan, while also highlighting the important role of governance quality, sectorial resilience, and investment types in shaping this relationship. The findings emphasize that while political instability poses a significant barrier to FDI, strategic governance reforms and targeted policies can mitigate these effects and enhance Pakistan's attractiveness as a destination for foreign investment. By focusing on political stability strengthening legal institutions, and fostering a favorable environment for risk-sharing investment types like joint ventures, Pakistan can enhance its ability to attract and retain foreign capital in an increasingly competitive global economy.

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