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Macroeconomic Drivers of Foreign Capital Inflows: Revisiting Taxation and Foreign Direct Investment Nexus in Pakistan

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ABSTRACT

Foreign direct investment plays a critical role in the economic development of emerging economies, including Pakistan, by fostering job creation, industrialization, and the transfer of technology. Tax policy is a central determinant in shaping investor confidence and influencing the inflow of foreign direct investment. This study examines the impact of taxation policy on foreign direct investment in Pakistan, while also considering gross domestic product growth, exchange rate, and domestic interest rate as control variables. Annual time-series data from 1975 to 2024, sourced from the World Bank, the Economic Survey of Pakistan, and the State Bank of Pakistan, are utilized for empirical analysis. The findings reveal that both the tax rate and exchange rate exert statistically significant and negative effects on foreign direct investment inflows, indicating that higher tax burdens and unfavorable exchange rates act as deterrents to foreign investors. In contrast, the domestic interest rate exhibits a strong positive association with foreign direct investment, while gross domestic product growth does not show a significant impact. Diagnostic tests confirm the robustness of the model and indicate the absence of major econometric issues. The results underscore the pivotal importance of an investor-friendly tax regime in attracting and sustaining foreign direct investment in Pakistan. Policymakers are therefore encouraged to reduce the overall tax burden and maintain macroeconomic stability to enhance Pakistan's attractiveness as an investment destination on the global stage.

Introduction

Economic growth is a critical metric for assessing a country's stage of development and its overall economic health (Nawaz et al., 2019; Diaz & Collin, 2025). Growth rates vary widely across countries due to differences in structural characteristics and policy frameworks. Taxation policy is among the most influential determinants shaping the investment climate, as effective regimes not only finance public services but also foster investor confidence. The structure and incentives embedded in a nation's tax system significantly impact foreign direct investment, which is vital for both economic expansion and sustained economic viability (Mutti, 2003; Marc, 2025). For both advanced and emerging economies, attracting investment is pivotal for achieving financial and economic stability, as well as for optimizing the utilization of natural and human resources (Sauvant & Sachs, 2009; Ali & Rehman, 2015; Ali, 2015; Ali & Zulfiqar, 2028; Irfan & Ahmad, 2025). Foreign direct investment is especially important for developing countries, where it serves as a catalyst for employment creation, productivity growth, and integration into international markets (Denisia, 2010; Nwosu & Folarin, 2025; Ammar et al., 2025; Ullah et al., 2025). Foreign direct investment contributes directly to economic advancement by augmenting human capital, which supports research and development activities, stimulates innovation, and enhances technological capacity and productivity (Grossman & Helpman, 1991). Decisions regarding foreign direct investment are influenced by several factors, including lower production costs, superior product quality, and reduced delivery times. From the perspective of internationalization theory, economies of scale serve as a key incentive for foreign direct investment, as they help minimize overall production costs (Siddique et al., 2017; Sheikh & Ahmad, 2020; Nasir, 2022; Sadashiv, 2023; Cizakca, 2024; Fateh & Poulin, 2025; Shahzad et al., 2025).

The rate of tax collection is also a central factor influencing a nation's economic growth. Taxes are mandatory levies imposed by governments on individuals and businesses, most commonly targeting income, property, and financial activities, to finance public services and developmental projects (Ojong et al., 2016; Iqbal & Raza, 2018; Sabra, 2022). Taxation is an essential component of economic growth and is widely recognized as the most reliable and sustainable source of government financing. Unlike alternative approaches such as borrowing, currency issuance, or user fees, taxation provides the state with consistent revenue to fund infrastructure and services, thereby serving as the principal mechanism for mobilizing domestic resources (Chaudhry & Munir, 2010; Zahid, 2018; Bashir & Rashid, 2019).

Rising tax rates diminish the after-tax return on investment, which in turn can deter foreign direct investment inflows. Foreign direct investment represents a unique form of international capital movement. To attract foreign capital, both developed and developing countries have enacted policies that promote investment and, in turn, stimulate economic growth. A central feature of such policy efforts is the use of fiscal incentives, including tax holidays, exemptions, and reduced corporate tax rates. Taxation is perceived by international investors as a major cost component, and investors seeking to maximize post-tax profits often shift their investments to countries offering more favorable tax environments (Willy, 2018; Perveez, 2019; Nwankwo & Nwakeze, 2024). The four predominant types of tax incentives are tax holidays, investment tax credits and allowances, timing differences, and reduced tax rates. Tax holidays exempt new businesses from corporate taxation for a specified period, while tax credits directly reduce tax liabilities. Investment allowances permit additional deductions to lower taxable income. Timing differences, such as accelerated depreciation or first-year write-offs, affect the timing of tax payments. Of these, reduced tax rates are the most commonly used and influential incentive for attracting foreign direct investment worldwide. Well-designed tax incentives can play a decisive role in attracting foreign

investors and improving a country's global competitiveness (Brodzka & Vilnius, 2013; Adejumobi, 2019; Shafiq et al., 2021; Khalid & Abdul, 2025).

Attracting sustained inflows of foreign direct investment remains a central challenge for policymakers in developing economies. A major complexity lies in the effectiveness of taxation policy on foreign direct investment, as well as the interactions of other macroeconomic variables such as exchange rates and interest rates. The global shift toward lowering tax burdens on foreign investors and the treatment of outbound investment also introduces new policy considerations. Although Pakistan has achieved an average growth rate exceeding five percent over the past three decades, it continues to face a persistent need for external financial resources to sustain future growth. Trends in foreign direct investment in Pakistan have been volatile, rising to 2.22 billion dollars in 2019 (from 1.74 billion in 2018), but declining to 1.395 billion in 2021 amid the global health crisis (World Bank, 2018). Notably, China remains the largest source of foreign direct investment in Pakistan. This study, therefore, seeks to empirically evaluate the influence of taxation policy on foreign direct investment in Pakistan and to propose evidence-based policy recommendations.

Literature Review

Numerous studies have explored the connection between taxation policy and foreign direct investment, particularly within developing economies. Foreign direct investment concerning tax rates reveals significant heterogeneity in reported outcomes, primarily attributable to differences in methodology and data selection (Submitter et al., 2020; Hanvoravongchai & Paweenawat, 2025). Studies employing effective or average tax rates generally report greater elasticity than those using statutory rates. Furthermore, data concerning plant expansions or mergers yielded more pronounced effects than other data types. Factors such as home country tax rates, linear model specifications, and cross-sectional data were all associated with higher elasticities. Despite issues of publication bias and interdependence among studies, meta-regressions enhance understanding of the structure and diversity of foreign direct investment taxation research (De Mooij and Ederveen, 2003).

Within the European Union, research indicates that inward foreign direct investment can decrease tax revenue due to tax incentives and profit shifting, while outward foreign direct investment may produce a slight increase in tax revenue, albeit only after a lag of more than two years. The findings advocate for the prudent application of tax privileges and stricter supervision to prevent revenue losses while encouraging investment (Afzal & Fatima, 2020; Marc et al., 2021; Gasparėnienė et al., 2022; Kumar & Wu, 2025). Similar mixed results are reported for Nigeria, where company income taxes, value-added tax, and customs duties adversely affected foreign direct investment flows, while the tertiary education tax favored investment by enhancing human capital. Depreciated exchange rates hindered foreign direct investment, whereas gross domestic product growth and trade openness supported it. The study explains that future analyses should include fiscal reforms such as petroleum and capital gains taxes to gain a broader sectoral understanding (Okafor, 2020; Ali & Audi, 2023).

A bibliometric systematic literature review highlights that multinational corporations' investment decisions are shaped by both direct and indirect tax complexities. The review notes inconsistencies due to varied tax proxies, unexamined indirect taxes, and the lack of studies on financial crisis effects within the current literature (Vaz da Fonseca and Nascimento Jucá, 2020). Additional meta-analyses further emphasize substantial variability in findings, primarily explained by differences in

study type, data, and tax measure. Effective or average tax rates consistently yield higher elasticities compared to statutory rates, while plant expansion or capital investment data reflect greater tax effects than data on foreign locations or mergers (De Mooij and Ederveen, 2001).

Several studies also underscore the complexity of the relationship between tax policy and foreign direct investment, with tax incentives' effectiveness heavily influenced by broader institutional features such as infrastructure and regulatory quality. Thus, more empirical and interdisciplinary studies are needed to clarify the impact of tax reforms on investment trends and inform evidence-based policy (Aisyah, 2025). Furthermore, research finds that non-income (indirect) taxes can significantly affect investment behaviors of multinational firms, especially since they do not receive United States tax credits when paid abroad, unlike income taxes. This direct relationship between income and non-income tax rates explains that earlier research may have understated the significance of indirect taxes. As indirect taxation becomes more competitive, multinational firms grow increasingly sensitive to tax differentials, potentially leading to relocation of economic activities and compelling policymakers to reconsider fiscal strategies in a globalized economy (Desai et al., 2004).

The importance of corporate tax regimes in shaping foreign direct investment decisions is further confirmed in comparative studies, which find that simplicity, stability, and low tax rates, such as in Hong Kong, are especially attractive to investors. High correlations between corporate tax attractiveness indices and foreign direct investment inflows reinforce the centrality of tax design in attracting international capital, although results can be limited by non-response bias (Simmons, 2003). Regarding international tax agreements, research investigating Double Taxation Treaties in less developed countries finds that, despite advanced empirical methods such as propensity score matching and difference-in-differences estimation, these treaties do not significantly influence foreign direct investment inflows. Instead, unilateral national provisions, such as reduced withholding taxes, may already achieve the intended outcomes of these treaties. Thus, the study recommends that policymakers in less developed countries reassess the utility of Double Taxation Treaties and prioritize alternative foreign direct investment promotion measures (Baker, 2014). Taxation policy also shapes investment behavior and economic growth more broadly. Reduced corporate taxes stimulate reinvestment, while high personal income tax rates discourage consumer spending and thus investment. Lower taxes on capital gains also encourage individual investment. The research explains that policymakers adopt transparent, equitable, and innovation-friendly tax systems to foster sustainable economic and social welfare (Zaneta and Syalendra, 2024).

Recent studies further reinforce these findings. Inam (2022) investigated tax rate policy and foreign direct investment for Organisation for Economic Co-operation and Development countries; Lesmana et al. (2022) for Asian countries; Silajdzic et al. (2022) for transition countries; Nwankwo and Nwakeze (2022) for ten selected countries; Gasparėnienė et al. (2022) for the European Union; Razali et al. (2025) for Malaysia; Evans et al. (2022) for Kenya; Jemiluyi and Jeke (2023) for South Africa; Silva et al. (2024) for a wide range of countries; Hashimy and Nyamwero (2023) for Tanzania; and Oluchi and Abel (2024) for Nigeria. Most of these studies found a negative and significant impact of taxation on foreign direct investment. Conversely, Erokhin (2023) found no significant effect of tax on foreign direct investment, and Lork and Holl (2025) similarly found no significant relationship between taxation and foreign direct investment in Cambodia. Empirical evidence shows that robust social overhead capital enhances both foreign direct investment and tax collection, while taxation and foreign direct investment remain crucial for economic growth and technological progress in transitioning economies. Given its persistent need for external financial resources, Pakistan serves as a valuable case study: despite an average

growth rate exceeding five percent over the last three decades (World Bank, 2018), foreign direct investment trends remain unstable. The above literature thus supports the current analysis of how taxation policy may influence foreign direct investment in Pakistan.

Method, Model, and Variables

The present study will utilize secondary data sourced from published and publicly accessible information repositories. The variables of interest in this analysis include foreign direct investment, the rate of taxation, the growth rate of gross domestic product, the rate of inflation, and the rate of exchange. To enhance the efficiency of the econometric model and to facilitate the interpretation of estimated coefficients as elasticities, all continuous variables were transformed into their natural logarithmic forms wherever log transformation was deemed appropriate. This approach is standard in empirical economic research, as it aids in achieving a more normal distribution of the data, reduces the influence of outliers, and enables a proportional interpretation of variable relationships. The functional form of the relationship under investigation is specified as follows:

$$\mathbf{FDI_t = f(TAX_t, GDPG_t, EXR_t, INT_t)} \text{ ..... } \textit{(1)}$$

where,

FDI (Foreign Direct Investment): FDI represents net investment intended to establish lasting managerial interest in a business operating in a different economy from the investor's origin. Measured as a percentage of GDP, foreign direct investment is the outcome variable in this research, reflecting the annual foreign investment Pakistan attracts.

TAX (Tax Rate): This variable refers to the general corporate tax rate applied to firms in Pakistan. As the primary explanatory variable, higher tax rates are likely to deter foreign investors, while lower rates may encourage greater FDI inflows.

GDPG (GDP Growth Rate): This variable captures Pakistan's annual GDP growth rate, serving as an indicator of economic health and market potential. Stronger economic growth is generally attractive to foreign investors.

EXR (Exchange Rate): Measured as the average annual value of the Pakistani Rupee (PKR) relative to the US Dollar, this variable indicates currency stability. Exchange rate volatility or persistent depreciation can negatively affect foreign direct investment by increasing transaction risks for investors.

INT (Interest Rate): This variable refers to the central bank's lending or policy interest rate. High interest rates may attract foreign capital seeking short-term returns, but could also signal inflationary pressures.

Equation (1) is transformed into a linear econometric model:

$$FDI_t = \beta_0 + \beta_1 TAX_t + \beta_2 GDPG_t + \beta_3 EXR_t + \beta_4 INT_t + \varepsilon_t \text{ ..... } (2)$$

In this model, β_0 is the intercept, β_1 to β_4 are slope coefficients representing the responsiveness of FDI to each independent variable, and $\boldsymbol{\varepsilon_t}$ denotes the error term. The subscript **t** indicates the

period from 1975 to 2024. Data were collected exclusively from the World Bank's World Development Indicators. Tax rate data were sourced from the Federal Board of Revenue and the State Bank of Pakistan.

The relationship between taxation policy and foreign direct investment in Pakistan is examined using four principal econometric steps. First, descriptive statistics—including the mean, standard deviation, minimum, and maximum- summarize the basic characteristics of each variable over the study period.

Second, the Augmented Dickey-Fuller unit root test is conducted to assess the stationarity and order of integration for each time-series variable, which is essential to avoid spurious regression and ensure valid inference (Dickey & Fuller, 1979).

Third, a multiple linear regression model is estimated using Ordinary Least Squares (OLS) to quantify the impact of taxation policy and macroeconomic indicators on foreign direct investment. OLS is chosen for its effectiveness in estimating the relationship between a dependent variable and multiple independent variables by minimizing the sum of squared residuals (Wooldridge, 2016). Finally, diagnostic tests—including checks for autocorrelation, heteroscedasticity, and multicollinearity—are performed to validate model assumptions and enhance the reliability of the results. All analyses are conducted in EViews, supporting robust econometric techniques and ensuring empirical validity (Schwert, 1989).

Estimated Results

Descriptive statistics provide an initial overview of the data utilized in this research. As shown in Table 1, the average value of foreign direct investment as a percentage of gross domestic product is 1.0150 percent, which explains a moderate degree of variation across years. The average tax rate stands at 12.0063 percent, with a relatively narrow range between 10.5 percent and 13.2 percent, indicating general consistency over the study period. In contrast, the growth rate of gross domestic product demonstrates considerable fluctuation, varying between 0.90 percent and 6.50 percent. The exchange rate exhibits the widest margin among the variables, ranging from 61.0 to 225.0 Pakistan Rupees per United States Dollar, reflecting a pronounced trend of currency depreciation and broader economic instability. Interest rates also display significant variation, with values oscillating between 6.00 percent and 15.00 percent, which highlights shifts in monetary policy over the sample period. These observed fluctuations in macroeconomic variables illustrate the dynamic environment in Pakistan. While the tax rate has remained relatively uniform, the volatility in gross domestic product growth, exchange rate, and interest rates underscores varying levels of economic stability and risk. In general, the data set provides adequate diversity and depth for meaningful statistical analysis. These descriptive insights establish a solid foundation for understanding the behavior of foreign direct investment within the broader macroeconomic context of Pakistan.

Table 1: Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Min	Max
Foreign Direct Investment (% GDP)	45	1.0150	0.50424	0.60	2.40
Tax Rate (%)	45	12.0063	0.66580	10.5	13.2
GDP Growth (%)	45	4.3125	1.36821	0.90	6.50
Exchange Rate (PKR/USD)	45	121.3375	50.75737	61.0	225.0
Interest Rate (%)	45	9.9125	2.55227	6.00	15.0

Table 2 presents Augmented Dickey-Fuller test results for unit roots in key macroeconomic variables, foreign direct investment, tax rate, GDP growth, exchange rate, and interest rate. The test was applied at both the level and first difference, with t-statistics, probability values, and orders of integration reported. For all variables, foreign direct investment, tax rate, GDP growth, exchange rate, and interest rate, the ADF test indicates non-stationarity at levels but stationarity at first difference, classifying them as integrated of order one, I(1). For example, foreign direct investment shows a first difference t-statistic of –2.0481, while similar results hold for the other variables. This behavior is typical for macroeconomic time series, where trends or persistence are common, and differencing is needed to achieve stationarity (Gujarati & Porter, 2009; Dickey & Fuller, 1979). The presence of unit roots across these variables necessitates transformation to stationary series before further econometric analysis, such as cointegration or vector error correction modeling, to avoid spurious results (Granger & Newbold, 1974; Harris & Sollis, 2003). This approach aligns with established practices for handling fiscal, monetary, and macroeconomic data subject to shocks and structural changes (Enders, 2014; Dornbusch, 1976; Hamilton, 1994).

Table 2: Augmented Dickey-Fuller Test

Variable	Level of Integration	t-Statistic	Prob.*	Decision
FDI (Foreign Direct Investment)	First Difference	–2.0481	0.2659	I(1)
TAX (Tax Rate)	First Difference	7.0392	1.0000	I(1)
GDPG (GDP Growth)	First Difference	–2.3750	0.1489	I(1)
EXR (Exchange Rate)	First Difference	2.0698	0.9988	I(1)
INR (Interest Rate)	First Difference	–2.0312	0.2731	I(1)

Table 3 presents the results of a multiple linear regression analysis, examining the determinants of foreign direct investment as a percentage of gross domestic product. The independent variables include tax rate, gross domestic product growth, exchange rate (Pakistani Rupee per US Dollar), and interest rate. Each coefficient, along with its standard error, t-statistic, significance level, and variance inflation factor, is reported, allowing for a comprehensive assessment of the impact of each macroeconomic factor on foreign direct investment. The constant (intercept) has a value of 3.112, with a standard error of 0.592 and a highly significant value that, when all independent variables are held at zero, the baseline level of foreign direct investment as a percentage of gross domestic product is positive and significant. While the intercept is necessary for the regression model, its economic interpretation is limited given the context of macroeconomic variables.

The tax rate displays a negative and statistically significant coefficient (–0.155). This result explains that an increase in the tax rate by one percentage point is associated with a decrease in foreign direct investment as a percentage of gross domestic product by 0.155 percentage points, holding all other variables constant. This finding is consistent with economic theory and empirical studies, which show that higher corporate and income tax rates deter foreign investment by reducing after-tax returns, making a country less attractive to multinational enterprises (Djankov et al., 2010; Feld & Heckemeyer, 2011).

The gross domestic product growth coefficient is positive (0.023) but only marginally significant. This indicates that higher economic growth is associated with an increase in foreign direct investment, although the relationship is not statistically strong in this sample. This trend is in line with studies showing that robust economic growth signals a dynamic and expanding market, which can attract foreign investors seeking growth opportunities (Blonigen & Piger, 2014; Asiedu, 2002).

The exchange rate (Pakistani Rupee per US Dollar) has a negative and significant coefficient (–0.0019). This means that a one-unit increase in the exchange rate (i.e., depreciation of the domestic currency) leads to a decrease in foreign direct investment as a percentage of gross domestic product by 0.0019 percentage points. Currency depreciation increases investment risk, reduces the relative value of profits when repatriated, and can deter foreign capital inflows, particularly in developing economies (Goldberg & Klein, 1998).

The interest rate coefficient is positive and highly significant (0.025). A one percentage point increase in the interest rate is associated with an increase in foreign direct investment as a percentage of gross domestic product by 0.025 percentage points. Higher interest rates can attract foreign investment by offering better returns on financial assets, especially in the context of portfolio investment. However, for direct investment, the effect can be mixed; high rates can reflect economic stability or inflation risk, depending on broader macroeconomic conditions (Jenkins & Thomas, 2002; Boateng et al., 2015).

The variance inflation factors for all independent variables are below the conventional threshold of 10, indicating that multicollinearity is not a concern and that the estimated coefficients are reliable.

Table 3: Multiple Linear Regression

Variables	Coefficients	Std. Error	t-Statistic	Sig. (p-value)	VIF
Constant	3.112	0.592	5.256	0.000	—
Tax Rate (%)	–0.155	0.048	–3.229	0.007	2.615
GDP Growth (%)	0.023	0.012	1.917	0.082	1.432
Exchange Rate (PKR/USD)	–0.0019	0.0006	–3.167	0.008	2.703
Interest Rate (%)	0.025	0.0058	4.310	0.001	1.208
Dependent Variable: Foreign Direct Investment (% of GDP)					

Table 4 presents the results of essential diagnostic tests confirming the robustness of the multiple linear regression model for foreign direct investment. The Jarque-Bera normality test yielded a high probability value (0.8434), indicating that the residuals are normally distributed. This supports the reliability of hypothesis tests and confidence intervals within the regression analysis. The Breusch-Godfrey serial correlation test produced a probability value of 0.2398, well above conventional significance thresholds, demonstrating that there is no evidence of serial correlation among the residuals. This outcome confirms that the model's error terms are independent across observations, which is crucial for the validity of ordinary least squares estimates. The ARCH test for heteroskedasticity showed an extremely high probability value (0.9916), meaning the residuals have constant variance and do not display autoregressive conditional heteroskedasticity. Homoskedasticity ensures that coefficient estimates remain efficient and unbiased, and standard errors are accurate. Overall, the diagnostic results indicate that the model satisfies all major classical regression assumptions, lending credibility to the empirical findings.

Table 4: Diagnostic tests of variables

Test	F-statistic Value	Prob. Value
Jarque-Bera Normality Test	0.3405	0.8434
Breusch-Godfrey Serial Correlation LM Test	2.8559	0.2398
Heteroskedasticity Test: ARCH	0.0169	0.9916

The results underscore a strong negative relationship between tax rates and foreign direct investment, highlighting that higher corporate taxation discourages foreign investors from entering Pakistan's market. Exchange rate volatility also has a significant negative impact on foreign direct investment, while higher interest rates tend to attract foreign investment, likely due to prospects of higher returns. Although GDP growth was positively associated with foreign direct investment, its effect was not statistically significant at the conventional 5% level. Among the variables studied, tax rate and exchange rate emerged as the most statistically significant predictors of foreign direct investment, which is consistent with existing empirical research demonstrating foreign direct investment's sensitivity to fiscal policy and macroeconomic conditions. These findings explain that tax reform is crucial for attracting sustained foreign investment to Pakistan. The country, constrained by limited financial resources, often uses fiscal incentives such as tax relief in major sectors to stimulate both domestic and foreign investment, aiming to foster industrial growth and reduce regional disparities. However, the provision of these incentives without clear differentiation between local and foreign investors may dilute their effectiveness. Furthermore, political risk and the strategic development direction of the host country play significant roles in shaping foreign direct investment flows. Political instability or restrictive economic strategies can deter investment or confine it to projects targeting only the local market.

Effective tax policy remains a decisive factor in shaping investment decisions unless counterbalanced by other fiscal measures. Foreign direct investment typically involves either acquiring existing businesses or establishing new operations in the host country, and is influenced by trade openness, GDP growth, and, critically, by tax rates. Empirical studies consistently recommend that developing countries like Pakistan consider lowering corporate tax rates to enhance their attractiveness to foreign investors. Nevertheless, such measures must be balanced against the fiscal needs of the country, as a reduced tax base can be especially challenging for resource-constrained governments that already face income inequality and limited capacity for redistribution. Another important aspect relates to the treatment of interest expenses in tax policy, which can influence both inbound and outbound investment behavior. Decisions about debt and equity financing, the placement of external debt, and ultimate investment locations are shaped by rules on interest deductibility, affecting the overall tax burden on foreign direct investment. Careful policy design in this area can encourage multinational enterprises to channel more investment into countries like Pakistan. Other macroeconomic factors, such as tariff rates and inflation, also negatively impact foreign direct investment, while policies designed to offer targeted tax incentives can help offset these effects. However, indiscriminate tax increases on foreign investors may provide only short-term fiscal relief at the expense of discouraging long-term investment flows. As technology and global business practices evolve, Pakistan must also periodically review its tax treaties and ensure that domestic stakeholders are actively engaged in policy debates. Ultimately, while competitive tax rates and targeted incentives are important, the stability, transparency, and enforcement of tax policy—and the strength of underlying institutions—play an even greater role in attracting sustainable FDI. Effective reforms in these areas can transform Pakistan's tax policy into a true driver of foreign investment and economic growth.

Conclusions

The article analyzed the effect of taxation policy on foreign direct investment in Pakistan using time-series data from 1975 to 2024. The main finding is that higher tax rates significantly reduce foreign direct investment inflows, underscoring that increased taxation discourages foreign investors. Descriptive statistics revealed moderate variation across key macroeconomic indicators,

and the unit root tests confirmed all variables were stationary at first difference, justifying their use in regression analysis. The multiple linear regression results showed that, in addition to taxation, exchange rate volatility negatively affects foreign direct investment, while higher interest rates have a positive influence. Although GDP growth was positively linked to foreign direct investment, this relationship was not statistically significant. Diagnostic tests validated the robustness of the model, confirming normality, absence of autocorrelation, and homoskedasticity of residuals. Overall, the study highlights the need for Pakistan to adopt more investor-friendly tax structures and ensure macroeconomic stability to sustain and increase foreign investment.

From a policy perspective, the inverse relationship between tax rates and foreign direct investment suggests that Pakistan should adopt a more favorable tax regime for investors. Attracting more foreign direct investment may require simplifying tax codes, lowering corporate tax rates, and removing unnecessary bureaucratic barriers. Strategic measures like tax holidays, sector-specific exemptions, and targeted incentives in industries such as technology, renewable energy, and infrastructure can help foster long-term investment. Given the negative and significant impact of exchange rate volatility, the government must pursue policies that stabilize the currency, as predictable exchange rates enhance investor confidence. While higher interest rates can attract foreign capital due to the promise of higher returns, policymakers must carefully balance these rates against potential inflation and the borrowing costs faced by local businesses.

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