Assessing the Role of Foreign Direct Investment in Poverty Alleviation: Insights from Pakistan

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https://doi.org/10.62345/jads.2024.13.2.110

Abstract

This research paper aims to help national policymakers understand the dynamics involved in the importance of foreign direct investment in poverty alleviation and thus formulate policies to attract FDI, utilizing time series data from 1990 to 2023. The study considers foreign direct investment (FDI), education, unemployment, and inflation as vital explanatory variables affecting poverty levels. Johnson's co-integration technique explored the long-term relationship between these variables and the poverty-ganger-cause test to determine whether one time series can predict another. Comprehensive research analysis, empirical evidence, and practical recommendations provide a solid foundation for policymakers, researchers, and development practitioners aiming to reduce poverty and foster economic growth in the country. The findings reveal significant long-term relationships between poverty and the independent variables: education, FDI, inflation, and unemployment. Specifically, education and inflation positively impact poverty, while FDI and unemployment have negative impacts. Notably, poverty does not cause FDI, nor does FDI cause poverty, as evidenced by p-values of 0.2996 and 0.4228, respectively. The study underscores the significant impact of FDI, inflation, and education on poverty. It highlights that foreign investment often displaces small local businesses, increasing unemployment and poverty. Therefore, the study recommends that the government implement robust policies and establish a monitoring team to curb corruption across all economic sectors. Furthermore, it suggests that the government should enforce financially solid policies, improve law and order, support small and medium enterprises, and urgently address the energy crisis to boost business opportunities and reduce poverty in Pakistan.

Keywords: Foreign Direct Investment, Poverty, Inflation, Unemployment

Introduction

Foreign inflows play an essential role in a country's development. Emerging and developed economies, too, required foreign inflows to run their economies. As time passes, low-developed nations rely more and more on foreign inflows because their growth is entirely based on grants from other nations. If the host country fails to contribute to and spend these inflows appropriately, it could negatively impact its country as a result: there is an increase in poverty and unemployment, and there is less investment in human capital in the country (Ali & Nishat, 2009).

Establishing a state during the conclusion of Global War II, 1939–1945, initiated the advancement of foreign direct investment (FDI) (Ahmad et al., 2019). Advanced nations focus on developing

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Compliance with ethical standards: There are no conflicts of interest (financial or non-financial). This study did not receive any funding.

economies, and foreign direct investment trends move towards these countries on a bureaucratic basis rather than on financial and social motives (Khan et al., 2019). The foreign direct investment inflows divert to nations that support the investors from abroad and give them financial assets and motivation. The primary goal of developing countries is to improve the state's estates and reduce poverty (Khan et al., 2019).

Foreign investment explains the behavior of overseas investors who invest in another country for business reasons (Chen, 2019). The potential gains of outside investment are:

- Career formation.
- The achievement of fresh machinery and education.
- The growth of the workforce through international competition.
- Increased tax income through FDI.

If a nation aims to achieve better outcomes in poverty reduction through FDI, the economic and political conditions must be favorable due to unemployment. FDI plays a crucial role in directly reducing poverty. When investors hire workers and offer them wages above the poverty line, it lessens the impact of poverty, thereby increasing investment. Conversely, if the investors set their wages below the poverty line, the effects of poverty reduction would be negligible. After all, wages bring people into poverty and do not help them to escape it (Moatari & Gaskari, 2016).

Pakistan, a developing economy, is grappling with severe issues, including poverty, with one-third of its population living below the poverty line due to factors such as a lack of education, essential social services, and health care, among others (United Nations Development Program, 2008). As in Pakistan, there needs to be more political stability and disappointing law-and-order conditions. Due to these factors, most investors are hesitant to invest here. The inappropriate policies and decline in economic activities discourage domestic investors, and there is a notable decrease in their participation in business (Rafi & Hussain, 2013).

In Pakistan, people view foreign investment as a crucial element of financial advancement and poverty alleviation. Outward investment may have effectively impacted poverty alleviation by three means: one is the tax income that the government receives from foreign investors, which removes poverty. The second factor, per capita income, plays a crucial role in reducing poverty, while foreign direct investment firms, based on their domestic countries and gross domestic product, contribute significantly to technological innovation and knowledge enhancement (Javorcik, 2004; Rafi & Hussain, 2013). In Pakistan, the quality of life has remained the same, and the average salary is insufficient to support a family due to inflation and rising food and transportation costs. However, most FDI comes from food industries in Pakistan, and their high prices create inflation (Finance Division, 2021). Mostly, Pakistani people are illiterate; they do not know any better way of earning money. As a result, people with low incomes remain poor (Farooq, 2018).

Pakistan is a developing economy with severe problems; one of these problems is poverty, with one-third of its people living below the poverty line. Factors such as a lack of water supply, credit availability, essential social services, health care, and many others contribute to poverty (United Nations Development Programme, UNDP 2008; Rafi & Hussain, 2013). According to the World Bank, Pakistan attracted $2.6 billion in FDI in 2020, a significant increase from $1.9 billion in 2019. Despite this, the country still faces high poverty rates, indicating the complex relationship between FDI and poverty alleviation. Similarly, approximately 24.3% of Pakistan’s lives below the national poverty line as of 2021. This highlights the urgent need for effective poverty reduction strategies. In Pakistan, there is a lack of political stability and disappointing law and order conditions, so most investors are frightened to invest here because of this. The inappropriate policies and decline in economic activities discourage foreign investors, and there is a notable decrease in their participation in business. So, this research paper studies the current scenario of foreign direct investment and poverty in Pakistan. It explains the role of FDI in poverty in Pakistan and analyses the causal relationship between FDI and poverty.

Literature Review

The existing literature clearly conceptualizes FDI and poverty. Poverty results from deprivation and a lack of life's fun life's needs. By this definition, the majority of people in Pakistan are poor and unable to ensure these basic needs (Aminu et al., 2018).

According to Adelowokan et al. (2023), poverty reduction in human capacity development was the variable that increased job creation and FDI entries in the Economic Community of West African States (ECOWAS) sub-region in the previous 30 years. Adelowokan et al. (2023) recommended that policymakers prioritize employment generation to boost FDI inflows and reduce poverty in the region. Similarly, Nkoro and Uko (2023) found that FDI positively affects economic growth and contributes to poverty reduction. Haruna et al. (2022) also believe that FDI has positive and negative shocks, which reduce poverty considerably in the long and short term. FDI inflows increase economic growth, create employment, transfer new technology, and reduce poverty.

Do et al. (2021) highlighted that FDI has contributed to declining poverty. Saleem et al. (2021) investigated the bidirectional causality between poverty and FDI and concluded that the causal effects of FDI on poverty reduction are stronger than poverty depletion impacts on FDI. Similarly, Khan *et al*. (2019) highlighted the link between investing abroad and lowering poverty in Pakistan. They established a two-way causal relationship between overseas investment and poverty alleviation. Through their study, Abiodun *et al*. (2018) demonstrated that foreign direct investment is a fundamental tool for reducing poverty in Nigeria.

Faridi et al. (2019) found that foreign inflows are very valuable for an open economy. Foreign inflows have a strong influence on the economic condition of the host state, and there is a prolonged association and causality between external outward inflows and poverty. Furthermore, FDI has a significant effect on poverty, as one unit of FDI raises poverty to 71.07 units.

Quinonez et al. (2018) concluded that there is no positive correlation between outward investment and poverty depletion in the region. On the other hand, the region's education positively correlates with macroeconomic stability, infrastructure, and human capital development.

Poverty has become a significant issue in developing countries such as Pakistan. Many researchers conducted qualitative analysis; many focused on quantitative analysis, using panel data from developing countries; and some conducted comparative analysis. However, a need remains to elucidate the comprehensive framework and conduct additional practical research using clearly defined variables, current data, and factors contributing to poverty. Therefore, the primary focus of this research is to examine the role of Foreign Direct Investment (FDI) in poverty depletion in the context of Pakistan from 1990 to 2023 and to explain the current state of FDI and poverty in Pakistan.

Research Methodology

The concept of poverty is multidimensional. The multidimensional poverty index (MPI) is derived from the household level. The Multidimensional Poverty Index (MPI) considers the negative impact of various forms of poverty, particularly severe deprivation, by calculating the average of each distinct deprivation across the nation. Identifying impoverished individuals is the first step in estimating poverty. In the multidimensional poverty process, a poor person is known by what is termed the twin procedure: the first dimension includes the cutoff method (like falling under a paucity line such as $1.25 per day if wealth poverty were being inscribed), and the second is the cutoff of the number of measurements in which a human must be needy (under the line) to be considered unidimensional poor. In applied analysis, poverty is defined by three aspects (health, education, and living standards).

Macroeconomic indexes of an economy are known as the significant factors in net foreign investment inflows and poverty in a country. The analysis of the theoretical rationale and existing literature also provides a basis for choosing the right mixture of fixed variables to explain the variation in foreign

investment flows and poverty trends in the country. The study applies the Johnson co-integration test to detect the exposure variables of FDI inflow in the country and the role of FDI in poverty in Pakistan (Khan & Mitra, 2014).

The variables of interest in this study were poverty, foreign direct investment, inflation rate, education, and unemployment rate. We collected the data from the World Development Indicators (WDI) and the Pakistan Economic Survey. To find out the role of foreign investment in poverty in Pakistan with some additional explanatory variables, the following econometric model is used:

$$POV_t = \beta 0 + \beta 1\ FDI_t + \beta 2 INFR_t + \beta 3\ Edu_t + \beta 4 UR_t + \mathcal{E}_t$$

$$\Delta \boldsymbol{POV} = \boldsymbol{B}_0 + \sum^{n} \boldsymbol{B}_1 \Delta \boldsymbol{FDI}_{\ I=1} + \sum^{n} \mathbf{B}_2 \Delta \mathbf{INFR}_{\ I=1} + \sum^{n} \boldsymbol{B}_3 \Delta \boldsymbol{EDU}_{\ I=1} + + \sum^{n} \boldsymbol{B}_4 \Delta \boldsymbol{UR}\ \boldsymbol{t}_{\ I+1} = \mathbf{1} + \mu$$

Where;

POV=Poverty headcount ratio

FDI=Foreign direct investment in million-dollars

INFR=Inflation rate measured in percentage

EDU= Literacy rate in percentage

UR= Unemployment rate in percentage

$\mathcal{E}t$ = Error Term

βo = Intercept term

β1,β2,β3…….β4 is the coefficient of independent variable.

Findings and Discussion

In time series analysis, the stationarity test has its significance in avoiding the unit root problem. It is too sure mandatory to choose a suitable approximation method for assessing the econometric models that describe the long-time association among the response and explanatory variables. The majority of factual work focused on time series data; we suppose that the underlying time series is stationary. A time series is called stationary if its mean, variance and (at variance lag) hold on the same, no worries about what site we estimate them, they are time constant (Shamim et al., 2014).

Before applying the Johnson technique of time series data, the order of integration is checked. Therefore, the Johnson co-integration certifies whether all variables are consolidated of order 1(I) at first difference or mutually integrated. However, the integration of order between variables at the second difference is not acceptable because it leads to inefficient results. For this motive, the Augmented Dickey fuller (ADF) test is used to test the order of integration. The result is shown in Table 1, where all the variables that are education, poverty, FDI, inflation, and unemployment are at the first difference and use five 5 per cent level of significance. Therefore, the result is obtained from the ADF test which fulfils the assumptions of the Johnson model to evaluate the long and short-period connection among the variables under analysis.

In table 1 below, the ADF Test value of the first variable poverty is 3.909125 and its critical value is - 3.58023 which is less than the ADF value the rule is that the ADF test value will be larger than the critical value and the degree of integration is order I(1). The second variable Education ADF test value is -6.377927 and its critical value is -3.580623 which is less than the ADF value. The third variable FDI its ADF test value is 3.605903 and the critical value is -3.580623 and integrated in order I(1). The variable inflation (INFR) ADF test value is -7.44163 and the critical is -3.580623 which is less than the ADF value. The variable Unemployment rate (UR) ADF test value is -5.937413 and the critical value is -3.580623 which is less than the ADF test value. All the variables are integrated in order one and used a 5% level of confidence interval.

Table 1: Results of ADF test for stationarity

Variables	ADF Test values	Critical	Order of integration
POV	3.909125	-3.580623	I (1)
EDU	-6.377927	-3.580623	I (1)
FDI	3.605903	-3.580623	I (1)
INFR	-7.44163	-3.580623	l (1)
UR	-5.937413	-3.580623	I (1)

Source: Results obtained by analyzing data through E-views 10 (x64)

The second step is to choose the maximum lag order by applying the Akaike information criterion and Schwarz information criterion (SIC) through vector Autoregressive (VAR) estimation. The variables are taken in lag 1 and 2 which is given below in table 2.

Table 2: Lag order used in the model

Lag	Log L	LR	FPE	AIC	SC	HQ
	-981.2562	NA	1.70e+23	70.51830	70.80377	70.60557
1	-788.2817	289.4618	2.45e+18	59.30583	61.30414*	59.91674
2	-728.3794	64.18100*	6.61e+17*	57.59853*	61.30967	58.73306*

Source: result obtained through E-Views 10(x64)

* indicates lag order selected by the criterion
LR: sequential modified LR test statistic (each test at 5% level)
FPE: Final prediction error
AIC: Akaike information criterion
SC: Schwarz information criterion
HQ: Hannan-Quinn information criterion

Table 2 shows that the lag order selection criteria for the poverty model range from lag zero to lag two. The greatest number of lag order selection criteria suggests two lags.

Table 3: Johnson Cointegration Model

Cointegrating Eq:	CointEq1
POV(-1)	1.000000
EDU(-1)	1.959011
	(0.13754)
	[14.2428]
FDI(-1)	-6.12E-09
	(1.3E-09)
	[-4.72780]
INFR(-1)	2.319008
	(0.41570)
	[5.57853]
UR(-1)	-4.822826
	(1.95530)
	[-2.46654]
C	-179.7428

Source: result obtained through E-Views 10(x64)

In table 3 it is shown that the co-efficient of explanatory variables education is 1.959011 is means that for every unit increase in the level of education, poverty is expected to increase by 1.9590 per cent. Its T-value is 14.2428, which is greater than 2 and is statistically significant. The coefficient of the explanatory variable FDI is -6.12. It means that for every unit increase in the level of FDI, POV is expected to decrease by 6.12 E-09 units, holding other factors constant.
With a t-statistic of -4.72780, the coefficient is significant, but the impact of FDI is extremely small due to its magnitude. The coefficient of explanatory variable inflation is 2.319008 which means that for every unit increase in INFR, POV is expected to increase by 2.319008 units, holding other factors constant. Its T value is 5.57853, which is greater than 2, so it is shown that it is statistically significant and theoretically, it has a positive relationship. The coefficient of explanatory variable unemployment is -4.822826 which means for every unit increase in UR, POV is expected to decrease by 4.822826 units, holding other factors constant. Its t-value is - 2.46654, which is greater than 2, which shows it is statistically significant.
The results suggest significant long-term relationships between POV and the independent variables (EDU, FDI, INFR, and UR). EDU and INFR have a positive impact on POV, while FDI and UR have a negative impact. The t-statistics indicate that these relationships are statistically significant.

Diagnostic Tests

There is no autocorrelation because autocorrelation exists in non-stationary data but there is a condition for Johansson co-integration test that the data is converted from non-stationary to stationary. So, if we convert this from non-stationary to stationary the autocorrelation is removed automatically. There is no Heteroskedasticity found in the model because the heteroskedasticity is between the samples but samples exist in primary data not in secondary data so there is no heteroskedasticity. The Heteroskedasticity in statistics occurs when the standard deviations of variables observed over different values of explanatory variables or as interconnected to prior periods, are non-constant. With heteroskedasticity, the tell-tale sign upon the visual procedure of the residual errors is that they will fan out over time. There is no Multicollinearity found among the independent variables, but it is found among the dependent and predictor variables. Multicollinearity ascribes to a state in which two or more exposure variables in multiple regression are most linearly associated (Gujarati & Porter, 5th Edition). e.g. the equation
Pov = HC+ Edu+ SK+DP.
In this equation POV represents poverty, HC represents human capital, Edu is Education, SK shows skills and DP is the dependency ratio. So, in this equation, the human capital, education and skills are highly related because the education and skills are called human capital.

Table 5: Multicollinearity

	POV	Edu	FDI	INFO	UR
Pov	1.000000	-0.915707	-0.637103	0.032358	-0.431423
Edu	-0.915707	1.000000	0.654913	-0.211945	-0.605144
FDI	-0.637103	0.454913	1.000000	0.199426	0.167263
INFR	0.032358	-0.211945	0.199426	1.000000	-0.492931
UR	0.431423	0.605144	0.167263	-0.492931	1.000000

Source: Results obtained by analyzing data through E-views 10 (x64)

In the above table, there is no multicollinearity among the explanatory variables because all the values of explanatory variables are less than 0.8. It means that there is no multicollinearity because the

explanatory variables are not related.

Granger Causality Test

To achieve the second objective of our research to know whether a causal relationship between FDI and poverty exists or not, for this purpose, we use the Granger causality test. Granger causality is a statistical hypothesis test for determining whether one-time series can predict another.

Table 6: Granger causality test

Null Hypothesis:	Obs	F-Statistic	Prob.
FDI does not Granger Cause EDU	34	0.44218	0.6480
EDU does not Granger Cause FDI		2.37061	0.1159
INFR does not Granger Cause EDU	34	4.20076	0.0279
EDU does not Granger Cause INFR		0.26812	0.7672
UR does not Granger Cause EDU	34	1.21555	0.3149
EDU does not Granger Cause UR		0.58888	0.5631
POV does not Granger Cause EDU	34	0.87991	0.4283
EDU does not Granger Cause POV		1.31136	0.2889
INFR does not Granger Cause FDI	34	4.02461	0.0317
FDI does not Granger Cause INFR		2.30109	0.1227
UR does not Granger Cause FDI	34	0.97452	0.3924
FDI does not Granger Cause UR		0.94969	0.4015
POV does not Granger Cause FDI	34	1.27086	0.2996
FDI does not Granger Cause POV		0.89394	0.4228
UR does not Granger Cause INFR	34	0.88330	0.4270
INFR does not Granger Cause UR		1.29467	0.2932
POV does not Granger Cause INFR	34	3.73562	0.0394
INFR does not Granger Cause POV		0.52704	0.5973
POV does not Granger Cause UR	34	3.16131	0.0612
UR does not Granger Cause POV		3.55070	0.0453

In the above table, no 6 shows the interpretation of each of the Granger causality test results based on a significance level (α\alphaα) of 0.05.

POV does not Granger-cause EDU because 0.4283 > 0.05, so EDU does not Granger-cause Pov because 0.2889 > 0.05.

POV does not Granger-cause FDI because 0.2996 > 0.05, so FDI does not Granger-cause POV because 0.4228 > 0.05.

POV Granger-causes INFR because 0.0394<0.05, but INFR does not Granger-cause POV because 0.5973 > 0.05.

POV does not Granger-cause UR (although it is close to the threshold) because 0.0612 > 0.05, but UR Granger-causes POV as 0.0453 < 0.05.

Conclusion

The finding concluded as significant long-term relationships between POV and the independent variables (EDU, FDI, INFR, and UR). EDU and INFR have a positive impact on POV, while FDI and UR have a negative impact. The one worth mentioning is that foreign business supplants small-level domestic business. In Pakistan, many FDI arrived in food industries such as pizza, KFC

etc. When they reached Pakistan, they replaced the small business such as KFC and the small-scale domestic business of burgers and kababs even so. Nevertheless, the domestic small- scale business owners were unemployed and augmented the magnitude of poverty. Another worthwhile factor is corruption. There is an extreme level of corruption in foreign companies. They hire employees from the host country and invest their money but provide no salary. At present Tien's company has come to Pakistan they invest a huge amount from people and say that find you the other tens people like own who invest the amount and then will start your salary. So, the people cannot fulfil this big target because it's very difficult to find ten people. The People are fear of investing, they say that are corrupt companies. Thus, those persons who invest here do not give their own money again and do not give any salary. In this way, they get a high amount of money from the people through these illegal ways. So poor people left their jobs at this company with this great loss and this leads to high unemployment and poverty. So that is why poverty is increasing at a high level instead of declining.

We also discover the disconfirming relationship between education and poverty. Once the education level increases the poverty declines. Education is the fundamental component that distinguishes the improvised from the rich. For instance, the ratio of educated households is half of illiterate poor households. Secondly, poor people have 75 per cent more children than rich people. By and large, the poor household children are not receiving any education and the cycle of poverty is perpetuated. We observe the crystal-clear fact that good jobs are secured by educated people as contrasted to illiterate people.

One more variable is inflation. When one unit increases in inflation, it leads to a decrease in the level of poverty. There exists a negative link between inflation and poverty. It escalates the profit of producers and diminishes poverty. The approximated result shows that there is a positive link between unemployment and poverty. When there is a rise in unemployment, therefore, an increase is also observed. However, the FDI creates jobs only for highly skilled employees. So, they are displacing local production that uses very low-skilled labor. Using that significantly increases the poverty gap index.

Policy Recommendations

The following suggestions and policy recommendations originate from the above-cited results and conclusions. The government should implement strong policies and hire a monitoring team to alleviate corruption in all sectors of the economy. The government should also try to implement strong financial policies to reduce poverty. The government should control the law- and-order situation, encourage small and medium enterprises and control energy crises on an emergency basis would increase the business opportunities in Pakistan; which would lead to a decrease the poverty in Pakistan.

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