Impact of Cultural, Economic and Political Factors on FDI and Trade Scenario: Empirical evidence from Afghanistan

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Abstract

Foreign direct investment is a critical and leading effective component of economic growth and is influenced by many economic, political and cultural factors. Foreign direct investment is a major form of international capital transfer and has increased substantially over the last decades as a consequence of rising global economic integration. It has even grown faster than world GDP and merchandise trade even despite of the large drop in world FDI flows at the turn of the millennium. The two-way flow between developed countries still accounts for the largest part of asset trade. To this end, an extensive theoretical and empirical analysis has been carried out over the period 2005-2019. This paper has tried to contribute empirical findings and results to the question as to what way economic, cultural and political factors influence FDI inflows. Therefore, this paper investigated a set of bilateral Afghanistan inward FDI stock data for the time period 2005-2019 in a panel with 15 countries. Cultural differences proved to have a significant negative effect on bilateral FDI stock. Also, the results demonstrated a significant effect of the type of legal family in a country on FDI. However, the effect of belonging to same legal family is negative. The political situation in a country proved to be a significant determinant of bilateral FDI stock. Countries with a low political rank divert more FDI to Afghanistan. The results reveal that U.S. policies produce no significant influence on long-term capital inflows to Afghanistan in the long-run. However, in the short-run U.S. diplomatic policies produces negative influence on inward FDI to Afghanistan. The results also reveal that domestic investment; financial development, and infrastructure exert significant positive impact on FDI in the long- as well as-short-run. More importantly, Afghanistan may establish its political ties with major international power, particularly with the United Sates on the basis of mutual interests and dignity and those relations should be consistent, sustainable and predictable.

INTRODUCTION

The first chapter commences with the background of the study and justifies the reason for the selection of this topic as my dissertation. The chapter precisely describes the study's background and sheds light on the status of the FDI inflow to Afghanistan. the chapter expands on the research questions and objectives, relevance, limitations, and dissertation chapter structure. The chapter's main goal is to provide more in-depth insight into the research

1.1 Background of the Study

It's difficult to get through a day in the age of globalization without the global economy affecting one's life in some manner. Every day, a significant amount of time is spent either consuming or providing goods and services for other countries. Terms like exports, imports, trade balance, exchange rate, and the names of organizations (e.g. WTO, IMF, and WB) and trade agreements (e.g. NAFTA, SAFTA, and IBSA) commonly appear in newspapers, magazines, and on the internet. As the world becomes globalized and, FDI is of major concern for investors across the globe, a topic of concentration for decades for developing countries (Jensen, 2013).

Foreign direct investment (FDI) is a primary mode of international capital transfer that has grown significantly in recent decades as a result of growing global economic integration. Despite a huge decline in global FDI flows at the turn of the millennium, it has increased faster than global GDP and merchandise trade. . Before the crisis, FDI had surged by more than 400 percent in the previous 15 years. Prospects of lower risk true diversification of investment options, reduced costs of capital for enterprises, and better capital allocation are the forces that promote global economic integration genuine FDI. All of these factors must eventually result in improved economic growth (Guerin, 2006). The key drivers of this rising global economy are large multinational corporations, which are internationalizing their supply chains and expanding worldwide by entering new countries to reach more consumers. MNEs currently account for one-third of global commerce, and they also account for the majority of intra-firm trade. The most essential feature of FDI is that it is concentrated in industries where the traditional competitive paradigm is the least appropriate (Brouwer et al, 2008). The two-way flow of assets between developed countries continues to make up the majority of asset

trade. Approximately 80. Furthermore, Brenton et al. (1999) argue in their article that FDI causes managerial and technological spillovers, resulting in enhanced export opportunities, international linkages, and local rivalry, as well as increased product variety. . "An incorporated or unincorporated enterprise in which a foreign investor controls 10% or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise, is described as a direct investment enterprise by the OECD. . A cross-border investment made by an investor to establish a long-term interest in a company based in another nation is known as a foreign direct investment (OECD). When it comes to international sales, a company can use a variety of approaches. A company can export its products, license a foreign company, employ agents, or invest in a foreign country. A company can produce directly in the country where it wants to sell its products by investing in Foreign Direct Investment (Petroulas, 2006). FDI comes in a variety of forms. The first is known as horizontal FDI, which is market-oriented and allows businesses to reach overseas markets. In this form, FDI serves as a trade alternative. . Vertical FDI, on the other hand, is production-oriented and allows transnational businesses to reduce costs. These multinational corporations attempt to gain a strategic edge by relocating low-wage work to other countries while preserving high-value-added research in the United States. TNOs use this method to manufacture parts or the full finished product in low-cost countries. FDI serves as a supplement to trade in this way. FDI flows are frequently viewed as either a trade substitution (horizontal FDI) or a trade complement (vertical FDI) (vertical FDI). The third sort of explanation states that the form of outsourcing is determined by market structure; while corporations in oligopolistic marketplaces gain additional profits, companies in competitive markets can reduce expenses. Firms that engage in horizontal FDI are said to sell their products in foreign markets, whereas firms that engage in vertical FDI are said to sell their products in domestic markets. (Guerin, 2006).

Aside from increased FDI flows, global economic integration has another essential element. Many research publications have been written about the role of cultural and political differences, which are generally considered as a barrier to global economic integration (Shenkar, 2001). "Cultural distance," according to Shenkar (2001), is a commonly utilized construct in international business, where it has been used to topics such as foreign investment expansion, entrance mode selection, and the performance of foreign-invested affiliates.

Tinbergen (1962) and Pöyhönen (1963) researched bilateral trade and foreign investment in the middle of the twentieth century, and independently established a gravity equation framework for empirical analysis. . Since then, scholars have effectively applied the gravity equation paradigm to a wide range of policy issues. They've used it to investigate the effects of exchange rates, a common currency, trade policy, and regional integration, among other things. Researchers have lately enlarged the scope of the gravity equation framework by adding variables that describe political and cultural differences to the gravity model. They want to know how cultural and political issues influence asset trading (Flörkemeier, 2002; Guiso et al., 2009; Kalemli-Ozcan and Sorensen, 2007; Heuchemer and Sander, 2007; Heuchemer et al., 2008). . These studies give empirical findings that suggest that confidence in other countries, institutions, and these institutions' trust in each other, as well as cultural differences, are key drivers, or, on the other hand, important impediments, to economic interchange. . Heuchemer et al. (2008) study the cultural and political differences as factors of European banking market integration. They use a dataset of European cross-border loans and deposits, as well as several gravity models with sociological proxies. These sociological proxies are variables that assess the Euclidean distance across European countries for various cultural and political characteristics.

1.2: FDI Scenario in Afghanistan

Savings and investment are widely recognized as fundamental pillars of economic development in the literature. To promote capital formation and thus economic growth, a high level of savings and investment is required. However, due to low per capita income in emerging nations, domestic savings fall short of the targeted amount (Khan, 2007). Domestic saving amounts to less than -4.42% of GDP in Afghanistan, while domestic investment accounts for 19% of GDP. The flow of foreign capital from overseas helps close the savings-investment gap. Private capital inflow from a parent firm to a location outside of the parent firm's native nation is characterized as a foreign direct investment (FDI). These investments consist of equity capital, inter-company debt, and reinvestment earnings. If an investment is big enough to provide the parent firm considerable control over the management of the enterprise (often more than 10% of the firm), it is called FDI rather than portfolio investment (Jensen, 2003, p. 588). FDI motives vary depending on the type of FDI. The main motivations are divided into

three categories: market-seeking, resource-seeking, and efficiency-seeking (Akhtar, 2000). is a significant component of capital flows and is seen to be one of the primary pathways via which financial globalization benefits the economy (Prasad, et al. 2003). To boost FDI, the trade and investment environment must be liberalized by reducing rules and providing particular incentives to foreign investors, such as tax breaks, tariff reductions or exemptions, and infrastructure subsidies (Zaidi, 2004). These measures have the potential to boost FDI inflows to underdeveloped countries like Afghanistan.

Although, the Afghan Constitution enshrines the free market, with minimal intervention by the state, yet Afghanistan is confronted by the problems of low growth, poor socio-economic conditions, and sustained balance of payments deficits. The inflows of FDI in Afghanistan in 2005 were US$ 271 million and decreased to 190 million US$ in 2010. The pattern of inflows followed a zig-zag pattern as in the years from 2011 to 2014 the level of FDI surged significantly. In 2015, however, the economy started flourishing and the level of FDI inflow was 169.15 million US$ before it dropped to US$ 139.20 billion in 2018 as shown in figure 1.1.

Figure 1.1: FDI inflow in Afghanistan (2005-2020)
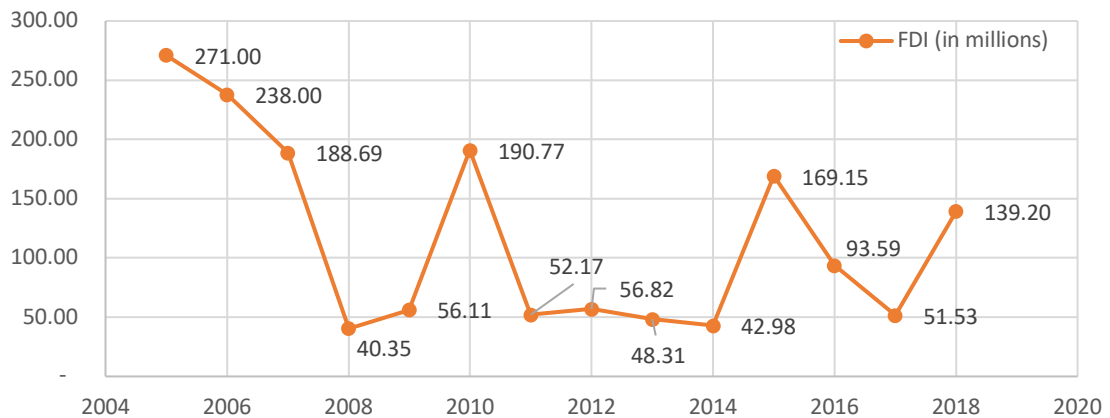
Source: Data collected from World Bank.

This drop-in FDI could be attributed to the deteriorating effects of global financial crises, which undermined foreign investors' ability to invest overseas due to lower corporate profits, increased risks, and limited financial resources. Global financial crises and an unstable economy undermined Afghanistan's macroeconomic fundamentals, resulting in a 94.61

percent drop in FDI from 2005 to 2018. However, FDI remained low in comparison to Afghanistan and other rising regional economies due to inconsistencies in government policies.

The political risk connected with the quality of domestic institutions could be one explanation for the low amount of FDI. Because investment decisions in the host economy are influenced by economical, political, and cultural factors (Akhtar, 2000 and Busse and Hefeker, 2007). FDI returns are determined by MNC earnings, expansion of company activities, market development, investment climate, macroeconomic considerations, the host country's development plan, and innovations, among other things. These factors have a substantial impact on FDI flows to developing countries. FDI may not flow into a country despite the presence of these favorable variables if the host country's political risk rating is low. . Investment is risky in an unpredictable political context, and investor trust is eroded. As a result, the political environment, both domestic and foreign, of the country that receives FDI has a critical influence in influencing FDI inflows (Butler and Joaquin, 1998). Because political risk is linked to the possibility that a sovereign host government would change the business climate suddenly, (Busse and Hefeker, 2007 and Bulter and Joaquin, 1998). Political risk influences location decisions because unexpected changes in government policy and institutional configuration might affect FDI flows. Political risk effects are quite substantial in empirical studies. The behavior of local variables that determine FDI inflows in the host country (such as market structure, labor costs, market size, exchange rate risks, trade liberalization, and institutional development, particularly development of domestic financial institutions) will vary depending on these motives. (Akhtar, 2000). Aside from the greater return objective, the political situation in the recipient country will have a significant impact on FDI.

Tinbergen (1962) and Pöyhönen (1963) investigated bilateral commerce and foreign investment in the middle of the twentieth century, and independently created a gravity equation framework for empirical analysis. Since then, scholars have effectively applied the gravity equation paradigm to a wide range of policy issues. . They've used it to investigate the effects of exchange rates, a common currency, trade policy, and regional integration, among other things. For more than four decades, Afghanistan has been plagued by political unrest. According to statistics from the Global Economy Report, 2017, the index of Political Stability

and Absence of Violence/Terrorism measures is -2.78 points, indicating that political instability is one of Afghanistan's major flaws. . There have been differing viewpoints on the major causes of Afghanistan's long-running political conflicts, with one aspect being blamed on inadequate leadership and governance, which paved the path for external involvement, making the Afghan government responsible for foreign agents rather than hosts. Internal and external elements are both to blame for Afghanistan's political instability. In the last four decades of war and volatility in Afghanistan, political instability has been a common occurrence. The political feud between Mohammad Ashraf Ghani Ahmadzai and Dr. Abdullah Abdullah has shaken investors' faith in the country, accelerating capital flight and political instability. As a result, international companies are subjected to the retaliatory effects of deteriorating diplomatic relations between their home and host countries (Boehmer et al., 2001). Foreign investors are acutely aware of the state of interstate political relations, as any deterioration increases the possibility of their firm being seized in the host country. (Desbordes and Vicard, 2009).

In Afghanistan's case, FDI flows may be influenced by its political connections with investor countries. Foreign money inflows into Afghanistan, for example, are strongly reliant on political relations with the United States and other key international powers. When Afghanistan has had excellent relations with international powers, particularly the United States, a rise in foreign capital inflows into Afghanistan has been observed. . The U.S. policies do not only affect the flows of capital to Afghanistan but many times it influenced the policies of other countries and bilateral and multilateral institutions towards Afghanistan. Extensive research work has been carried out concerning other countries like Afghanistan, Afghanistan, China *inter alia*, by Nishat *et al.* (1998), Akhtar (2000), Shah and Ahmed (2004), Aqeel and Nishat (2004), Khattak *et al.* (2005), Afza and Khan (2009), Yousaf *et al.* (2008) Awan *et al.* (2010), Khan and Samad (2010) and Hakro and Ghumro (2011) among others. The role of diplomatic relations has been overlooked in this research, which has focused on the economic and political causes of FDI. To our knowledge, no study has looked into the relationship between foreign direct investment and Afghanistan's political connections with international powers. This research bridges the gap. Over the period 2005-2018, the study will look at the impact of Afghanistan's political connections with international powers on FDI, as well as other factors such as domestic infrastructure, financial growth, trade openness, and political

instability. The study focuses on the influence of major international powers, primarily the United States, in determining foreign direct investment in Afghanistan.

1.2 Problem Statement

Following the Taliban's defeat in 2001, both the international community and Afghans began the process of establishing the Afghan state. Afghanistan, a war-torn country, lacked the infrastructure to sustain government activities and the people's ability to earn a living. The country's operations, such as governance, corporate activity, and the international community, were all at war with terrorists, necessitating the flow of finance. In such circumstances, the country was in desperate need of cash to keep the savings and investment cycle going. According to numerous studies, economic theories, and an awareness of global politics, there is a relationship between economic, political, and cultural elements that influence the flow of FDI. In this light, the current research aims to find out how economic, political, and cultural aspects influence FDI inflows. Through this goal, from 2005 to 2019, a comprehensive theoretical and empirical examination will be conducted. The ultimate goal is to determine whether US policy has a major impact on long- and short-term capital inflows. Additionally, economic characteristics such as domestic investment, financial development, infrastructure, national resource endowments, and trade openness, as well as political risk-related factors such as political rights, civil liberties, and political repression, will be assessed.

The overall goal is to determine whether cultural, economic, and political aspects have a substantial impact on foreign direct investment inflows. These sociological proxies have not yet been employed to evaluate FDI stock between the US and partner nations, to our knowledge. This thesis will attempt to provide empirical findings and conclusions to the subject of how cultural and political factors influence assets to trade, particularly foreign direct investment (FDI). The gravity equation, as well as social proxies, such as markers of cultural and political disparities, will be evaluated in this study to assess the impact of economic, cultural, and political factors on FDI inflows to Afghanistan from 2008 to 2019. These sociological proxies have not yet been employed to evaluate FDI stock between the US and partner nations, to our knowledge. This thesis will attempt to provide empirical findings and conclusions to the subject of how cultural and political factors influence assets to trade, particularly foreign direct investment (FDI). The gravity equation, as well as social proxies, such as markers of cultural and political disparities, will be evaluated in this study to assess the

impact of economic, cultural, and political factors on FDI inflows to Afghanistan from 2008 to 2019.

1.3 Research Gap

The academic literature is useful in identifying research issues and research gaps, which are the main pillars on which the current study's aims are built. Political variables such as the role of US policies, diplomatic policies, political risk-related factors (i.e. political rights, civil liberties, and political repression) as well as cultural and economic elements are rarely considered in Afghanistan studies. Although some studies have focused on macroeconomic and political set up like foreign exchange, trade openness, inflation, political rights, civil liberties, and political repression but the other factors like domestic investment, financial development, infrastructure, natural resource endowments, and cultural affinities have been completely under looked while assessing the role of international relations on FDI in Afghanistan. At the macro–level, the current study attempts to incorporate the variables in measuring the impact of international relations on FDI in Afghanistan. Furthermore, there is hardly little research in Afghanistan that documents the trends and patterns of FDI at the national level. The current study differs from previous research in several areas, and it adds to the existing body of knowledge in the following ways: To begin with, it has included variables that are different from those used by other researchers. Second, the current research examines FDI trends and patterns, as well as the economic, cultural, and political risks that affect FDI flows to Afghanistan, and assesses the effect of US policies in FDI flows to Afghanistan.

1.4 Motivation and Research Questions

As the primary aim of MNCs is to make the most of their investment revenues. They have no keen curiosity to invest in the country, having no or partial profit occasions. In general, MNCs desire countries with ongoing management, comprehensive economic policies, good organization, and greater economic freedom in terms of cultural, economic, and political factors on FDI. The goal of this research is to look into and assess the impact of cultural, economic, and political aspects on FDI inflows in Afghanistan. The impact of political risks (political repression), economic elements, and cultural factors that matter for multinationals, as well as Afghanistan's political connections with key international powers, are the main emphasis of this study. The current research aims to answer the following questions in particular. :

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- What are the trends and dimensions of FDI in Afghanistan?
- How do political, economic, and cultural factors affect the flows of FDI to Afghanistan?

1.5 Research Objectives

- To find out the trends and dimensions of FDI in the Afghanistan economy.
- To analyze the impact of political, cultural, and economic dimensions on the flows of FDI to Afghanistan.

1.6: Hypotheses

Different factors of FDI are suggested by theoretical and empirical literature, from which various hypotheses can be generated. Furthermore, two primary reasons for variances in bilateral asset trading can be recognized, based on the theory and empirical literature outlined above.

Hypothesis 1: Bad political relations between the United States and Afghanistan adversely affect the inflows of FDI to Afghanistan.

Hypothesis 2: Political repression/political risk negatively affects the flow of FDI to Afghanistan.

Hypothesis 3: Cultural factors negatively affect the flow of FDI to Afghanistan.

Besides the hypothesis variables, we consider other variables as control variables in the equation.

1.7 Rationale of the Study

This research is important in determining the significance of international political relations in attracting foreign direct investment to Afghanistan. Furthermore, the findings will aid in justifying the role of US policies, diplomatic policies, domestic investment, financial development, infrastructure, natural resource endowments, and trade openness in influencing long-term or short-term capital inflows to Afghanistan. Political risk variables (such as political rights, civil liberties, and political repression) will also be assessed to improve the country's political climate. The report will assist policymakers in developing policies that promote FDI inflows to Afghanistan. More crucially, Afghanistan will be in a position to create stable,

lasting, and predictable political partnerships with major international powers, including the United States, based on common interests and dignity.

1.8 Limitations and implications of the Study

The determinants of Foreign Direct Investment depend on many economic dimensions and as well as political factors. In this study, the core focus is to ascertain the impact of a limited number of economic-political factors/variables on Foreign Direct Investment (FDI). Furthermore, the impact of only one country (USA) is taken into consideration and some other countries which invest in Afghanistan are excluded like Pakistan, UAE, India, and Saudi Arabia.

This research has the potential to impact both theory and policy. If cultural and political factors can be used to explain the patterns of bilateral FDI stock, then a country's financial integration will be aided. We might be able to illustrate which part of the FDI stock is not dependent on easily changed policies like exchange rates or tax rates, but rather on stable characteristics like culture and political situation by using the United States as an example. As we can see from the chart above, overall outward FDI to developing nations has dropped over the last eight years. Our findings may be useful to governments in developing nations as they adjust their policies to attract FDI.

1.9 Scope and significance of the Study

Over the period 2005-2018, the study will look at the impact of Afghanistan's political connections with international powers on FDI, as well as other factors such as domestic infrastructure, financial growth, trade openness, and political instability. The study focuses on the influence of major international powers, primarily the United States, in determining foreign direct investment in Afghanistan. . The future scope is to include and investigate other potential economic variables coupled with other political variables to address the impact on FDI. The other angle of the study could be including countries that have due importance in the FDI inflows into Afghanistan.

This study fills the literature gap from Afghanistan's standpoint as one of the least developed countries with a lack of empirical evidence of the political, economic, and cultural effects on FDI inflows in Afghanistan. Besides, this study contributes to the benefit of the Afghan Government's policymakers for them to consider the valuable findings of this study while

developing long-term national priority programs and policies. Furthermore, this study is a good source of reference for future scholarly studies on this specific topic.

1.10 Chapter Scheme

The rest of the study is organized according to the arrangement below. : Chapter 1 defines the problem statement, the background of the study, motivation, research gap, and research questions along with research objectives, significance, and limitations of the study. Chapter 2 presents the literature review covering the dimensions like the relationship between political stability and FDI, trends and patterns of FDI inflows to Afghanistan, and determinants of FDI by taking into consideration the theoretical and empirical studies. Chapter 3 sheds light on the model specification, data, and methodology employed to achieve the desired results. Chapter 4 focuses on the results and discussions thereby presenting the review of investment policies and FDI inflows to Afghanistan. The connection between Foreign Direct Investment and Interstate Political Relations in Afghanistan perspective, with a detailed descriptive analysis of the U.S. policies towards Afghanistan and the empirical results along with discussions. Finally, Chapter 5 presents the concluding remarks with policy implications and recommendations.

CHAPTER 2
REVIEW OF LITERATURE

This chapter includes the literature review which is relevant to the subject matter of the study to completely understand the concept of how there is a connection between economic, cultural factors, and political relations that impact foreign direct investment. As the literature review is necessary to lay the foundation of research and provide information on the work done in the related area and the theoretical framework on which the proposed solution of the problem is based. To make the in-depth study of the problem significant studies have been taken up, that are most relevant for this analysis and finding the existing gap in the research area. In this regard, some of the significant studies have been taken under study to evaluate the role of economic, cultural factors, and political relations on foreign direct investment and evaluate the extent of association. This chapter will also go over many hypotheses that could explain how political and cultural issues influence FDI. Aside from Empirical FDI research, other publications on information asymmetry and investment risk caused by political instability are mentioned. Following that, we'll attempt to generate hypotheses from this theoretical basis. . The section is divided into four subsections with sub-section 2.1 focusing on dependence of FDI inflows, section 2.2 presents the review of FDI policy, trends and patterns of FDI inflows to Afghanistan, and finally, subsection 2.3 outlines the determinants of FDI by taking into consideration theoretical and empirical studies including the studies outlining the relationship between political dimensions and FDI.

2.1 FDI Flows Dependence

2.1.1: FDI Flows Dependence on International Informational Asymmetries

To optimize the overall yield, stock flows should be geographically distributed, according to portfolio diversification theory and the neoclassical model. The fact that FDI flows are spatially concentrated in certain regions and nations is a stylized fact. The forces of financial integration, like the forces of global economic integration, are driven by the prospects of more efficient capital allocation, diversity of investment options, lower cost of capital for firms, and economic growth. Nonetheless, the challenges of information asymmetry are well-known in international financial markets. Various articles discuss how countries' overseas asset

holdings are skewed toward the home market. These skewed portfolios are under-diversified and produce market turbulence. (French and Poterba, 1991; Tesar and Werner, 1995).

Lane (2001) emphasizes that despite the rapid rate of globalization, behavioral and informational hurdles continue to obstruct global financial market integration. Furthermore, in a panel data regression model based on a gravity equation, Portes et al. (2001) and Portes and Rey (2000) study bilateral equity flows and bonds. The information impact outweighs the diversification effect in their sample. They claim that a diversification motive has only shaky support. They find no evidence of a diversification motive when they adjust for informational frictions. When it comes to capital mobility and globalization, it's common to assume that international capital markets are frictionless, but this doesn't appear to be the case when it comes to informational barriers.

The fundamental reason for capital market segmentation appears to be informational asymmetries. Models based on autarky prices, factor endowments, and comparative advantage dominate asset trade theories. Those theories should be dominated by models based on differentiated assets, transaction costs, information asymmetries, and some kind of familiarity effect (Helpman and Razin, 1978; Svensson, 1988; Obstfeld and Rogoff, 1996), while those theories should be dominated by models based on differentiated assets, transaction costs, information asymmetries, and some kind of familiarity effect (Helpman and Razin, 1978; Svensson, 1988; Obstfeld and Rog (Heath and Tversky, 1991; Huberman, 2001). A transition to these models, similar to the shift in goods trading to theoretical modeling, should be made. Although it focuses on portfolio choice and asset pricing rather than transaction quantities, literary information asymmetries are more frequently employed in finance than in asset trade literature.

Finance literature does, however, teach us some crucial lessons. At a macro level, Gordon and Bovenberg (1996) created a model between international and domestic investors. They found in their paper that the informational asymmetry theory had indirect but strong support. Their research looked at the link between current account deficits and real interest rates. Portes et al. (2001) discover that an asset's necessary amount of knowledge impacts the importance of the information variables in their research, which is entirely US-centered. For example, information variables explain a bigger portion of the variance in assets with high information

content, such as corporate bonds, than assets with low information content, such as treasury bonds. Because of their high information richness, information variables should be crucial explanatory factors for the forecast of FDI flows, according to this hypothesis.

In their article, Ahearne et al. (2004) analyze the value of a public listing in the United States for overseas enterprises. They conclude that, because public listings are standardized and produce credible financial information, they are a significant approach to lower information costs. Their findings show that a country's entire amount of publicly traded US companies explains a significant portion of a country's weight in US investors' portfolios. Companies from nations where the regulatory environment is not as strict as in the United States are represented in a smaller proportion of US stock portfolios. This is a significant contributor to the phenomena of home bias.

Huberman (2001) studied a sample of Regional Bell Operating Company stockholders, and his findings demonstrate that when people invest abroad, they frequently invest in the familiar, ignoring portfolio theory rules in the process. As a result, they don't invest just in diversification principles, but rather in "familiarity." Information asymmetry or some type of "familiarity effect" is also mentioned by French and Poterba (1991). With knowledge asymmetry, transaction costs rise, reducing international bilateral stock flows. A familiarity impact influences information asymmetry directly, and this familiarity effect decreases as economic distance increases. Economic remoteness is mostly determined by two things. To begin with, economic distance is determined by national and governmental disparities, which are explained by institutional differences, political situations, and cultural variances. This is also the paper's core topic and research question. . Secondly, economic distance depends on geographical distance, which is attended to in the next section.

2.1.2 Informational asymmetry and distance; and the gravity model

Tesar (1995) examines the portfolio selections of Canadian and American investors, concluding that, to the extent that individuals invest in foreign equities, their decisions are not only motivated by diversification concerns. Geographic distance, on the other hand, appears

to be a significant factor in explaining international portfolio investment decisions. According to Coval (1999), investors favor companies that are close to them since they have easier access to information about them than companies that are far away and about which they have limited knowledge. If the company is located near them, it is easier for investors to speak with employees, managers, and suppliers. In short, a less distant investment is easier for an investor to oversee, therefore distance, both literally and metaphorically, separates an investor from potential investments. Furthermore, in their article, Ghosh and Wolf (1999) look at asset holdings and conclude that informational asymmetries increase with distance.

According to Rauch (2001), geographic remoteness impedes cultural interchange, making interactions between economic agents more difficult. This is the most natural explanation for why informational asymmetries are positively connected with geographical distance, and it is also related to the cultural aspects discussed in the following paragraph. Cultural affinities or similarities, which are directly tied to international economic contacts, determine network effects (Rauch, 2001). According to Tesar and Werner (1995), geographic proximity plays a significant role in international portfolio allocation decisions. In their study on economic distances, Coval and Moskowitz (1999) show that investment biases are influenced by airfares and phone costs, which is maybe a modern explanation of geographical distance. Distance is determined by the amount of money paid to communicate with another person rather than the number of kilometers traveled, which is highly connected.

In addition, Portes and Rey (2004) examine gross cross-border equity movements in their article. They look at a group of 14 nations and their bilateral equity flows, revealing a distinct geographic pattern of international asset transactions, and conclude that geographic distance is positively connected with informational asymmetry. They come to the conclusion that a gravity model, as employed in goods trade, will also work in a model of financial asset transfer. Distance is employed in a gravity model to correct data for disparities in FDI flows. Furthermore, De Menil (1999) examines FDI flows between European nations in his study and claims that a gravity model explains the differences in FDI flows between those countries. . Moreover, in a substantial amount of papers, it is empirically observed that trade and FDI flows are correlated. This could be an argument in favor of a gravity model, in which distance

is used to explain equity flows. Most recent studies state that there exists a positive correlation between the bilateral flow of goods and the flow of financial assets. (Brenton et al., 1999)

Furthermore, in their article about the trade-off between the benefits of a foreign affiliate of a multinational firm and the cost of expanding the distance between this affiliate and the head office, De Sousa and Lochard (2006) investigate the applicability of a gravity model. They concluded that, in its simplified version, FDI is influenced not just by distance but also by a bilateral internal and outward effect. This is linked to both the GDP of the country and a multilateral effect depending on the relative desirability of alternative locales. . (De Sousa and Lochard, 2006) However, despite the plethora of empirical evidence, the gravity equation for international equity transfers has limited theoretical backing. One of the few articles, by Martin and Rey (2004), provides a theory in which equity flows are explained by a gravity model. The model is then tested by Portes and Rey (2005), who show that it has the same explanatory power as the trade model in explaining the transfer of equity flows (Martin and Rey, 2004). Bergstrand and Egger (2007) also provide a theoretical framework by attempting to estimate a gravity equation to anticipate FDI flows using an extended 2x2x2 knowledge-based capital model of multinational companies. Despite the lack of theoretical foundations, the gravity model is nonetheless commonly utilized to explain FDI flows today. In the basic gravity model, the distance appears to be a major explaining component, which is complemented by both countries' GDP and other factors such as language and trade, which I will explore in more detail in the methods section. Should cultural and political aspects, however, be included in the model, and what role do they play in understanding bilateral FDI? In the following two sections, we will attempt to answer this question.

2.1.3 Informational Asymmetry and Cultural and Political Differ.

To evaluate financial assets such as company shares and bonds, relevant data is required, which is not always readily available or understandable to all market participants. What exactly does this pertinent information imply? Accounting standards, legal institutions, company culture, political environment and changes, asset market organization, and pertinent institutions are all covered. Cairnes emphasized in 1874 that, in addition to geographic distance, differences in political systems, language, religion, and social conventions can be regarded as barriers to capital transfers.

Different national accounting standards and procedures also create informational obstacles, according to Pagano et al. (2002) and Ahearne et al. (2004). In his essay on FDI flows to emerging markets, Bekaert (1995) examines the role of indirect investment barriers and claims that they are crucial in explaining international investment patterns. Poor information regarding those markets, such as inadequate accounting standards, ineffective settlement processes, and poor investment protection, are among the indirect barriers to investment, according to him. As a result, many institutions create indirect or informational barriers, resulting in knowledge asymmetry and impeding economic integration. . Language, institutional and regulatory variations, and the expense of acquiring information about international markets are further discussed by Tesar and Werner (1995). According to Tesar (1995), the reason why people have a home bias in their investments is that they must first develop a comprehensive model that includes institutional restrictions before they can rule out home bias.

Home bias explanations, according to Coval (1999), should focus on the key variables that inhibit foreign investment, such as differences in legislation, culture, taxation, sovereign risk, and exchange rates. Using a gravity model, Portes (2004) investigates a panel data set on bilateral gross cross-border equity flows between 14 nations. He is interested in information asymmetry. . The findings are unaffected by a variety of factors, including the legal system's effectiveness, language, and the presence of a large financial center. Even after adjusting for goods trade, these information variables are still significant in Portes' model. This means that theories implying a perfect correlation between asset and goods trade do not account for all of the informational asymmetry impacts on asset trade. "These findings may have consequences for the home bias literature," Portes says. Diverse countries have different collections of data, which has a significant impact on their international dealings. With our information variables, we capture various aspects of these data sets. More theoretical and empirical work relating transactions and holdings appears to be required."

As previously stated, the political climate may have an impact on information or transaction costs. Enhanced investments and reduced macroeconomic instability in the EMU were explored by De Sousa and Lochard (2006), who found that this was due to increased transparency and credibility of national regulations and policies. Because investors know less

about international institutions and markets, according to French (1991), they attribute additional risk to overseas investments and do not base their investment decisions purely on returns and standard deviations of returns. Grinblatt and Keloharju (2001) analyze the effects of culture, language, and distance on investments and commerce within Finland using a gravity type equation model. Their study looks at the behavior of Finnish and Swedish investors as well as Finnish and Swedish companies operating in Finland. "Investors concurrently display a preference for neighboring enterprises as well as firms with the same language and culture," they find. " (Grinblatt and Keloharju, 2001). When it comes to ownership weights in Finnish enterprises, culture and language appear to have a favorable correlation. Sander and Kleimeier (2004) also note the role of legal and cultural variables in explaining economic convergence among countries in their article. Guiso (2009) examines data on bilateral trust between European countries to show how cultural biases might affect economic interaction. He discovers specific cultural aspects of the match between the trusted and trusting countries, such as genetic and somatic similarities, history of conflicts, and that higher bilateral trust leads to more trade and direct investment between countries, in addition to the general level of trust among the population of a country. He also discovered that commodities with a higher level of trust are more susceptible to this impact. Guiso (2009) finds that culturally-based views are significant influencers of economic interchange and, in particular, direct investments. Guerin (2006) writes in his paper on FDI flows that "the familiarity effect, which reduces informational frictions and induces investments, encourages investors to invest in countries with similar characteristics and legal systems," and that "the cost of information gathering would likely increase with distance as familiarity with the host country's investment opportunities, customs, and culture decreases." As stated in the introduction, scholars such as Flörkemeier 2002, Guiso et al. 2005, Heuchemer and Sander 2007, Kalemli-Ozcan and Sorensen 2007 have begun to include political and cultural differences in the gravity equation framework. . The articles have demonstrated how cultural and institutional differences can act as both drivers and impediments to economic interchange. . It is also proposed that the impact of these variables is more important for FDI flows.

In his work on cultural distance, Shenkar (2001) contends that there are three key thrusts of cultural differences that have been mentioned in the FDI literature. The first was created to explain cultural distance and the launch or sequencing of foreign investment, a theory in which

the concept of familiarity is introduced, claiming that MNEs should invest less in culturally distant areas. The paucity of Japanese FDI in the West was explored by Osawa (1979) and Yoshino (1976), who found that it was most likely related to cultural differences. The comparatively high number of US FDI investments in Canada, according to Davidson (1980), could be explained by their cultural closeness. . Cultural differences, on the other hand, could be a justification for increasing FDI flows between home and host markets to address upheaval, transactional, and market failures, according to Dunning (1988). In his literature assessment, Shenkar believes that cultural differences can produce both disruption and synergy. Heuchemer (2008) looks into the elements that influence European financial integration, focusing on the potential stumbling blocks of cultural and political concerns. He demonstrates that, in addition to border and distance impacts, legal heritage and cultural variations have a significant impact on the structure of bilateral cross-border banking in this study. He also discovers that governance and political issues have less of an impact on the explanation of cross-border financial integration.

2.1.4 Political instability causes a risk

In his work, Ahearne (2004) discusses the impact of country variations and the importance of familiarity effects. "Information asymmetries can occur between countries due to disparities in accounting standards, disclosure regulations, and regulatory settings," Ahearne claims. If investors are considering making an FDI investment in a foreign company, they must rely on documents prepared under different accounting standards and regulations than in their home country, and the credibility of these documents is determined by the country's regulations, institutions, and political situation, which vary significantly. These disparities result in information and transaction expenses that must be borne by the investor. As a result, information costs in certain nations may be much greater than in others due to differences in accounting standards, disclosure requirements, regulatory environments, institutions, and political situations. . In his article, Bekaert (1995) constructs a return-based market integration metric for nineteen emerging equities markets. He specifies three types of barriers in his article. The first is legal impediments imposed by various legal organizations, such as ownership limitations and taxation. Second, disparities in available information, investor protection, and accounting rules create hurdles. Third, emerging market-specific risks (EMSR) create hurdles

that stifle international investment and create de facto segmentation. . EMSRs include political risk, economic policy risk, economic and political instability liquidity risk, and maybe currency risk. In his article, Bekaert also states that some people believe these risks aren't priced because they're diversifiable, but he cites Chuhan (1994) to show that, for example, liquidity issues are a key barrier to investment in emerging markets. Other EMSRs, as Bekaert (1995) points out, are tied to specific country hazards, in addition to a large number of publications that quantify political risk and investments around the world. "For example, credit ratings reflect not only views of political stability but also aspects relating to the economic situation," he says. For example, unstable macroeconomic policies appear to have a negative impact on stock market performance. Investment barriers are a direct result of the domestic policies followed by individual economies."

2.2 Review of FDI policy

Since 2002, Afghanistan has used a marketing economic system. Since then, the government has implemented several regulations and processes, as well as various incentives, to attract FDI into the economy. Unfortunately, due to several political and economic issues, the outcomes were not as planned. For a long time, industrialized and developing countries have pursued different policies and techniques to achieve high levels of economic growth and development. The policy of deregulation and admitting foreign direct investments is the most significant of all (FDI). Global FDI flows fell by 27% to USD 1,097 billion in 2018, owing mostly to US tax reform. This maintains the trend of a 16 percent drop in FDI flows in 2017. Afghanistan's economy is one of the post-war and post-conflict economies emerging. . Since 2001, this economy has been reliant on foreign help and investments (Taliban regime). Transitions in security, economics, and politics have all presented significant problems in the post-2014 age.

Afghanistan's economy has suffered as a result of the removal of international soldiers, support, and funding. Since the beginning of 2016, Afghanistan's economy has struggled with ongoing uncertainty in provinces such as Kunduz and Helmand, which are key northern provinces of Afghanistan, where Taliban activities have progressed and become headlines, investments have declined, and the reason for such a situation has affected investors' minds to invest their capital in Afghanistan. It resulted in poor infrastructure, governance, insecurity, and corruption, as well as government policies that make it impossible to build the economy in the future. Afghanistan's economy is currently reliant on agriculture, which accounts for a

significant amount of the country's gross domestic product (GDP). In 2016, they experienced low yields, primarily of cereals.

The Afghan government encourages FDI in infrastructure development, participation in bilateral and multilateral trade agreements, and trade-related reforms in construction, telecommunications, transportation, and logistics. Due to a lack of rule of law, FDI investments in Afghanistan dropped from 2005 to 2013. In the World Bank's conducting business 2018 report, Afghanistan comes bottom globally and regionally in terms of investor protection. According to AISA, the service sector attracted 89 percent of FDI in Afghanistan, while manufacturing attracted ten percent and agriculture attracted one percent. When it comes to FDI, Afghanistan has seen significant progress in terms of regional integration, economic collaboration, and infrastructural development. According to certain research, FDI has been declining since 2011, but the new policies are expected to encourage investors to contribute millions of dollars in foreign direct investment (FDI) and aid support, both foreigners and Afghans, into the economy. The Afghan economy has received more than $83 million in foreign direct investment, accounting for 43 percent of the country's GDP.

The quantity of FDI inflows to South Asia surged in 2018, with India and Bangladesh receiving 44 and 2.2 billion US dollars, respectively. Meanwhile, due to political and economic volatility, FDI flows to Central and North Asia have continued to decline. Because of political upheaval, Afghanistan's economy was hit the hardest, attracting only 0.13 billion dollars (UNCTAD Report, 2018). Even if there is no unanimity among Afghans about this option, the new constitution of Afghanistan deems the market economy to be the country's economic system (Fishstein and Amiryar, 2015).

After decades of conflict and political disorder, the constitution was passed on December 13, 2003, ushering Afghanistan into the modern period of the twenty-first century. While militant attacks grew, it was a shock to FDI inflows to Afghanistan, which continued until 2014, when President Ghani's administration reached a security pact with the United States. According to the deal, the United States can keep military outposts in Afghanistan until 2024. (DoD, U. S., 2013). Meanwhile, the High Investment Council (HIC) was founded under Afghanistan's private investment law, and HIC later established the Afghanistan Investment Support Agency (AISA) to speed up the process of attracting additional investment, particularly foreign direct investment (FDI).

Furthermore, some notable efforts have been made by enacting democratic investment rules and levying a low FDI tax. All eligible foreign and domestic enterprises interested in investing in any area of the economy are protected by law against discriminatory government acts under Afghanistan's Private Investment Law, which was adopted in 2005. However, given the country's rapid growth over the last decade and vast potential, the amount of FDI flowing into Afghanistan is not impressive. Wani and Rehman (2017) conducted a study on the determinants of FDI in Afghanistan, demonstrating the inflow of capital. The impact of FDI on Afghanistan's economy, in particular, is being investigated. Their study used the OLS method for the years 2005-2015, and the results demonstrated a positive relationship between FDI and determinants, except for the inflation rate, which had a negative impact. From the perspective of Afghanistan, Muhammad et al (2013) demonstrated a link between interest rate and investment. The impact of the interest rate on an investor investing within the country has been demonstrated by these researchers. . They've been using this strategy for a year (1964-2012). According to the findings of this study, investment is one of the most important factors of GDP and can lead to an improved economy. They concluded that interest rates and investment are inextricably linked and that fluctuations in interest rates would result in a loss of investment or savings for Afghanistan's economy.

Werker et al. (2013) looked at the Afghan economy and found that the exchange rate is strongly linked to growth. The findings and analysis for this research study revealed that Afghanistan has higher import balances than export balances, indicating a lack of improvements in commodities exported. According to the findings, there is a mismatch between the balance of payments and the trade balance, causing the economy to perform poorly and the growth rate to remain low. According to certain research, the impact of FDI is determined by the host country's absorptive ability, which includes governmental, economic, and technological factors. We also conclude our grounds and more especially to know FDI link with factors such as inflation rate, exchange rate, interest rate, and others in economic growth in Afghanistan based on all of the aforementioned research.

2.3 Determinants of Foreign Direct Investment

The theoretical foundation of FDI, according to Braunerhjelm and Svensson (1996), is fractured and consists of bits and pieces from several fields of economics. The idea that FDI can expand due to production economies of scale can be traced back to Adam Smith (1776)

and David Ricardo, two classical economists (1817). MNCs grow their activity at the worldwide level due to interest rate differentials, according to neoclassical economic theory. Capital flows from low-return economies to high-return economies under the neoclassical framework, which assumes risk-free and perfect competition. (Harrison, 2000).

According to the neoclassical view, foreign investment benefits economic development by replacing inferior technology, producing competition and productivity gains, raising foreign exchange, and strengthening the host country's infrastructure (Harrold and Lall, 1993). Vernon (1966) established that FDI occurs when manufacturing costs are low and the firm encounters rivalry in the maturation of its products. When the product matures and skilled labor contributes to production, a high-income, labor-saving product is generated, and the host country becomes a desirable location. The key determinants of FDI, according to Dunning (1993), Hymer (1976), and Caves (1996), are ownership advantages, location advantages, and gains from internationalization. .22

Furthermore, recent research has demonstrated a positive relationship between FDI and financial development (Hermes and Lensink, 2003 and Alfaro et al., 2003). Hermes and Lensink (2003) looked into the relationship between financial development, FDI, and economic growth and discovered a favorable correlation between the two. They defended their findings by claiming that a well-developed financial system efficiently mobilizes savings, hence increasing the number of resources available to finance investment. Furthermore, financial development hastens the adoption of new technology by lowering the risk of doing so (Dutta and Roy, 2010). Foreign enterprises can borrow for innovative activities thanks to the improved financial infrastructure. Better financial institutions attract more foreign investment, which is critical to the economy's growth.

Another important driver of FDI is trade openness. More horizontal FDI may be related to a decline in openness since investment businesses gain from trade barriers by establishing production sites abroad. Vertical inflows gain greatly from increased openness, according to Bevan and Estrin (2000) and Resmini (2000). Export orientation is also significant in recruiting FDI, according to Singh and Jun (1995). The impact of openness on FDI can be good if FDI is export-oriented, but it can be negative if FDI is motivated by 'tariff jumping.' (Aseiedu, 2002 and Mhlanga et al., 2010).

Another school of thought emphasizes the importance of democratic institutions since the benefits of FDI to host countries are reduced when democratic institutions are weak. One line of research suggests that democratic institutions and FDI have a beneficial association (Harms and Ursprung, 2002, Jensen, 2003 and Busse and Hefeker, 2005, among others). As a result, the quality of democratic institutions is the most important factor in determining growth rates and per capita income in different countries. Higher affluence has been linked to effective protection of civil liberties and property rights, expanded economic and political freedom, and low levels of corruption. (Kapuria-Foreman, 2007, Quere et al., 2007 and Khan and Samad, 2010).

Economists are increasingly agreeing that economic freedom and high-quality democratic institutions are expected to have a positive impact on economic growth via promoting FDI (Bengoa and Sanchez-Robles, 2003, Brooks et al., 2003, and Khan and Samad, 2010). Poor institutions contribute to political unrest, which has a detrimental influence on FDI inflows. (Root and Ahmad, 1979 and Schneider and Frey, 1985).

Desbordes and Vicard (2005) recently proved that interstate diplomatic relations have a considerable impact on the location of foreign direct investment in emerging nations. They claimed that international investors are concerned about a country's diplomatic relations with other countries because deteriorating diplomatic relations could result in retaliation. They also claimed that economic ties, such as foreign aid, FDI, and trade, can be used as a security policy tool. For example, in 1990, the US threatened Yemen with terrible consequences if it did not support Resolution No. 678 on the use of armed forces in Iraq. (Pilgar, 2002).

Another example is that, before the recent war in Iraq, President Bush planned to take the vote to the United Nations Security Council (UNSC), even though he knew the French would vote. However, he was attempting to gain a simple majority in the Security Council by distributing aid packages to some of the non-permanent members. (Eldar, 2004 and Dreher et al., 2007).

According to Fleck and Kilby (2006), the geographical distribution of total World Bank financing is influenced by business interests in the United States, and this influence fluctuates among presidential administrations. 23 Similarly, Schraeder et al. (1998) show that political-interest variables are relevant in assistance allocation for the United States, Japan, France, and Sweden. Political-interest variables are significant predictors for some countries, including the

United States, according to Alesina and Dollar (2000), but not for others. According to Andersen et al. (2006), the United States had a considerable impact on IDA loans from 1993 to 2000.

Votes for the Pressler and Brown Amendments, according to Anwar and Michaelows (2006), confirm the importance of these political-economic drivers. They also discovered that whereas ethnic business lobbies looked to have dominated in the case of the Pressler Amendment, the direct influence of population groups of Indian and Pakistani ancestry appeared to have dominated in the case of the Brown Amendment. Furthermore, the analysis reveals that US commercial interests based on FDI and exports had a minor impact. This means that international politics and capital inflows are linked and that international politics influences foreign capital flows to recipient countries.

According to Nigh (1985), between 1948 and 1978, U.S. manufacturing FDI was higher in emerging countries with which the US had cooperative diplomatic relations. Desbordes and Vicard (2009) confirm this conclusion for the period 1990-2000. Similarly, Biglaiser and DeRouen (2007) proved that countries hosting a large number of US military soldiers attract US FDI (not multinational FDI) and that the presence of US troops might be taken as a sign of excellent diplomatic relations between the US and host countries.

The effect of international relations in affecting the status of FDI influx was investigated by Gangi and Ahmad (2015). International relations were discovered to be one of the most critical aspects that can influence FDI inflow. Sudan's favorable relations with East Asian countries (China, India, and Malaysia) have aided the flow of foreign direct investment into the country. Sudan's strained relations with the United States and other Western countries, on the other hand, have hampered FDI inflows.

In South Africa, Francois and Thomas (2018) investigated the relationship between foreign direct investment (FDI), political risk, and economic growth. Time series data from 1995 to 2016 were used to perform a bounds test for co-integration using an ARDL model. Political risk and economic growth affect the degree of foreign direct investment in both the short and long run, according to the study's findings. When compared to GDP, the political risk rating was found to have a greater impact on FDI flow. According to the conclusions of the study, the South African government must lower political risk to boost foreign investment into the country, which might help with economic growth and welfare.

The influence of political instability on foreign direct investment and Malaysia's economic growth was studied by Nazeer and Masih (2017). Based on time-series data spanning 30 years from 1984 to 2013, the autoregressive distributed lag (ARDL) approach to co-integration proposed by Pesaran et al. (2001) was used. The empirical findings demonstrated that in Malaysia, there is a long-run and short-run relationship between political instability, FDI, and economic growth, with economic growth serving as the primary driver of political instability and FDI.

Khan *et al* (2013) From 1986 to 2009, the influence of political risk on foreign direct investment was presented for 94 nations. Most political risk indicators were found to have a negative link with FDI for the world as a whole, as well as for high-income countries, although the relationship was strongest for upper-middle-income countries. Over the last 20 years, Pandya (2016) has surveyed scholarly research on the political economy of foreign direct investment (FDI). The fast rise of FDI, particularly in emerging countries, and the advent of fierce competition among governments to attract investors are reflected in FDI studies throughout this time period. As a result of FDI deregulation, strong financial investment incentives, and the implementation of international agreements, countries have become more accessible to FDI. Even though substantial research suggests multinational firms prefer to invest in nations with robust property rights protections, the question of whether incentives and international agreements help countries attract FDI is still debated.

Camba (2017) studied the rise and decline of Chinese foreign direct investment in the Philippines to define inter-state relations and state capacity. According to this study, the rise and fall of Chinese FDI are influenced not only by the host country's conflictual or cooperative ties with China but also by the strength or weakness of several types of state capability. State capacity moderates the impact of inter-state relations on the three types of Chinese FDI: state, private, and illicit capital. . The study's findings indicate the adaptability of Chinese FDI, which can adjust to a variety of political and historical contexts. Desbordes (2010) also finds that for US MNEs investing in developing nations, both global and diplomatic political risks are important. This unresolved disagreement among economists and political scientists on the factors that influence FDI encourages us to reexamine the topic. In addition to other aspects, the empirical research gives some information on the relationship between FDI and

international political relations. As a result, more research on the influence of US-Afghanistan political relations on FDI is required.

Chapter 3

Research Methodology

This chapter describes the study's research methodology. . The study is based on secondary data sources and quantitative methodology is employed. The chapter is further divided into subsections with sub-section 3.1 focusing on Research Philosophy and Approach, section 3.2 presenting the variable explanation along with instrumentation and operationalization of the variables, section 3.3 empirical model, subsection 3.2 depicts data description and variables, subsection 3.3 deals with the operationalization of variables and finally, subsection 3.4 sheds light on the methodology part.

3.1 Research Philosophy and Approach

The study's philosophy is based on pragmatism as the pragmatic approach selected, which is not dedicated to philosophy or authenticity, permits the investigator to select measures that best meet the objectives. The investigative approach to this study is deductive. In this method, the study aims to find the reply to a particular question or statement.

3.2 Instrumentation and Operationalization of the variables

A New dataset is created for this study by gathering and merging data from various sources.

Table 3.1: Instrumentation and Operationalization of the variables

Variable	Definition	Expected Sign
GDP per capita	Gross domestic product per capita serves as a proxy for relative factor endowments.	+
Population	Population acts as a proxy for the size of a country and in combination with GDP per capita economic mass is represented in the model.	+
Distance	Geographical distance is considered to be a proxy of bilateral transaction costs. Distance is measured between the Afghanistan capital and its neighboring country's capital.	-

Border	The border is a dummy variable which captures shows the existence of a common border between Afghanistan and the neighboring country.	-
Language	In a gravity model, it is also a common strategy to use a dummy variable for the existence of a common language.	+
Trade	Trade is the sum of imports and export between Afghanistan and neighboring countries.	+/-
Market Capitalization	In the model, each country's market capitalization is an endogenous variable. Higher aggregate demand from foreign countries implies higher asset prices, which boosts agents' incentives to initiate new riskier initiatives and list more financial assets.	+
Tax Rate	Corporate tax rates decrease returns in FDI, which takes away incentives to invest in a foreign country with high corporate tax rates.	-
DIPR	DIPR is derived from publicly available data on US economic and military sanctions placed on Afghanistan from time to time, as well as other released material like press briefings and newspaper stories. The DIPR scale ranges from 0 (no sanctions) to 1 (heavy sanctions), with 0.5 representing partial sanctions (i.e. sanctions on military aid but not on economic aid).	+
Tax Treaty	A tax treaty is a mutual agreement or bilateral contract of countries to lower taxes for each other. A tax treaty is a dummy variable.	+
Cultural Differences	Cultural differences are measured as Euclidean distance and are derived from Hofstede's four cultural dimensions and have also been used to examine in Heuchemer *et al.* (2008). These include	-

	"Power Distance Index (PDI)"Individualism (IDV) "Masculinity (MAS) "Uncertainty Avoidance Index (UAI)
Political Indicators	Six different political or governance criteria are used to express political disparities. These six different characteristics of governance are defined by the World Bank and are measured in units ranging from -2.5 to 2.5, with higher values indicating better governance outcomes. Voice and accountability (VA), political stability and absence of violence (PSNV), government effectiveness (GE), regulatory quality (RQ), rule of law (RL), and corruption control (CC) are the six political aspects outlined (CC).

3.2.1: Diplomatic relations between Afghanistan and US

There is a scarcity of information about Afghanistan's political relations with the United States. As a result, the variable DIPR, which represents Afghanistan's political ties with the United States, is created as a proxy for interstate political relations. DIPR is derived from publicly available data on US economic and military sanctions placed on Afghanistan from time to time, as well as other released material like press briefings and newspaper stories. The DIPR scale ranges from 0 (no sanctions) to 1 (heavy sanctions), with 0.5 representing partial sanctions (i.e. sanctions on military aid but not on economic aid).

Table 3.2: Summary of U.S. Aid Policies towards Afghanistan (2005-2020)

Time Period	Nature of Relations	U.S Policies	Aid Flows	The weight assigned to *DIPR*
2005	Good	No sanctions	Economic aid, military aid	0
2006	Good	No Sanctions	Economic and military aid	0
2007	Partial Deterioration	Minor sanctions	Economic aid and less military aid	1
2008	Partial Deterioration	Minor sanctions	Economic aid and less military aid	1
2009	Good	No sanctions	Economic and military aid,	0

2010	Good	No sanctions	Economic and military aid,	0
2011	Good	No sanctions	Economic and military aid,	0
2012	Partial Deterioration	Minor sanctions	Economic aid and less military aid	1
2013	Good	No sanctions	Economic and military aid in terms of training	0
2014	Good	No sanctions	Economic and military aid in terms of training	0
2015	Partial Deterioration	Less sanctions	Economic aid and less military aid	1
2016	Partial Deterioration	Less sanctions	Economic aid and less military aid	1
2017	Good	No sanctions	Economic and military aid,	0
2018	Good	No sanctions	Economic and military aid,	0
2019	Good	No sanctions	Economic and military aid,	0
2020	Good	No sanctions	Economic and military aid,	0

Source: Adapted from Muram and Wani, 2020.

3.3 Research Methodology and Data Collection Procedure

The scope of the gravity equation framework has lately been thoroughly investigated by scholars who included variables to the gravity model that represent political and cultural variations. Flörkemeier, 2002; Guiso et al., 2009; Kalemli-Ozcan and Sorensen, 2007; Heuchemer and Sander, 2007; Heuchemer et al., 2008) are attempting to determine the impact of cultural and political influences on asset trade. These studies give empirical findings that suggest that confidence in other countries, institutions, and these institutions' trust in each other, as well as cultural differences, are key drivers, or impediments, to economic interchange. Heuchemer et al. (2008) study the cultural and political differences as factors of European banking market integration. . As per the literature review, the best data collection procedure for this study is the secondary source, and this study uses annual time series data for the period spanning from 2005 to to analyze the relationship and effect of 2020economic, cultural, and political factors affecting FDI inflow to in Afghanistan. The following data have been extracted separately from World Bank WDI, WITS, Trading Economics, and UN COMTRADE 2020.

3.3.1 Data Analysis Methods and Model

We attempt to outline the functional forms of the models to be estimated in this part, as well as define the variables that best match the models. Because country-specific factors can

influence the dependent variable and the sample that is analyzed concerns data for the same country over time, the model is analyzed as for panel data, also known as longitudinal data, which is analyzed differently as pure cross-sectional data or pooled cross-sectional data. In addition, an equation for analyzing FDI flows over time must be defined. As noted in the theoretical section, gravity equations are utilized to model trade flows in the empirical literature. The gravity equation is the most widely used tool for resolving bilateral investment flows and positions, and it's also the finest technique to investigate the impact of third-party elements including economic, cultural, and political disparities. Economic masses of both trade and non-trading countries are utilized to explain investment flows in the gravity equation model. In addition to the economic masses, geographical distance (DISTANCE) is also incorporated in the regression equation. The model is completed by the gravitational constant (G):

$$X_{ij} = GDP_{it} * GDP_{jt}/[Distance_{ij}]^2 \qquad (1)$$

where Xijt is defined as bilateral asset trade of country I to country j in year t. To arrive at the regression model the gravity equation is converted into a linear relationship between the explanatory variables and the trade flows, in this case, FDI flows. A logarithmic version of the regression model is shown:

$$\ln(X_{ijt}) = X_0 + \beta_1 lnGDP_{it} + \beta_2 lnGDP_{jt} + \beta_3 lnDistance_{ij} \qquad (2)$$

This is the essence of the gravity model but in the empirical literature more variations and extensions of the basic gravity, model is presented. The study will show and test these variations and extensions after which is best fit our data. The best approach supporting the augmentation includes Baltagi's approach (2003) defined as follows:

$$ln(Xijt) = X_0 + \beta_1 lnSize_{ijt} + \beta_2 lnREL_{ijt} + \beta_3 lnSimilar_{ijt} + \beta_4 lnDistance_{ijt} +$$

$$\beta_5 Border_{ij} + \beta_6 DIPR_{ij} + \sum_{k=1}^{n} \beta_k lnY_{ijt} + u_{ijt} \qquad (3)$$

Baltagi derives the variables SIZE, REL, and SIMILAR from Krugman (1980) and Helpman & Krugman's advancements in trade theory (1985). Size is defined as the product or sum of the GDPs of both trade partners, and it indicates the economic masses of both trading partners. REL is a proxy for relative factor endowments and presumably a level of familiarity. It measures the difference in economic welfare between trading partners in terms of GDP per capita (GDPpc). SIMILAR is a similarity index that compares the GDP of both trade countries and acts as a proxy for relative country size. Baltagi adds the dummy variable BORDER to

the gravity model, which symbolizes a neighboring country. . The remainder stochastic disturbance is represented by uijt. Guerin (2006) also presents a gravity equation by specifying the following model: The model includes Baltagi's approach (2003) defined as follows:

$$\text{Inflw(ijt)} = \alpha + \beta_1 \text{lnPop}_{ijt} + \beta_2 \text{lnGDPPC}_{it} + \beta_3 \text{lnDistance}_{ij} + \beta_4 Z_{ij} + t_t + d_j + e_{ij,t}$$

(4)

In this gravity equation, country size is measured as POP which represents the population in a partner country. Economic prosperity is again measured in GDPpc and also the distance is incorporated in the model by Guerin. These variables are in logs, therefore the coefficients can be interpreted as semi-elasticities. A set of control variables are added to the model, Zij, time dummies, tt, source country dummies, dj, and the remainder stochastic disturbance i.e. the error term, eij,t.

Portes and Rey (2005) use a gravity model in their article on asset trade and arrives at the next model:

$$\text{logT}_{ij} = k_1(\text{logM}_i M_j) + k_2 \text{log}(\tau)_{it} + k_3 \quad (5)$$

Mi and Mj represent the economic masses of country i and country j. In this equation economic masses are measured as equity market capitalizations. τij represents the transaction cost between the trading partners. k1<0, k2<0, and k3 are constants to be estimated.

These models is tested combined and separately, to arrive at the best-fit model for our data, and used to estimate the parameters of the variables.

In theory, OLS may be used to estimate the baseline model we'll be employing. However, due to omitted variable effects, the estimation results may be skewed (Heuchemer, 2008). These omitted variable effects could indicate effects that are similar across all country pairs I but specific to any year (t), as well as effects that are country pair specific but comparable across all years (ii). As a result, panel data techniques should be used, and the term "error" will be defined as follows: :

$$\mu_{ijt} = (\pi_{ij}) + (\tau)_t + \epsilon_{ijt} \quad (6)$$

In this equation, the error term is explained by λij, which reflects any time-invariant bilateral idiosyncratic effect, and τt, which captures the time effect. The equation is completed with an error term.

Unobserved impacts can be classified as either fixed or random. As a result, the unobserved temporal effect might be thought of as fixed. Possible trends or aggregate shocks, such as

global business cycles, global capital market shocks, or variations in the global rate of interest year dummies, are incorporated in the model to control for occurrences. The use of year dummies in the model allows the equation's intercept to change over time, which can be used to compensate for trends. The unobservable time effect or fixed effect, t, is represented in the equation above by the subscript t, which stands for year t. ij is the nation fixed effect and can be thought of as a separate intercept to be estimated for each country. There may be time-specific factors that are consistent across countries and have an impact on the dependent variable. . These factors are obtained in λij.

A Least Squared Dummy Variable Model (LSDV) is used to evaluate panel data containing unobserved effects. This method gives findings that are adjusted for country-specific effects and errors as well as time-specific effects and inaccuracies. This fixed effects model allows us to use OLS to analyze panel data while obtaining results that are equivalent to those obtained using pure cross-sectional data. (Wooldridge, 2002).

We anticipate that the given parameters will capture a significant degree of variation in the data. Fixed effects techniques, on the other hand, are unable to estimate models containing time-invariant variables such as border, distance, language, or the political and cultural issues that we are interested in. They're also unable to estimate models with country invariant variables like the US population and Afghanistan's GDP per capita. As a result, these fixed effects approaches will be employed to estimate the robustness of country and time-variant variables. To get at the best result, the robustness check is accomplished by testing with various control variables, normalizations, and dummies that are commonly used in asset trading.

Furthermore, in our model a substantial amount of country-specific differences are measured, most of those variables act as a proxy for political and cultural differences, which are non-time varying. These political and cultural variables are measured as Euclidean distances between two countries:

$$ED = \sqrt{\sum_{k=1}^{k}(V_{ik} - V_{jk})^2} \quad (7)$$

ED defines Euclidean distance and V are the different variables that are taken into account of country i and country j.

The modeling strategy is thus as follows: We first create a baseline gravity equation using pure trade-theoretic explanatory factors, then estimate these various variables, before defining a basic gravity model that best matches our data. Second, we add two more variables to this

model that are commonly used in empirical asset trade models, and we test the robustness of the variables included in the first model. Finally, the enhanced model is expanded with cultural and political variables individually, and Wald-tests are used to determine their significance. Non-varying variables such as time and country were removed from the model, and fixed and random panel effects were investigated. Finally, all of the variables are put into the gravity model to be tested, and these variables are checked again using Wald-tests. Fifth, we remove non-varying factors such as time and country from the model and assess fixed and random panel effects. . Because of the absence of a clear theoretical foundation, the model is empirically tested and the variables best fit our data are selected and placed into the model.

3.3.2 Gravity equations

Different gravity equations are defined to test the effect and robustness of the models and explain variables.

3.3.1 Basic gravity equation

For both Afghanistan and its trading partners, various models and factors such as GDP, population, and GDP per capita were tested. As demonstrated below, the most appropriate model incorporates population and GDP per capita. This implies that GDP is also included in the model; nevertheless, population and GDP per capita fit our data better. All variables were examined both with and without log, with the most significant variable being chosen. The following basic benchmark gravity equation is derived from adding Distance, Border, and Language to the gravity model. :

$$\log FDI_{it} = \beta_0 + \beta_1 lnPop_{ast} + \beta_2 lnPop_{it} + \beta_3 lnGDPpc_{ast} + \beta_4 GDPpc_{it} +$$
$$\beta_5 Distance_i + \beta_6 Border_i + \beta_7 Language_i + e_{it} \qquad (8)$$

i = 1,…, N ; t = 1,…, T,

Whereby N is the number of countries and T the number of years, εit is the remainder stochastic disturbance, $\varepsilon it \sim IID (0,\delta)$

3.3.3 Augmented Gravity equation

By adding log Trade and log Market cap to the basic gravity equation we developed the augmented gravity equation. Trade, DIPR, and Market cap are frequently used to explain variables in the empirical asset trade literature and also add significance to our model.

This leads to the following augmented gravity equation:

$$logFDI_{it} = \beta_0 + \beta_1 lnPop_{ast} + \beta_2 lnPop_{it} + \beta_3 lnGDPpc_{ast} + \beta_4 GDPpc_{it} +$$
$$\beta_5 Distance_i + \beta_6 Border_i + \beta_7 Language_i + \beta_8 Trade_{it} + \beta_3 DIPR_{ij} +$$
$$\beta_9 lnMarketcap_{it} + e_{it} \qquad (9)$$

Where i = 1,…, N; t = 1,…, T, and by employing this model, the robustness of the basic gravity model can be tested.

3.3.4 Augmented gravity equation including explaining variables separately

Explaining variables are added to the augmented gravity equation separately to test if they are significant and add value to the model running Wald-tests. Y represents the following variables: Tax Rate, Tax Treaty, Culture, Political, VA, PSNV, GE, RQ, RL, CC, VAR, PSNVR, GER, RQR, RLR, and CCR

$$lnFDI_{it} = \beta_0 + \beta_1 lnPop_{ast} + \beta_2 lnPop_{it} + \beta_3 lnGDPpc_{ast} + \beta_4 GDPpc_{it} +$$
$$\beta_5 Distance_i + \beta_6 Border_i + \beta_7 Language_i + \beta_8 Trade_{it} + \beta_9 lnMarketcap_{it} + \beta_{10}Y +$$
$$\beta_9 lnDIPR_{it} + e_{it} \qquad (10)$$

i = 1,…, N ; t = 1,…, T,

3.3.4 Total gravity equation including all explaining variables

The study concludes by specifying the total model including all explaining variables that were tested above. Again run Wald-tests to test if the different variables are significant in the extended model.

$$lnFDI_{it} = \beta_0 + \beta_1 lnPop_{ast} + \beta_2 lnPop_{it} + \beta_3 lnGDPpc_{ast} + \beta_4 GDPpc_{it} +$$
$$\beta_5 Distance_i + \beta_6 Border_i + \beta_7 Language_i + \beta_8 Trade_{it} + \beta_9 lnMarketcap_{it} +$$
$$\beta_{10}Taxrate_i + \beta_{11}Taxtreaty_i + \beta_{12}Culture_i + \beta_{13}VA_i + \beta_{14}PSNV_i + \beta_{15}GE_i +$$
$$\beta_{16}RQ_i + \beta_{17}RL_i + \beta_{18}CC_i + e_{it} \qquad (11)$$

i = 1,…, N ; t = 1,…, T,

3.3.5 Time and country fixed effects model

In this model, all time and country non-varying variables are left out of the model to test time and country fixed effects. The following model is specified to test time-fixed effects:

$$lnFDI_{it} = \beta_0 + \beta_1 lnPop_{ast} + \beta_2 lnPop_{it} + \beta_3 lnGDPpc_{ast} + \beta_4 GDPpc_{it} +$$
$$\beta_5 Distance_i + \beta_6 Border_i + \beta_7 Language_i + \beta_8 Trade_{it} + \beta_9 lnMarketcap_{it} +$$
$$\beta_{10}Taxrate_i + \beta_{11}Taxtreaty_i + \beta_{12}Culture_i + \beta_{13}VA_i + \beta_{14}PSNV_i + \beta_{15}GE_i +$$
$$\beta_{16}RQ_i + \beta_{17}RL_i + \beta_{18}CC_i + \tau_t + e_{it} \qquad (12)$$

i = 1,…, N ; t = 1,…, T,

The following model is specified to test country-fixed effects:

$$\ln FDI_{it} = \beta_0 + \beta_1 lnPop_{ast} + \beta_2 lnPop_{it} + \beta_3 lnGDPpc_{ast} + \beta_4 GDPpc_{it} +$$
$$\beta_5 Trade_{it} + \beta_6 lnMarketcap_{it} + \lambda_t + e_{it} \quad (13)$$

$i = 1,…, N\ ;\ t = 1,…, T,$

CHAPTER 4

RESULTS, ANALYSIS, AND DISCUSSIONS

In this chapter, the results of the regression models are presented and explained, according to the equations discussed in the methodology. After which, the estimated parameters of the economic, political, and cultural factors are explained. From this, a Wald test and robustness check will be carried out to test the significance and the robustness of the economic, political, and cultural parameters. The chapter is concluded with a discussion of the results.

4.1 Results

The models are discussed in the same sequence as in the methodology. First, the basic gravity model is explained.

Table 4.1: Basic Gravity Model

Method:	Panel Least Squares: 2005-201		
Sample:	2005-2020		
Periods included:		15	
Cross-sections included:		15	
Total panel observations	225		
Dependent Variable	ln(Inward FDI Stock)		
		Coefficient	Probability
C		-231.2210	0.000
lnGDPPC		2.2312	0.000
lnGDPPCA		-8.2759	0.000
lnPOPA		25.4032	0.000
BORDER		0.6882 -	0.000
DISTANCE		0.0002	0.000
LANGUAGE		0.8615	0.000
DIPR		0.672	0.000
Adjusted R-squared		0.790	
S.E. of regression		1.222	
Sum squared resid		1917.754	
Log-likelihood		-1220.529	
F-statistic		405.987	
Prob(F-statistic)		0.000	

Table 4.2: Augmented Gravity Model

Method:	Panel Least Squares: 2005-2019		
Sample:	2005-2020		
Periods included:		15	
Cross-sections included:		15	
Total panel observations	225		
Dependent Variable	ln(Inward FDI Stock)		
		Coefficient	Probability
C		-241.32	0.000
lnGDPPC		2.23	0.000
lnPOP		-8.27	0.000
lnGDPPA		25.40	0.000
lnPOPA		23.87	0.000
BORDER		0.682	0.000
DISTANCE		0.002	0.000
LANGUAGE		0.861	0.000
lnTrade		0.451	0.000
lnMarketcap		0.213	0.000
DIPR		0.311	0.000
Adjusted R-squared		0.790	
S.E. of regression		1.222	
Sum squared resid		1917.754	
Log-likelihood		-1220.529	
F-statistic		398.787	
Prob(F-statistic)		0.000	

Source: Data output from E-Views 12.0

The results as presented in table 4.1, portray the positive sign of parameters except for GDPPC, thereby reflecting the positive effect on asset trade between Afghanistan and its

partner countries. GDPPCA has a negative effect on inward FDI, therefore, an increase in economic growth in Afghanistan causes a decrease of FDI stock between Afghanistan and their partner countries. As transportation costs grow as a function of distance, it becomes more cost-effective for an MNE to manufacture overseas and, for example, invest in a subsidiary firm, hence increasing FDI. The fact that distance has a major impact on outbound FDI stock underscores this point because the profitability of manufacturing overseas is determined by costs, particularly labor costs. With exception of distance for total FDI stock and inward FDI stock, all signs are significant at a 1% level of significance. In table 4.2, in the augmented gravity model in trade and lnMarketcap variables have been added to the model to increase the model's fit. R-squared increases after adding both variables to 82%, 84%, and 76% for total FDI stock, inward FDI stock, and outward FDI stock respectively, an overall increase of approximately 10%. When adding Trade and Market capitalization to the model all signs of the remaining variables stay the same except for border and distance which change from positive to negative. This is probably caused by the correlation between trade and both border and distance. In the augmented gravity equation border and distance are insignificant for outward FDI stock at a 10% significance level.

4.1.3 Augmented gravity model including explaining variables separately

The explaining variables are employed in the augmented gravity model separately and the results will also be discussed separately per variable. With exception of legal family, culture, and the separate political indicators: VA, PSNV, GE, RQ, RL, and CC. Higher quality or a higher rank means more stability and less risk. First, in the inward FDI stock model, the sign of the political rank parameter is positive indicating that countries with a high rank or quality of total political situation will invest more FDI in the US than countries that have a low rank or quality of the total political situation. This suggests a strong weight of vertical FDI flows from abroad to Afghanistan.

4.1.4 Total model including all explaining variables

In this paragraph, four different models are shown. An important advantage of showing four models is that we can test the robustness of the parameters. In all four models, all variables are included.

Table 4.3: Total Gravity Model; including Legal Family and Political Difference indicators

Method:	Panel Least Squares: 2005-2019		
Sample:	2005-2020		
Periods included:	15		
Cross-sections included:	15		
Total panel observations	225		
Dependent Variable	ln(Inward FDI Stock)		
		Coefficient	Probability
C		-241.32	0.000
lnGDPPC		2.23	0.000
lnPOP		-8.27	0.000
lnGDPPA		25.40	0.000
lnPOPA		23.87	0.000
BORDER		0.682	0.231
DISTANCE		0.002	0.000
LANGUAGE		0.861	0.530
lnTrade		0.451	0.000
lnMarketcap		0.213	0.000
Taxrate		0.0002	0.000
Taxtreaty		-0.5540	0.000
Legalfam		0.01201	0.600
Culture		-0.01213	0.000
VA		-0.00001	0.003
PSNV		-0.00001	0.005

	Coefficient	Probability
GE	0.00001	0.000
RQ	0.00021	0.000
RL	-0.00054	0.000
CC	0.00032	0.000
Adjusted R-squared	0.790	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	
F-statistic	398.787	
Prob(F-statistic)	0.000	

Source: Data output from E-Views 12.0

Table 4.4: Total Gravity Model; including Legal Family 01 and Political Difference indicators

Method:	Panel Least Squares: 2005-2019	
Sample:	2005-2020	
Periods included:	15	
Cross-sections included:	15	
Total panel observations	225	
Dependent Variable	ln(Inward FDI Stock)	
	Coefficient	Probability
C	-241.32	0.000
lnGDPPC	2.23	0.000
lnPOP	-8.27	0.000
lnGDPPA	25.40	0.000

lnPOPA	23.87	0.000
BORDER	0.682	0.231
DISTANCE	0.002	0.000
LANGUAGE	0.861	0.530
lnTrade	0.451	0.000
lnMarketcap	0.213	0.000
Taxrate	0.0002	0.000
Taxtreaty	-0.5540	0.000
Legalfam	0.01201	0.600
Culture	-0.01213	0.000
VA	-0.00001	0.003
PSNV	-0.00001	0.005
GE	0.00001	0.000
RQ	0.00021	0.000
RL	-0.00054	0.000
CC	0.00032	0.000
Adjusted R-squared	0.790	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	
F-statistic	398.787	
Prob(F-statistic)	0.000	

Source: Data output from E-Views 12.0

Table 4.5: Total Gravity Model; including Legal Family and Political Rank indicators

Method:	Panel Least Squares: 2005-2019	
Sample:	2005-2020	
Periods included:	15	
Cross-sections included:	15	
Total panel observations	225	

Dependent Variable	ln(Inward FDI Stock)	
	Coefficient	Probability
C	-241.32	0.000
lnGDPPC	2.23	0.000
lnPOP	-8.27	0.000
lnGDPPA	25.40	0.000
lnPOPA	23.87	0.000
BORDER	0.682	0.231
DISTANCE	0.002	0.000
LANGUAGE	0.861	0.530
lnTrade	0.451	0.000
lnMarketcap	0.213	0.000
Taxrate	0.0002	0.000
Taxtreaty	-0.5540	0.000
Legalfam	0.01201	0.600
Culture	-0.01213	0.000
VA	-0.00001	0.003
PSNV	-0.00001	0.005
GE	0.00001	0.000
RQ	0.00021	0.000

	Coefficient	Probability
RL	-0.00054	0.000
CC	0.00032	0.000
Adjusted R-squared	0.790	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	
F-statistic	398.787	
Prob(F-statistic)	0.000	

Source: Data output from E-Views 12.0

Table 4.6: Total Gravity Model; including Legal Family 01 and Political Rank indicators

Method:	Panel Least Squares: 2005-2019	
Sample:	2005-2020	
Periods included:	15	
Cross-sections included:	15	
Total panel observations	225	
Dependent Variable	ln(Inward FDI Stock)	

	Coefficient	Probability
C	-241.32	0.000
lnGDPPC	2.23	0.000
lnPOP	-8.27	0.000
lnGDPPA	25.40	0.000
lnPOPA	23.87	0.000
BORDER	0.682	0.231
DISTANCE	0.002	0.000

LANGUAGE	0.861	0.530
lnTrade	0.451	0.000
lnMarketcap	0.213	0.000
Taxrate	0.0002	0.000
Taxtreaty	-0.5540	0.000
Legalfam	0.01201	0.600
Culture	-0.01213	0.000
VA	-0.00001	0.003
PSNV	-0.00001	0.005
GE	0.00001	0.000
RQ	0.00021	0.000
RL	-0.00054	0.000
CC	0.00032	0.000
Adjusted R-squared	0.790	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	
F-statistic	398.787	
Prob(F-statistic)	0.000	

Source: Data output from E-Views 12.0

If we compare those four models we see that the best fit or the highest R-squared (adjusted) is produced in model 6, namely 0.867%, followed by model 5, model 4, and model 3, with 0.866%, 0.860%, and 0.838% respectively. In addition, Legalfam01 fits the data more precisely than Legalfam shown by the adjusted R-squared. If we have a closer look at the different explaining variables and compare the four different extended models we see that the first five explaining variables in the model: C, lnGDPpc, ln Pop, lnGDPpcUS and PopUS

have approximately the same parameter and are all significant, except for ln Pop in model 3 and 4. In models (5and 6) including the political rank variables distance also has a positive effect on inward FDI stock but in models (3 and 4) including the political difference variables it has a negative effect on inward FDI. The corporate tax rate of a partner country has a negative effect on total and outward FDI stock and the effect on inward FDI stock is ambiguous and insignificant and depends on the model.

4.1.5 Time and country fixed effects models

In this section, the models are tested with time-fixed effects or year dummies. The first four models contain the same variables as models 3-6 excluding population Afghanistan and GDP per capita in the Afghanistan. Because these variables are the same for each country they only differ in time. Thus, it is impossible to incorporate these variables into a time-fixed model. The fifth model (11) is tested with cross-section fixed effects or country dummies and therefore all the time-invariant variables are excluded. The following five fixed effects models are shown:

Table 4.7: Total Gravity Model; including Legal Family and Political Difference (Time Fixed)

Method:	Panel Least Squares: 2005-2019	
Sample:	2005-2020	
Periods included:	15	
Cross-sections included:	15	
Total panel observations	225	
Dependent Variable	ln(Inward FDI Stock)	
	Coefficient	Probability
C	-241.32	0.000
lnGDPPC	2.23	0.000
lnPOP	-8.27	0.000

lnGDPPA	25.40	0.000
lnPOPA	23.87	0.000
BORDER	0.682	0.231
DISTANCE	0.002	0.000
LANGUAGE	0.861	0.530
lnTrade	0.451	0.000
lnMarketcap	0.213	0.000
Taxrate	0.0002	0.000
Taxtreaty	-0.5540	0.000
Legalfam	0.01201	0.600
Culture	-0.01213	0.000
VA	-0.00001	0.003
PSNV	-0.00001	0.005
GE	0.00001	0.000
RQ	0.00021	0.000
RL	-0.00054	0.000
CC	0.00032	0.000
Adjusted R-squared	0.790	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	
F-statistic	398.787	
Prob(F-statistic)	0.000	

Source: Data output from E-Views 12.0

Table 4.8: Total Gravity Model; (Legal Family 01 and Political Difference, Time Fixed)

Method:	Panel Least Squares: 2005-2019
Sample:	2005-2020
Periods included:	15
Cross-sections included:	15
Total panel observations	225
Dependent Variable	ln(Inward FDI Stock)

	Coefficient	Probability
C	-241.32	0.000
lnGDPPC	2.23	0.000
lnPOP	-8.27	0.000
lnGDPPA	25.40	0.000
lnPOPA	23.87	0.000
BORDER	0.682	0.231
DISTANCE	0.002	0.000
LANGUAGE	0.861	0.530
lnTrade	0.451	0.000
lnMarketcap	0.213	0.000
Taxrate	0.0002	0.000
Taxtreaty	-0.5540	0.000
Legalfam	0.01201	0.600
Culture	-0.01213	0.000
VA	-0.00001	0.003
PSNV	-0.00001	0.005
GE	0.00001	0.000
RQ	0.00021	0.000
RL	-0.00054	0.000
CC	0.00032	0.000
Adjusted R-squared	0.790	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	

F-statistic	398.787	
Prob(F-statistic)	0.000	

Table 4.9: Total Gravity Model; (Legal Family and Political Rank, Time Fixed)

Method:	Panel Least Squares: 2005-2019	
Sample:	2005-2020	
Periods included:	15	
Cross-sections included:	15	
Total panel observations	225	
Dependent Variable	ln(Inward FDI Stock)	

	Coefficient	Probability
C	-241.32	0.000
lnGDPPC	2.23	0.000
lnPOP	-8.27	0.000
lnGDPPA	25.40	0.000
lnPOPA	23.87	0.000
BORDER	0.682	0.231
DISTANCE	0.002	0.000
LANGUAGE	0.861	0.530
lnTrade	0.451	0.000
lnMarketcap	0.213	0.000
Taxrate	0.0002	0.000
Taxtreaty	-0.5540	0.000
Legalfam	0.01201	0.600
Culture	-0.01213	0.000

	Coefficient	Probability
VA	-0.00001	0.003
PSNV	-0.00001	0.005
GE	0.00001	0.000
RQ	0.00021	0.000
RL	-0.00054	0.000
CC	0.00032	0.000
Adjusted R-squared	0.790	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	
F-statistic	398.787	
Prob(F-statistic)	0.000	

Source: Data output from E-Views 12.0

Table 4.10: Total Gravity Model; including Legal Family 01 and Political Rank (Time Fixed)

Method:	Panel Least Squares: 2005-2019	
Sample:	2005-2020	
Periods included:	15	
Cross-sections included:	15	
Total panel observations	225	
Dependent Variable	ln(Inward FDI Stock)	
	Coefficient	Probability
C	-241.32	0.000
lnGDPPC	2.23	0.000
lnPOP	-8.27	0.000

lnGDPPA	25.40	0.000
lnPOPA	23.87	0.000
BORDER	0.682	0.231
DISTANCE	0.002	0.000
LANGUAGE	0.861	0.530
lnTrade	0.451	0.000
lnMarketcap	0.213	0.000
Taxrate	0.0002	0.000
Taxtreaty	-0.5540	0.000
Legalfam	0.01201	0.600
Culture	-0.01213	0.000
VA	-0.00001	0.003
PSNV	-0.00001	0.005
GE	0.00001	0.000
RQ	0.00021	0.000
RL	-0.00054	0.000
CC	0.00032	0.000
R-squared	0.7861	
Adjusted R-squared	0.7901	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	
F-statistic	398.787	
Prob(F-statistic)	0.000	

Source: Data output from E-Views 12.0

Model 9 has the greatest fit or the highest R-squared (adjusted) when comparing the four models, followed by models 10, 8, and 7. Legalfam01 fits the data better than any of the four different extended models. Ln Trade is in all models significant and has a positive effect on FDI between the Afghanistan and partner countries. The corporate tax rate of a partner country has a negative effect on total and outward FDI stock.

Table 4.11: Augmented Gravity Model (Country Fixed)

Method:	Panel Least Squares: 2005-2019	
Sample:	2005-2020	
Periods included:	15	
Cross-sections included:	15	
Total panel observations	225	
Dependent Variable	ln(Inward FDI Stock)	
	Coefficient	Probability
C	-241.32	0.000
lnGDPPC	2.23	0.000
lnPOP	-8.27	0.000
lnGDPPA	25.40	0.000
lnPOPA	23.87	0.000
lnTrade	0.451	0.000
lnMarketcap	0.213	0.000
R-squared	0.7861	
Adjusted R-squared	0.790	
S.E. of regression	1.222	
Sum squared resid	1917.754	
Log-likelihood	-1220.529	
F-statistic	398.787	
Prob(F-statistic)	0.000	

Source: Data output from E-Views 12.0

4.1.6 Comparison of parameters for different models

- **Legal Family and Legal Family 01**

Table 4.12: : Parameters & probabilities of Legal Family and Legal Family 01

Legalfam	Normal		Time Fixed		Separately
	Political Difference	Political Rank	Political Difference	Political Rank	
Inward	0.014(0.82)	0.054(0.34)	0.004(0.83)	0.053(0.04)	0.033
Legalfam01	Normal		Time Fixed		Separately
	Political Difference	Political Rank	Political Difference	Political Rank	
Inward	-0.622(0.00)	-0.781(0.56)	-0.765(0.63)	-0.03(0.00)	0.102

Source: Data output from E-Views 12.0

Legal Family and Legal Family 01 are significant, at a 1% significance level, in the models explaining inward FDI stock. As theory suggests, belonging to the same legal family increases familiarity and reduces transaction costs which should raise investments between countries. Introducing legal family into the augmented gravity model decreases the significance of border and distance in the model.

- **Culture**

Table 4.13: Parameters & probabilities of Culture

Culture	Normal				Time Fixed				Separately	
	Legal Family		Legal Family01		Legal Family		Legal Family01			
Political Difference										
Total	-0.013	0	-0.023	0	-0.007	0	-0.014	0	-0.013	-0.007

Inward	-0.015	0	-0.035	0	-0.006	0	-0.015	0	-0.015	-0.006
Outward	-0.017	0	-0.027	0	-0.005	0	-0.016	0	-0.017	-0.005
Political Rank										
Total	-0.007	0	-0.017	0	-0.027	0	-0.018	0		
Inward	-0.006	0.01	-0.016	0.01	-0.0016	0.01	-0.0109	0.01		
Outward	-0.005	0.05	-0.015	0.05	-0.104	0.05	-0.015	0.05		

Source: Data output from E-Views 12.0

In all three augmented gravity models, inward FDI stock, the difference in culture between Afghanistan and its partner countries is significant at a 1% significance level. In the model the sign of culture's parameter is negative. The theoretical foundation suggests that Culture together with trade is the most robust explaining variable. In models explaining political rank, culture is slightly less significant. The theoretical foundation suggests that differences in culture decrease familiarity and increases transaction costs, which causes lower investments between partner countries. It has the same sign and magnitude in all models.

- **Voice and Accountability**

Table 4.14: Parameters & probabilities of Voice and Accountability indicator

VA	Normal				Time Fixed				Separately	
	Legal Family		Legal Family01		Legal Family		Legal Family01			
Political Difference										
Total	-0.013	0	-0.023	0	-0.007	0	-0.014	0	-0.013	-0.007
Inward	-0.015	0	-0.035	0	-0.006	0	-0.015	0	-0.015	-0.006
Outward	-0.017	0	-0.027	0	-0.005	0	-0.016	0	-0.017	-0.005

	Legal Family		Legal Family01		Legal Family		Legal Family01	
Political Rank								
Total	-0.007	0	-0.017	0	-0.027	0	-0.018	0
Inward	-0.006	0.01	-0.016	0.01	-0.0016	0.01	-0.0109	0.01
Outward	-0.005	0.05	-0.015	0.05	-0.104	0.05	-0.015	0.05

Source: Data output from E-Views 12.0

Afghanistan's ranking in Voice and Accountability (VA) Rank is significant, at a 1% significance level. VA Rank has a positive sign, which means that inward FDI diverted to Afghanistan from partner countries resembles high-quality voice and accountability. More FDI investments are initiated in Afghanistan compared to countries with low VA ranks.

- **Political Stability No Violence**

Table 4.15: Parameters & probabilities of Political Stability No Violence indicator

PSNV	Normal				Time Fixed				Separately	
	Legal Family		Legal Family01		Legal Family		Legal Family01			
Political Difference										
Total	-0.013	0	-0.023	0	-0.007	0	-0.014	0	-0.013	-0.007
Inward	-0.015	0	-0.035	0	-0.006	0	-0.015	0	-0.015	-0.006
Outward	-0.017	0	-0.027	0	-0.005	0	-0.016	0	-0.017	-0.005
Political Rank										
Total	-0.007	0	-0.017	0	-0.027	0	-0.018	0		
Inward	-0.006	0.01	-0.016	0.01	-0.0016	0.01	-0.0109	0.01		
Outward	-0.005	0.05	-0.015	0.05	-0.104	0.05	-0.015	0.05		

Political Stability No Violence (PSNV) is significant in explaining inward FDI stock at a significance level of 1%. Political Stability No Violence (PSNV) is significant in explaining inward FDI stock at a significance level of 1%. Large investors like the UK, Netherlands, and France occupy a rather low rank in this indicator. This shows that empirical results do not underwrite the theoretical foundation of familiarity in the area of politics.

- **Government Effectiveness**

Table 4.16: Parameters & probabilities of Government Effectiveness indicator

GE	Normal				Time Fixed				Separately	
	Legal Family		Legal Family01		Legal Family		Legal Family01			
Political Difference										
Total	-0.013	0	-0.023	0	-0.007	0	-0.014	0	-0.013	-0.007
Inward	-0.015	0	-0.035	0	-0.006	0	-0.015	0	-0.015	-0.006
Outward	-0.017	0	-0.027	0	-0.005	0	-0.016	0	-0.017	-0.005
Political Rank										
Total	-0.007	0	-0.017	0	-0.027	0	-0.018	0		
Inward	-0.006	0.01	-0.016	0.01	-0.0016	0.01	-0.0109	0.01		
Outward	-0.005	0.05	-0.015	0.05	-0.104	0.05	-0.015	0.05		

Government Effectiveness (GE) Difference is, in general, significant in explaining inward FDI stock. Its parameter has a negative sign explaining inward stock, meaning that similar countries provide more FDI to Afghanistan. Government Effectiveness (GE) Difference is, in general, significant in explaining inward FDI stock. Its parameter has a negative sign explaining inward stock, meaning that similar countries provide more FDI to Afghanistan. Government

Effectiveness Rank is significant, at a 10% significance level when added to the augmented gravity model.

Regulatory Quality

Table 4.17: Parameters & probabilities of Regulatory Quality indicator

RQ	Normal				Time Fixed				Separately	
	Legal Family		Legal Family01		Legal Family		Legal Family01			
Political Difference										
Total	-0.013	0	-0.023	0	-0.007	0	-0.014	0	-0.013	-0.007
Inward	-0.015	0	-0.035	0	-0.006	0	-0.015	0	-0.015	-0.006
Outward	-0.017	0	-0.027	0	-0.005	0	-0.016	0	-0.017	-0.005
Political Rank										
Total	-0.007	0	-0.017	0	-0.027	0	-0.018	0		
Inward	-0.006	0.01	-0.016	0.01	-0.0016	0.01	-0.0109	0.01		
Outward	-0.005	0.05	-0.015	0.05	-0.104	0.05	-0.015	0.05		

Source: Data output from E-Views 12.0

Regulatory Quality (RQ) difference is significant in the inward FDI model at a 1% significance rate, only if RQ difference is added to the augmented gravity model separately it is significant at a 10% significance rate. Regulatory Quality (RQ) difference is significant in the inward FDI model at a 1% significance rate. In all models, the sign of this parameter is negative suggesting that Afghanistan receives less FDI from countries with high regulation quality. This contradicts the theoretical foundation, which states that high-quality regulation facilitates investments.

- **Rule of Law**

Table 4.18: Parameters & probabilities of Rule of Law indicator

ROL	Normal				Time Fixed				Separately	
	Legal Family		Legal Family01		Legal Family		Legal Family01			
Political Difference										
Total	-0.013	0	-0.023	0	-0.007	0	-0.014	0	-0.013	-0.007
Inward	-0.015	0	-0.035	0	-0.006	0	-0.015	0	-0.015	-0.006
Outward	-0.017	0	-0.027	0	-0.005	0	-0.016	0	-0.017	-0.005
Political Rank										
Total	-0.007	0	-0.017	0	-0.027	0	-0.018	0		
Inward	-0.006	0.01	-0.016	0.01	-0.0016	0.01	-0.0109	0.01		
Outward	-0.005	0.05	-0.015	0.05	-0.104	0.05	-0.015	0.05		

Source: Data output from E-Views 12.0

The rule of Law (RL) difference is significant in the inward and FDI model at a 5% significance level. The rule of Law (RL) difference is significant in the inward and FDI model at a 5% significance level. This indicates that a low-quality Rule of Law in a partner country decreases FDI investments. The augmented model suggests the opposite, according to the theory of familiarity.

- **Control of Corruption**

Table 4.19: Parameters & probabilities of Control of Corruption indicator

COC	Normal				Time Fixed				Separately	

	Legal Family		Legal Family01		Legal Family		Legal Family01			
Political Difference										
Total	-0.013	0	-0.023	0	-0.007	0	-0.014	0	-0.013	-0.007
Inward	-0.015	0	-0.035	0	-0.006	0	-0.015	0	-0.015	-0.006
Outward	-0.017	0	-0.027	0	-0.005	0	-0.016	0	-0.017	-0.005
Political Rank										
Total	-0.007	0	-0.017	0	-0.027	0	-0.018	0		
Inward	-0.006	0.01	-0.016	0.01	-0.0016	0.01	-0.0109	0.01		
Outward	-0.005	0.05	-0.015	0.05	-0.104	0.05	-0.015	0.05		

Source: Data output from E-Views 12.0

   Control of Corruption (CC) difference is significant in the inward FDI model at a 5% significance level. The more dissimilar a country is in control of corruption, the more it invests in Afghanistan. However, the sign is ambiguous in the total models and suggests the results are not robust.

4.1.7 Wald-test

In this section, a Wald-Test is performed on the political indicators, also in combination with the cultural difference indicator.

Table 4.20: Wald-test

		Test Statistic	**All Political Indicators Excl. Cultural indicator.**			**All Political Indicators Incl. Cultural indicator**		
Wald-Tests			**Value**	**df**	**Prob**	**Value**	**df**	**Prob**
1	Legalfam Political Difference	F-statistic	5.07	6.987	0	4.09	7.987	0

#								
		Chi-square	32.87	4	0	22.47	4	0
2	Legalfam01 Political Difference	F-statistic	11.09	6.987	0	14.07	7.987	0
		Chi-square	54.9	4	0	53.9	4	0
3	Legalfam Political Rank	F-statistic	12.67	6.987	0	12.07	7.987	0
		Chi-square	105.09	4	0	125.09	4	0
4	Legalfam01 Political Rank	F-statistic	13.87	6.987	0	12.87	7.987	0
		Chi-square	108.09	4	0	118.09	4	0
5	Legalfam Political Difference (Time Fixed)	F-statistic	5.09	6.987	0	6.09	7.987	0
		Chi-square	34.098	4	0	36.098	4	0
6	Legalfam01 Political Difference (Time Fixed)	F-statistic	11.097	6.987	0	13.097	7.987	0
		Chi-square	34.23	4	0	44.23	4	0
7	Legalfam Political Rank (Time Fixed)	F-statistic	34.98	6.987	0	44.98	7.987	0
		Chi-square	198.08	4	0	148.08	4	0
8	Legalfam01 Political Rank(Time Fixed)	F-statistic	19.08	6.987	0	14.08	7.987	0
		Chi-square	101.09	4	0	121.09	4	0

Source: Data output from E-Views 12.0

From table 4.20 it is concluded that Political Rank is a better estimator of bilateral FDI stock than Political Difference in combination with the Legal Family variable. These results are robust as they are roughly similar in the time-fixed models. We can conclude that in the model including Legal Family and Political Rank the political and cultural indicators are the most significant.

4.1.8 Robustness check

In this section, the robustness of the cultural and political variables is checked. A model which best fits the data is identified, after which it will be tested for robustness by dropping a country from the sample each time.

Table 4.21: Robustness Check

Robustness Check	Legal Family 01 Political Rank		Legal Family Political Rank		Legal Family 01 Political Difference		Legal Family 01 Political Rank (Time Fixed)	
Country	Coefficient	prob	Coefficient	prob	Coefficient	prob	Coefficient	prob
Pakistan	-0.021	0.01	-0.071	0.01	-0.009	0.01	-0.043	0.01
India	-0.031	0.02	-0.065	0.02	-0.075	0.02	-0.075	0.02
US	-0.009	0.01	-0.075	0.01	-0.031	0.01	-0.065	0.01
UK	-0.075	0.03	-0.009	0.03	-0.009	0.03	-0.075	0.03
KSA	-0.031	0.04	-0.031	0.04	-0.043	0.04	-0.009	0.04
UAE	-0.009	0.02	-0.009	0.01	-0.075	0.01	-0.009	0.01
Denmark	-0.075	0.01	-0.075	0.02	-0.065	0.02	-0.075	0.02
Sweden	-0.031	0.03	-0.065	0.01	-0.075	0.01	-0.031	0.01
Netherland	-0.009	0.04	-0.043	0.03	-0.009	0.03	-0.009	0.03
Norway	-0.075	0.01	-0.075	0.04	-0.065	0.04	-0.043	0.04

Germany	-0.031	0.04	-0.065	0.01	-0.055	0.01	-0.075	0.01
Indonesia	-0.009	0.03	-0.075	0.01	-0.009	0.01	-0.065	0.01
Poland	-0.075	0.02	-0.009	0.01	-0.008	0.01	-0.075	0.01
Japan	-0.021	0.04	-0.035	0.01	-0.075	0.01	-0.031	0.01
Australia	-0.043	0.01	-0.075	0.01	-0.075	0.04	-0.065	0.04

Source: Data output from E-Views 12.0

The total model with Legal Family 01 and political Rank is selected because this model has the best fit and highest R-squared. Culture's parameter has a value of -0.009, which means that one unit increase, in Euclidean distance, between Afghanistan and a partner country, total FDI stock decreases by 0.9% (Exp((-0.009)-1)*100). The outliers of the model, including Legal Family and Political Rank, are the cases when Denmark, Poland, and the Netherland are being dropped, which leads to an estimated coefficient of 0.017 and 0.004 respectively. These estimates result in a decrease of 1.6% and 0.4% FDI inflow per unit. If the total model with legal family 01 and political rank (Table 4.6) is selected as the preferred model. The sensitivity of the different political and cultural variables can be calculated. The parameter of legal family 01 is -0.39, which means that belonging to the same legal family decreases FDI stock by 32% (Exp ((-0.39)-1) *100). The political rank variable: voice and accountability (VA) have a parameter of 0.0197, which means that a one-unit increase in the political rank index indicates that FDI stock increases with 2% (Exp ((0.0197)- 1) *100).

4.2 Discussions

The different models described above tested the impact of economic, cultural, and political variables on the magnitude of FDI stock between Afghanistan and its trading partners. The models show several significant and robust results for the control variables as well as the explaining variables mentioned in the research question and hypotheses. The outliers of the model, including Legal Family and Political Rank, are the cases when Denmark, Poland, and the Netherland are being dropped, which leads to an estimated coefficient of 0.017 and 0.004 respectively. These estimates result in a decrease of 1.6% and 0.4% FDI inflow per unit. If the total model with legal family 01 and political rank (Table 4.6) is selected as the preferred model. The sensitivity of the different political and cultural variables can be

calculated. The parameter of legal family 01 is -0.39, which means that belonging to the same legal family decreases FDI stock by 32% (Exp((-0.39)-1)*100). The political rank variable: voice and accountability (VA) have a parameter of 0.0197, which means that a one-unit increase in the political rank index indicates that FDI stock increases with 2% (Exp((0.0197)-1)*100).

Both countries' GDP per capita have proven to be significant and robust in the different gravity models. However, the GDP per capita of the trading partner showed a positive sign, and the GDP per capita of Afghanistan showed a negative sign. Meaning that the low GDP per capita of Afghanistan and high GDP per capita of the trading partner positively affect FDI growth. The positive sign of the trading partner could be explained by the fact that the growth of a country's GDP increases possibilities to invest but also options to invest in. Following this explanation, the negative sign of the GDP per capita of Afghanistan is remarkable. It can be concluded that increasing GDP makes Afghanistan more self-centered or inward-looking. The Population of Afghanistan and the trading partners positively affect the magnitude of bilateral inward FDI. This is according to the theory of the gravity model which states that the size of a country determines for a large part inward FDI. The parameters have proven to be robust and significant.

Border's parameter estimation proved to be less robust. The estimation of its parameter is, in roughly half of the models, significant and in the models in which it is significant renders a negative sign for inward FDI stock. However, this shows only after correcting for trade. This is possibly due to FDI being a supplement of trade. Distance is roughly in all models significant. Language is in all models significant, except for the model including legal family and political difference variables, probably due to correlation effects. In all other models, language is significant. Speaking the same language has an unambiguously positive effect on bilateral inward FDI. In the case of the augmented gravity model, where trade and market capitalization were added. Trade is significant, robust, and has an unambiguously positive effect on bilateral inward FDI. Overall, FDI acts as a complement of trade according to the gravity model. It is also according to the theory of familiarity, as trade induces familiarity, which increases bilateral FDI. Market Capitalization is not significant and robust, as discussed before market capitalization influences FDI stock to a particular country, not from a country.

Regarding the control variables, existing theory and literature are confirmed by this thesis. Only, as mentioned above, the GDP per capita Afghanistan parameter estimation yields a divergent result. This could be typical for Afghanistan and deserves some further investigation. Subsequently, we arrived at the additional explaining variables, which are also represented in our hypotheses. Respectively: culture, legal family, legal family 01, political difference indicators, and political rank indicators.

First, in this empirical study the following hypothesis was tested:

H1: Cultural differences have a significant effect on FDI inflow between Afghanistan and their trading partners.

As explained above culture is together with trade the most robust explaining variable. In all the gravity models culture's parameter has the same magnitude and sign. Only in combination with political difference indicators, the effect is approximately twice as large as in combination with political rank indicators. In models explaining political rank, culture is slightly less significant probably due to correlation effects between culture and political rank. Therefore, based on the results of the regression analysis, hypothesis one can be confirmed

To investigate the effect of legal systems on FDI we identified two different variables to test the following hypothesis:

H2: Belonging to the same legal family, or a particular type of legal family, has a significant effect on FDI inflow between Afghanistan and their trading partners.

Legal family indicates the type of legal family a country's legal system belongs to. Legal family 01 indicates if a country has the same legal system as Afghanistan. Broadly, it can be concluded that both Legal Family and Legal Family 01 are significant, at a 1% significance level, in the models explaining inward FDI. In contrast, both Legal Family and Legal Family 01 are insignificant in explaining inward FDI stock, except for the models combining political difference indicators and legal family 01. The estimated parameters of the legal factors have the same negative sign in the models and broadly the same magnitude, concluding that they are rather robust. The parameter of legal family 01 is larger, because the input differs between 0 and 1, as the input of the legal family differs between 0 and 3. Looking at the fit of the

models, in which the legal family variables are represented, the legal family has more explaining power; however, the difference is very small. So, based on the results of the regression analysis, hypothesis two can be confirmed, however, the inward FDI stock between Afghanistan and their trading partners is not explained by legal family.

At last, we tested political variables to see how they influence inward FDI stock. Therefore, we identified the following two hypotheses:

H3: The quality of the political situation/indicators in a country does not have has/have a significant effect on FDI stock between Afghanistan and their trading partners.

H4: Differences in political situation/indicators have/have a significant effect on FDI stock between Afghanistan and their trading partners.

The total political difference variable, "political", has been added to the augmented gravity model and was tested significant, at a 5% significance level, in explaining inward FDI stock. "Political" showed a positive sign, meaning that countries with a dissimilar political profile can expect less FDI investments in Afghanistan. The total rank variable "political" was also added to the augmented model rendering a parameter with a negative sign, significant at a 1% significance rate. This negative sign means that countries with a low political rank can expect more FDI investments in Afghanistan. Taking in mind that Afghanistan has a rather high average political rank of 183 this corresponds with the "political" variable which shows that dissimilar countries can expect more FDI investments. Furthermore, in the inward model "political" was significant at a 5% significance rate and showed a positive sign. This means that countries with a high political rank are expected to invest more FDI in Afghanistan than countries with a low political rank. The political rank table shows that countries with high rank are mainly developed countries and a low rank corresponds with developing countries. Consequently, our findings correspond with literature on vertical and horizontal FDI. Vertical FDI usually flows from developed to developing country and horizontal FDI often flows from developed to developed countries. Also, the six different political indicators were added to the gravity model showing substantially more explaining power than the total political variables, both in the form of political difference and in the form of political rank. This could be explained by the fact that different political indicators show different, opposite, signs, which

increases explaining power if they are taken separately. Almost all six different political variables have a significant effect on bilateral FDI stock, extensively explained in the paragraph above. When having a closer look at the differences between the political difference and the political rank variables we can see that models including the political rank variables have a better explaining power. Especially, the models include a political indicator in which Afghanistan has a low, more average, rank. This means that both countries with a low rank as well as countries with a high rank are very dissimilar from Afghanistan. This suggests that political rank has a better explaining power than political difference. The political difference indicators are significant purely because they are correlated with political rank and not because they explain the "familiarity" element in FDI theory. This could be an explanation why models including political rank indicators have more explaining power, a higher R-squared, than models including political difference indicators. Applying the theory, explained in the theoretical section, to this conclusion we could conclude that the risk of instability is more important than the risk of unfamiliarity. So, hypothesis three can be rejected as political rank has a significant effect on inward FDI. Hypothesis four can be confirmed because it seems that difference does not explain the significant variables in the model but the fact that difference is correlated with rank explains that the variables are significant.

Chapter 5

Conclusion and Policy Implications

With FDI's cosmic importance in the economic and business arena, numerous studies have been carried out to find the determinants. The current study was performed to shed light on a topic that has not received much attention. Cultural risk factors, along with political risk factors, have only recently received attention as determinants of FDI, albeit in a narrower sense. Thus, this study presents the *raison d'être* for a detailed analysis of the impact of economic, cultural, and political factors on FDI, taking different indicators of the former, including civil liberties (CL), political rights (PR), political repression (PREP), and polity, as an alternative measure of political risks. The primary goal of this research is to look at the impact of economic, political, and cultural factors on FDI inflows in Afghanistan. The rest of the chapter is divided into sections, with section 2.1 concluding the study, whereas policy recommendations are presented in section 5.2.

5.1: Conclusion

Foreign direct investment is a major form of international capital transfer and has increased substantially over recent decades as a consequence of rising global economic integration. It has even grown faster than world GDP and merchandise trade, even despite the large drop in world FDI flows at the turn of the millennium. The two-way flow between developed countries still accounts for the largest part of the asset trade. Around 80% of total FDI flows are invested between developed countries. Furthermore, the inward FDI stock of developing countries has decreased over the last eight years as a percentage of total inward FDI stock. This development is unfavorable for developing countries, as foreign direct investments are regarded as a substantial contributor to international economic integration and development in general. If developing countries want to reverse this trend, governments and companies of these developing countries need to know which factors determine FDI inflow. Besides easily changeable factors like economic ones, we have investigated more robust factors like cultural and political ones. If cultural and political variables can explain the patterns of bilateral FDI stock, a country's financial integration depends on it. Our results could be helpful for the Afghanistan government to adapt their policy to attract FDI. The role of cultural and political

differences, which are often seen as an interfering factors in realizing global economic integration, has been the subject of many scientific articles.

The current study was performed to shed light on a topic that has not received much attention. Political risk as a determinant of FDI has received attention only recently, though under a narrower meaning. Thus, this study presents the *raison-d-etre* for a detailed analysis of the impact of economic, cultural, and political factors on FDI, taking different indicators of the former, including civil liberties (CL), political rights (PR, political repression (PREP) and polity as an alternative measure of political risks. Political risk factors are difficult to quantify. However, using the data from Freedom House, this study has empirically deduced that political risk factors play an important role in determining FDI inflows. In this context, the government of Afghanistan should try to contain political risks to the furthest extent since the indicators conclude that Afghanistan is prone to political risks and uncertainties in the short run. It is also important that political parties, other stakeholders, and bureaucrats in these countries take into account the fact that aggravation of political situations in the countries would lead to an overall negative impact. The consensus, disregarding any region or country, should be to reduce political risks and uncertainties since political instability plays an important role in the determination of FDI and consequently, the long-run economic performance of a country.

This study has examined how international relations affect FDI inflows into Afghanistan, and the broader insight is that international relations matter in the international political economy in ways that go beyond their official mission or originally intended economic effects. One of those long-standing debates in the literature is how the economic and political dimensions are connected and their likely impact on FDI. Our findings support that these dimensions are complements. Finally, our research has important implications for scholars and practitioners interested in the politics of economic development. After years of apprehension, many developing countries have become interested in attracting FDI. Policymakers—not just at the World Bank and IMF, but also now in most developing country governments— consider FDI desirable because it provides much-needed capital and brings new technology as well as training for workers and managers to the country, and thus may contribute to economic growth (Farrell et al. 2003). Yet, multinational corporations are often wary of investing in developing countries. We show that developing countries—if they want to attract more FDI—

can make commitments to liberal economic policies more credible via international institutions, thus reassuring foreign investors and thereby increasing inward FDI.

This study developed a nexus between FDI and international political relations for Afghanistan over the period 2005–2018. The main focus of the study is to examine how political relations between Afghanistan and the United States affect the inflows of FDI to Afghanistan. Based on extensive theoretical and empirical analysis, we obtain some striking results.

Our findings suggest that United States policies concerning Afghanistan influence only economic and military aid flows, but not private capital inflows (i.e., FDI) in the long run. We find that the United States' policies towards Afghanistan do not much correlate with the policies of other donors and investing countries. Our findings also suggest that economic sanctions against Afghanistan do not affect U.S.-Afghanistan trade relations. These findings are verified by the results obtained using econometric analysis, which shows that U.S. sanctions policies have no significant impact on FDI inflows to Afghanistan in the long run. However, in the short run, U.S. policies influence FDI inflows to Afghanistan negatively. The analysis further suggests that in Afghanistan, economic factors such as domestic investment, good infrastructure, the real effective exchange rate, and natural resource endowments exert significant influence on FDI. Among the policy-related factors, only financial development produces a positive and significant effect on FDI inflows. The institutional factors, such as political rights, civil liberties, and political repression produces no significant impact on FDI in the long run. However, in the short run, only civil liberties significantly influence the inflows of FDI. The general conclusion that emerges from this study is that the deterioration of U.S.-Afghanistan relations neither influences the flows of private capital nor bilateral and multilateral capital in the long run. However, negative effects on the private capital flows have been seen in the short run. Besides, economic and policy-related factors play a significant role in the determination of FDI in Afghanistan, while institutional factor exerts no significant impact on the FDI in Afghanistan.

To contribute to empirical findings, the question as to which economic, cultural, and political factors influence asset to trade, and in particular FDI, must be answered. Two main theories could be identified that explain why cultural or political factors affect bilateral asset trade.

Firstly, information asymmetries between countries determine the level of investments between those countries. Information asymmetry induces transaction costs that negatively affect bilateral investment flows. Secondly, additional risk comes with investing in a particular country because of instability. If a political situation in a country is unstable or it has a low quality this will involve extra risk in investing in that country.

The first theory explains the effect of cultural differences on bilateral FDI stocks, and the results show that there exists an unambiguously negative effect of cultural differences on FDI stocks. It was expected that the first theory would also explain the difference in the legal family between Afghanistan and its partner countries. Hence, the estimation of the legal family parameter was significant. Both theories mentioned above could explain the effect of the political situation indicators. However, the results showed that the political rank indicators had more explanatory power than the political difference indicators. This suggests that the theory above, based on political instability, is more likely to explain the influence of the political situation on bilateral FDI stock. Although the different indicators show opposite effects, they all prove to have a significant effect on FDI. In general, the results show that countries with a low political rank attract more FDI than countries with a high political rank do.

If developing countries should make policy based on the results of this thesis, they should aim their policy at countries with similar cultures or different legal families, as those countries are more likely to invest in FDI. Although all the different political indicators should be anticipated differently, they could conclude that political instability does not obstruct FDI, as politically unstable countries attract more FDI, according to the results.

5.2 Policy Implications

The findings have important policy implications in general and for Afghanistan in particular:

- Afghanistan should aim to base its policy on countries with similar cultures or different legal families, as those countries are more likely to invest in FDI.

- Although all different political indicators should be anticipated differently, they could conclude that political instability does not hamper FDI (as politically unstable countries attract more FDI according to the results).

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- International relations, particularly U.S.-Afghan relations, adversely influence inward FDI to Afghanistan in the short run. Therefore, measures should be taken to review foreign policy and establish a close diplomatic relationship with the United States. However, these relations may be based on mutual respect, trust, sustainability, and predictability.

- We obtain evidence that trade and FDI are substitutes rather than complements. Therefore, the government may focus more on its liberalization and investor-friendly policies and remove bottlenecks hampering FDI. Furthermore, the government may encourage export-oriented FDI.

- FDI exerts crowding-in effects on domestic investment, therefore measures should be taken to encourage and facilitate local investors and broaden the circle of domestic investors by providing more infrastructure services, credit facilities and improving the physical infrastructure. These measures do not only further encourage domestic investment but also help in attracting more FDI.

- It is also suggested that the exploration and up-gradation of natural resources play an important role in attracting FDI.

- Institutional factors, such as political rights, civil liberties, and political repression, remain insignificant. Hence, there is a need to strengthen the location factors like incentives, consistency, and continuity of liberalization policies and the liberal investment regime.

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