Foreign Direct Investment, International Trade, and Formation of Entrepreneurial Class

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Abstract—**This paper examines the argument that developing economies are not in a win-win situation while engaging in free trade because such international competition prevents the emergence and growth of domestic entrepreneurial class. For this purpose, we developed two different models to examine the formation of entrepreneurial class and domestic entry in Pakistan using time series data from 1980 to 2017. Findings of the study indicate that foreign direct investment positively impacts the formation of entrepreneurial class and facilitate domestic entry in the country. Study shows that investment in research and development, institutional environment, and human resource development through technical and vocational education can upshot huge potential gains from foreign direct investment and international trade. Additionally, it can improve institutional environment to facilitate the absorption, accumulation of knowledge, technology, and spillovers arising along-with FDI inflows. Moreover, the study provides context-specific insights for policy-planners in developing counties to have more from the FDI inflows and may provide nascent entrepreneurs with survival, sustenance and growing hacks.**

Index Terms—**Foreign direct investment, formation of entrepreneurial class, institutional environment, spillovers.**

I. INTRODUCTION

During recent past decades, foreign direct investment (FDI) has been discussed extensively in international business (IB) with it enormous effects of the host country [1]. In particular, host country receives economic growth and productivity, simultaneously opt severe competition risk to in term of new domestic entry and enhances the competition environmental between the existing firms, in turn, they are not more capable of competing with international firms [2], [3]. Therefore, regarding the FDI impact on host economy, there are both positive and negative views on domestic entry and start-up creation [4]-[6].

Entrepreneurial orientation in host country, that is, the formation of an entrepreneurial class may suffer [7], [8] or might get sparked with FDI inflows. This shows a bifurcation in findings that need further explanations, particularly in a developing country like Pakistan, where domestic markets and firms are fragile to economic shocks, competition, and fluctuations.

Since Pazos [9] it has been further claimed that openness to the international trade, particularly allowing inflows of FDI and freeing international trade, leads to impede

development of entrepreneurial class, and therefore, might be detrimental to the developing economies as a whole [10], [11]. Likewise, in context of developing countries, inflows of FDI put hurdles for new entry, damage resource allocation and may lower the economic growth in the host country due to price, financial, trade and other distortions [12], [13]. Notably, provision of subsidies, tax cuts, economic incentives instigate and foster fragile firms that avoid international competition and prefer to perform in a monopolistic environment – this value chain ends with inefficiency, misallocation of resources and incapability to fuel broader development [14]-[16].

Despite the existence of these contradictory theories, some empirical models suggest that FDI promote new entry and facilitate the formation of entrepreneurial class, and boosts economic growth as well [17], [18]. In addition, FDI serves in technological transfer, shed spillovers and provide business know-how to masses and improves the productivity of firms in host country [19], [20]; consequently, it benefits exiting entrepreneurs and smooth pathways to facilitate further entry [21], [22]. Similarly, FDI contributes to improve human resource and expertise, job provisions, alleviating poverty, raising exports, and create new income opportunities [23], [24], thereby improving the state of resource allocation and domestic firms capacity to compete, innovate and expand by investing in technology, innovation and human resource development [25], [26].

The extent to which FDI can contribute to the formation of entrepreneurial class and domestic entry depends on the variety of factors. However, host country characteristics termed as absorptive capacity to seek benefits from the technological spillovers from more industrialized nations and capability to best utilize and accumulate the knowledge and technology is a precondition to determine the extent of economic benefits [27]-[29]. The key determinants of the "absorptive capacity" is the quality of institutions in the host country, particularly, the protection of property rights and the rule of law [28], [30]. However, there are inconsistencies in existing literature concerning the role of FDI shed of entrepreneurial class and facilitating new entry showing lack of a theoretical framework to understand the varying effect of FDI [31], [32]. Consequently, to best of authors' knowledge there is handful of evidence on how the FDI spillovers hedge or instigate entrepreneurial class formation in a country with limited exports, foreign trade exposure and marginal resource allocation in the research and innovation [33]-[35]. Given the importance of the study topic, there is a need to advance our knowledge and understanding on the scope and scale of the impact of FDI on formation of entrepreneurial class and domestic entry in the host country-with varying characteristics.

In an effort to address the existing inconsistencies in the literature, in this study we take a new market and

institutions-based perspective to argue that absorption capacity of entrepreneurs, R&D, and host country environment are significant players in the formation of entrepreneurial class and facilitate further domestic entry. This study is based on this line of research and the aim to make substantial contributions to existing FDI literature. Author's conceptualization is purely based on understanding of the host country (Pakistan) institutional mechanism through which it exploits and absorbs FDI [36], [37]. We build on an argument that local institutions in term of protection of private property, energy, and raw input supply, regulatory and legal enforcement, political stability might moderate the different impacts of FDI on domestic entry and formation of entrepreneurial class. More specifically, a more developed sitting of local institutions facilitate and motivate both local and foreign firms to curtails negative impact of FDI on domestic entry, instigate the formation of entrepreneurial class through bilateral knowledge, technology, spillovers and expertise sharing, and compete to rationalize output. In contrast, poorly managed local institutions may lead to strengthen the negative impacts rather than positive ones to in the host country. Further, the aim to address the inconsistencies in the literature and to develop a better understanding on the role of FDI in formation of entrepreneurial class, therefore, this study investigates the effects of FDI and international trade in textile sector of Pakistan. Study provides empirical evidence to establish and clarify the role of FDI in a developing country context and suggest the appropriate policy interventions to facilitate the significant entrepreneurial entry in the given and linked sectors. Further, study findings shed light on the role of government policies, institutions, law & order situation, and R & D in rational absorption of

FDI and accumulation of knowledge, technology spillovers, expertise sharing and ultimately to facilitate the domestic entry and formation of the entrepreneurial class in Pakistan.

II. DATA AND METHOD

A. Project-Related Data on FDI and Formation of the Entrepreneurial Class

In this paper, we run two different models to measure the role of FDI in the formation of entrepreneurial class and also assessed the role institutional factors to aid absorptive capacity through the accumulation of knowledge to leapfrog new entry of firms and gaining potential benefits arising from the inflows of FDI. Therefore, both of the empirical models were developed in consideration on the prevailing context of Pakistan and existing literature on FDI and formation of the entrepreneurial class. Specifically, Model 1, measure the role of FDI and several other explanatory variables in formation of the entrepreneurial class, whereas Model 2, examines the relationship between domestic factors and FDI and international trade, and measure the spillovers effect of FDI in the country. For this purpose, time-series data for the given variables were taken from various authentic local and international sources for the period of 1980-2017. Concerning the use of time-series data, Ortolano, Sanchez-Triana [38] report that in a developing country context, thirty-year (30 observations) data is enough to analyze to proposed relationships. Re Moreover, Ordinary Least Square (OLS) was used to test the models developed herein, information of the variables shown in Table I.

TABLE I: DESCRIPTION OF THE STUDY VARIABLES

Variables	Description	Data source	Abbreviation
[1]Formation of entrepreneurial class (Indexed variable)	1. Yearly number of textile units imported	Economic Survey of Pakistan	FEnt_C
	2. Yearly number of textile firms registered	Economic Survey of Pakistan	
[2]Yearly inflows of FDI	1.Yearly presence of FDI in all sectors ($B)	State Bank of Pakistan	FDI
GDP growth rate	Yearly growth rate of gross domestic product (percentage)	Economic Survey of Pakistan	GDP_GR
Labour force employed	Yearly statistics of labor force (percentage)	Bureau of Statistics	LF_Prod
R & D	Budget allocation for R & D in industrial ($B)	Economic Survey of Pakistan	RD
Law & order situation	Yearly numbers of bomb blasts	Economic Survey of Pakistan	LO_St
[3]Internal stability	Type of government was used as a proxy variable to measure internal stability; if there was a democratic government then 1, otherwise 0	Bureau of Statistics	Int_Stab
Government support	Government support in the form of subsidies to the textile sector in the form of a cut in taxes, electricity and gas prices, etc.	State Bank of Pakistan	GS
Infrastructure development	Yearly budget allocation for infrastructure and development projects	Economic Survey of Pakistan	Inf_Dev
Electricity shortfall	Yearly statistics of energy shortfall in the textile sector	Economic Survey of Pakistan	Elec_SF
Technical & vocational education	Yearly enrolment in technical & vocational education (thousand)	Bureau of Statistics	TVE
Net Exports (proxy variable of international trade)	Yearly net exports (exports – imports) of the textile sector ($B)	Economic Survey of Pakistan	NX_Tex

[1] Dependent variable for model 1.

[2] Dependent variable for model 2.

B.   Formation of Entrepreneurial Class (Model 1)

Textile sector accounts for 9 percent in GDP of Pakistan and consumes 45 percent of labor force directly or indirectly, so therefore, this sector is a big chunk in the country's economy. In view of Nawaz, Ali [39] venture formation in the textile sector is apparent for investigating the entrepreneurship context in Pakistan, being a leading export sector it exhibits the overall paradigm of business growth and new entry in the country. For the purpose of measuring the formation of the entrepreneurial class, an indexed variable consisting of two variables; the yearly number of textile imported units; and the yearly number of domestic textile firms registered were taken. As both factors indicate

the expansion of textile sector in the given period, and therefore, an indexed variable was taken as a proxy variable to measure the formation of entrepreneurial class in the country with overtime inflows of FDI. According to Bulinskiĭ [40], indexed variables are best choice in a particular scenario when the impact of one variable cannot be measured directly, therefore, using an indexed variable the reliability of robustness might be increased. Model 1, represents the proposed sitting of variables as following:

Model 1: $FEnt\_C = \beta_0 + \beta_1 FDI + \beta_2 LF\_Prod + \beta_3 GDP\_GR + \beta_4 RD + \beta_5 LO\_St + \beta_6 Int\_Stab + \beta_7 GS + \beta_8 Inf\_Dev + \beta_9 Elec\_SF + \beta_{10} TVE + \mu\ z$

TABLE II: RESULTS OF OLS ESTIMATION

Variables	Model 1	Model 2
	Coefficients	Coefficients
Constant	2.347	3.580
NX_Tex	-	0.362**
LF_Prod	0.247**	1.174*
GDP_GR	1.342NS	1.086NS
RD	1.061	1.030*
Int_Stab	0.157**	0.602*
TVE	0.488*	0.967**
Inf_Dev	0.128NS	0.812*
Elec_SF	−2.018**	1.704NS
LO_St	0.825*	−0.085**
GS	0.753**	-
FDI	0.643*	-
R^2	0.964	0.927
Log-likelihood	51.02	18.68
Schwarz criterion	142.1	70.11
Rho	0.146	0.497
Akaike criterion	124.0	118.65
Hannan-Quinn	130.4	103.06
Durbin-Watson	2.084	1.996

Note: * $p \le 0.01$, and ** indicate $p \le 0.05$ respectively; NS, stands for non-significant; Number of observation = 37

III.   RESULTS

In this study, we used OLS estimation to analyse the proposed models herein. Regarding the formation of entrepreneurial class (Model 1, Table II), results of the study suggest that labor force productivity, GDP growth rate, internal stability, technical and vocational education, law and order situation, government support and foreign direct investment are positively related, while electricity shortfall is negatively impacting the formation of entrepreneurial class in the country. Regarding the GDP growth, there are several studies that show similar findings [41]-[43]. Our results lend support from the studies of Mittal and Weingast

[44] and Isaacs [45] in America and South Africa which note that internal stability provides the fundamental nurturing environment to domestic entry and provide a levelled field to international firms through FDI. Concerning the role of technical and vocational education, this study pledges support from study of Alam [46] in Bangladesh, Agrawal [47] empirical work in India, and study of Mustapha and Abdullah [48] in Malaysia which jointly reinforce the significance of technical and vocational education and note that it step forward toward the knowledge-based economy capable of numerous start-ups. Similarly, regarding the role of law and order situation, our study findings are in line with Nawaz [49] work in Pakistan, Nahar [50] findings in Bangladesh, and O'Hanlon and de Albuquerque [51] study in Afghanistan – these studies compliment that good law and order situation promote the existing businesses and encourages the new entry and build the confidence of international investors to by minimizing their risks associated with such situation. Thereby, our

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[3]Unfortunately, Pakistan has been ruled by non-democratic forces (military dictators) for the several years since it's independence. Thus, we included the dummy variable to capture the impact either there was democracy or military were ruling (marshal law) the country.

findings for the role of government support in term of tax cut, energy supply on relief charges and duty-free export grants are also pledges the support from existing literature [52]-[55]. Thus, results suggest that FDI is substantially contributing in the formation of entrepreneurial class and encourages the domestic and international investors through provision of fundamental infrastructure and services to invest, grow and sustain and develop in a better market.

TABLE III: DIAGNOSTIC TESTS

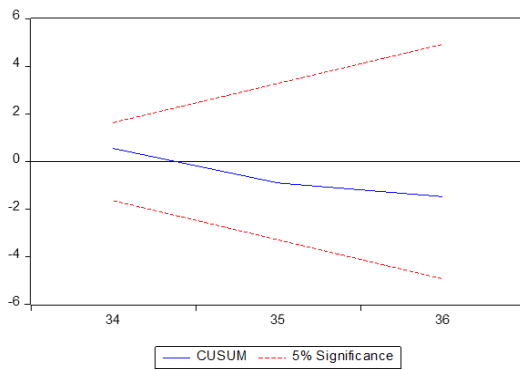| Test Statistics	LM Version	F Version
Serial Correlation Test	CHSQ(1) = 0.482[0.447]**	F(1, 12) = 0.137[0.635]**
Functional Form Test	CHSQ(1) = 1.164[0.311]**	F(1, 12) = 0.239[0.2]**
Normality Test	CHSQ(2) = 0.592[0.674]**	Not applicable
Heteroscedasticity Test	CHSQ(1) = 0.016[0.752]**	F(1, 33) = 0.007[0.629]**

Fig. 1. Plot of cumulative recursive residuals.

Concerning the association between FDI and domestic institutional factors (Table II); net exports of textile sector, labor force productivity, research and development, internal stability and technical and vocational education are positively impacting inflows of FDI, while line order situation in the country negatively related to inflows of FDI. Studying the role of net exports to attract higher inflows of FDI, our study findings are related with work of Boly, Coniglio [56] in sub-Saharan Africa, and Tan and Tang [57] empirical findings of time series analysis in five major Asian economies. Baskoro, Hara [58] work on the labor force productivity, and it's contribution to fetch higher levels of FDI inflow and outflow compliment our findings. Likewise, regarding the research and development and FDI, Guimón, Chaminade [59] study Chile, and Cai, Boateng [60] study in China which note that R&D investments contribute to human resource development and making foremost factor of production instigate a signal for international firms to invest in. Therefore, with such a substantial contribution in enhancing the state of domestic entry and to fetch higher levels of FDI inflows, labor force productivity, research and development, and technical and vocational education were providing a catchy view to international players [62]-[64]. Moreover, study shows the consistent, unbiased and statistically sound results that are further confirmed by the Table III, which shows that all of the parametric tests are significantly assures the validity of data and results reported herein. In addition, this study measures the stability of a developed relationship using Ramsey functional test, which shows that the relationship between the variables is

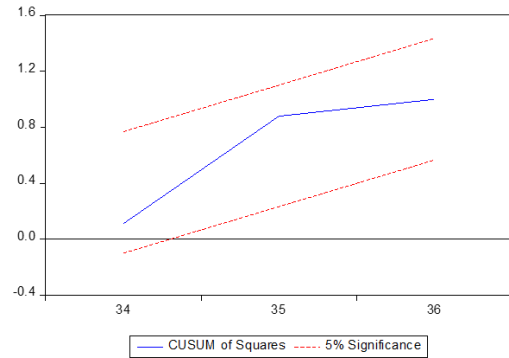verifiable. Fig. 1 and 2, reveal that proposed relationships are stable as they do not show any instant change.

Fig. 2. Plot of the cumulative sum of squares of recursive residuals.

IV. CONCLUSIONS

This study examined the argument that foreign direct investment, international trade either beneficial or harmful to developing countries, (i.e., Pakistan), as these two carries international competition which may inhibit the formation of entrepreneurial class and domestic entry in the country. For that purpose, we developed two different models by taking the data from the textile sector of Pakistan in which the formation of entrepreneurial class was measured exogenously, while domestic entry was measured endogenously. Findings of the study indicate that among institutional factors labor force productivity, GDP growth rate, internal stability, technical and vocational education, line order situation, government support and foreign direct investment are positively related to the formation of entrepreneurial class in the country. It suggests that formation of entrepreneurial class, particularly entrepreneurial development in the textile sector of the country depends on the number of factors viz; 1) labor productivity grows; 2) GDP growth; 3) country moving into democratic era (i.e., internal stability); 4) number of enrolment in technical and vocational institutes excel; (5) betterment in the law and order situation; and 6) positive initiatives taken by government to support domestic entry and facilitate the formation of entrepreneurial class. Contrary, as the country has been severely suffering from the energy crisis, electricity shortfall has negatively impacted the formation of the entrepreneurial class in the country. It highlights that as energy supply is the critical ingredient to run the textile sector in the country, thus increasing electricity shortfall negatively impacts the formation of entrepreneurial class and lowers the competitive advantage among domestic entrepreneurs in international markets. More importantly, findings indicate that FDI inflows facilitate the formation of the entrepreneurial class in the country.

Regarding the role of institutional factors in absorption of FDI inflows, accumulation of knowledge generated by mutual interaction between international and domestic entrepreneurs, technology and spillovers in influencing domestic entry, net exports of textile sector, labor force productivity, research and development, internal stability, and technical and vocational education are positively impacting inflows of FDI. Additionally, it also indicates that

as a country engage in international trade and observe an enormous increase in net textile exports, in turn, it accelerates, facilitate, and boost further domestic entry. On the other hand, prolonged engagement in the war on terror and bad law order situation negatively impacted the inflows of FDI in the country. Moreover, institutional factors and government initiatives to enhance the budget allocation for research and development and support technical and vocational education are providing a catchy view with considerable effect of FDI inflows. Findings of the study provide implications for academia, industry and as well for policymakers in both government and private sector to come up with best possible ways to get maximum advantage from FDI and international trade to smooth the pathways in domestic entry and facilitate the formation of entrepreneurial class in the country. Interestingly, the study shows insightful findings by comparing the results with existing studies in various both developing and developed country context to better develop the understanding of contextual models developed herein. Hence, through context-specific insights, particularly for developing counties with similar economic circumstances like Pakistan, study provide a way-forward to gain potential benefits along-with FDI inflows through envisions of the role domestic factors as well.

CONFLICT OF INTEREST

Authors declare no conflict of interest.

AUTHOR CONTRIBUTIONS

R.M. and Z.W. conceived and designed the study; R.M. collected and analyzed the data, and write the paper; Z.W. contributed to revising the paper and adjusted the framing of the paper.

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