

Foreign capital and good governance plays a very essential role in the development process of any country. High quality of governance can establish predictable, fair and consistent implementation of the rules in the economy to smoothen its growth path. Despite receiving large quantities of foreign aid (FA) and Foreign direct investment (FDI), Pakistan like many other developing countries, has remained stagnant and become more aid dependent. This grim reality provokes the concept to examine the effectiveness of capital inflows by incorporating the role of governance quality in achieving the economic growth. Moreover the hypothesis is also investigated i.e. the countries that receive more FA becomes able to attract more FDI but this occurs only in the presence of good quality of governance. One of the causes for the limited growth effects of capital inflows in Pakistan is found to be the existence of weak quality of governance. The five main models with different combination of variables are being analytically established for Pakistan during the period in between 1984-2012. The study has made use of Johansen (2001) co integration and Toda and Yamamoto (1995), and Dolado and Lutkepohl (1996) granger non-causality testing procedures. By utilizing of Block endogeneity Wald test, a bi directional causality strictly running from FA to FDI, DINV and GQ is evidenced. While a one way causality is running from economic growth towards FA is also found. In addition, the results reveals in favour of growth-led FDI rather than FDI-led growth in Pakistan. FDI and FA are not complementary flows rather they are substituting flows. Assistance accumulates domestic capital which helps in enhancing DINV. Moreover it is very crucial to enhance the GQ in Pakistan and innovations in governance framework are needed to be done for better outcomes on as and when required basis.

Key Terms: Economic Growth, Foreign Aid, Foreign direct investment, Governance quality, Toda and Yamamoto and Dolado and Lutkepohl methodology/