




The determinants of foreign direct investment in conflict-prone environments: A case study of Palestinian territories

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ABSTRACT

Article History

Received: 3 May 2024
Revised: 7 October 2024
Accepted: 21 October 2024
Published: 15 November 2024

Keywords

Armed conflict
Foreign direct investment
Infrastructure
Investment climate
Palestinian territories
Trade openness.

JEL Classification:

F21; F23; P33; D74.

The purpose of this paper is to investigate the complex relationship that exists between foreign direct investment (FDI) and armed conflict intensity, specifically in the Palestinian territories during the ongoing conflict with Israel. It examines various determinants, including market size, trade openness, labor cost, inflation, infrastructure, and fixed capital formation. Using available quarterly data from Q1 2010 to Q3 2023 and using EViews 13 software, the study adopted the Autoregressive Distributed Lag (ARDL) estimating model approach. The study concludes that the intensity of the armed conflict has a conclusive negative impact on the volume of foreign direct investment flow to Palestinian territories. It was also found that market size, trade openness, and gross capital formation are the main determinants contributing to the inflow of FDI and mitigating the negative impact of armed conflicts. Additionally, the study reveals that escalating conflict and Israeli occupation severely limit infrastructure access, contributing to its degradation and hindering foreign direct investment. It recommends that policymakers in conflict-affected areas prioritize peacebuilding and implement risk-reduction strategies to enhance political stability, promote GDP growth, increase trade openness, and improve infrastructure.

Contribution/Originality: This research is the first to target the determinants of FDI in the Palestinian territories. This research fills a significant gap in studies related to the Palestinian economy. Many studies exist about the determinants of foreign direct investment across countries. However, the research is unique in that it measures the variable of conflict intensity that influences FDI. Its conclusions provide additional insight into this complex relationship, engaging the reader.

1. INTRODUCTION

Investment flows, particularly foreign direct investment (FDI), are not merely financial transactions but the lifeblood of economic development plans and strategies, especially in the developing world. These sustainable investment inflows and capital formation not only present tangible opportunities to overcome the remaining challenges of developing economies but also create employment, generate wealth, boost government tax revenues, stimulate skills transfer, and foster economic growth (OECD, 2002). Therefore, any factors that hinder the smooth flow of capital and foreign direct investment in developing countries consistently undermine their economic development and the welfare of their population (Ezeoha & Ugwu, 2015).

The concept and content of foreign direct investment have undergone significant changes, but it remains a promising stimulus for economic growth and prosperity. According to the United Nations Conference on Trade and

Development, foreign direct investment is a long-term relationship and management capacity between a parent company or subsidiary in one country and the country receiving the investment. The parent company must own at least 10% of the company's shares (UNCTAD, 2000).

Although countries need to enhance their investment climate to attract foreign investors, FDI flows are influenced by several well-known factors, and host countries conduct studies to promote positive determinants and overcome negative ones that hinder the continuous flow. One of the most important determinants that hamper FDI inflows is political instability or involvement in internal or external armed conflicts, which reduces the advantage of FDI these countries enjoy compared to neighboring countries (Lee, 2017). Armed conflicts also limit a country's ability to attract FDI as they hamper international investment and generate capital outflows, which harm local economic progress (Maher, 2015). In this context, numerous studies commonly assumed that armed conflict in any country reduces the profitability of investment (Collier & Hoeffler, 2004). Undoubtedly, this country relies on a fundamental premise that the proliferation of peace and eradicating violence foster economic activity, while conflict engenders contrasting consequences.

However, an alternative perspective suggests that war or armed conflict may create new investment opportunities. What supports this viewpoint is that although attacks can cause significant disruptions in production, conflicts can challenge government control and stimulate alternative investment (Blair, Christensen, & Wirtschafter, 2022). According to Singer (2004) companies and traders often take advantage of the chaos in war-torn countries to further their interests, whether through illegal activities or by supporting opposing factions (Reno, 1998; Singer, 2007). Weinstein (2007) observed these organizations benefiting from chaos and using inexpensive labor or subcontractor. Globally, an estimated 60,000 multinational corporations (MNCs) operate in more than 70 conflict zones where social unrest has been suppressed and active fighting or civil wars have ended. In this context, MNCs influence or are affected by conflicts, so they may be linked to them regardless of location or field (Bais & Huijser, 2005).

In this regard, I will use this paper to analyse the factors that influence the inflow of foreign direct investment into the Palestinian territories. The Palestinian economy is characterised by its weak structure due to its small size and limited resources. External factors heavily influence this open economy (UNCTAD, 2012). The political and historical context of the Palestinian economy, which has witnessed and continues to witness armed conflict with the Israel side in various periods, closely links these characteristics.

The Israeli occupation of the Palestinian territories in the West Bank and Gaza Strip began in 1967. Following the signing of the Oslo Accord (1993) the Palestinian Authority was given partial self-governance in certain areas of the occupied territories.

However, the Palestinian territories, which were isolated in 1967, have been deprived of their previous trade relations and forced to establish unbalanced economic ties with Israel. Israeli policies and practices have resulted in restrictions and obstacles on the movement of individuals and goods, as well as control over crossings. With the denial of access to and exploitation of natural resources in the area known as (C) and East Jerusalem, the Palestinian economy has experienced significant structural distortions, according to the United Nations Economic and Social Commission for Western Asia (ESCWA) (2022). In addition to the tight blockade imposed on the Gaza Strip since 2008 and its exposure to five wars since then, the Palestinian economy has suffered from two fundamental and worsening imbalances: resource gap and labor market dysfunction, and an unhealthy reliance on external sources of income in the absence of clear sectoral policies and inadequate infrastructure development.

The Palestinian territories have experienced an increased financial and economic crisis in light of the current political situation. This has resulted in a decline in growth rates, a rise in unemployment and poverty rates, and the impoverishment of a large segment of the Palestinian people. Additionally, there has been a decrease in investment and a trade deficit. The Palestinian National Authority has relied on various external funding sources, including foreign direct investment, to overcome challenges such as Israeli policies and obstacles, as well as the scarcity of

natural and financial resources. This is aimed at financing the construction of the Palestinian state and its institutions and achieving economic development.

To enhance the investment climate and encourage foreign investors to invest in the Palestinian territories, the government implemented reforms and amended investment legislation, offering them numerous guarantees and privileges. However, despite these efforts, several obstacles still need to be overcome, leading most indicators to a lack of progress in foreign direct investment in the Palestinian territories.

This paper analyzes the complex relationship between FDI and the intensity of armed conflict, focusing on the Palestinian territories amidst the ongoing conflict with Israel. To achieve this, specific research questions were posed, with detailed answers provided in the results and conclusions. The study primarily explores the determinants of FDI in conflict-prone environments, examining how factors such as market size, trade openness, labor costs, inflation, infrastructure, capital formation, and the intensity of armed conflict influence FDI flows into the Palestinian territories.

While numerous studies have explored FDI determinants in various countries, there remains a gap in research specific to conflict-affected regions. This study addresses that gap by investigating the impact of key economic and structural factors on FDI flows in territories experiencing prolonged occupation and conflict.

The structure of the paper begins with the introduction; it serves as a gateway to the research. The second section covers both theoretical and empirical literature. The third section focuses on the data and methodology, detailing the data used, the empirical methodology employed, and the model specifications. The fourth section presents the experimental results and discussion, where the results are thoroughly analyzed and interpreted. Finally, the paper concludes with a section on the conclusion; it not only summarizes the main findings but also suggests potential areas for further study, highlighting the implications and potential impact of the research.

2. LITERATURE REVIEW

2.1. Theoretical Literature

Neoclassical global trade theories provide valuable insights into the phenomenon of foreign direct investment. In their study, [Marandu and Ditshweu \(2018\)](#) focused on the neoclassical rate of return-on-investment theory as an initial model for foreign direct investment (FDI). International spending is driven by variations in investment returns across different countries, as hypothesised. Given the same conditions, it is theorised that money will move from countries with lower returns to those with higher returns to maximise profits. If all countries achieve equal capital gains, trade will keep going.

[Hymer \(1960\)](#) Market Imperfections Theory states that sophisticated knowledge leads to superior commodities, enabling organisations to regulate pricing and gain a competitive advantage over local institutions. Producing unique goods that meet client wants and replace local products achieves this gain. Competition underpins institutions. This theory holds that institutions will die if they cannot compete in the market. It assumes a lack of competition in emerging or host country markets and a product shortage. National institutions in host countries cannot compete with foreigners in economic or producing activities or meet commercial organisation criteria for other functional activities. Due to their greater access to financial resources, technology, and administrative skills than host state entities, multinational firms are encouraged to invest abroad.

However, the market imperfections theory must explain why foreign production is the most favourable method for utilising the firm's advantage. In addressing this problem, [Dunning \(1980\)](#) and [Fayerweather \(1982\)](#) created what is known as international production theory. According to this theory, a company's decision to invest overseas depends on three main attributes: the advantages available to the company itself, the benefits of the host countries that make it beneficial for the company to invest in another country, and the advantages of internalisation to reduce costs instead of relying on external resources such as licenses, trade agents, and distributors.

Another aspect of this theory on foreign investment is the concept of internalisation, which [Buckley and Casson \(1976\)](#) thoroughly examined. The internalisation theory of FDI proposes that multinational businesses (MNEs) strategically arrange their internal operations to gain future benefits. They examine multinational business formation introspectively and explain their idea using three assumptions: firms attempt to improve profits in imperfect markets; faults in intermediate product markets motivate the urge to build internal markets; and global market integration leads to many multinational firms. An efficient external market environment may allow an MNC to capitalise on its technical production processes, know-how, and brand identification. The company plans to invest in numerous countries to construct an internal market and achieve its ambitions. Multinational businesses create hierarchies when there is limited demand for intermediate products or when the external market is insufficient.

Regarding theories that examine the effects of wars and armed conflict on foreign direct investment, one prominent theory is the 'war ruin' theory, which highlights the detrimental impact of armed conflict on institutions. This school claims military conflict harms economic, political, and social institutions. Famous researchers like [Russett \(1970\)](#); [Diehl and Goertz \(1985\)](#) and [Li \(2006\)](#) study how armed conflict affects foreign direct investment. These researchers claim that armed conflict causes inflation, unemployment, overwork, military expenditure, resource reallocation, and government debt. These effects persist after the combat ([Zafeer, 2015](#)). This school stands as the leading literary authority, while the 'war renewal' school holds a different view. This nascent topic was advanced by [Organski and Kugler \(1981\)](#). One idea suggests that war may improve a country's economy, politics, and society.

By highlighting capital's adaptability to economic changes, the [Collier \(1999\)](#)—paradigm can be used to analyse how foreign investors respond to armed conflict. The different types of capital include fixed capital, such as land, labour, unskilled labour, and liquid capital. According to his analysis, liquid capital can adapt more during economic downturns than fixed capital. According to [Imai and Weinstein \(2000\)](#) local and private investors carefully consider the potential benefits of their investments in the country compared to acquiring assets abroad during violent conflicts. Engaging in combat hurts economic productivity and speeds up fixed asset deterioration, decreasing return on investment. This results in domestic and foreign investors shifting their assets away from the domestic economy, leading to capital flight. In addition, armed conflict discourages international investors from venturing into economically and politically unstable regions, as they opt for more secure options. [Imai and Weinstein \(2000\)](#) conducted research that suggests portfolio substitution is common during civil crises. It is believed that the promptness and agility of private agents in transferring liquid funds contribute to capital flight from areas experiencing crises.

2.2. Empirical Literature

[Ashine \(2024\)](#) analysis of FDI inflows to Ethiopia from 2018 to 2022 provides a detailed account of how political instability and conflict, especially the Tigray War, negatively impacted investment. While the study's qualitative approach, which includes document analysis and case studies, offers valuable insights, it lacks a robust quantitative component that could have strengthened the causal claims about the direct impact of conflict on FDI. Furthermore, Ashine's identification of challenges such as ethnic conflicts and foreign currency shortages, although important, seems to generalize the situation without delving into the specific mechanisms through which these factors deter investment. Though sound, the recommendation to maintain political stability is somewhat simplistic and overlooks the complexity of governance and economic reforms needed in such a volatile context.

[Shou, Shan, Shao, Lai, and Zhou \(2024\)](#) take a different approach by focusing on risk mitigation strategies employed by foreign SMEs in conflict zones. Their application of Instrumental Stakeholder Theory (IST) to examine corporate social responsibility (CSR) practices as risk buffering strategies is innovative, but the study's reliance on a cross-country survey of Chinese SMEs may limit the generalizability of its findings. The emphasis on CSR practices, such as corporate philanthropy and workforce localization, as effective strategies is compelling; however, the study

could have benefited from a deeper exploration of the limitations and potential unintended consequences of these practices, particularly in contexts where CSR might be perceived as superficial or insincere.

Alfar, Elheddad, and Doytch (2024) offer a nuanced analysis of the relationship between conflict and greenfield mining FDI across 151 countries. Their study examines the geographical spillover effects of conflict on FDI. However, it fails to account for such investments' broader socio-economic and environmental impacts in conflict zones. The study finds that FDI from neighboring countries can negatively impact the recipient economy, raising essential questions about the ethical implications of cross-border investments in conflict-prone areas, which the authors do not fully address.

Abdul Rahman and Saif (2020) study on the effects of political stability post-Arab Spring on FDI flows highlights a critical period in the Middle East. However, the study's conclusions about the role of political stability in attracting FDI are somewhat predictable and lack a deeper analysis of the specific policies or reforms that contributed to stabilizing these economies. Additionally, the study does not sufficiently address the long-term sustainability of FDI in regions where political stability may be fragile or temporary.

Lee (2017) challenges the conventional wisdom that armed conflict uniformly deters FDI by introducing a model that considers the impact of political risk on commodity prices. While the model provides a fresh perspective on how investors might capitalize on conflict-induced price fluctuations, it also risks oversimplifying the complex relationship between conflict and investment. The study's reliance on data from the petroleum sector might limit the applicability of its findings to other industries, where the dynamics of conflict and FDI could differ significantly.

Akhtar and Yasin (2015) explore the factors influencing FDI in South and Southeast Asia, emphasizing the role of non-economic factors like political instability and terrorism. While their comprehensive analysis provides valuable insights, the study could have been strengthened by a more nuanced exploration of how these factors interact with each other and economic variables. The broad timeframe (1996-2010) also raises questions about the relevance of the findings to current geopolitical realities, which have evolved significantly since the period studied.

Ezeoha and Ugwu (2015) examine the combined influence of armed conflicts on FDI inflows in Africa using a dynamic Generalized Method of Moments (GMM) model. The study's findings that well-developed infrastructure can mitigate the negative impact of conflict on FDI are significant. However, the study does not sufficiently explore the challenges of rebuilding infrastructure in post-conflict settings. Moreover, the study's focus on natural resource-rich countries limits its applicability to resource-poor nations, where conflict dynamics and FDI might differ.

Asiedu (2006) broadly analyses the factors affecting FDI in 22 African countries, using panel data to examine the impact of political instability, corruption, and other variables. While the study offers important insights, its reliance on data from 1984 to 2000 may limit its relevance to the current global economic environment. The study's recommendation that small or resource-poor nations can attract FDI by improving their institutions and policies is sound but perhaps overly optimistic, given many countries' entrenched challenges.

Fielding (2004) study on the Israeli-Palestinian conflict and capital flight offers a valuable historical perspective. However, its focus on Israeli data may overlook the broader regional dynamics influencing investment flows. While the study's high correlation between violence and capital flight is crucial, a deeper exploration of the causal mechanisms behind this relationship could have been beneficial.

Demirhan and Masca (2008) cross-sectional analysis of FDI inflows into developing countries provides a helpful overview of economic factors influencing FDI. However, the study's model may oversimplify the complex interplay of these factors in real-world settings. The reliance on data from 2000-2004 also raises questions about the study's applicability to current global conditions, where new factors, such as digital transformation, may play a significant role.

Finally, Pradhan (2008) examines the factors influencing FDI in India, focusing on infrastructure. The study finds that inadequate infrastructure deters FDI, consistent with other literature. However, exploring the political and institutional barriers to infrastructure development in India could have enriched the analysis. Additionally, the study's

focus on data from 1970 to 2004 may limit its relevance to current policy discussions, where the landscape of global FDI has changed significantly.

3. DATA AND METHODOLOGY

3.1. Data

Relying on the previous experimental literature and according to the most discussed by the earlier studies adopted in this study, the following determinants will be relied upon in this study: intensity of the conflict, the market size, trade openness, gross capital formation, infrastructure, inflation rate, labour costs. The data used to analyse the determinants of foreign direct investment in the Palestinian territories consists of quarterly data from the first quarter of 2010 to the third quarter of 2023.

- **Conflict Intensity:** One of the most direct ways to express the violence and intensity of a conflict is to count the number of casualties, including deaths and injuries, resulting from the conflict (Ezeoha & Ugwu, 2015). Measuring the number of Palestinians killed or injured in politically motivated incidents of violence can provide a quantitative measure of the violence and intensity of conflict. This paper only uses the number of Palestinians killed for political motives per quarter as in the Collier and Hoeffler (2004); Fielding (2004) and Hegre and Sambanis (2006) studies, as these data were obtained from the Israeli human rights organisation B'Tselem every quarter.

- **Market Size:** The size of the market in the host country is an essential factor influencing FDI inflows. The small size of the market typically discourages investment, unless it is in close proximity to raw materials or other large markets. Market size is usually measured by a country's GDP (Mottaleb & Kalirajan, 2010) or per capita GDP (Demirhan & Masca, 2008). This study uses gross domestic product (GDP) as a proxy for measuring market size. The GDP data is obtained quarterly from the Palestinian Central Bureau of Statistics (PCBS) database.

- **Trade openness** refers to the absence of restrictions on the movement of trade exchange and the factors of production in an economy. It is well established that foreign direct investment is more likely to flow into open economies than closed ones. This openness contributes to economic efficiency and prevents trade imbalances. These markets, the production elements, interest foreign investors who want to maximise profits. They prioritise economic efficiency and avoid imposing limitations. Previous research used by this study has shown that trade openness may be quantified by the ratio of total exports and imports to GDP, as demonstrated by Demirhan and Masca (2008) and Asiedu (2006). This paper quantified Palestine's trade openness level by computing the total exports and imports ratio to GDP. The data for this analysis was collected quarterly from the Palestinian Central Bureau of Statistics.

- **Gross Capital Formation (GCF):** An increase in the generation of gross domestic capital is closely connected to promoting economic growth, resulting from improvements in the investment environment. These enhancements strengthen domestic investment and attract more significant foreign direct investment inflows. Improving the economic structure makes it possible to enhance the investment climate, thereby promoting increased capital accumulation. As a result, the increase in capital formation leads to improved economic performance and a subsequent increase in foreign direct investment. This idea is corroborated by the results of a study conducted by Suleiman, Kaliappan, and Ismail (2015) and Govil (2013) the analysis performed by Ranjan and Agrawal (2011). This study utilises the quarterly gross fixed capital formation data from the Palestinian Central Bureau of Statistics database.

- **Infrastructure:** is considered one of the most critical factors determining foreign direct investment in any country, as its availability contributes to facilitating the work of foreign investors, and infrastructure projects in themselves may be considered opportunities to attract foreign capital to carry out these projects in the host country. This study adopts previous studies, which measure infrastructure as the number of telephone lines per 1,000 people (Asiedu, 2006; Demirhan & Masca, 2008). Telephone lines also reflect the availability of communications and information technology. The World Bank (WB) database provided the annual data for this indicator, which this paper converted into quarterly data using the Denton method.

- **Inflation:** High inflation rates (Annual percentage change in consumer prices) indicate the country's economic instability, resulting in an uncertain investing climate. As a result, high inflation rates can negatively affect the flow of foreign direct investment. Rising production costs lead to a decrease in overall earnings. In addition, investors often prioritise short-term economic activities rather than long-term investments. Previous studies by [Demirhan and Masca \(2008\)](#) and [Asiedu \(2006\)](#) have examined the impact of the inflation rate on foreign direct investment through experimental investigations. For this research, we will utilise inflation data from the Palestinian Central Bureau of Statistics as a determinant impacting foreign direct investment in Palestine.

- **Labor cost:** The impact of wages on labour costs associated with FDI has been a topic of significant debate since [Chakrabarti \(2001\)](#) research. Although the consequences may vary, proponents of modernisation and reliance hypotheses agree that low-cost labour is crucial in luring multinational corporations (MNCs). However, research continues to examine the impact of wages on FDI, as shown by [Demirhan and Masca \(2008\)](#). Thus far, there has been no consensus on this matter. Several research studies that have examined the impact of higher salaries in the host nation on FDI have produced inconsistent results. According to much research, raising salaries may discourage FDI. Other studies, however, have not shown any appreciable influence or positive association. Employee pay and work remittances are used to calculate labour costs, and a negative result is anticipated ([Ranjan & Agrawal, 2011](#); [Suleiman et al., 2015](#)). To assess labour cost as a factor influencing foreign direct investment, this paper included in our research the workers' remittances and pay of employees received in US dollars as the measure of labour cost, which we collected from the Palestinian Central Bureau of Statistics.

Table 1. Summary of the variables and expected sign.

Variable	Description	Source	Expected sign	
			Positive	Negative
FDI	Total FDI inflows (US\$)	UNCTAD		
Conflict intensity (CONFi)	The number of fatalities arising from conflicts	B'Tselem		√
Market size (MAR)	Gross domestic product (GDP)	PCBS	√	
Trade openness (TRDO)	(Total export + Total import) / GDP	PCBS	√	
Gross capital formation (GCF)	Gross capital formulation/ GDP	PCBS	√	
Infrastructure (INFR)	Telephone line per 1000 people	WB	√	
Labor cost (LABC)	Workers' remittances and compensation of employees	PCBS		√
Inflation rate (INF)	Annual change in consumer price index	PCBS		√

3.2. Empirical Methodology

As the first quantitative study on the determinants of foreign direct investment (FDI) in the Palestinian territories, this research provides a comprehensive and precise analysis of the factors influencing investment flows in a conflict-ridden environment. The study utilizes the most comprehensive available data, applying the Autoregressive Distributed Lag (ARDL) model due to its ability to handle time series data with varying frequencies and to analyze long-term correlations between variables. This methodology successfully overcomes the limitations of traditional integration techniques, enhancing the findings' accuracy within the Palestinian territories' unique context.

The ARDL model, first introduced by [Pesaran and Pesaran \(1997\)](#) was chosen because previous methods like Johansen and Engle-Granger required time series data to be integrated in the same order. [Pesaran, Shin, and Smith \(2001\)](#) developed an ARDL cointegration approach, integrating Autoregressive and Distributed Lag models. This approach influences the lagged values of the time series data and the lagged values of the explanatory variables. Unlike other cointegration methods such as [Engle and Granger \(1987\)](#); [Johansen \(1988\)](#) and [Johansen and Juselius \(1990\)](#) ARDL can apply the bounds testing approach to cointegration regardless of whether the variables are I(0) or I(1). However, the variables must not be integrated in order I(2) or higher, as the critical F-statistic values calculated

by Pesaran et al. (2001) do not apply in such cases. Unlike other integration tests, the ARDL approach is well-suited for small sample sizes, which typically require large samples for greater efficiency. Its dual capacity to estimate long-term and short-term relationships simultaneously and its ability to address issues like serial correlation and omitted variables make it particularly effective (Ifa & Guetat, 2018).

Given the nature of the study, it is essential to confirm the stationarity of the time series data used by conducting the Augmented Dickey-Fuller (ADF) test for unit roots. Next, we will utilise the ARDL bounds testing approach based on the given formula:

$$\Delta y_t = \beta_0 + \sum_{i=1}^n \beta_i \Delta y_{t-i} + \sum_{i=0}^n \delta_i \Delta x_{t-i} + \varphi_1 y_{t-1} + \varphi_2 x_{t-1} + \mu_1$$

When looking at the equation, it is essential to consider the different components involved. The first difference operator (Δ), drift components (β_0), and the error term (μ) play crucial roles. The error term is anticipated to demonstrate attributes such as serial independence, homoscedasticity, and normal distribution. All β and δ coefficients are nonzero, with φ_1 also being negative and significant, indicating the rate of change. The parameters β_i and δ_i represent short-term dynamic coefficients, while φ_1 and φ_2 represent long-term coefficients.

The subsequent phase will confirm the existence of a durable association between the variables through the utilisation of the bounds test, as per the F-test methodology proposed by Pesaran et al. (2001). The cointegration is examined in the preceding equation by comparing the outcomes of the null hypothesis, which posits the absence of cointegration, with the alternative hypothesis, which acknowledges the existence of cointegration. The decision is made by comparing the computed F value with the critical values proposed by Pesaran et al. (2001) within the required bounds. When the calculated F value exceeds the tabulated value, we reject the null hypothesis and accept the alternative hypothesis. After identifying cointegration among the variables, the subsequent step is to estimate the long-term equation using the provided formula:

$$y_t = \beta_0 + \sum_{i=1}^p \partial_i y_{t-i} + \sum_{i=0}^q \theta_i x_{t-i} + \epsilon_t$$

Where ∂ , θ represents the variable's coefficients, p and q refer to the lag periods for those variables, while ϵ represents the random error term.

Then, specifications of the ARDL autoregressive distributed lag model for short-run dynamics and Error Correction Model are derived by constructing the following equation (ECM):

$$ECM: \Delta y_t = c + \sum_{i=1}^p \partial_i \Delta y_{t-i} + \sum_{i=0}^q \theta_i \Delta x_{t-i} + \omega ECT_{t-1} + v_t$$

ECT_{t-1} represents the error correction term, while the coefficients in the short-run equation reflect the short-run dynamics that guide the model toward equilibrium. The coefficient ω , also known as the error correction coefficient, measures the speed of adjustment, indicating how rapidly short-term imbalances are corrected to reach long-term equilibrium. For the model's short-term estimates to be valid, ω should be negative and statistically significant.

3.3. Model Specifications

This study aims to identify the determinants of foreign direct investment (FDI) in the Palestinian territories, as stated previously. It is possible to describe the model as follows:

$$LFDI_t = a + \beta_1 LCONF_t + \beta_2 LMAR_t + \beta_3 LTRDO_t + \beta_4 LGCF_t + \beta_5 LINFR_t + \beta_6 LABC_t + \beta_7 LINF_t + \epsilon_t$$

Were:

- $LFDI_t$ = Log of foreign direct investment
- $LCONFi_t$ = Log of the number of fatalities arising from conflicts in Palestine
- $LMAR_t$ = Market size (log Gross Domestic Product GDP).
- $TRDO_t$ = Trade openness is calculated by dividing the sum of imports and exports of goods and services by the gross domestic product (GDP).
- $LGCF_t$ = Gross capital formation divided by GDP.
- $LINFR_t$ = Infrastructure (number of main telephone lines per 1000 people).
- $LABC_t$ = Log of workers' remittances and employees' compensations was received as a measure of labor cost.
- $LINF_t$ = Inflation rate (consumer price index as a proxy of economic stability).
- ε_t = The error term.

4. EMPIRICAL RESULTS AND DISCUSSION

4.1. Unit Root Test

Before conducting the ARDL bounds test, it is essential to assess the stationarity status of all variables to determine their level of integration. To avoid unreliable outcomes, it is necessary to confirm that the variable's level of stationarity is not $I(2)$. Fosu and Magnus (2006) argue that the F-statistics calculated for $I(2)$ by Pesaran et al. (2001) have been regarded as invalid due to the concept made by the bounds test, which assumes that the variables being evaluated are either $I(0)$ or $I(1)$.

Table 2. Unit root test.

Variable	Formula	Augmented Dickey-Fuller (ADF)		Phillip-Perron		Conclusion
		Levels	1 st difference	Levels	1 st difference	
LFDI	Intercept	-0.457	-7.639***	-1.288	-8.649***	I(1)
	Intercept & trend	-3.702**	-7.558***	-3.678**	-8.556***	
LCONFi	Intercept	-5.730***	---	-5.748***	---	I(0)
	Intercept & trend	-5.571***	---	-5.769***	---	
LAMAR	Intercept	-2.501	-7.705***	-2.945**	-8.816***	I(1)
	Intercept & trend	-3.688**	-7.772***	-3.627**	-10.282***	
LTRDO	Intercept	-1.783	-9.129***	-1.348	-10.978***	I(1)
	Intercept & trend	-3.065	-9.218***	-2.903	-24.132***	
LGCF	Intercept	-2.243	-9.757***	-2.433	-11.964***	I(1)
	Intercept & trend	-3.433*	-9.832***	-3.334*	-19.664***	
LINFR	Intercept	-2.136	-3.638***	-2.135	-2.969**	I(1)
	Intercept & trend	-2.353	-3.595**	-2.163	-3.188*	
LABC	Intercept	-1.354	-10.174***	-1.693	-13.129***	I(1)
	Intercept & trend	-3.477*	-10.168***	-3.412*	-17.242***	
LINF	Intercept	-0.513	-7.383***	-0.531	-7.389***	I(1)
	Intercept & trend	-1.511	-7.310***	-1.617	-7.320***	

Notes: ***, **, and * denote rejecting the null hypothesis of unit root existence at the 1%, 5%, and 10% significance levels, respectively. The lag length selection was based on the Schwarz information criterion (SIC) for the ADF test, and the bandwidth selection was based on Newey-West using Bartlett Kernel for the PP tests.

It is crucial to perform unit root tests in the ARDL procedure to ensure that none of the variables have an integration order of $I(2)$ or higher. The Dickey-Fuller test (ADF) and the Phillips-Perron test (P.P.) are commonly used to determine if a unit root exists in a time series. This study utilises tests to evaluate the stationarity of the time series in the model. It confirms that the variables of interest do not display stationarity in their second differences, or $I(2)$, as shown in Table 2.

4.2. Lag Length Criteria

After verifying that no variables are integrated at $I(2)$ and that all variables are either $I(0)$ or $I(1)$, it becomes essential to assess whether a long-term relationship exists between foreign direct investment and its determinants. As a result, the variables are set up for the cointegration test. Using the Johansen procedure may also require determining the appropriate lag order for estimation.

Table 3. Lag length criterion.

Lag	LogL	LR	FPE	AIC	SC	HQ
0	480.530	NA	1.24E-18	-18.531	-18.228	-18.415
1	720.315	394.940	1.29E-21	-25.424	-22.697*	-24.382
2	819.284	131.959	3.94E-22	-26.795	-21.644	-24.827
3	898.296	80.562	3.70E-22	-27.384	-19.808	-24.489
4	1029.656	92.725*	9.04e-23*	-30.026*	-20.026	-26.204*

Note: * Indicates lag order selected by the criterion LR: Sequential modified LR test statistic (Each test at 5% level), FPE: Final prediction error, AIC: Akaike information criterion, SC: Schwarz information criterion, HQ: Hannan-Quinn information criterion

Table 3 indicates that lag length 4 is the most appropriate for estimating the Johansen cointegration test. Several selection criteria were used to arrive at this conclusion, except the Schwarz information criterion (SC), which recommends using only one lag.

4.3. Cointegration Tests

Table 4 presents the results of the unrestricted cointegration rank test. The Johansen cointegration analysis provides the greatest eigenvalue for both the trace and unrestricted cointegration rank tests. The Trace test yields five cointegrating vectors, while the Maximum Eigenvalue test yields two cointegrating vectors. These test results assist in determining the long-term balance between the variables. By comparing the trace and maximum statistics with the critical values as the observed p -values approached 0, we confirmed significant evidence of cointegration.

Table 4. Long run cointegration results.

Hypothesised No. of CE(s)	Trace			Maximum eigenvalue		
	Trace statistic	0.05 critical value	p -value**	Max-eigen statistic	0.05 critical value	p -value**
None *	216.446	159.530	0.000	61.913	52.363	0.004
At most 1 *	154.533	125.615	0.000	47.018	46.231	0.041
At most 2 *	107.516	95.754	0.006	32.633	40.078	0.270
At most, 3 *	74.882	69.819	0.019	26.669	33.877	0.281
At most 4 *	48.213	47.856	0.046	22.794	27.584	0.182
At most 5 *	25.419	29.797	0.147	16.937	21.132	0.175
At most 6	8.482	15.495	0.415	6.663	14.265	0.530
At most 7	1.819	3.841	0.177	1.819	3.841	0.177

Note: The trace test indicates five cointegrating equation(s) at the 0.05 level, while the max-eigenvalue test indicates two cointegrating equation(s). * Denotes rejection of the hypothesis at the 0.05 level. **MacKinnon, Haug, and Michelis (1999) p -values.

4.4. Autoregressive Distributed Lag Model (ARDL) and Bound Test

As shown in Table 5, the calculated F statistics of (12.124643) are greater than the upper bounds of 3.79, 4.39, and 5.64 at significance levels of 10%, 5%, and 1%. Therefore, the null hypothesis, which mentions no long-term relationships exist, is rejected. Instead, we accept the alternative hypothesis that a long-run cointegration relationship exists between foreign direct investment and the independent variables. Thus, it has been verified that there is cointegration among the examined variables.

Table 5. Autoregressive distributed lag bounds test.

Null hypothesis: No long-run relationships exist		
Test statistics	Value	
F-statistics	12.124	
Critical value bounds		
Significance	Lower bound I(0)	Upper bound I(1)
10%	2.590	3.789
5%	3.039	4.339
1%	4.055	5.640

4.5. Discussion

After estimating the long-term coefficients, as shown in Table 6, it was found that the model variables previously examined for the cointegration relationship were selected in accordance with the economic theory that discusses the determinants of the flow of foreign direct investment into the Palestinian territories. According to the results, most of these variables follow economic theory, as some showed positive and negative coefficients.

- **Impact of Armed Conflict on FDI:** The primary focus of our study is the correlation between the intensity of the armed conflict variable and the inflow of foreign direct investment into Palestinian territories. It shows a statistically significant negative relationship between the intensity of armed conflict and the inflow of foreign direct investment into Palestinian territories. The increasing level of conflict between Palestinians and Israelis leads to a significant decline in foreign direct investment flows into Palestinian territories, aligning with theoretical expectations. This result largely agrees with previous conflict theories and empirical evidence presented by [Alfar et al. \(2024\)](#) and [Ezeoha and Ugwu \(2015\)](#). However, these findings contradict those of [Lee \(2017\)](#) and other researchers who have pointed out the positive aspects of armed conflict, such as the relative security of locally consumed goods production in conflict, as conflict actors are interested in continuing these activities.
- **Market Size and FDI:** The results also showed that the log of GDP, which measures market size, has a positive and significant effect on the flow of foreign direct investment in the long run, consistent with prior expectations. This means that as the size of the Palestinian economy increases in terms of productivity, it leads to an increase in demand and, consequently, an increase in the flow of foreign direct investment into Palestine. This result is consistent with economic theory and the findings of studies conducted by [Adekunle \(2020\)](#) and [Mottaleb and Kalirajan \(2010\)](#).
- **Trade Openness and FDI:** The results regarding trade openness indicate a positive and significant relationship between this variable and FDI. Therefore, an increase in trade openness leads to an increase in foreign investments. This result is consistent with the economic theory and the findings of studies conducted by [Le, Pham, and Pham \(2023\)](#); [Hashmi, Hongzhong, and Ullah \(2020\)](#); [Ang \(2008\)](#) and [Asiedu \(2006\)](#).
- **Fixed capital formation and FDI:** The results also indicate a significant and positive relationship between total fixed capital formation and the inflow of foreign direct investment into Palestinian territories. This suggests a close relationship between promoting economic growth through improvements in the investment environment and increasing domestic capital generation. These improvements enhance local investment and facilitate attracting more significant foreign direct investment inflows. This is consistent with economic theory and studies by [Suleiman et al. \(2015\)](#) and [Ranjan and Agrawal \(2011\)](#).
- **Infrastructure and FDI:** A significant and negative relationship was observed between the infrastructure and foreign direct investment. This result contradicts economic theory and practical studies, such as [Vi Dũng, Bích Thủy, and Ngọc Thắng \(2018\)](#); [Demirhan and Masca \(2008\)](#) and [Asiedu \(2006\)](#). However, this result was consistent with [Bekana \(2016\)](#) and [Pradhan \(2008\)](#) findings. It can be argued that the current efforts to develop infrastructure in Palestine are insufficient for attracting foreign direct investment. This highlights the persistent issues with infrastructure facilities, which impede the smooth flow of foreign direct investment.

Therefore, the negative sign for this variable suggests that infrastructure discourages foreign direct investment and requires further attention. The Palestinian territories weak infrastructure is not solely due to limited public financial resources. Instead, there is a more critical main reason, which is the restrictions and obstacles imposed by the Israeli side on Palestinian access to the Palestinian territories, which are subject to the political classification known as Area C of the West Bank lands according to the division of the Oslo Accord (1993) and Fesen (2021). As a result of these restrictions, the Palestinian Authority lacks control over most of the West Bank when it comes to planning and land use. These areas instead fall under the jurisdiction of the IDF Civil Administration. As a result, the central and local government entities, such as municipalities or village councils, cannot assign land for public services or infrastructure. This significantly impacts the overall availability of infrastructure services, encompassing transport networks, water and energy provision, communication systems, waste management and disposal, and industrial zones (World Bank Group, 2014).

- Inflation and FDI: The results indicate a significant negative relationship between inflation rates and foreign direct investment. This aligns with theoretical expectations that high inflation rates imply economic instability, as well as empirical studies conducted by Tampakoudis, Subeniotis, Kroustalis, and Skouloudakis (2017); Demirhan and Masca (2008) and Asiedu (2006). Research indicates that high inflation rates hinder the attraction of foreign direct investment, as they escalate production requirements and subsequently raise production costs. This, in turn, reduces project profits and restricts the flow of foreign direct investment into Palestinian territories.
- Labour Costs and FDI: As evident from the results, the labour cost coefficient has a significantly high negative effect, indicating that a higher labour cost is unattractive for foreign direct investment. This is consistent with the economic theory of Khamphengvong, Xia, and Srithilat (2018) and Ranjan and Agrawal (2011) findings. Finally, the sign of the coefficient of the dummy variable representing Covid-19 was negative and significant.

Table 6. Estimated long-run coefficient using ARDL (1,2,4,4,3,4,4,3) model.

Dependent variable: LFDI				
Variable	Coefficient	Std. error	t-statistic	Prob.
<i>LMAR</i>	0.776	0.160	4.838	0.000
<i>LTRDO</i>	0.993	0.160	6.205	0.000
<i>LCONF_i</i>	-0.024	0.006	-3.798	0.002
<i>LGCF</i>	0.165	0.083	1.981	0.065
<i>LABC</i>	-0.212	0.066	-3.221	0.005
<i>LINF</i>	-1.679	0.328	-5.121	0.000
<i>LINFR</i>	-0.864	0.194	-4.462	0.000
<i>C</i>	13.530	1.696	7.978	0.000
<i>@trend</i>	0.004	0.001	3.594	0.002

4.6. Error Correction Estimation Results

The results of the error correction model indicated that the coefficient of the error correction term reflects the speed at which the variables return to equilibrium. This coefficient should be significant and negative to confirm the presence of cointegration among the variables. The absolute value of the error correction term coefficient reveals how quickly equilibrium is restored, while a negative sign indicates convergence within the short-term kinetic model. A negative and significant coefficient for the error correction term (ECMt-1) demonstrates cointegration more effectively.

Table 7 presents the coefficients (ECTt-1) for this mode. The experimental results show that the model explains 94% of the short-run foreign direct investment changes. Regarding the error correction term, the coefficient was negative and significant at 1%, confirming a long-term parallel relationship. The value of 0.963 indicates that the model corrects 96% of the shock effects each quarter.

Table 7. Error-correction estimation for estimated: ARDL (1,2,4,4,3,4,4,3).

Cointegrating form				
Variable	Coefficient	Std. error	t-statistic	Prob.
C	13.530	1.146	11.809	0.000
D(LMAR)	-0.020	0.050	-0.394	0.697
D(LMAR(-1))	-0.299	0.069	-4.337	0.000
D(LTRDO)	0.245	0.039	6.207	0.000
D(LTRDO(-1))	-0.515	0.067	-7.712	0.000
D(LTRDO(-2))	-0.133	0.051	-2.593	0.016
D(LTRDO(-3))	0.052	0.037	1.395	0.176
D(LCONFi)	0.001	0.001	0.712	0.484
D(LCONFi(-1))	0.015	0.002	6.782	0.000
D(LCONFi(-2))	0.014	0.002	8.419	0.000
D(LCONFi(-3))	0.007	0.002	4.098	0.000
D(LGCF)	0.112	0.031	3.564	0.002
D(LGCF(-1))	-0.144	0.034	-4.258	0.000
D(LGCF(-2))	-0.213	0.025	-8.495	0.000
D(LCOE)	-0.079	0.024	-3.310	0.003
D(LCOE(-1))	0.097	0.024	4.013	0.001
D(LCOE(-2))	0.057	0.019	2.995	0.007
D(LCOE(-3))	-0.046	0.016	-2.801	0.010
D(LINF)	-0.608	0.253	-2.403	0.025
D(LINF(-1))	-0.341	0.207	-1.646	0.113
D(LINF(-2))	-2.038	0.232	-8.775	0.000
D(LINF(-3))	-0.758	0.308	-2.458	0.022
D(LINFR)	0.564	0.475	1.188	0.247
D(LINFR(-1))	-1.310	0.782	-1.675	0.107
D(LINFR(-2))	1.175	0.466	2.523	0.019
DUM_19	-0.038	0.008	-4.881	0.000
@TREND	0.004	0.000	11.718	0.000
ECM(-1)	-0.963	0.082	-11.808	0.000
R-squared	0.941	Mean dependent var	0.008	
Adjusted R-squared	0.871	S.D. dependent var	0.026	
S.E. of regression	0.009	Akaike info criterion	-6.243	
Sum squared resid	0.002	Schwarz criterion	-5.182	
Log-likelihood	187.186	Hannan-Quinn criteria.	-5.837	
F-statistic	13.538	Durbin-Watson stat	2.342	
Prob(F-statistic)	0.000			

4.7. Diagnostic and Stability Testing

The procedure of conducting residual diagnostic tests generates F-distribution or Chi-square asymptotic statistics and their corresponding probability values (p -values). The p -values reflect the likelihood of observing an examination statistic equal to or greater than the sample statistic, assuming the null hypothesis holds. Thus, when the p -value is low, it is reasonable to reject the null hypothesis. Some of the tests that are done on the model outcome are the normality, serial correlation, and heteroscedasticity tests (Souza, Sodr , Noma, Tanoshi, & Pedroso, 2022). The results of the diagnostic tests are shown in Table 8, which indicates that the model passed each test required to confirm that there were no problems with serial correlation or heteroscedasticity and that the residuals had a normal distribution.

Table 8. Diagnostic test results.

Test	Statistics	Probability	Decision
Heteroscedasticity	0.901	0.615	No heteroscedasticity
Serial correlation	0.465	0.761	No serial correlation
Normality (Kurtosis)	0.793	0.673	Residuals are normally distributed.

4.8. Testing the Structural Stability of the Model

Examining the stability of long-run and short-run estimates based on the results shown in Figure 1 and Figure 2, it can be concluded that the CUSUM and CUSUMSQ tests support the claim made by Pesaran and Pesaran (1997). According to their assertion, if the plots of the CUSUM and CUSUMSQ fall within the 5% critical bounds, then there is no evidence to reject the null hypothesis that all coefficients are stable. It is evident that the model, along with its short-run and long-run coefficients, is stable.

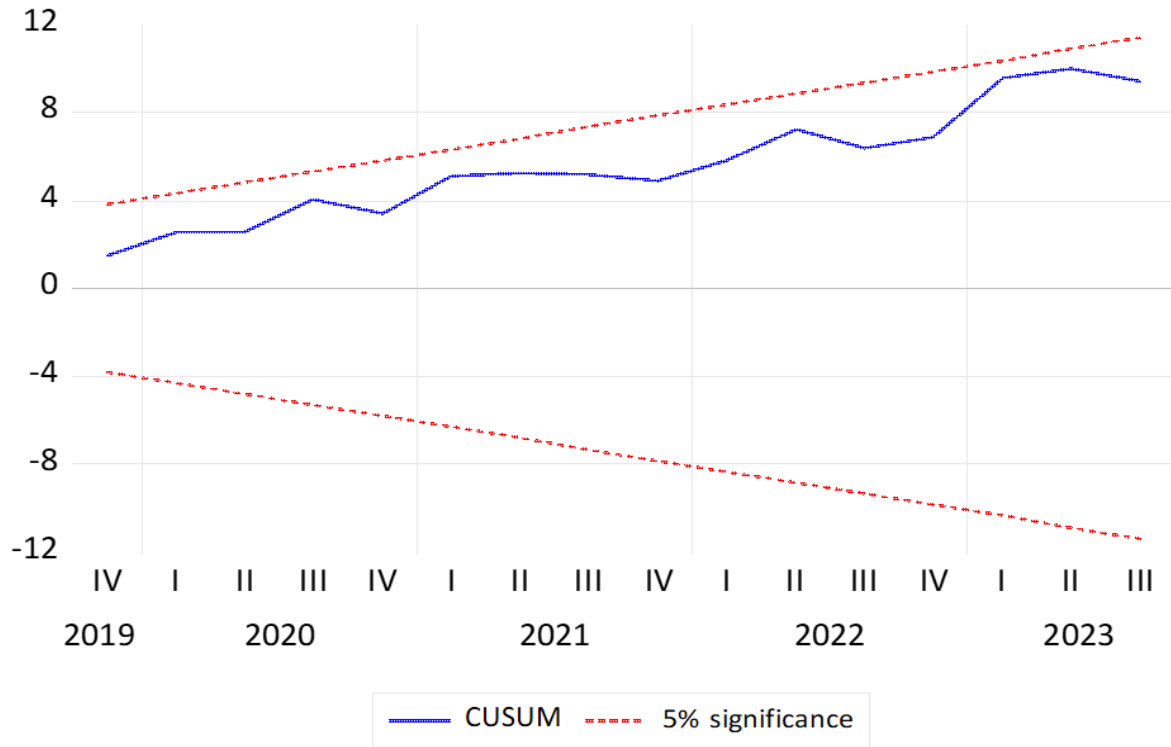


Figure 1. CUSUM test.

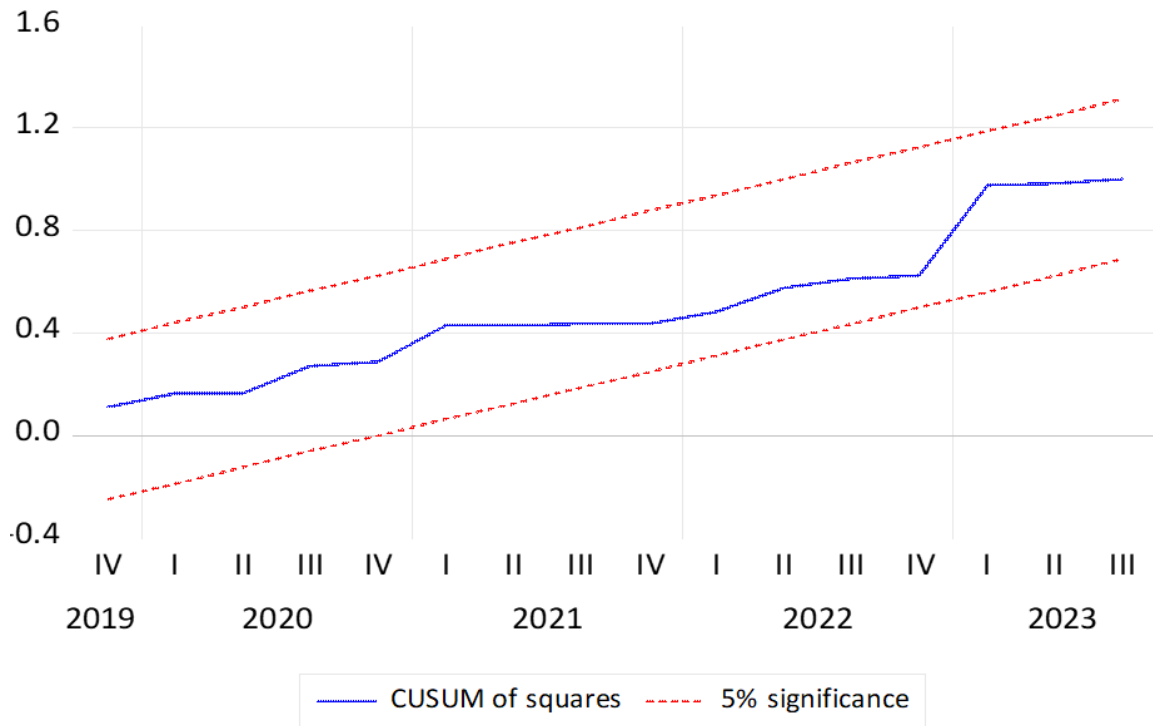


Figure 2. CUSUM of squares test.

5. CONCLUSION

Foreign direct investment is considered one of the most critical factors that effectively contribute to the development of countries. It provides capital and modern technology, which are utilised in establishing economic and developmental projects to achieve social welfare for all members of society. Countries compete to attract this type of investment by creating an investment environment and conditions that stimulate more investors and attract them to the host countries to drive economic and social development in those countries. However, several factors influence investors' decisions to invest in a host country, with the degree of political stability and the absence of armed conflict being the most significant.

This study examines the impact of the Israeli-Palestinian conflict on the flow of foreign direct investment to the Palestinian territories. According to previous studies, it takes into account six other determinants that significantly influence foreign direct investment. These determinants include market size, trade openness, gross capital formation, infrastructure, labour cost, and inflation.

The main finding of our analysis, which represents our focus in this study, is the relationship between the intensity of the armed conflict variable and the foreign direct investment inflow into Palestinian territories. The result of the coefficient for this variable is negative and significant, consistent with conflict theories and previous empirical studies. This means an increase in armed conflicts between the Palestinian and Israeli sides slows foreign direct investment flows into Palestinian territories. As expected, the log of GDP, which measures market size, has a positive and significant effect on foreign direct investment in the long run. Therefore, as the productivity of Palestinian economy increases, demand also rises, leading to an increase in foreign direct investment. Trade openness positively and significantly affects foreign direct investment. Increased trade openness attracts more foreign investment. The results also show a strong correlation between total fixed capital formation and foreign direct investment in Palestinian territories. Improvements in the investment environment link domestic capital generation to economic growth. These upgrades boost local investment and attract more FDI.

The relationship between the infrastructure and foreign direct investment was significant and negative. This result contradicts economic theory and practical studies. One could argue that Palestine's current infrastructure development efforts are not sufficient to attract foreign direct investment. The results show that inflation rates indicate economic instability and have a significant negative impact. Finally, as the results show, the cost of labour coefficient has a significantly high negative effect, suggesting that a higher labour cost is unattractive for foreign direct investment.

This study suggests that policymakers in conflict-affected regions such as the Palestinian territories should focus on certain key areas. These include prioritising conflict resolution and peace-building efforts to improve political stability, implementing strategies to stimulate economic growth and increase GDP, reducing barriers and enhancing trade agreements to promote trade openness, strengthening infrastructure to attract foreign investors, managing inflation and labour costs, providing incentives to encourage domestic capital formation, and adopting a variety of strategies to attract foreign direct investment.

5.1. Limitations and Future Research Directions

Infrastructure represents the most significant limitation of this study. The fact that the study found that the relationship between infrastructure variables and foreign direct investment is negative contradicts economic theory and empirical research, and this indicates that the form and components of infrastructure do not live up to the level of investors' expectations.

Data reliability is also considered another critical determinant, as the available data, or part of it, maybe incomplete and sometimes inaccurate. This may affect the results reached, weaken the strength of the conclusions, and thus affect the recommendations.

Future research should focus on the following areas:

- Focus on Infrastructure Development: Future studies should investigate why infrastructure and foreign direct investment negatively correlate. Understanding whether the issue lies in infrastructure quality, type, or perception could help improve investment attractiveness.
- Sector-Specific Research: More precisely, it would be possible to research those Palestinian industries most influenced by armed conflict, infrastructure quality, or labour costs. On this basis, specific, appropriate strategies for developing targeted support for attracting foreign investment in such sectors with high latent potential will also be developed.
- Investor perspectives and preferences: The reasons for labour cost and infrastructure being critical determinants of foreign direct investment decisions may have to be gauged through investor surveys or interviews.

Funding: This study received no specific financial support.

Institutional Review Board Statement: Not applicable.

Transparency: The author states that the manuscript is honest, truthful, and transparent, that no key aspects of the investigation have been omitted, and that any differences from the study as planned have been clarified. This study followed all writing ethics.

Data Availability Statement: Mohammad Aref Mohammad Ibrahim can provide the supporting data of this study upon a reasonable request.

Competing Interests: The author declares that there are no conflicts of interests regarding the publication of this paper.

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