

Does Government Effectiveness Drive FDI-Led Economic Growth? Evidence from Nepal

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Abstract

The study empirically examines the impact of foreign direct investment (FDI) on economic growth in Nepal and evaluates the moderating role of government effectiveness. Using an ARDL model and annual time-series data from 1996 to 2024, the bounds test indicates a stable long-run relationship among the variables. The findings show that foreign direct investment has a positive and significant impact on growth in both the long run ($\beta=0.05$, $p<0.01$) and the short run ($\gamma=0.01$, $p<0.05$). Conversely, government effectiveness shows negative and weakly significant effects in the short run ($\gamma = -0.045$, $p < 0.1$), but is insignificant in the long run due to persistent institutional instability in Nepal. Crucially, the interaction between FDI and government effectiveness is positive and statistically significant in both the long run ($\beta=0.45$, $p<0.01$) and the short run ($\gamma=0.14$, $p<0.01$). The findings show that good governance and strong institutions play a vital role in amplifying the growth-enhancing effects of FDI by operationalizing effective policies, thereby fostering a favorable environment for foreign investors and enhancing capital inflows. Therefore, Nepal should prioritize institutional improvements and effective policy implementation to attract more FDI and foster economic growth.

Keywords: Foreign direct investment, Government effectiveness, Economic growth, ARDL model

JEL classification: C23, F21, F43, O43

Introduction

Foreign direct investment (FDI) as a source of capital is considered a contributing factor to economic growth and boosts productivity growth through technology transfer and employment creation (Al-Eitan, 2013). FDI inflows initiate structural transformation and support economic prosperity through

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capital mobility and market openness. FDI encourages growth in both developed and developing countries. FDI has become a driver of prosperity for regional economic powerhouses, as is evident from Singapore and Malaysia. FDI inflows are vital for developing countries, as they complement and stimulate domestic investment in capital-scarce economies (Jude & Levieuge, 2013). Its role is recognized as a catalyst for growth in developing economies (Hoang, Wiboonchutikula & Tubtimtong, 2010).

Recognizing these benefits, Nepal has pursued policies, such as globalization, liberalization, and privatization strategies, to attract foreign capital since 1990. These policies encompassed legal reform, investment-friendly policies, public-private partnerships, industry incentives, and infrastructure development. Despite these efforts and strategic advantages such as adjoining markets, a favorable climate, abundant natural resources, and an inexpensive labor force, FDI inflow in Nepal remains marginal. The limited impact of FDI is further constrained by intense global competition and domestic structural weaknesses (Adhikari, 2013; Pant, 2010), signifying the need for further assessment of its effectiveness on economic growth.

Despite abundant natural and human resources, Nepal remains a low-income, agrarian economy that supports a large share of the country's population yet suffers from limited productivity growth (Basnett et al., 2014). Economic performance has fluctuated in Nepal over the past decades. The statistics show that GDP growth swings from a peak of 8.2% in 1994 to a low of -2.4% in 2021 (Ministry of Finance, 2022). These statistics show an urgent need for FDI to mobilize underutilized resources and enhance productivity, thereby stimulating sustainable economic growth in Nepal.

Extensively, research shows that the growth-enhancing role of FDI relies on governance quality. Government effectiveness, such as policy formulation, bureaucratic efficiency, and implementation capacity, can ensure the productive use of FDI inflows (Globerman & Shapiro, 2002; Knack & Keefer, 1995). Strong institutions, such as the rule of law, control of corruption, and political stability, reduce investment risk, lower transaction costs, and create a predictable policy environment that encourages sustainable capital inflows (Jensen, 2003; Alfaro, Kalemli-Ozcan, & Volosovych, 2008; Wei, 2000; Busse & Hefeker, 2007). Thus, empirical evidence from developing economies shows that FDI significantly contributes to growth where institutional factors are robust. This highlights the developmental benefits of FDI that are conditional on government effectiveness (Bénassy-Quéré, et al., 2007; Alfaro et al., 2008).

Though the importance of FDI is widely recognized, previous studies conducted in Nepal have mostly focused on FDI trends, challenges, and prospects, overlooking its direct impact on economic growth, particularly the government's role in formulating supportive policies to attract FDI. Research by Majagaiya (2010), Bista (2017), Phuyal and Sunuwar (2018), Pokharel and Pokharel (2019), Parajuli (2021), and Balami, et al. (2024) and others has primarily employed correlation analysis, Granger causality, ordinary least squares, and Johansen cointegration techniques to examine the relationship between FDI and economic growth.

Still, prior studies neither systematically integrated key macroeconomic determinants in real terms nor used realized FDI instead of approved FDI within the growth model framework. Some of them primarily employed static models rather than a dynamic approach, such as the autoregressive distributed lag model (ARDL), which partially addresses endogeneity concerns and helps reduce simultaneity and omitted variable bias. Moreover, these works overlooked the role of government effectiveness, which can enhance FDI's effect on economic growth in Nepal. This highlights the importance of conducting a rigorous study using advanced econometric techniques to investigate the effect of FDI on economic growth through the role of government effectiveness and to generate policy-relevant insights for developing countries like Nepal.

Addressing a gap in prior work, this study examines the impact of foreign direct investment on Nepal's economic growth and evaluates whether government effectiveness moderates this relationship. This research paper applies the ARDL model to annual time-series data from 1996 to 2024. This paper is based on the assumption that FDI contributes positively to economic growth in Nepal, and this is enhanced by government effectiveness. This paper aims to address persistent challenges, including low productivity and poor institutional performance, that hinder the positive effects of FDI in Nepal. These challenges highlight the need to evaluate whether FDI inflows effectively support national development priorities and to formulate policies that attract more FDI and promote long-term growth in Nepal. Thus, the basis of this study is clear and distinct from previous work in Nepal.

The paper is organized into five sections. The first section introduces this study, the second presents the relevant literature, and the third discusses the methodology and data. Likewise, the fourth section analyses the data and presents the results and discussion; the fifth section concludes with policy implications.

Literature Review

The relationship between FDI and economic growth is a central concern in development economics. Growth theories offer different views on how FDI influences long-term macroeconomic performance and define the role of FDI within the paradigms of neoclassical theory (capital accumulation) and endogenous growth theory (technology transfer/knowledge spillovers).

The neoclassical growth theory stipulates that economic growth is driven by exogenous factors (Solow, 1956; Swan, 1956). Neoclassical economists emphasize that FDI temporarily boosts growth by augmenting the capital stock and technology transfer to the host country (Herzer et. al., 2008) and posit a positive link between capital accumulation and output growth (Barro & Sala-i-Martin, 1995). However, FDI does not nurture the long-run growth path due to diminishing marginal returns to capital. The framework centers solely on exogenous technological progress, highlighting long-run economic growth.

Conversely, endogenous growth theory (Romer, 1986; Lucas, 1988) assumes that technological innovation is endogenous and regards foreign direct investment as an important channel for technology diffusion and knowledge spillovers, thereby helping raise long-run growth by enhancing productivity and technology diffusion (Nair-Reichert & Weinhold, 2001). Thus, the contribution of foreign direct investment to growth depends on absorptive capacity and human capital development (Borensztein et al., 1998), as well as on institutional quality (Al Nasser, 2010). These factors are the core views of endogenous growth and absorptive capacity theory.

Furthermore, Elboiashi (2011) synthesizes the contribution of FDI to growth through both direct (capital accumulation) and indirect (knowledge spillovers) impacts. FDI can boost the host country's economy via capital accumulation, foreign technology transfer (exogenous growth theory), and by enhancing the host country's stock of knowledge through technology transfer, knowledge, and skill spillovers (endogenous growth theory).

The effect of interaction between FDI and government effectiveness on economic growth has been extensively theorized and empirically validated over the past two decades. Early works established that governance quality and its effectiveness are key determinants of FDI inflows. Wei (2000) theorized that corruption is a hidden tax on investors, reducing capital inflows and undermining FDI's growth potential. Further, Nunnenkamp and Spatz (2003) emphasize the mediating role of good governance in determining the productivity-enhancing effects of FDI.

Subsequent cross-country analyses by Asiedu (2006), Busse and Hefeker (2007), and Chakraborty and Nunnenkamp (2002) strengthened the theoretical propositions and confirmed that political stability, democratic accountability, and the rule of law significantly shape the FDI–growth relation in developing economies with institutional fragility. Furthering this discourse, Fu (2008) theorizes that the type and quality of FDI inflows, the strength of local absorptive capacity, and complementary assets in the host region are crucial factors in driving knowledge-based development through FDI.

The research conducted by Moyano et al. (2015) in Colombia, Sheng et al. (2024) in China, and Gutiérrez-Portilla et al. (2019) in Spain emphasize the conditional nature of FDI's growth effect, which is shaped by the host country's absorptive capacity and local infrastructure. Globerman and Shapiro (2002) introduced the notion of governance infrastructure and linked institutional efficiency to investor confidence and human capital. In an analysis of emerging markets, Paul and Jadhav (2019) identify a comprehensive suite of governance drivers and state that infrastructure quality, trade cost measured by tariff and non-tariff barriers, institutional quality measured by the effective rule of law, political stability, regulatory quality, and the control of corruption are significant determinants of FDI in emerging markets.

This unequal distribution, driven by pre-existing infrastructure and supportive policies, leads to a positive overall nexus for the country, but an uneven (heterogeneous) impact across its sub-national regions. Taken together, prior studies indicate the developmental effects of FDI. Furthermore, researchers argue that domestic institutional readiness and regional disparities in governance and productivity growth are major factors in sustaining economic growth.

Recent cross-country studies have employed more rigorous dynamic modeling, incorporating governance indices and measures of institutional effectiveness. Among these, the study by Bhujabal et al. (2024) shows that appropriate governance structures, characterized by low levels of corruption, the absence of violence, political stability, stronger accountability, stronger regulatory quality, and an effective judiciary, attract more foreign investment. Such investments lead to positive spillover effects in the economy through GDP, international business activities, and financial sector development. Likewise, using the system GMM model, Yerrabati (2021) finds that good governance increases FDI's effects on growth in developing economies, and that FDI's effects weaken due to regulatory rigidity.

In addition, the studies by Aizenman et al. (2013) and Nasir et al. (2018) find that the rule of law, government effectiveness, and regulatory quality play a decisive role in sustaining the long-run impact of FDI on economic growth

in developing economies. Likewise, Maranik et al. (2024) studied the case of ASEAN alongside Japan, China, and South Korea and argued that every nation should have an effective institutional framework and a stronger rule of law to attract foreign investors. They further explained that regulatory quality and control of corruption are equally important. Nevertheless, political stability and government accountability negatively affect FDI due to a non-linear relationship.

International evidence consistently demonstrates the growth effect of FDI, which is governed by governance quality, institutional strength, and human capital development. FDI generally promotes economic growth, and its effectiveness depends on the policy environment, infrastructure, and the host country's absorptive capacity.

Empirical studies on the FDI–growth relationship in Nepal have mostly examined the nature, trends, correlation, and direction of causality, though some have reported mixed and contradictory findings from regression estimates. Early evidence by Majagaiya (2010), using Granger causality and cointegration techniques for the period 1980–2006, found a long-run relationship running from FDI to GDP. However, the study did not fully explore the magnitude or economic significance of this effect. Using multiple regression analysis and annual data from 1982 to 2007, Bista (2017) found a significant positive impact of foreign direct investment on GDP. According to him, one of the critical factors affecting the effectiveness of foreign direct investment in Nepal is policy uncertainty. However, the study applied approved foreign direct investment instead of realized FDI, which could be a discrepancy between actual investment and its impacts on the economy

According to Phuyal and Sunuwar (2018), focusing on sector-based analysis, investments in the industrial, tourism, and agricultural sectors made significant contributions to GDP growth between 2007 and 2016. Consistent with this, Nepal Rastra Bank (2018) observed that FDI was largely invested in the services industry (about 70.2%), with FDI stock at 6.1% of GDP. This reveals the growing significance of foreign investment in Nepal's economy. Likewise, the findings from the study by Balami et al. (2024), which used sectoral and descriptive analyses, revealed a positive relationship between FDI and GDP. However, the findings from the study were based on correlation rather than causality.

Recent empirical studies on Nepal show mixed findings regarding the growth effects of FDI. The majority of these studies reveal a positive relationship between FDI and growth; however, the findings on causality remain weak and inconsistent. For instance, the findings of Pokharel and Pokharel (2019), Parajuli (2021), and Dhungel and Lamichhane (2023) indicate a positive effect of FDI on GDP growth in Nepal.

Conversely, Paudel (2022) found no significant long-run effect but found one-way causality from GDP to FDI, suggesting that economic growth attracts investment rather than investment driving growth. However, these studies also suffer from methodological limitations, particularly the reliance on approved rather than realized FDI, which affects the accuracy of the estimated effect. In contrast, other evidence indicates a more complex relationship in which economic growth and macroeconomic variables, such as remittances and total investment, appear to drive FDI inflows rather than the reverse. Thus, FDI is more responsive to GDP growth and remittance inflows, suggesting a possible reverse causality in Nepal's economy.

Thus, the key limitations across most studies are their reliance on approved FDI data rather than actual inflows, and a limited focus on institutional and policy effectiveness in assessing the real effect of FDI. Moreover, existing studies largely emphasize the direct relationship between FDI and growth, ignoring how governance quality, policy implementation, and institutional effectiveness may influence FDI's effect on growth. Although recent international literature emphasizes the importance of governance and institutional quality in enhancing FDI spillover effects through technology transfer and productivity gains, this dimension remains unexplored in Nepal's economy. Thus, this study adds value to the existing literature by addressing this unexplored dimension in the Nepalese context.

Research Methodology

This section outlines the research design, the theoretical and conceptual frameworks, and it formulates the econometric model employed in the study. This section further details the selection of variables and data, with their nature, sources, and descriptive characteristics.

Research design

Quantitative methods and a correlational research design, along with inferential statistics, are used in this study to analyze the relationship between FDI and growth with government effectiveness as a moderator in the case of Nepal. For analysis, the autoregressive distributed lag (ARDL) model is used as the econometric technique, along with secondary annual time-series data from 1996 to 2024. The key variables of this study include GDP per capita, FDI, government effectiveness, gross capital formation, and inflation rate.

Theoretical foundation and conceptual framework

The conceptual framework is grounded in the endogenous growth model and builds on the extended neoclassical model developed by Barro (1991), which

analyzes long-term economic growth. Further, Bosworth and Collins (2003) and Durlauf, Johansson, and Temple (2005) were advanced and empirically applied in the literature on cross-country growth empirics.

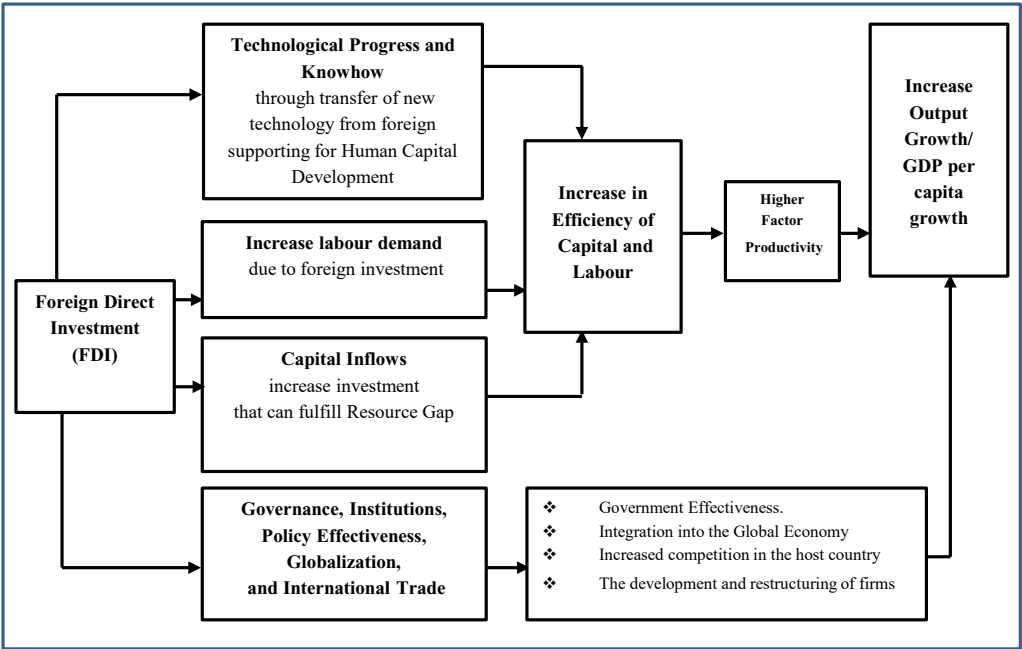
The model assumes that growth is influenced by factors of production such as capital, labor, and human capital, as well as by policy and institutional variables that affect total factor productivity (TFP). Consequently, Nepal’s GDP can be modeled using a neoclassical framework employing the Barro Regression (Paudel, 2022).

A generic representation of the Barro model is as follows:

$$Y_i = \beta_0 + \beta_1 X_i + \beta_k Z_i + \xi_i \dots \dots \dots (1)$$

Where, Y_i denotes output growth, X_i represents factors of production, such as physical capital (K), human capital (H), and labor (L), as suggested by the endogenous growth model. The study uses gross capital formation (lnGFCF) as a proxy for physical capital. Z_i represents the shocks in the economy and includes growth determinants beyond Solow’s growth theory, which represent policy variables such as the government effectiveness index (lnGEI), foreign direct investment (lnFDI), inflation (lnINF), and the interactive term (lnFDI*lnGEI). These variables are selected for Barro regression following Barro (1991) and Sala-I-Martin (1997).

Figure 1: The theoretical linkage between FDI and economic growth



Source: Author based on theoretical underpinnings, 2025

This framework can capture production inputs, technological improvement, and policy efficiency to shape economic growth in Nepal. Government effectiveness comprises reforms such as the degree of independence from political interference, the quality of public services, the quality of policy formulation and implementation, and the credibility of the government's commitment to relevant policies.

FDI increases domestic capital, transfers advanced technology, and enhances skill development, thereby eventually contributing to economic growth (Borensztein et al., 1998). FDI improves productivity through knowledge diffusion, process automation, and efficient resource utilization, ultimately boosting total factor productivity and promoting sustainable long-term growth.

Besides these direct effects, FDI integrates host countries with the global economy. This fosters trade, increases capital flows, and incentivizes innovation among local firms. This enhances firms' standards by exposing domestic firms to new markets, ideas, and practices, thereby enhancing factor efficiency, increasing productivity, and promoting economic growth. Moreover, FDI catalyzes domestic firms' development by providing access to capital, technology, and expertise through joint ventures or partnerships, thereby aiding expansion, efficiency, and market entry.

Overall, FDI promotes productivity, technological progress, and resource allocation efficiency. Nevertheless, several factors, such as the host nation's institutional strength and policy framework, determine the effect of FDI on the economy. The effectiveness of FDI integration involves managing the risks and externalities of foreign investment to ensure sustainable economic growth.

Nature and sources of data

This study uses annual secondary time-series data from 1996 to 2024². The data for key variables such as GDP per capita, gross fixed capital formation, and FDI inflows were extracted from the economic survey (Ministry of Finance, 2011, 2025), while the inflation rate (INF) were obtained from the quarterly economic bulletin (Nepal Rastra Bank, 2025). The data for the government effectiveness index (GEI)³ was sourced from the World Bank (2025).

For data consistency, all variables are expressed in their logarithmic forms to stabilize variance and ensure robustness in estimation. To account for negative observations, FDI and GEI are taken in natural logarithms, following Thanh

² Data on the government effectiveness index up to 2024.

³ The missing data of the government effectiveness index for 1997, 1999, and 2001 are derived using a linear trend using EViews commands.

(2015). Here, GEI was transformed using $\ln(\widehat{GEI}) = \ln(GEI+2)$ and FDI was transformed using $\ln(\widehat{FDI}) = \ln(FDI+1)$. The interaction term ($\ln FDI * \ln GEI$) was derived by multiplying the mean-centered series, following standard econometric procedures to reduce potential multicollinearity among $\ln FDI$, $\ln GEI$, and their interaction term.

Empirical model: Cointegration test using ARDL model

The ARDL⁴ bounds testing approach developed by Pesaran, Shin, and Smith (2001) and Pesaran and Shin (1999) is applied to examine the existence of long-run and short-run dynamics among the variables, and the ARDL model is presented as:

$$\begin{aligned} \Delta \ln GDP_{PCt} = & \gamma_0 + \sum_{i=1}^p \gamma_1 \Delta \ln GDP_{PC(t-i)} + \sum_{j=0}^q \gamma_2 \Delta \ln GFCF_{(t-j)} + \sum_{k=0}^r \gamma_3 \Delta \ln FDI_{(t-k)} + \sum_{l=0}^s \gamma_4 \\ & \Delta \ln GEI_{(t-l)} + \sum_{m=0}^n \gamma_5 (\Delta \ln FDI * \ln GEI)_{(t-m)} + \sum_{n=0}^v \gamma_6 \Delta \ln INF_{(t-n)} + \delta_0 + \\ & \delta_1 \ln GDP_{PC(t-1)} + \delta_2 \ln GFCF_{(t-1)} + \delta_3 \ln FDI_{(t-1)} + \delta_4 \ln GEI_{(t-1)} + \delta_5 \\ & (\ln FDI * \ln GEI)_{(t-1)} + \delta_6 \ln INF_{(t-1)} + \xi_t \dots \dots \dots (2) \end{aligned}$$

Where, Δ is the first difference operator, γ_0 is the drift component, γ and δ coefficients represent short- and long-run relationships, while ξ_t is a white-noise error term. The cointegration relation of equation (2) is:

$$\ln GDP_{PCt} = \beta_1 \ln GFCF_t + \beta_2 \ln FDI_t + \beta_3 \ln GEI_t + \beta_4 (\ln FDI * \ln GEI)_t + \beta_5 \ln INF_t + \xi_t \dots \dots \dots (3)$$

Where, $\beta_i = -(\frac{\delta_i}{\delta_1})$ represent long-run elasticities. When the cointegration confirms the presence of a long-run relationship in the model, the Error Correction Model (ECM) corrects the short-run disequilibrium and is represented as:

$$\begin{aligned} \Delta \ln GDP_{PCt} = & \gamma_0 + \sum_{i=1}^p \gamma_1 \Delta \ln GDP_{PC(t-i)} + \sum_{j=0}^q \gamma_2 \Delta \ln GFCF_{(t-j)} + \sum_{k=0}^r \gamma_3 \Delta \ln FDI_{(t-k)} + \sum_{l=0}^s \gamma_4 \\ & \Delta \ln GEI_{(t-l)} + \sum_{m=0}^n \gamma_5 (\Delta \ln FDI * \ln GEI)_{(t-m)} + \sum_{n=0}^v \gamma_6 \Delta \ln INF_{(t-n)} + \lambda ECM_{t-1} + \xi_t \dots \dots \dots (4) \end{aligned}$$

4 The ARDL model is a dynamic econometric approach that is well suited for small sample sizes, employs a single reduced-form equation, simultaneously estimates short-run and long-run relationships, facilitates bounds testing for cointegration under mixed orders of integration, mitigates endogeneity through the inclusion of lagged variables, allows flexible and variable-specific lag structures, enables the derivation of an error correction model for dynamic adjustment, addresses autocorrelation issues, and often delivers superior forecasting performance.

The parameter λ represents the speed of adjustment to the model's equilibrium. A negative and significant value indicates convergence to the long-run equilibrium of the system. The error correction term ($ECMt$) is determined as follows:

$$ECMt = \ln GDP_{Pc_t} - \beta_1 \ln GFCF_t - \beta_2 \ln FDI_t - \beta_3 \ln GEI_t - \beta_4 (\ln FDI * \ln GEI)_t - \beta_5 \ln INF_t \dots \dots \dots (5)$$

Stationarity tests (ADF), diagnostic checks (Breusch-Godfrey, White, Jarque-Bera), specification tests (Ramsey RESET), and stability tests (CUSUM and CUSUMSQ) ensure model adequacy and robustness.

Results and Discussion

This section presents the empirical findings of the study and provides a detailed discussion of the results. It begins by examining the nature and trends of FDI and GDP per capita in Nepal, followed by an assessment of government effectiveness and its role in the FDI-growth relationship using ARDL estimation techniques.

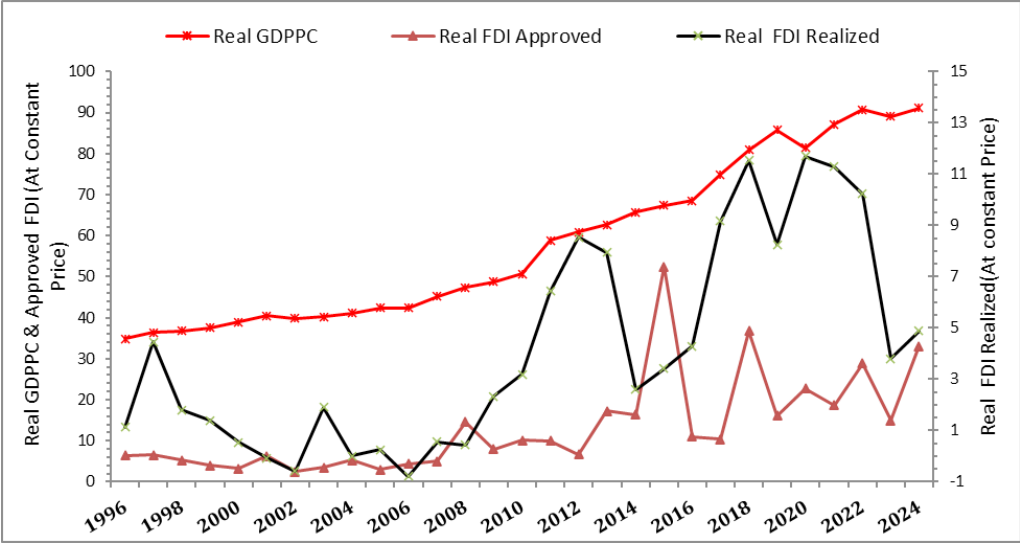
Nature and trends of FDI and GDP per capita in Nepal

This section analyzes the trends of GDP per capita, approved FDI, and realized FDI at 2010/11 constant prices from 1996 to 2024. It explores how the relationship between realized FDI and GDP per capita has evolved, providing insights into the relationship.

Figure 2 shows the trends of GDP per capita (GDP_{Pc}), approved FDI, and realized FDI in constant 2010/11 prices from 1996 to 2024. The trend in GDP_{Pc} shows a stable, nearly linear upward trajectory. This trend signifies sustained but modest long-term economic expansion, although a temporary deceleration is observed in 2020 due to the COVID-19 shock. In contrast, the trend in approved FDI shows considerable volatility, characterized by sharp, irregular peaks.

The troughs indicate transient shifts in investor sentiment and macro-level shocks. This instability reflects pronounced influences from specific disruptive events, notably the structural contractions in FY 2016, 2017, 2019, and 2023. These followed major non-economic and economic crises: devastating earthquakes, the global pandemic, and domestic financial tightening.

Figure 2: Trends of GDP per capita, approved FDI and FDI realized
(Annual volume for GDPPC in Rs thousand and FDI in Rs billion)



Source: Author’s computation, 2025

Realized FDI is also volatile but shows an upward trend after 2006. Initial volatility, including pre-2005 negative values, is associated with a period of intense political instability (the Maoist insurgency, 1996-2006). The stabilization and upward shift after 2006, coinciding with the democratic transition, demonstrate a structural improvement in the efficiency of approved investment into actual capital inflows. This further highlights the importance of political stability in sustaining foreign investment (Khatiwada, 2021).

Geopolitical risk and the absence of the rule of law adversely influenced investor confidence (Nepal Rastra Bank, 2018). Supporting this, Regmi (2023) stated that:

There are barriers such as the business environment, poor infrastructure, and lack of skilled human resources, political transitions, weak governance, natural calamities, and the tax slab which are critical in Nepal.”- Regmi (2023)

Overall, GDP per capita follows a linear upward path, while approved FDI shows irregular volatility, and realized FDI exhibits considerable fluctuations with a slowly increasing trend. Together, these illustrate Nepal’s evolving economic structure with the growing role of government effectiveness and political stability for attracting and sustaining foreign capital inflows.

Assessment of government effectiveness for FDI-growth relation in Nepal

This subsection provides a detailed assessment of the ARDL model results and discusses the findings of the study on the role of governance in the FDI-growth nexus.

Descriptive statistics and correlation matrix

The descriptive statistics, including the mean, maximum, minimum, and standard deviation of the variables (Table 1), show the distribution pattern, range of variation, and degree of dispersion or volatility. The correlation matrix in Table 2 shows the degree and direction of association among the variables.

Table 1: Descriptive statistics of variables (1996–2024)

Variable	Mean	Maximum	Minimum	Std. Dev.	Observations
lnGDPPC	4.01	4.51	3.55	0.33	29
lnGFCF	3.85	5.26	2.49	0.92	29
lnFDI	1.23	2.54	-1.55	1.05	29
lnGEI	0.07	0.27	-0.18	0.12	29
lnFDI×lnGEI ¹	-0.11	0.28	-0.22	0.11	29
lnINF	1.83	2.53	0.89	0.42	29

Note: The interaction term lnFDI×lnGEI captures how the marginal effect of foreign direct investment (FDI) on the dependent variable, economic growth, varies with changes in government effectiveness, indicating whether institutional quality amplifies or weakens the impact of FDI.

Source: Author’s Computation, 2025.

A lower standard deviation than the mean indicates that the values are clustered around the mean and relatively symmetric. Hence, the data is stable and consistent for statistical analysis.

Table 2: Correlation Matrix of Variables (1996–2024)

Variables	lnGFCF	lnFDI	lnGEI	lnFDI×lnGEI	lnINF
lnGFCF	1.00				
lnFDI	0.70	1.000			
lnGEI	-0.33	-0.09	1.00		
lnFDI×lnGEI	-0.19	-0.49	0.02	1.00	
lnINF	0.04	0.22	0.17	0.01	1.00

Source: Author’s Computation, 2025

The correlation coefficients for all variables are below 0.80. This indicates low to moderate correlation among the study variables. This result shows no evidence of severe multicollinearity that would distort the ARDL estimates. Therefore, all variables are retained for estimating the ARDL model.

Unit root test

This table presents the results of the Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) stationarity test of the selected variables.

Table 3: Unit root test results

Test Variable	ADF Test				PP Test			
	Intercept	I (d)	Intercept & Trend	I (d)	Intercept	I (d)	Intercept & Trend	I (d)
lnGDPPC	-5.07*	I(1)	-5.01*	I(1)	-5.07*	I(1)	-5.01*	I(1)
lnGFCF	-3.60**	I(1)	-3.51***	I(0)	-3.57**	I(1)	-3.49***	I(0)
lnFDI	-8.01*	I(1)	-7.87*	I(1)	-8.01*	I(1)	-7.87*	I(1)
lnGEI	-3.88*	I(0)	-4.01**	I(0)	-5.84*	I(0)	-5.84*	I(0)
lnFDI*lnGEI	-5.05*	I(0)	-5.26*	I(0)	-4.57*	I(0)	-6.96*	I(0)
lnINF	-2.78***	I(0)	-4.75*	I(1)	-2.78***	I(0)	-6.41*	I(1)

*Note: *, **, and *** represents 1%, 5%, 10% level of significance.*

Source: Author’s Computation, 2025

The ADF and PP results indicate that the variables are integrated of mixed orders, I(0) or I(1), but none are I(2). This validates the suitability of the ARDL approach for estimating long-run and short-run relationships, as advocated by Pesaran and Shin (1999).

Bounds test result for co-integration

Following Pesaran et al. (2001) and Pesaran and Shin (1999), the bounds test is used to test for the presence of a long-run relationship in the growth model. Table 4 shows the results of the calculated F-statistic for the bounds test of the selected ARDL (2, 2, 2, 2, 2, 1) model based on the Akaike Information Criterion (AIC).

The result shows that the calculated F-statistic for the model, 4.043, exceeds the critical value of upper bound critical value at the 5% significance level. Therefore, the null hypothesis of no cointegration is rejected, indicating the existence of a long-run relationship among the variables.

Table 4: Bounds test result for co-integration

F-Bounds Test		Null Hypothesis: No levels relationship		
Test Statistic	Value	Significance level	I(0)	I(1)
F-statistic	4.043	10%	2.26	3. 35
K	5	5%	2.62	3.79
Actual Sample Size	29	1%	3.41	4.68

Source: Author’s Computation, 2025

ARDL estimation for long and short run effect of FDI on growth

Based on the Akaike Information Criterion (AIC), the ARDL lag order (2, 2, 2, 2, 2, 1) model was selected, and the estimate of the long- and short-run dynamics are presented in Table 5.

**Table 5: ARDL (2, 2, 2, 2, 2, 1) estimates (unrestricted constant and no trend)
(Dependent variable: GDPPC)**

Variable (in Log Form)	Coefficient	Standard error	T-statistics	P-value
Long Run Estimate				
Gross fixed capital formation (lnGFCF)	0.338	0.007	47.06	0.000
Foreign Direct Investment (lnFDI)	0.053	0.008	6.253	0.000
Government Effectiveness Index(lnGEI)	0.032	0.054	0.59	0.567
Interactive Term (lnFDI*lnGEI)	0.448	0.102	4.381	0.001
Inflation (lnINF)	-0.034	0.007	-4.465	0.001
Short Run Estimate²				
D(lnGDPPC(-1))	0.657	0.152	4.316	0.001
D(lnGFCF)	0.446	0.053	8.282	0.000
D(lnFDI)	0.009	0.003	2.582	0.027
D(lnGEI)	-0.045	0.020	-2.217	0.051
D(lnFDI*lnGEI)	0.143	0.028	5.106	0.000
D(lnINF)	-0.046	0.006	-6.837	0.000
Constant (C)	2.041	0.328	6.028	0.000
ECM(-1)	-0.742	0.123	-6.032	0.000
Statistical Tools		Model Forecast		
R-squared	0.958	RMSE		0.012
Adjusted R-squared	0.927	MAE		0.010
S.E. of regression	0.010	MAPE		0.256
D-W Statistics	2.242	SMAPE		0.256
F-statistics	31.41	Theil Inequality		0.001
P=value	0.000	TheilU2		0.248

Note: First lags estimate is sufficiently explained in short run dynamics, so successive lags estimation in ARDL estimate are excluded in Table 5.

Source: Author's Computation, 2025

The ARDL model estimation shows that the positive coefficient on FDI indicates that a 1% increase in foreign capital inflows increases Nepal's long-term productive capacity by 0.05%. The short-run elasticity also indicates a smaller but significant growth impact of FDI of 0.01%. The findings indicate that higher FDI inflows support economic growth in Nepal. Thus, FDI supports growth through capital inflows and knowledge spillovers, in accordance with Borensztein et al. (1998), Li and Liu (2005), and Aizenman et al. (2013).

Government effectiveness fails to establish a stable long-run equilibrium with economic growth, while the GEI shows a weakly significant negative short-run effect of -0.045%. The result reflects the absence of a stable long-run relationship due to the Maoist insurgency, democratic restoration process, bureaucratic hurdles, and government instability over the past three decades. Governance improvements often fail to spur long-term growth when other structural hurdles are present (Kaufmann et al., 2002). Moreover, the absence of a stable long-run relationship implies that the growth-governance relationship is inconsistent in a developing-country environment due to a poor institutional transmission mechanism and the 'halo effect' of past performance (Kaufmann et al., 2002; Kurtz & Schrank, 2007).

The interaction term is statistically significant, and a 1% increase in the FDI-governance effectiveness interaction increases per capita GDP by 0.448% in the long run and 0.143% in the short run. It shows that good governance enhances the growth effects of FDI and suggests that FDI's impact is greater when governance is efficient. Consequently, good governance is vital for improving developmental advantages by accumulating capital, leading to sustainable economic growth (Ghosh and Saha, 2024; Mongi and Saidi, 2024).

A highly significant positive relationship exists between gross fixed capital formation and GDP per capita, indicating that a 1% rise in domestic investment raises GDP per capita by 0.338% in the long run and increases GDP per capita by 0.446% reduction in the short run. These results indicate that sustained investment improves productive capacity and income generation, supporting the need to adopt an investment-led growth strategy for Nepal's economy (Budha, 2012). This aligns with the theory that capital accumulation is an important factor for growth (Solow, 1956; Mankiw, Romer, and Weil, 1992).

In contrast, inflation ($\ln INF$) is negatively associated with growth: a 1% increase in the price level causes a 0.034% reduction in GDP per capita in the long run and a 0.046% in the short run. High inflation reduces real GDP per capita due to higher costs of capital. It also distorts relative prices and depresses investment growth, thereby negatively affecting growth (Barro, 1996; Fischer, 1993), a pattern that often exhibits a threshold effect (Paudel & Raut, 2022).

Finally, a statistically significant and negative error correction term ($\lambda = -0.742$, $p < 0.01$) shows that 74.2% of the short-run disequilibrium is corrected within each period. An adjusted R^2 of 0.92 indicates that the model has high explanatory power, as about 92% of the variation in Nepal's GDP per capita is explained by the included variables. Likewise, the highly significant F-statistic of 31.41 ($p < 0.001$) points to the joint significance of the regressors. Further, the forecasting statistics indicate high predictive accuracy for the ARDL model. Overall, the ARDL model is statistically sound and reliable for forecasting, with high accuracy in both short- and long-run relationships.

Residual diagnostic and sensitivity tests

The results of the LM test, heteroskedasticity test, Jarque-Bera test, Ramsey reset test, and CUSUM and CUSUM squares tests provide critical insights into autocorrelation, constant variance, normality, model misspecification, and model stability.

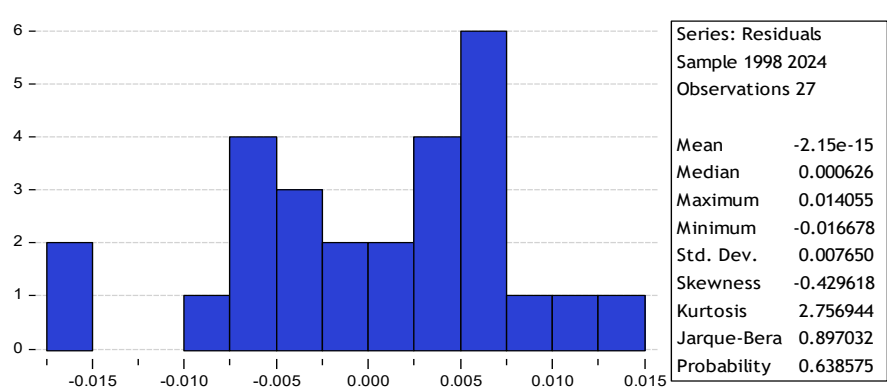
Table 6: LM correlation, Heteroscedasticity, and Ramsey RESET test

Econometric Tools	Statistical Test	Statistics	P-Value
Breusch-Godfrey Serial	F-stat	0.405	0.679
Correlation LM Test	Observed R ²	2.483	0.288
Breusch-Pagan-Godfrey	F-statistics	1.404	0.297
Heteroscedasticity Test	Observed R ²	18.68	0.285
Ramsey Reset Test	F-statistics	0.491	0.501

Source: Author’s computation, 2025

In the LM test, the p-value of the observed R-squared was found to be 28.8% (p=0.288), and in the heteroskedasticity test, the p-value of the observed R-squared was found to be 0.285 (28.5%), both of which exceed the 5% significance level. Therefore, the null hypotheses of no autocorrelation and homoscedasticity cannot be rejected. These findings indicate that the residuals exhibit no autocorrelation or heteroscedasticity. For the Ramsey RESET test, the p-value associated with the F-statistic (0.491) is 0.501 (50.1%), which exceeds the 5% significance level and indicates that the null hypothesis of no misspecification in the model’s functional form cannot be rejected. Therefore, the model shows no evidence of functional-form misspecification.

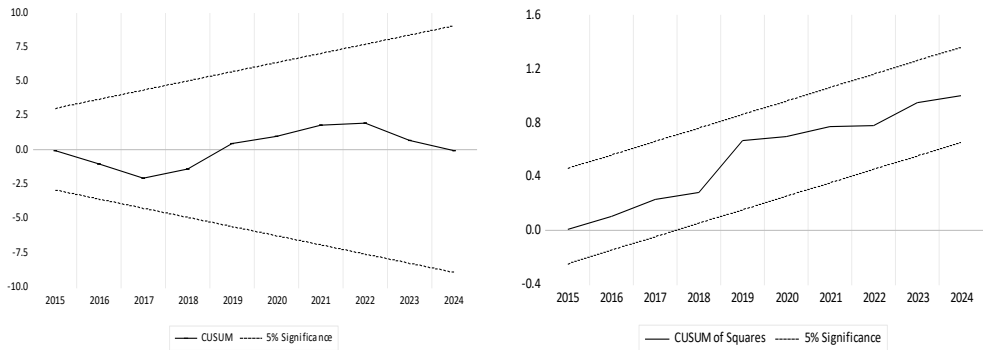
Figure 3: Jarque-Bera normality test



Source: Author’s Computation, 2025

The Jarque-Bera normality test yields a statistic of 0.897 with a p-value of 0.638 (63.8%), which is greater than 5%. Thus, the null hypothesis of normally distributed residuals cannot be rejected.

Figure 4: CUSUM and CUSUM squares test



Source: Author’s computation, 2025

CUSUM and CUSUM squares tests show that the model is stable at the 5% significance level. In conclusion, the results of diagnostic and stability test show that the assumptions of the classical linear regression model are upheld.

Robustness check of the result

The CUSUM test for parameter stability indicates that the relationship between growth and FDI is stable. Similarly, the CUSUMSQ indicates the stability of the model’s variance over the sample period, ensuring that the model is robust to structural shocks. To further validate the ARDL findings, an alternative regression using the FMOLS estimation technique was conducted (Table 7).

Table 7: FMOLS estimate for long run relationship

Variables (in Log Run)	Coefficient	P-value
lnGFCF)	0.320	0.000
lnFDI	0.047	0.000
lnGEI	0.046	0.260
(lnFDI*lnGEI)	0.088	0.078
lnINF	-0.046	0.000
Constant (C)	2.800	0.000

Source: Author’s Estimate, 2025

The FMOLS estimation technique was employed as a robustness check to address potential endogeneity and to ensure the consistency of the long-run

parameters. The FMOLS estimation corroborates the ARDL findings, as the signs and significance levels of the long-run coefficients are identical to those obtained from the ARDL model.

Discussion

ARDL estimates show a positive and significant relationship between FDI and economic growth in both the long run ($\beta=0.053$, $p<0.01$) and the short run ($\gamma=0.009$, $p<0.05$). Conversely, government effectiveness shows negative and weakly significant effect in the short run ($\gamma = -0.045$, $p < 0.1$), but is insignificant in the long run due to persistent institutional instability in Nepal. Remarkably, the interaction term between FDI and government effectiveness shows a positive and significant relationship with GDP per capita in both the long run ($\beta = 0.45$, $p < 0.01$) and the short run ($\gamma = 0.14$, $p < 0.01$), which indicates that better institutions strengthen the growth effect of FDI in Nepal.

The relatively modest coefficient suggests that while FDI is beneficial, its impact in Nepal may be constrained by the concentration of investment in the services and energy sectors, which may have limited horizontal spillovers compared to manufacturing. The findings resonate with the seminal works of Borensztein, De Gregorio, and Lee (1998), Bosworth and Collins (1999), and Li and Liu (2005), who highlight that FDI facilitates capital sufficiency, technology transfer, skill enhancement, and ultimately, productivity gains when the host countries have sufficient absorptive capacity and sound governance. The significant long-run interaction between FDI and government effectiveness supports Globerman and Shapiro's (2002) assertions of the 'governance infrastructure hypothesis', which states that:

"The effectiveness of FDI in promoting growth depends critically on the governance infrastructure within which it operates." -Globerman and Shapiro (2002)

Subsequent empirical literature strongly reinforces this argument through cross-country evidence by Zhang and Liu (2021), who conclude that:

"The Rule of Law has positive effects on inward FDI, and absence of Corruption, effective regulation enforcement, and open government are the most significant factors of Rule of Law to facilitate FDI". -Zhang and Liu (2021).

The positive elasticity coefficients reflect the conditional relationship and suggest that the growth impact of FDI depends on the government's institutional quality and policy environment, which supports the attraction of external capital to productive sectors. Nevertheless, while market size and wage levels

remain dominant factors for inducing FDI inflows, core economic policies and regulations play a critical role in shaping investment decisions.

Equally, contrasting perspectives warn against the view that FDI is universally beneficial. Jensen (2003), Carkovic and Levine (2005), Wells and Wint (2000), and Aitken and Harrison (1999) argue that under certain conditions, FDI can crowd out domestic enterprises and increase income inequality. Further, Long et al. (2018) argue that FDI can worsen natural resource depletion and increase the extraction of energy, forest, and mineral resources. Such exploitation is more evident in countries like Nepal, where fragile governance structures and infrastructure bottlenecks hinder the efficient absorption of FDI. Due to persistent political instability and institutional rigidity, it is difficult to establish the credibility of policies, thereby discouraging long-term investments and limiting the scope for transforming FDI into structural economic change.

The findings show that government effectiveness is not only complementary to FDI inflows but also a key determinant of the ability of these inflows to lead to sustained economic growth. By applying the theories of the threshold effect and absorptive capacity, Jung (2020) demonstrates that institutional quality is essential to overcoming investment frictions. Superior governance facilitates technology upgrading and productivity spillovers, thereby ensuring that FDI contributes to sustained economic growth rather than remaining an isolated capital injection. As Jung explains:

“Better institutional quality lowers the costs of FDI and enhances its contribution to long-run productivity growth” -Jung (2020).

This proposition is further supported by Azman-Saini et al. (2010), who state that:

“FDI by itself has no direct impact on output growth will only affect growth if the level of economic freedom is sufficiently high” -Azman-Saini et al. (2010).

The positive effect of the long-run interaction term between FDI and government effectiveness indicates that institutional strength amplifies the growth effect of FDI by ensuring regulatory predictability and policy coherence. As governance reforms mature, their growth-enhancing effects become more pronounced, validating the governance-augmented FDI–growth hypothesis.

Nepal’s relatively favorable tax structure and improving business environment provide a foundation for FDI attraction, yet structural constraints such as weak infrastructure, administrative delays, and political uncertainty, continue to limit potential gains. Thus, Nepal should adopt open and liberal policy reforms to

strengthen governance institutions, ensure political stability and transparency, and promote sector-specific incentives for production, infrastructure, and technology-intensive investment, as suggested by Jha et al. (2013). The government must also enhance human capital formation and maintain macroeconomic stability to maximize FDI's growth effects.

In essence, Nepal's experience supports the premise of the institutional amplification effect advanced by Globerman and Shapiro (2002), who argue that identical levels of FDI yield higher growth dividends under effective governance. Strengthening institutions, accountability, and regulatory quality will improve investor confidence, attract higher-quality FDI, and ensure that such inflows catalyze broad-based and sustainable growth. Eventually, FDI inflows depend on the strength and credibility of the country's institutional structure. Therefore, FDI inflows serve not as an automatic driver of growth but as a conditional catalyst, with their transformative capacity in developing countries like Nepal, where capital is scarce for development.

Conclusion

The present study investigates the role of government effectiveness in the effect of FDI on Nepal's economic growth, using the ARDL bounds test approach based on annual time-series data from 1996 to 2024. The results show that there is a stable long-run cointegrating relationship among the variables studied. The results reveal that FDI positively influences economic growth in both the long run ($\beta=0.053$, $p<0.01$) and the short run ($\gamma=0.009$, $p<0.05$), while government effectiveness has a negative impact in the short run ($\gamma=-0.045$, $p<0.1$). Crucially, the results find a positive and significant effect of the interaction term between FDI and government effectiveness on economic growth in both the long run ($\beta = 0.45$, $p < 0.01$) and in the short run ($\gamma=0.14$, $p<0.01$). The results indicate that FDI positively influences economic growth, while good governance amplifies the growth-enhancing effect of foreign capital by strengthening policy credibility, reducing transaction costs, and improving transparency. The findings substantiate the governance-augmented FDI-growth hypothesis and suggest that the developmental gains from FDI are contingent upon the strength of the governance and institutional framework.

Persistent structural constraints and bureaucratic inefficiencies are common characteristics of developing countries like Nepal. Therefore, good governance in such fragile countries can act as a catalyst that transforms foreign investment into sustainable economic growth. According, the study recommends that Nepal prioritize strengthening governance, institutional quality, and regulatory

predictability to attract technology-intensive FDI and promote sustainable economic growth. The study contributes to the empirical literature by providing evidence from Nepal that may offer implications for similar developing economies and demonstrates that good governance with better institutional quality is complementary and potentially transformative for productivity growth and economic welfare through FDI-led growth. However, the limitations include missing data, the inability to incorporate all relevant institutional indicators, the exclusion of non-linear effects, and the limited evaluation of FDI-related policies. Furthermore, measures of GEI are subjective and prone to measurement error and bias, as often noted in the literature. Thus, the results and policy implications are interpreted in light of such caveats. Future research could explore sector-specific FDI effects, additional governance dimensions, and potential nonlinear relationships using expanded datasets and new empirical techniques.

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