International Journal of Economics, Commerce and Management
United Kingdom ISSN 2348 0386 Vol. 14, Issue 11, Nov 2026

https://ijecm.co.uk/

THE MODERATING ROLE OF INSTITUTIONAL QUALITY ON FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN KENYA: AN EMPIRICAL ANALYSIS USING EVIEWS (1963–2023)

Julius Kiptoo Kirui
Moi University, Kenya
kirui.julius@mu.ac.ke

Abstract

This study investigates the conditional effect of institutional quality on the relationship between Foreign Direct Investment (FDI) inflows and long-run economic growth in Kenya using annual time-series data spanning from 1963 to 2023. The study employed quantitative ex-post facto longitudinal econometric research design. The dataset utilized strictly the secondary. The data was extracted from World Development Indicators, World Governance indicators and Kenya National Bureau of Statistics Database. Employing an Autoregressive Distributed Lag (ARDL) Bounds testing approach implemented in Eviews, the empirical model incorporates an interactive structural specification to evaluate whether governance dynamics alter the productivity returns of external capital. The empirical results reveal that while the standalone impact of FDI on Kenya's real GDP growth over the 60-year period is statistically non-significant, the interaction term capturing the joint effect of FDI and institutional quality is positive and highly significant ($p < 0.05$). This confirms the presence of a critical institutional threshold, indicating that foreign capital operates as an effective engine of macroeconomic growth only when cushioned by strong regulatory frameworks, property rights enforcement, and low transactional friction. Short-run dynamics demonstrate an error correction speed of adjustment of -42.2% annually, pointing to robust structural convergence. Diagnostic evaluations, including Breusch-Godfrey and CUSUM stability tests, confirm model resilience. The findings imply that policy architectures in East Africa must shift from the raw volume-driven attraction of FDI toward systemic institutional optimization.

Keywords: Foreign Direct Investment; Institutional Quality Index; Economic Growth; ARDL Bound Test; Eviews; Kenya

Licensed under Creative Common

INTRODUCTION

Foreign Direct Investment (FDI) has long been heralded within macroeconomic theory as a principal catalyst for development, capital accumulation, and technology transfer in capital-constrained developing nations. In emerging economies like Kenya, the historical pursuit of foreign capital has consistently anchored long-term developmental blueprints, from the post-independence sessional papers to modern frameworks such as Kenya Vision 2030. Traditionally, neoclassical paradigms suggest that FDI directly supplements domestic savings, introduces state-of-the-art technological capabilities, and creates structural employment. However, the empirical reality across Sub-Saharan Africa, and specifically within the East African Community (EAC), showcases a puzzling disconnect: massive spikes in inbound foreign capital frequently fail to spark corresponding long-run accelerations in real gross domestic product (GDP) growth.

This paper contends that the missing link in the transmission mechanism from foreign capital to sustainable economic growth lies in the structural maturity of the recipient country's governance framework—specifically, its institutional quality. Grounded in New Institutional Economics (NIE), we argue that the presence of high-quality institutions (such as strong contract enforcement, robust protection of private property rights, minimal corruption, and administrative efficiency) acts as a structural filter. Without these institutional guardrails, FDI inflows run the risk of creating isolated, extractive 'enclave economies' that repatriate profits while offering virtually zero meaningful spillovers to localized industries. Conversely, when cushioned by strong public and commercial institutions, foreign capital becomes deeply embedded within the host economy, fostering genuine human capital development and localized industrial integration.

Historically, Kenya provides a rich time-series environment to analyze these intersecting dynamics. Following independence in 1963, the government enacted the Foreign Investments Protection Act (FIPA) of 1964 to assure international investors of capital security. Yet, the subsequent decades witnessed volatile institutional shifts, varying from centralized state regimes in the 1970s and 1980s to intense multi-party transition shocks in the early 1990s. The breakthrough structural transformation occurred with the promulgation of the New Constitution in 2010, which fundamentally overhauled governance, enhanced judicial independence, and streamlined commercial regulatory frameworks. By utilizing a rigorous time-series dataset spanning a comprehensive 60-year trajectory (1963–2023) analyzed via an Autoregressive Distributed Lag (ARDL) interactive model in EViews, this study isolates both the standalone and conditional parameters governing FDI efficiency, filling a critical empirical gap in the long-run development literature of East Africa.

Licensed under Creative Common

THEORETICAL AND EMPIRICAL REVIEW

The theoretical foundation linking foreign capital flows, institutional frameworks, and economic trajectories draws from two main paradigms: Endogenous Growth Theory and New Institutional Economics (NIE). Endogenous growth models (Romer, 1986; Lucas, 1988) demonstrate that long-run growth depends heavily on technological progress and knowledge spillovers, rather than just raw labor and capital accumulation. Within this framework, FDI serves as an vital channel for these spillovers, transmitting managerial expertise and advanced technology across national borders. However, these models often assume that the host country possesses the necessary baseline capacity to absorb such advancements. Recognizing this limitation, New Institutional Economics (North, 1990) provides the critical context by asserting that institutions define the underlying incentive structures of an economy. High-quality institutions significantly lower transaction costs and reduce structural uncertainties, encouraging long-term, high-spillover capital investments over volatile, short-term speculative ventures.

Empirically, the debate over whether FDI directly drives growth remains highly contested. Early cross-country studies by Borensztein et al. (1998) introduced the threshold hypothesis, showing that FDI accelerates economic expansion only when the host country possesses a sufficient baseline level of human capital. This threshold perspective was expanded to governance by Acemoglu et al. (2005) and Asiedu (2002), who observed that sub-Saharan Africa's historical difficulty in maximizing capital productivity stemmed directly from structural institutional deficits. While recent literature has increasingly focused on regional contexts, time-series evaluations covering over half a century within a single nation remain scarce. Many existing models suffer from specification bias by evaluating FDI and growth in isolation. This study directly resolves that limitation by incorporating an explicit interaction term (FDI × IQI) to statistically test the moderating role of governance systems in Kenya.

RESEARCH METHODOLOGY

This study adopts a quantitative, ex-post facto, longitudinal econometric research design. The design is classified as ex-post facto because the historical macroeconomic phenomenon and institutional transformations under investigation have already occurred. Consequently, the underlying data vectors cannot be subject to direct manipulation or experimental control. The longitudinal element tracks annual time-series observations across a continuous 60-year horizon from 1963 to 2023

The dataset utilizes strictly secondary, macro-level annual time-series indicators covering the period 1963–2023. To minimize measurement errors and ensure data replication integrity, values are harmonised from credible international and national repositories.The

Licensed under Creative Common

primary data providers include the World Bank's World Development Indicators (WDI), the Worldwide Governance Indicators (WGI) database, and the historical statistical abstracts compiled by the Kenya National Bureau of Statistics (KNBS). Because continuous governance indexes like the WGI were established in 1996, the historical institutional quality proxy from 1963 to 1995 is constructed using backward-extrapolated normalized indexes. These are anchored on historical political regimes, property rights legislation, and legal shifts, re-scaled into a uniform econometric index ranging from 0 (very weak) to 10 (exceptionally strong governance).

To examine the conditional relationship between foreign capital, governance, and macroeconomic expansion, this study specifies a multivariate linear interaction model as follows: $RGDPG_t = b_0 + b_1*FDI_t + b_2*IQI_t + b_3*(FDI_t * IQI_t) + b_4*GFCF_t + b_5*TO_t + b_6*INF_t + e_t$

Where, RGDPG represents Real GDP Growth (%), FDI denotes Foreign Direct Investment Net Inflows as a percentage of GDP, and IQI is the composite Institutional Quality Index normalized on a 0–10 scale. The variable (FDI × IQI) represents the central interaction term designed to capture the moderating effect. Control variables include Gross Fixed Capital Formation (GFCF as a % of GDP) to capture domestic investment, Trade Openness (TO as the sum of exports and imports divided by GDP), and the Inflation Rate (INF) based on the Consumer Price Index to account for macroeconomic stability. The term e_t represents the stochastic error term.

Given that macroeconomic time-series data often exhibit mixed integration orders, we employ the Autoregressive Distributed Lag (ARDL) Bounds Testing approach developed by Pesaran, Shin, and Smith (2001). The ARDL technique holds significant advantages over traditional cointegration methods: it yields robust small-sample properties across our 60-year horizon and permits estimation regardless of whether the underlying variables are integrated of order I(0), I(1), or mutually cointegrated. Prior to model estimation, standard Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) tests are conducted to confirm that no variable exceeds the I(1) threshold, thereby avoiding invalid F-statistics. The unrestricted error correction representation of the ARDL framework allows for the simultaneous estimation of long-run equilibrium relationships and short-run dynamic adjustments.

RESULTS AND DISCUSSION

The empirical estimation began with pre-estimation unit root checks. The ADF and PP test statistics confirmed that variables like RGDPG and Inflation are stationary at their levels [I(0)], whereas FDI, GFCF, Trade Openness, and the Institutional Quality Index become

Licensed under Creative Common

stationary after their first differences [I(1)]. This mixture of integration levels validates the selection of the ARDL model structure. Next, the F-Bounds test was conducted to evaluate the existence of a long-run relationship. With a lag length of (1, 0, 1, 1, 0, 0) determined by the Akaike Information Criterion (AIC) in EViews, the calculated F-statistic was 4.86. This comfortably exceeds the critical upper-bound threshold of 3.61 at the 5% significance level, rejecting the null hypothesis of no cointegration and confirming a stable long-run equilibrium.

Table 1: Long-Run Interactive Regression Parameters (Dependent Variable: RGDPG)

Variable	Coefficient	t-Statistic	Prob.
Constant (b_0)	4.512	3.891	0.000
FDI Inflows (% of GDP) (b_1)	-0.142	-0.514	0.609
Institutional Quality Index (IQI) (b_2)	0.345	2.118	0.038
Interaction Term (FDI x IQI) (b_3)	0.118	2.742	0.008

As detailed in Table 1, the long-run EViews output reveals a vital structural insight. The standalone coefficient for FDI Inflows is negative and statistically non-significant ($b_1 = -0.142$, $p > 0.05$). This confirms that raw capital inflows, when evaluated independently of the host country's regulatory environment, do not exert a reliable upward pressure on Kenya's economic growth. Crucially, however, the interaction term (FDI × IQI) exhibits a positive coefficient of 0.118 and is highly significant statistically ($p < 0.01$). This confirms the central hypothesis of the study: institutional quality acts as a vital growth amplifier for foreign investment. By taking the partial derivative of growth with respect to FDI, the net marginal effect is established as $d(RGDPG)/d(FDI) = -0.142 + 0.118(IQI)$, illustrating that foreign capital yields positive returns once the institutional index exceeds a threshold of approximately 1.20.

The short-run error correction dynamic reveals a robust Error Correction Term (ECT_{t-1}) coefficient of -0.422, which is highly significant ($p = 0.000$). This indicates a swift adjustment mechanism, implying that approximately 42.2% of macroeconomic distortions or deviations from the long-run equilibrium path are corrected annually. Post-estimation diagnostic checks executed in EViews confirm the statistical reliability of the framework: the Breusch-Godfrey Serial Correlation LM test indicates no residual correlation, and the ARCH test confirms homoskedasticity. Furthermore, the cumulative sum (CUSUM) and cumulative sum of squares

Licensed under Creative Common

(CUSUMSQ) plots remain within the critical 5% boundaries, demonstrating structural stability across the entire 60-year analytical timeline.

CONCLUSION AND POLICY RECOMMENDATIONS

This study provides empirical evidence clarifying the conditional transmission mechanism between foreign capital inflows and macroeconomic outcomes in Kenya from 1963 to 2023. By using an interactive time-series framework in EViews, the analysis successfully demonstrates that the long-run growth benefits of FDI are entirely conditional upon institutional quality. While standalone capital inflows fail to generate significant growth outcomes, their interaction with strong institutional metrics produces a highly significant, positive effect on real GDP growth. These findings confirm that structural governance frameworks—such as the protection of property rights, administrative efficiency, and judicial predictability—are mandatory prerequisites to transform foreign capital from isolated economic enclaves into broad-based national growth drivers.

Based on these insights, several key policy recommendations are proposed for economic planners and investment authorities like KenInvest. First, the national strategy must pivot from a volume-driven approach focused merely on raw capital attraction toward an institutional alignment strategy. Investment incentives should prioritize multinational entities that establish deep linkages with localized supply chains, supported by streamlined commercial arbitration mechanisms. Second, the government must continuously safeguard the independence of regulatory bodies and commercial courts, ensuring the absolute sanctity of contracts to minimize transaction risks for long-term infrastructure and manufacturing investments. Ultimately, attracting foreign capital will only yield sustainable economic spillovers if Kenya continues to strengthen the transparency, stability, and depth of its core public institutions.

Proposes practical research paths for future studies, including the use of Non-linear ARDL (NARDL) models to capture asymmetric threshold adjustments, expanding to disaggregated sectorial vectors, and analyzing institutional harmonization within regional blocs like the East African Community (EAC) or the African Continental Free Trade Area (AfCFTA).

REFERENCES

Acemoglu, D., Johnson, S. and Robinson, J.A. (2005) 'Institutions as a fundamental cause of long-run growth', in Aghion, P. and Durlauf, S. (eds), Handbook of Economic Growth, Amsterdam: North-Holland, pp. 385–472.

Asiedu, E. (2002) 'On the determinants of Foreign Direct Investment to Africa: Is Africa different?', World Development, 30(1): 107–19.

Licensed under Creative Common

Borensztein, E., De Gregorio, J. and Lee, J-W. (1998) 'How does Foreign Direct Investment affect economic growth?', Journal of International Economics, 45(1): 115–35.

Lucas, R.E. (1988) 'On the mechanics of economic development', Journal of Monetary Economics, 22(1): 3–42.

North, D.C. (1990) Institutions, Institutional Change and Economic Performance, Cambridge: Cambridge University Press.

Pesaran, M.H., Shin, Y. and Smith, R.J. (2001) 'Bounds testing approaches to the analysis of level relationships', Journal of Applied Econometrics, 16(3): 289–326.

Romer, P.M. (1986) 'Increasing returns and long-run growth', Journal of Political Economy, 94(5): 1002–37.

Licensed under Creative Common