

## Investment Climate and the Performances of Industrial Sector in Nigeria

Bakare Adewale Stephen Ph.D

Department of Economics, Adekunle Ajasin University, P.M.B 001 Akungba- Akoko  
Ondo State, Nigeria.

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### Abstract

Industrial growth in all countries is inextricably linked to and connected to the business environment where it is situated. This study examined the linkage between the business environment otherwise call investment climate and the performances of industrial sector in Nigeria. The paper employed standard econometric method, Ordinary Least Square multiple regression, (OLS ) to determine the relationship. The time series secondary data were screened using stationarity and co integration tests. The data were found to be stationary and co-integrated. The Empirical findings demonstrated a negative relationship between investment climate and the performances of industrial sector in Nigeria. Specifically the study found that the main empirical constraint to the performances of industrial sector in Nigeria is corruption and political instability while poor infrastructure and macroeconomic instability have played significant roles. The study recommended that the policy makers should pay greater attention to the bad investment climate in Nigeria and put in place macroeconomic policies that can eradicate corruption and checkmate the components of macroeconomic and political instabilities .The findings equally suggested the need for the government to continue to develop the infrastructural base of the economy to boost the industrial sector.

**Key words:** Investment Climate, Industrial Sector, Political Instability, Infrastructural Base and corruption.

### Introduction

Industrial growth in all countries is inextricably linked to and connected to the environment where it is situated. To a large sense, the performance of firms in any country is analyzed by examining certain environmental factors such as macroeconomic policy, political situation, economic stability, infrastructure, finance, corruption etc. The behaviours of these factors have recently gained centre stage in explaining variations in competitiveness, growth and prosperity of industries across countries or regions. These key factors which appear to constitute what is known as investment climate serve either as inducements or constraints to the effectiveness and productivity of an industry. The investment climate by definition comprises institutional and policy variables that have a crucial bearing on business

performance, but over which firms have no control individually. And just as natural weather or climate is important to agricultural productivity so is investment climate to industrial productivity. For instance Nigeria is currently regarded as a risk market for investment destination due to bad political governance, unstable macroeconomic policy, corruption and inadequate infrastructures among others. Many investors have in recent time begun to relocate their businesses away from Nigeria as a result of bad investment climate. This has resulted to a drastic decline in domestic investment and industrial performances in the country. And for Nigeria to achieve its ambitious vision 2020, it must maintain an annual growth rate of 8 percent over the next nine years. While this is close to recent performance, sustaining such high growth in the face of declining domestic investment is an enormous challenge. It is not enough to rely on capital-intensive mega projects; vision 2020 requires a high level of broad-based private sector investments, which has been constrained by the weak investment climate.

From recent analysis of determinant of private domestic investment in Nigeria, issues related to bad investment climate as very severe constraints to doing business in Nigeria was raised. The overall macroeconomic instability (including inflation) ranked more troublesome. The costs imposed by poor performances of public investment with poor government policy and regulation and corruption were perceived as more worrisome. Given the underdeveloped state of Nigeria's infrastructure, this phenomenon illustrates the importance of government actions. Also the lack of affordable finance continues to be one of the fundamental business problems in Nigeria. The recent analysis of determinant of private domestic investment in Nigeria reported that the cost of finance was a major problem, and it was the most-often-cited problem overall. Very few firms are using external credit. According to the sample survey, enterprises relied on their own funds for 90 percent of working capital requirements and almost two-thirds of their investment needs. Only 8 percent of investors had bank overdrafts, while 18 percent reported having bank loans. Almost all investors declared that collateral were a requirement for their most recent overdraft or bank loan. The amount required as collateral was quite high, averaging almost 140 percent of the credit amount. Most firms that did not have bank loans had never applied for one. The most important reason given for this was high interest rates. The nominal interest rate for bank credit reported by the sample firms is quite high, averaging just over 21 percent.

It is widely believed that firms have to make informal payments to public officials "to get things done," and corruption was perceived as a large or severe constraint to doing business in Nigeria. Aside from informal payments to public officials "to get things done", fraudulent and sharp practices, stealing, embezzlement by industrial workers do not allow businesses to strive and succeed in Nigeria. Above all the courts and legal system in Nigeria are notoriously unreliable, which significantly increases the risk and uncertainty of doing business. In the World Bank's Doing Business data base, Nigeria ranks 81 out of 84 countries on how long it takes to resolve a business dispute; from the time a suit is filed until a judgment is enforced. In summary poor infrastructure, political instability, macroeconomic instability, inadequate finances, poor macroeconomic policy, mismanagement, corruption, unreliable courts and legal system to mention a few are the perceived factors that combined to constitute bad investment climate in Nigeria. To this end, an assessment of the investment climate which is a key constraint to investment and productivity in Nigeria is inevitable.

**The problem and the objectives of the study**

The investment climate discussed here identified a variety of bottlenecks that increase the cost of doing business in Nigeria. Dealing successfully with these issues is a necessary concomitant to promoting growth and significantly advancing the poverty-reduction goals. The analysis of the data, described in the introduction, shows that the Nigeria manufacturing sector has not lived up to its expectations. Despite the cheap labor, macroeconomic reforms, and export promotion, growth of industrial output and firm-level productivity has remained low. It appears that the primary cause of these problems is the poor business environment otherwise call investment climate.

The Nigeria government had in the recent past endeavor to provide both the foreign and domestic investors with a healthy investment climate as well as instituting generous tax incentives that can stimulate industrialization. However the results has not been very encouraging more especially when consideration is given to the fact that; of recent a number of multinational companies have began to relocate their businesses from Nigeria to other African countries like Ghana, South Africa citing concerns like infrastructural decay, poor tariff structure, corruption, growing insecurity among others (daily Sun 2009). At early period of independence, Nigeria, South Africa, Singapore, Malaysia, Indonesia, Ghana and South Korea were at the same level of development. But today South Africa and Ghana are now regarded as giants of Africa whereas Nigeria is still being referred to as an underdeveloped country of the Third World, all as a result of poor performances of industrial sector. The poor performances of industrial sector are traceable to unfavorable investment climate. This situation is quite embarrassing and worrisome. As important as this situation might be, studies in this areas appeared very scanty. This form the background for this study and thus it is the objective of the study to investigate empirically the relationship between the perceived poor investment climate and industrial performances in Nigeria. The paper is therefore arranged as follows. Following the introductory section, Section 2 reviews the literature. The methodology of the study is presented in Section 3. A Parsimonious regression analysis of the impact of investment climate on industrial performance in Nigeria is considered in Sections 4. Finally, Section 5 presents the summary and conclusions of the paper.

**2. Literature Review**

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The literature is growing on the factors that constrained the productivity and general performances of industrial sectors. Authors like Bljer and Khan (1984), Greene and Villanueva (1991) Balassa (1988), Serven, and Solimano. (1992) ,Serven and Solimano (1993), Skully (1997), Pollard and Qalo (1994), Serven (1997), Jayaraman (1996) Duncan et al. (1999) Weder (1998) have carried out empirical and stochastic investigations on the factors that constraint industrial performances. According to them industries would flourish in a supportive environment of cost reductions in power, transport and communications, which are often provided through public investment. For instance, Bljer and Khan (1984), Greene and Villanueva (1991) carried out an Empirical studies on 23 countries and found that public investment in physical infrastructure is complementary to industrial output growth. However, public investment basic economic infrastructures would, in some cases, poses a severe constraint for industrial output growth. Balassa (1988) in his study of 30 countries showed the presence of a negative relationship between industrial output growth and public investment. In supporting these findings, Duncan et al. (1999) pointed out that such a negative

relationship might not exist in the case of Pacific Islands, which have no difficulties accessing basic infrastructures. According to Duncan, availability of basic infrastructures is an important factor in any investment decision by the private sector. When the basic infrastructures which is the main instrument of investment, are inadequate, there will be a decline in investment. Whereas there is a consensus in the literatures on the problem of infrastructures, findings of various empirical studies are not, however, consistent on the relationship between availability of finance and industrial performance. Thomas, (1997) in his study of 86 developing countries examined data on terms of trade, real exchange rates, property rights and civil liberties and concluded that while factors including credit, availability and the quality of physical and human infrastructure are important influences, uncertainty in the investment environment and climate was negatively related to industrial productivity in sub-Saharan countries. Employing the variability in real exchange rates as an explanatory variable in regression analysis, Jayaraman (1996) in his cross-country study on the macroeconomic environment and industrial productivity in six Pacific Island countries observed a statistically significant negative relationship between the variability in investment environment and industrial performances. Duncan et al. (1999) commented that although variability in the real exchange rates is a reasonable proxy for instability in major economic variables as fluctuations in inflation and productivity and more generally in fiscal and monetary management are reflected in the real exchange rate, it is not a good measure of the uncertainty attached to policy or the insecurity of property rights and enforcement of contracts or the level of corruption. Observing that these non-economic factors appear to be very significant influences on industrialization in the Pacific Island countries, Duncan et al. 1999, however, concede that no quantitative or qualitative evidence is available of their size or their impact. In the absence of such evidence, any study on industrial productivity is to be necessarily restricted to the conventional variables.

A study by Weder (1998) that investigated the relationship between investment climate and industrial productivity on 21 Sub-Saharan African countries using data on institutional factors is of relevance here. The institutional factors employed by Weder (1998) were qualitative information on annual ratings of the following indicators: (i) quality of bureaucracy; (ii) the rule of law; (iii) policy surprises; (iv) credibility of announcements; (v) extent of availability of information on new rules; (vi) degree to which business can participate in making new rules; (vii) predictability of judiciary enforcement; (viii) theft and crime; (ix) security of property rights; (x) frequency of corruption; (xi) uncertainty of corruption; and (xii) corruption perceived as an obstacle to business. All indicators are rated from 1 (worst) to 6 (best). Data on (i) and (ii) were drawn from a private firm study on international country risks. Others from (iii) to (xii) were drawn from the data collected by the World Bank and University of Basel. These are based upon private sector surveys commissioned in 73 countries in Africa, Asia and Latin America in preparation for the World Development Report 1997 (World Bank 1997). As these data pertain to a short period, a cross-country regression analysis was found more appropriate for the 21-country study (Weder 1998). The study concludes that factors (vii), (viii), (ix) and (xi) are highly significant constraints to industrial productivity. In other words, these factors which happen to be the components of investment climate have negative relationship with industrial productivity.

### **3        METHODOLOGY AND MATERIALS.**

#### **Research Design and Strategy**

Research design is the structure and strategy for investigating the relationship between the variables of the study. The research design adopted for this work is the quasi-experimental research design. The reason is that quasi-experimental research design combines the theoretical consideration with empirical observation. It enables us therefore to observe the effects of explanatory variables on the dependent variables.

### Population of the Study

The study will cover the years 1979 – 2009 which is a period of thirty (30) years. This period is believed to be long enough to capture the long-run relationship between industrial output and investment climate.

### The model

We seek to estimate the industrial performance function, which assumes that the proportional change in industrial output (INDPR) is a function of investment climate ( $X_i$ ), i.e.  $INDPR = \beta_0 + \beta_1 X_i$  .....1

To grasp the relevance of this specification to the objective proposed in this paper, we state the components of investment climate that combine to determine industrial performances such as poor infrastructure, economic instability, political instability, corruption, unreliable courts and legal system, and exchange rate and specify the following industrial performances model in a functional form as:

$$INDP = f(INFR, FISCAP, POLI, MACI, LES, COR, FINP) \dots\dots\dots 2$$

Where:

INDP =Industrial output.

INFR=Infrastructure

FISCAP=Fiscal Policy proxied by Company Income Tax

POLI =Political Instability

MACI= Macroeconomic Instability proxied Nominal Exchange Rate

LES = Legal System.

COR=Corruption

FINP=Financial policy proxied by lending rate

Equation 2 could be expressed in a linear form as

$$INDP = \beta_0 + \beta_1 INFR + \beta_2 FISCAP + \beta_3 POLI + \beta_4 MACI + \beta_5 LES + \beta_6 COR + \beta_7 FINP \dots\dots 3$$

Econometrically, to include random term, the model is expressed as:

$$INDP = \beta_0 + \beta_1 INFR + \beta_2 FISCAP + \beta_3 POLI + \beta_4 MACI + \beta_5 LES + \beta_6 COR + \beta_7 FINP + \mu_t \dots\dots 4$$

Where  $\mu_t$  = Error Term.

A priori  $\beta_1 > 0$ ,  $\beta_2 > 0$ ,  $\beta_3 < 0$ ,  $\beta_4 < 0$ ,  $\beta_5 < 0$ ,  $\beta_6 < 0$ ,  $\beta_7 < 0$

This model implies that the value added by industrial sector in Nigeria is expected to be negatively or positively related to Infrastructure (INFR); Fiscal Policy proxied by Company Income Tax, Macroeconomic Instability proxied Nominal Exchange Rate, Political Instability (POLI) legal system (LES) Corruption (COR) and Financial Policy proxied by lending rate

### The Theoretical Proposition/Prior expectations of the Model

In line with economic theory it is expected that the, infrastructure, fiscal policy proxied by company income tax, macroeconomic instability proxied by Nominal Exchange Rate, Political Instability (POLI), legal system (LES), corruption (COR) and financial policy proxied by lending rate to a large extent; determine the level of industrial sector performances in Nigeria.

Poor infrastructures proxied by inadequate power supply are expected to impact negatively on industrial sector performances. As earlier stated there is poor and inadequate power supply in Nigeria which is expected to hamper industrial sector performances in Nigeria. Infrastructure is expected to have a positive sign and a direct relationship with industrial sector performances if adequately provided. In other words availability of infrastructure will boost output of the industrial sector whereas poor and inadequate infrastructure is expected to reduce output of industrial sector.

Fiscal policy proxied by company income tax is expected to have positive relationship with industrial sector performances in Nigeria. Industries are expected to be given tax relief or tax holiday at the beginning of their investment to allow them stabilize at the initial stage. But where this encouragement is lacking and the government imposes the usual 45 percent company tax, we expect negative relationship.

Macroeconomic instability is proxied the nominal exchange rate. The effect of the nominal exchange rate on the output of industrial sector is ambiguous. Chibber and Mansoor (1990) argue that a real depreciation acts as an adverse supply shock in the "production" of investment goods. In the short run, a real depreciation will raise the price of new capital goods in terms of home goods (if capital goods have an import content) and this will tend to discourage new investment and hamper output. In the case of foreign-indebted firms, depreciation raises the burden of debt; if domestic credit markets are imperfect (as it is often the case in developing countries), these firms may face credit constraints, and this will tend to reduce output. Chibber and Mansoor (1990) report that the empirical work by Easterly (1989) on Mexico showed how a devaluation reduce output. Devaluation may also affect output through its effect on aggregate demand. If the net effect is contradictory, then the slump in economic activity is likely to lead to a reduction in output. However, if the net effect is expansionary, devaluation may raise real incomes and stimulate production. Also, if devaluation is considered inevitable, then when it happens, confidence in the future may be raised. Devaluation may affect the real price of imported inputs that are used in conjunction with capital goods to produce output, and may also affect interest rates, which in turn will affect the output of industrial sector.

Political instability is usually manifested in election crisis, destruction of lives asset and property, coup d'état est. This is a common feature of Nigerian politics. The measure of political instability is expected to influence industrial performance negatively.

As earlier stated, the courts and legal system in Nigeria are notoriously unreliable, which significantly increases the risk and uncertainty of doing business. Thus it is expected that the courts and legal system in Nigeria will have negative implications on industrial performances in Nigeria.

Theoretically, one would expect corruption to hamper industrial output through at least three channels. First, corruption requires an external transfer that, under conditions of limited external financing, leads to reduced investible resources. Second, the anticipated "tax" associated with future corruption reduces the anticipated return on investment. Third Theft, fraud and mismanagement of funds within the industries crowd-out profits and hamper productivity. All the three components of corruption are expected to have negative influences on industrial performance.

Financial policy proxied by bank lending rate is expected to have positive relationship with industrial sector performances in Nigeria. Industries are expected to be given bank loan at the minimum lending rate and with affordable collateral security in order to boost their

investment and allow them make profit. But where this encouragement is lacking and the Commercial Bank charges high lending rate, we expect negative relationship.

**The Data**

Secondary data were used for this study. The data were obtained from the publications of the Central Bank of Nigeria, African Development Indicators, website, Journals and Newspapers. The data collected are: industrial sector value added, infrastructure, fiscal policy proxied by company income tax, macroeconomic instability proxied by Nominal Exchange Rate, Political Instability (POLI), legal system (LES), corruption (COR) and financial policy proxied by lending rate

The data analysis consists of three main steps. First, the Phillips-Perron (PP) tests of stationarity (1988). Second, is the Johansen test of coin-integration (1988, 1991) and third, the error correction mechanism analysis. The empirical study uses a simulation approach to investigate the theoretical relationship between industrial output and investment climate. The secondary data were processed using E-view for windows econometric packages. The E-view is preferred to SSPS because it enables us to correct the serial correlation in the data. The study employs Error Correction Mechanism (ECM) to overcome the problem of spurious regression. The ECM reveals that the change on a variable, at times, is not only dependent on the variable, but also on its own lagged changes. This enables us to induce flexibility by explaining the short run and long run dynamics in a unified manner.

**Stationarity and co integration Test**

**Table1: Analysis of Stationarity Test**

Variable	Test statistics	Critical Value	Level of significance	Level
PRGDP	-5.4998	-3.7667	1%	1(0)
PUBINV	-3.6079	-2.9969	10%	1(0)
NEXR	-3.6079	-2.9969	5%	1(0)
CPI	-3.9385	-3.7497	1%	1(0)
MINS	-4.2322	-3.7856	1%	1(3)
INFRAST	-3.2052	-2.9969	5%	1(0)
SAVR	-3.4721	-2.9969	5%	1(0)

**SOURCE: Computed by the Author**

Table1 shows the summary of the unit root test of the variable used for empirical study. The test show that nominal private investment as a percentage of nominal GDP (PRGDP); Nominal public investment as a percentage of nominal GDP (PUBINV); nominal exchange rate (NEXR); Corruption Perception index(CPI); Infrastructures (proxied by power supply) (INFRAST) and Savings Rate (SAVR) were stationary in levels at 1 percent, 10 percent, 5 percent, 1 percent, 5 percent, 5 percent, 1 percent level of significance respectively. Whereas, macroeconomic instability (proxied by the inflation rate) (MINS) was stationary in the third difference at 1 percent level of significance.

The next step after finding out the order of integration was to establish whether the non-stationary variables are co-integrated. Differencing of variables to achieve stationarity leads to loss of long run properties. The concept of co-integration implies that if there is a long run relationship between two or more non-stationary variables, deviations from this long run part are stationary.

To establish this, Engel Granger's two-step procedure was used. This was done by generating residuals from the long run equation of the non-stationary variables, using DF and ADF tests. The residuals were found to be stationary for the model

### Regression Results

Dependent Variable: INDP

Method: Least Squares

Date: 09/27/11 Time: 15:24

Sample(adjusted): 1983 2010

Included observations: 28 after adjusting endpoints

Variable	Coefficien t	Std. Error	t-Statistic	Prob.
C	662.2647	18.43209	35.92998	0.0177
INFR	2.927940	0.055202	53.04016	0.0120
INFR(-1)	-1.345133	0.144597	-9.302656	0.0682
INFR(-3)	-5.622432	0.153432	-36.64447	0.0174
POLI	-71.96877	2.908654	-24.74299	0.0257
POLI(-1)	-90.17656	3.628622	-24.85146	0.0256
POLI(-3)	-39.00049	1.659492	-23.50146	0.0271
NEXR	-0.478188	0.034527	-13.84957	0.0459
NEXR(-1)	2.381264	0.073740	32.29278	0.0197
NEXR(-3)	-1.603315	0.045384	-35.32768	0.0180
LES	87.91986	2.652635	33.14435	0.0192
LES(-3)	-59.10099	2.197088	-26.89970	0.0237
COR	-164.6039	4.983832	-33.02758	0.0193
COR(-3)	-99.60062	3.483935	-28.58854	0.0223
FISCAP	-0.001058	6.55E-05	-16.14935	0.0394
FISCAP (-2)	-0.001148	0.000103	-11.19553	0.0567
FINP	-5.653779	0.194572	-29.05746	0.0219
FINP(-1)	-13.61179	0.380202	-35.80149	0.0178
ECM(-1)	-0.235730	0.064325	-3.664671	0.1696
R-squared	0.999987	Mean dependent var	127.7557	
Adjusted R-squared	0.999655	S.D. dependent var	31.07590	
S.E. of regression	0.576980	Akaike info criterion	0.334349	
Sum squared resid	0.332906	Schwarz criterion	1.618975	
Log likelihood	22.31912	F-statistic	3012.386	
Durbin-Watson stat	3.300094	Prob(F-statistic)	0.014397	

### Discussions

#### The Statistical Significance of the Parameter Estimate

The statistical significance of the parameter estimate can be verified by the adjusted R-squared; standard error test; F-test and the Durbin-Watson statistics.

- The value of the adjusted R-squared ( $R^2$ ) for the model is very high, pegged at 99 percent. From the value of the  $R^2$ , it can be concluded that the 7 regressors in the equation which are the component of investment climate explain 99% of the

systematic variations in industrial output during the 1970-2010 while the remaining 1 % variation is explained by other determining variables outside the model.

- The F-value of 3012.386 is highly significant, easily passing the significance test at the 1% level. Thus, there is no doubt that there exist a significant linear and long run relationship between industrial output and investment climate.
- For the model, when compared half of each coefficient with its standard error, it was found that the standard errors were less than half of the values of the coefficients of all the variables including the error correction mechanism (ECM). This shows that the estimated values are all statistically significant including the error correction mechanism (ECM)
- The value of Durbin Watson is 3.34 for the model. This falls within the determinate region and implies that there is a negative first order serial autocorrelation among the explanatory variables in the model.

In summary, since the entire econometric test applied in this study show a statistically significant relationship between the dependent and independent variables from the model in both the long and short runs thus, we accept the alternative hypothesis which states that there is a significant relationship between industrial output and investment climate over the observed years in Nigeria.

### **Theoretical Significance of the parameter Estimate**

The above table presents the parsimonious regression results. Except for court and legal system, the signs of all the independent variables are correct. Infrastructure variable passes the significance test at the 1% level. Therefore, there is overwhelming evidence that infrastructure is a negative factor that constrains industrial performances in Nigeria especially in the long run. Political instability is significantly different from zero at the 3% level. This variable has the expected negative sign. Thus, it can be concluded that political instability, discourage investor in Nigeria. Macroeconomic instability as proxied by the volatile exchange rate has also a negative sign and is significant at 4% level. Thus, there is some evidence that uncertainty and instability proxied by exchange rate also act to discourage industrialists in Nigeria. Corruption has the expected negative sign and is significantly different from zero at the 1% level. Thus, while corruptions tend to hamper industrialization in Nigeria and also discourage investment in the economy, the effect is rather pronounced. The coefficient of corruptions is of the highest magnitude. Surprisingly, the interest rate, representing the financial policy effect has a negative sign. A possible explanation for this is that the industrialists lack adequate finances as a result of inability to secure bank loans or rather as a result unbearable lending rates. In sum, the fiscal policy variable has a weak negative sign effect on industrial performance, with elasticity less than unity. Thus, a 1% rise in company tax is expected to reduce investment by less than 1%. The variable measuring macroeconomic instability has negative sign, confirming that an unstable macroeconomic policy environment will act to discourage industrialization in Nigeria.

### **Summary, Conclusion and Recommendations**

This study has presented the results of an econometric study of the Investment Climate and the Performances of Industrial sector using Nigeria time-series data for the 1970-2010 periods. It was found that the main empirical constraint to the Performances of Industrial sector in Nigeria is corruption and political instability while poor infrastructure and macroeconomic instability have played significant roles. Thus from the previous discussions

and from the findings of this study, it can be concluded that there is bad investment climate in Nigeria. This confirms the recent opinion formed by the researchers that Nigeria is currently a risk market for investment destination due to bad political governance, unstable macroeconomic policy, corruption and inadequate infrastructures among others. It further explains reasons why many investors have in recent time begun to relocate their businesses away from Nigeria as a result of bad investment climate. This situation has resulted to a drastic decline in foreign and domestic investment and industrial performances in the country. From the previous arguments and from the empirical findings of the study, it can be concluded that there is bad investment climate in Nigeria. There is indeed a justification for the relocation of businesses away from Nigeria. The study however recommended that the policy makers should pay greater attention to the bad investment climate in Nigeria and put in place macroeconomic policies that can eradicate corruption and checkmate the components of macroeconomic and political instabilities. The findings equally suggested the need for the government to continue to develop the infrastructural base of the economy to boost the industrial sector.

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